



## **HBOS Treasury Services plc**

*(incorporated with limited liability in England and Wales)*

**€60 billion Covered Bond Programme unconditionally guaranteed by**

## **HBOS plc**

*(incorporated with limited liability in Scotland)*

and

## **The Governor and Company of the Bank of Scotland**

*(established by an Act of the Parliament of Scotland in 1695)*

and

**unconditionally and irrevocably guaranteed as to payments of interest and principal by**

## **HBOS Covered Bonds LLP**

*(a limited liability partnership incorporated in England and Wales)*

Under this €60 billion covered bond programme (the **Programme**), HBOS Treasury Services plc (or as applicable, the successor to its business pursuant to the HBOS Group Reorganisation Act 2006 (as defined herein) (the **Issuer**) may from time to time issue bonds (the **Covered Bonds**) denominated in any currency agreed between the Issuer and the relevant Dealer(s) (as defined below).

The payments of all amounts due in respect of the Covered Bonds have been unconditionally guaranteed on a joint and several basis by HBOS plc (**HBOS**) and The Governor and Company of the Bank of Scotland (**Bank of Scotland** and together with HBOS in its capacity as guarantor, the **Group Guarantors**). HBOS Covered Bonds LLP (the **LLP** and, together with the Group Guarantors, the **Guarantors**) has guaranteed payments of interest and principal under the Covered Bonds pursuant to a guarantee which is secured over the Portfolio (as defined below) and its other assets. Recourse against the LLP under its guarantee is limited to the Portfolio and such assets.

The Covered Bonds may be issued in bearer or registered form (respectively **Bearer Covered Bonds** and **Registered Covered Bonds**). The maximum aggregate nominal amount of all Covered Bonds from time to time outstanding under the Programme will not exceed €60 billion (or its equivalent in other currencies calculated as described in the Programme Agreement described herein), subject to increase as described herein.

The Covered Bonds may be issued on a continuing basis to one or more of the Dealers specified under *General Description of the Programme* and any additional Dealer appointed under the Programme from time to time by the Issuer (each a **Dealer** and together the **Dealers**), which appointment may be for a specific issue or on an ongoing basis. References in this Offering Circular to the **relevant Dealer(s)** shall, in the case of an issue of Covered Bonds being (or intended to be) subscribed by more than one Dealer, be to all Dealers agreeing to subscribe such Covered Bonds.

**An investment in Covered Bonds issued under the Programme involves certain risks.** See *Risk Factors* for a discussion of certain factors to be considered in connection with an investment in Covered Bonds.

The Covered Bonds and the guarantees in respect of the Covered Bonds have not been and will not be registered under the U.S. Securities Act of 1933, as amended (the **Securities Act**), and may not be offered or sold in the United States or to, or for the benefit of, U.S. persons unless such securities are registered under the Securities Act or pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. See *Form of the Covered Bonds* for a description of the manner in which Covered Bonds will be issued. Registered Covered Bonds are subject to certain restrictions on transfer, see *Subscription and Sale*.

Application has been made to the Commission de Surveillance du Secteur Financier (the **CSSE**) in its capacity as competent authority under the Luxembourg Act dated 10 July 2005 on prospectuses for securities to approve this document as a base prospectus. Application has also been made to the Luxembourg Stock Exchange for Covered Bonds issued under the Programme to be admitted to trading on the Bourse de Luxembourg, which is the Luxembourg Stock Exchange's regulated market (the **Luxembourg Stock Exchange's regulated market**) and to be listed on the Official List of the Luxembourg Stock Exchange.

References in this Offering Circular to Covered Bonds being **listed** and all related references shall mean that such Covered Bonds are intended to be admitted to trading on the Luxembourg Stock Exchange's regulated market and have been listed on the Official List of the Luxembourg Stock Exchange.

Notice of the aggregate nominal amount of Covered Bonds, interest (if any) payable in respect of Covered Bonds, the issue price of Covered Bonds and any other terms and conditions not contained herein which are applicable to each Tranche (as defined under *Terms and Conditions of the Covered Bonds*) of Covered Bonds will be set out in a final terms document (the **Final Terms**) which, with respect to Covered Bonds to be listed on the Luxembourg Stock Exchange, will be filed with the CSSE.

The Programme provides that Covered Bonds may be listed and/or admitted to trading, as the case may be, on such other or further stock exchange(s) or markets as may be agreed between the Issuer, the Guarantors, the Bond Trustee (as defined herein), the Security Trustee (as defined herein) and the relevant Dealer(s). The Issuer may also issue unlisted Covered Bonds and/or Covered Bonds not admitted to trading on any market provided that the terms of any such issue are made available to all holders of listed Covered Bonds.

The Issuer and the Guarantors may agree with any Dealer and the Bond Trustee that Covered Bonds may be issued in a form not contemplated by the Terms and Conditions of the Covered Bonds herein, in which event a supplement to the Offering Circular, if appropriate, will be made available which will describe the effect of the agreement reached in relation to such Covered Bonds.

### **Arranger for the Programme**

**HBOS Treasury Services plc**

### **Dealers**

**Citi**

**Dresdner Kleinwort**

The date of this Offering Circular is 9 May 2007.

**This document comprises a base prospectus for the purposes of Article 5.4 of Directive 2003/71/EC (the Prospectus Directive) but is not a prospectus for the purposes of Section 12(a)(2) or any other provision of or rule under the Securities Act.**

**The Issuer and the Guarantors (the Responsible Persons) accept responsibility for the information contained in this offering circular (the Offering Circular). To the best of the knowledge of the Issuer and the Guarantors (each having taken all reasonable care to ensure that such is the case) the information contained in this Offering Circular is in accordance with the facts and does not omit anything likely to affect the import of such information.**

**This Offering Circular is to be read in conjunction with all documents which are incorporated herein by reference (see *Documents Incorporated by Reference*). This Offering Circular shall be read and construed on the basis that such documents are incorporated and form part of this Offering Circular.**

**The information contained in this Offering Circular was obtained from the Issuer and other sources, but no assurance can be given by the Dealers, the Bond Trustee or the Security Trustee as to the accuracy or completeness of such information. None of the Dealers, the Bond Trustee or the Security Trustee makes any representation, express or implied, or accepts any responsibility, with respect to the accuracy or completeness of any of the information contained or incorporated in this Offering Circular. Neither the Dealers nor the Bond Trustee nor the Security Trustee accepts any liability in relation to the information contained or incorporated by reference in this Offering Circular or any other information provided by the Issuer and the Guarantors in connection with the Programme.**

**No person is or has been authorised by the Issuer, the Guarantors, any of the Dealers, the Bond Trustee or the Security Trustee to give any information or to make any representation not contained in or not consistent with this Offering Circular or any other information supplied in connection with the Programme or the Covered Bonds and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer, the Guarantors, any of the Dealers, the Bond Trustee or the Security Trustee.**

**Neither this Offering Circular nor any other information supplied in connection with the Programme or any Covered Bonds (i) is intended to provide the basis of any credit or other evaluation or (ii) should be considered as a recommendation by the Issuer, the Guarantors, the Sellers (as defined below), any of the Dealers, the Bond Trustee or the Security Trustee that any recipient of this Offering Circular or any other information supplied in connection with the Programme or any Covered Bonds should purchase any Covered Bonds. Each investor contemplating purchasing any Covered Bonds should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Issuer and/or the Guarantors. Neither this Offering Circular nor any other information supplied in connection with the Programme or the issue of any Covered Bonds constitutes an offer or invitation by or on behalf of the Issuer, the Guarantors, the Sellers, any of the Dealers, the Bond Trustee or the Security Trustee to any person to subscribe for or to purchase any Covered Bonds.**

**Neither the delivery of this Offering Circular nor the offering, sale or delivery of any Covered Bonds shall in any circumstances imply that the information contained herein concerning the Issuer and/or HBOS and/or Bank of Scotland and/or the LLP and/or the Sellers is correct at any time subsequent to the date hereof or that any other information supplied in connection with the Programme is correct as of any time subsequent to the date indicated in the document containing the same. The Dealers, the Bond Trustee and the Security Trustee expressly do not undertake to review the financial condition or affairs of the Issuer, the Guarantors or the Sellers during the life of the**

**Programme or to advise any investor in the Covered Bonds of any information coming to their attention. Investors should review, *inter alia*, the most recently published documents incorporated by reference into this Offering Circular when deciding whether or not to purchase any Covered Bonds.**

**This Offering Circular does not constitute an offer to sell or the solicitation of an offer to buy any Covered Bonds in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Offering Circular and the offer or sale of Covered Bonds may be restricted by law in certain jurisdictions. The Issuer, the Guarantors, the Sellers, the Dealers, the Bond Trustee and the Security Trustee do not represent that this Offering Circular may be lawfully distributed, or that any Covered Bonds may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer, the Guarantors, the Sellers, the Dealers, the Bond Trustee or the Security Trustee which would permit a public offering of any Covered Bonds outside the Grand Duchy of Luxembourg or distribution of this Offering Circular in any jurisdiction where action for that purpose is required. Accordingly, no Covered Bonds may be offered or sold, directly or indirectly, and neither this Offering Circular nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Offering Circular or any Covered Bonds may come must inform themselves about, and observe, any such restrictions on the distribution of this Offering Circular and the offering and sale of Covered Bonds. In particular, there are restrictions on the distribution of this Offering Circular and the offer or sale of Covered Bonds in the United States, the European Economic Area (including the United Kingdom and The Netherlands) and Japan, see *Subscription and Sale*.**

**The Covered Bonds and the guarantees from the Guarantors in respect thereof have not been and will not be registered under the Securities Act. The Covered Bonds in bearer form are subject to U.S. tax law requirements and, subject to certain exceptions may not be offered, sold or delivered within the United States or to U.S. persons.**

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

In connection with the issue of any Tranche of Covered Bonds, the Dealer or Dealers (if any) named as the Stabilising Manager(s) (or persons acting on behalf of any Stabilising Manager(s)) in the applicable Final Terms may over-allot Covered Bonds (provided that, in the case of any Tranche of Covered Bonds to be admitted to trading on a regulated market in the European Economic Area, the aggregate principal amount of Covered Bonds allotted does not exceed 105 per cent. of the aggregate principal amount of the relevant Tranche) or effect transactions with a view to supporting the market price of the Covered Bonds at a level higher than that which might otherwise prevail. However, there is no assurance that the Stabilising Manager(s) (or persons acting on behalf of a Stabilising Manager) will undertake stabilisation action. Any stabilisation action may begin on or after the date on which adequate public disclosure of the final terms of the offer of the relevant Tranche of Covered Bonds is made and, if begun, may be ended at any time, but it

must end no later than the earlier of 30 days after the issue date of the relevant Tranche of Covered Bonds and 60 days after the date of the allotment of the relevant Tranche of Covered Bonds.

**In making an investment decision, investors must rely on their own examination of the Issuer and the Guarantors and the terms of the Covered Bonds being offered, including the merits and risks involved. The Covered Bonds have not been approved or disapproved by the United States Securities and Exchange Commission or any other securities commission or other regulatory authority in the United States, nor have the foregoing authorities approved this Offering Circular or confirmed the accuracy or determined the adequacy of the information contained in this Offering Circular. Any representation to the contrary is unlawful.**

**None of the Dealers, the Issuer or the Guarantors makes any representation to any investor in the Covered Bonds regarding the legality of its investment under any applicable laws. Any investor in the Covered Bonds should be able to bear the economic risk of an investment in the Covered Bonds for an indefinite period of time.**

### U.S. INFORMATION

**This Offering Circular is being provided on a confidential basis in the United States to a limited number of “qualified institutional buyers” within the meaning of Rule 144A under the Securities Act (QIBs) or institutional “accredited investors” as defined in Rule 501(a)(1), (2), (3) or (7) under the Securities Act (Institutional Accredited Investors)) in connection with the consideration of the purchase of the Covered Bonds being offered hereby. Its use for any other purpose in the United States is not authorised. It may not be copied or reproduced in whole or in part nor may it be distributed or any of its contents disclosed to anyone other than the prospective investors to whom it is originally submitted.**

**Registered Covered Bonds may be offered or sold within the United States only to QIBs or Institutional Accredited Investors, in either case in transactions exempt from registration under the Securities Act. Each U.S. purchaser of Registered Covered Bonds is hereby notified that the offer and sale of any Registered Covered Bonds to it may be being made in reliance upon the exemption from the registration requirements of the Securities Act provided by Rule 144A under the Securities Act (*Rule 144A*).**

**Purchasers of Definitive IAI Registered Covered Bonds (as defined under *Form of the Covered Bonds*) will be required to execute and deliver an IAI Investment Letter (as defined under *Form of the Covered Bonds*). Each purchaser or holder of IAI Registered Covered Bonds (as defined under *Form of the Covered Bonds*), Covered Bonds represented by a Rule 144A Global Covered Bond (as defined under *Form of the Covered Bonds*) or any Covered Bonds issued in registered form in exchange or substitution therefor (together *Legended Covered Bonds*) will be deemed, by its acceptance or purchase of any such Legended Covered Bonds, to have made certain representations and agreements intended to restrict the resale or other transfer of such Covered Bonds as set out in *Subscription and Sale and Transfer and Selling Restrictions*. Unless otherwise stated, terms used in this paragraph have the meanings given to them in *Form of the Covered Bonds*.**

### NOTICE TO NEW HAMPSHIRE RESIDENTS

**NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED UNDER CHAPTER 421-B OF THE NEW HAMPSHIRE REVISED STATUTES WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS**

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

#### **AVAILABLE INFORMATION**

**To permit compliance with Rule 144A in connection with any resales or other transfers of Covered Bonds that are “restricted securities” within the meaning of the Securities Act, the Issuer and Guarantors have undertaken in a deed poll dated 16 October 2006 (the Deed Poll) to furnish, upon the request of a holder of such Covered Bonds or any beneficial interest therein, to such holder or to a prospective purchaser designated by him, the information required to be delivered under Rule 144A(d)(4) under the Securities Act if, at the time of the request, the Issuer is neither a reporting company under Section 13 or 15(d) of the U.S. Securities Exchange Act of 1934, as amended (the Exchange Act), nor exempt from reporting pursuant to Rule 12g3-2(b) thereunder.**

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

Notwithstanding anything herein to the contrary, investors (and each employee, representative or other agent of the investors) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the offering and all materials of any kind (including opinions or other tax analyses) that are provided to the investors relating to such tax treatment and tax structure (as such terms are defined in Treasury Regulation Section 1.6011-4). This authorization of tax disclosure is retroactively effective to the commencement of discussions between the Issuer, the Dealers or their respective representatives and a prospective investor regarding the transactions contemplated herein.

#### **FORWARD-LOOKING STATEMENTS**

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



## SERVICE OF PROCESS AND ENFORCEMENT OF CIVIL LIABILITIES

The Issuer is a corporation organised under the laws of England, the LLP is a limited liability partnership organised under the laws of England and the Group Guarantors are corporations organised under the laws of Scotland. All of the officers and directors named herein reside outside the United States and all or a substantial portion of the assets of the Issuer and of such officers and directors are located outside the United States. As a result, it may not be possible for investors to effect service of process outside England or Scotland (as applicable) upon the Issuer, the LLP, the Group Guarantors or such persons, or to enforce judgments against them obtained in courts outside England or Scotland (as applicable) predicated upon civil liabilities of the Issuer or such directors and officers under laws other than English or Scots law (as applicable), including any judgment predicated upon United States federal securities laws. The Issuer has been advised by Allen & Overy LLP, its counsel, that there is doubt as to the enforceability in England and Wales in original actions or in actions for enforcement of judgments of United States courts of civil liabilities predicated solely upon the federal securities laws of the United States.

## PRESENTATION OF FINANCIAL INFORMATION

The consolidated annual financial statements of HBOS for the years ended 31 December 2006 and 31 December 2005 were prepared in accordance with International Financial Reporting Standards (**IFRS**). IFRS relevant to the Group differs from generally accepted accounting principles in the United States (**U.S. GAAP**) in certain material aspects. For a discussion of certain differences among IFRS, U.K. GAAP and U.S. GAAP, see Annex A to this Offering Circular. In addition, the audited financial information incorporated by reference herein is subject to auditing and auditor independence standards applicable in the United Kingdom, which differ from those applicable in the United States.

Unless otherwise indicated, any reference in this Offering Circular to the *IFRS Financial Statements* is to the audited Consolidated Financial Statements (including the notes thereto) of the Group incorporated by reference in this Offering Circular.

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

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

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

## EXCHANGE RATES

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

Date	Applicable Exchange Rate
31 December 2006 (closing) .....	\$1.97
31 December 2005 (closing) .....	\$1.72
31 December 2006 (average) .....	\$1.84
31 December 2005 (average) .....	\$1.82

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

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

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## DOCUMENTS INCORPORATED BY REFERENCE

The following documents which have previously been published and have been filed with the CSSF shall be incorporated by reference herein, and form part of, this Offering Circular:

- (a) the annual report and audited consolidated annual financial statements of each of the Issuer and the Group Guarantors for the two financial years ended 31 December 2005 and 31 December 2006, see *General Information—Auditors* for a description of the financial statements currently published by each of the Issuer and the Group Guarantors;
- (b) the auditor's report and audited non-consolidated annual financial statements for the financial periods ended 31 December 2005 and 31 December 2006 of the LLP; and
- (c) solely for purposes of understanding the impact of the HBOS Group reorganisation, the annual report and audited consolidated annual financial statements of Halifax for the financial year ended 31 December 2006 (**Halifax Financial Statements**)

The financial statements referred to in (a), (b) and (c), above are collectively referred to herein as the **Consolidated Financial Statements**.

Any information not listed in the cross reference lists below, but which is contained in a document incorporated by reference, is given for information purposes only.

Following the publication of this Offering Circular a supplement may be prepared by the Issuer and approved by the CSSF in accordance with Article 16 of the Prospectus Directive. Statements contained in any such supplement to the Offering Circular (or contained in any document incorporated by reference therein) shall, to the extent applicable (whether expressly, by implication or otherwise), modify or supersede statements contained in this Offering Circular or in a document which is incorporated by reference in this Offering Circular. Any statement so modified or superseded shall not, except as so modified or superseded, constitute a part of this Offering Circular.

The Issuer and the Guarantors will provide, without charge, to each person to whom a copy of this Offering Circular has been delivered, upon the request of such person, a copy of any or all of the documents deemed to be incorporated herein by reference unless such documents have been modified or superseded as specified above. Requests for such documents should be directed either to the Issuer, the Group Guarantors or the LLP, at their respective offices set out at the end of this Offering Circular and such documents will also be published on the website of the Luxembourg Stock Exchange ([www.bourse.lu](http://www.bourse.lu)). In addition, such documents will be available upon request from the principal office of J.P. Morgan Bank Luxembourg S.A. in Luxembourg.

The Issuer and the Guarantors will, in the event of any significant new factor, material mistake or inaccuracy relating to information included in this Offering Circular which is capable of affecting the assessment of any Covered Bonds, prepare a supplement to this Offering Circular or publish a new offering circular for use in connection with any subsequent issue of Covered Bonds.

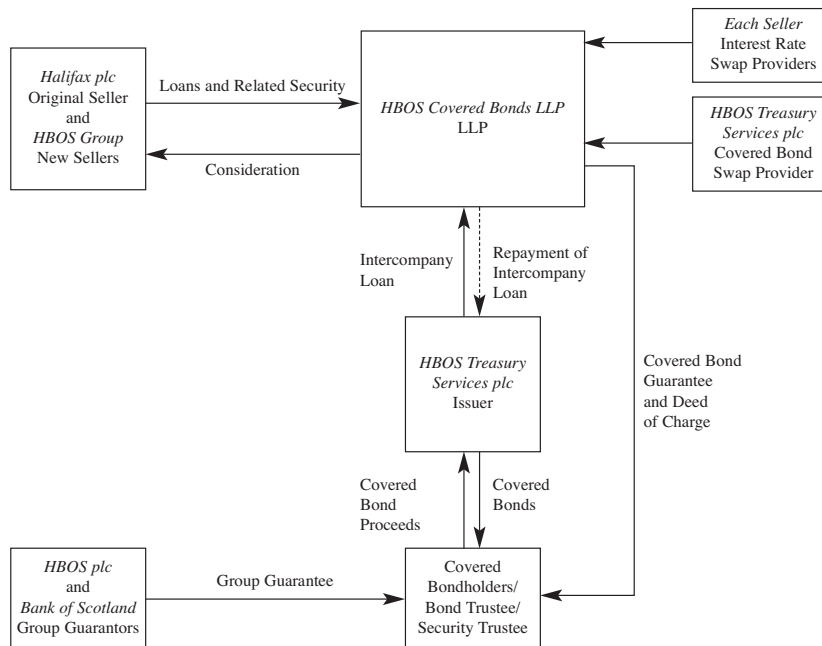
## Cross Reference List

<b><i>IFRS Financial Statements</i></b> <b><i>Commission Regulation (EC) No. 809/2004, Annex IX, 11.1</i></b>	<b><i>Annual</i></b> <b><i>Report 2005</i></b>	<b><i>Annual</i></b> <b><i>Report 2006</i></b>
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## STRUCTURE OVERVIEW

The information in this section is a summary of the structure relating to the Programme and does not purport to be complete. The information is taken from, and is qualified in its entirety by, the remainder of this Offering Circular. Words and expressions defined elsewhere in this Offering Circular shall have the same meanings in this summary. An index of certain defined terms used in this document is contained at the end of this Offering Circular.

### Structure Diagram



### Structure Overview

- Programme:** Under the terms of the Programme, the Issuer will issue Covered Bonds to Covered Bondholders on each issue date (each, an **Issue Date**). The Covered Bonds will be direct, unsecured and unconditional obligations of the Issuer.
- Intercompany Loan Agreement:** Under the terms of the Intercompany Loan Agreement, the Issuer will make Term Advances to the LLP in an amount equal to the Sterling Equivalent of the gross proceeds of each Series or, as applicable, Tranche of Covered Bonds. The Term Advances will not be repaid by the LLP until all amounts payable under the corresponding Series of Covered Bonds have been repaid in full. Payments by the Issuer of amounts due under the Covered Bonds will be satisfied out of its own moneys or, failing that, out of the Group Guarantee and are not conditional upon receipt by the Issuer of payments from the LLP pursuant to the Intercompany Loan Agreement. Amounts owed by the LLP under the Intercompany Loan Agreement will be subordinated to amounts owed by the LLP under the Covered Bond Guarantee.
- Group Guarantee:** The Group Guarantors have, under the terms of the Trust Deed, provided a guarantee, on a joint and several basis (as between themselves) and severally (as between themselves and the LLP), in respect of all Covered Bonds issued from time to time by the Issuer under the Programme and all other amounts payable by the Issuer under the Trust Deed. The obligations of each

of the Group Guarantors under the Group Guarantee constitute direct, unsecured and unconditional obligations of each Group Guarantor and rank *pari passu* among themselves and equally with all other unsecured and unsubordinated obligations.

- *Covered Bond Guarantee:* Under the terms of the Trust Deed, the LLP has also provided a guarantee on a several basis (as between the Group Guarantors and itself) as to payments of interest and principal under the Covered Bonds (the **Covered Bond Guarantee**). The LLP has agreed to pay an amount equal to the Guaranteed Amounts when the same shall become Due for Payment but which would otherwise be unpaid by the Issuer or the Group Guarantors. The obligations of the LLP under the Covered Bond Guarantee constitute direct and (following the occurrence of an HBOS Event of Default, the service of an HBOS Acceleration Notice on the Issuer and the Group Guarantors and the service of a Notice to Pay on the LLP or, if earlier, the service on the Issuer and the LLP of an LLP Acceleration Notice) unconditional and unsubordinated obligations of the LLP, secured as provided in the Deed of Charge. The recourse of the Covered Bondholders to the LLP under the Covered Bond Guarantee will be limited to the assets of the LLP from time to time. Payments made by the LLP under the Covered Bond Guarantee will be made subject to, and in accordance with, the Guarantee Priority of Payments or the Post-Enforcement Priority of Payments, as applicable.
- *The LLP's Assets:* The LLP will use the proceeds of the Term Advances received under the Intercompany Loan Agreement from time to time (i) to purchase the Initial Portfolio and each New Portfolio, consisting of Loans and their Related Security, from the Sellers in accordance with the terms of the Mortgage Sale Agreement and/or (ii) to invest in Substitution Assets in an amount not exceeding the prescribed limit and/or (iii) if an existing Series, or part of an existing Series, of Covered Bonds is being refinanced (by the issue of a further Series or Tranche of Covered Bonds) to repay the Term Advance(s) corresponding to the Covered Bonds being so refinanced and/or (iv) to make a deposit in the GIC Account and/or subject to written confirmation from the LLP that the Asset Coverage Test is met on the relevant Issue Date (both before and immediately following the making of the relevant Term Advance), to make a Capital Distribution to any Seller (in its capacity as a Member) by way of distribution of that Member's equity in the LLP in an amount equal to the Term Advance or any part thereof, which is to be paid to the Member on the relevant Issue Date by telegraphic transfer or as otherwise directed by the Member. To protect the value of the Portfolio under the terms of the LLP Deed, the LLP and the Members will be obliged to ensure that the Asset Coverage Test (as described below) will be satisfied on each Calculation Date.
- *Consideration:* Under the terms of the Mortgage Sale Agreement, the consideration payable to the relevant Seller for the sale of Loans and their Related Security to the LLP on any Transfer Date will be a combination of (i) a cash payment paid by the LLP to the relevant Seller and/or (ii) the relevant Seller being treated as having made a Capital Contribution to the LLP (in an amount up to the difference between the Current Balance of the Loans sold by the relevant Seller as at the relevant Transfer Date and the cash payment (if any) paid by the LLP) and (iii) Deferred Consideration.
- *Security:* To secure its obligations under the Covered Bond Guarantee and the Transaction Documents to which it is a party, the LLP has granted security over the Charged Property (which consists principally of the LLP's interest in the Portfolio, the Substitution Assets, the Transaction Documents to which it is a party, the LLP Accounts and the Authorised Investments) in favour of the Security Trustee (for itself and on behalf of the other Secured Creditors) pursuant to the Deed of Charge.
- *Cashflows:* Prior to service of a Notice to Pay on the LLP under the Covered Bond Guarantee, the LLP will:
  - apply Available Revenue Receipts to pay Deferred Consideration to each Seller in respect of the Loans sold by each Seller to the LLP, but only after payment of certain items ranking higher in

the Pre-Acceleration Revenue Priority of Payments (including certain expenses, amounts due to the Interest Rate Swap Providers, amounts to be credited (if any) to the Reserve Fund and the Pre-Maturity Liquidity Ledger and interest due and payable on the Term Advances). For further details of the Pre-Acceleration Revenue Priority of Payments, see *Cashflows* below; and

- apply Available Principal Receipts towards making Capital Distributions to the Members but only after, *inter alia*, funding any liquidity that may be required in respect of Hard Bullet Covered Bonds following any breach of the Pre-Maturity Test and acquiring New Loans and their Related Security offered by the Sellers to the LLP. For further details of the Pre-Acceleration Principal Priority of Payments, see *Cashflows* below.

Following service on the LLP of a Notice to Pay (but prior to an LLP Event of Default and service of an LLP Acceleration Notice) the LLP will use all moneys (other than Third Party Amounts) to pay Guaranteed Amounts in respect of the Covered Bonds when the same shall become Due for Payment subject to paying certain higher ranking obligations of the LLP in the Guarantee Priority of Payments. In such circumstances, the Sellers (as Members of the LLP) will only be entitled to receive any remaining income of the LLP after all amounts due under the Covered Bond Guarantee in respect of the Covered Bonds have been paid in full or have otherwise been provided for.

Following the occurrence of an LLP Event of Default and service of an LLP Acceleration Notice, the Covered Bonds will become immediately due and repayable (if not already immediately due and payable following the occurrence of an HBOS Event of Default as against the Issuer and the Group Guarantors) and the Bond Trustee will then have a claim against the LLP under the Covered Bond Guarantee for the Early Redemption Amount in respect of each Covered Bond together with accrued interest and any other amounts due under the Covered Bonds and the security created by the LLP over the Charged Property will become enforceable. Any moneys recovered by the Security Trustee from realisation of the Charged Property following enforcement of the Security created by the LLP in accordance with the Deed of Charge will be distributed according to the Post-Enforcement Priority of Payments.

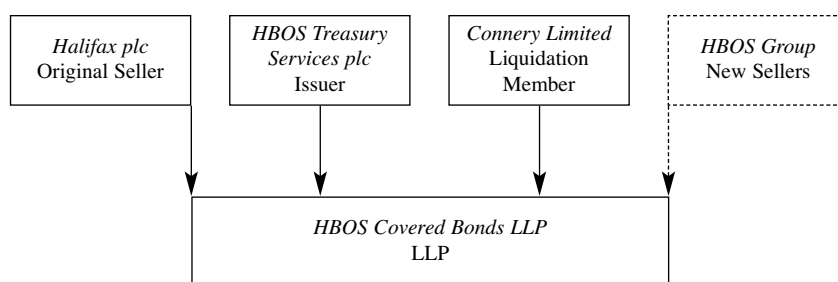
- *Asset Coverage:* The Programme provides that the assets of the LLP are subject to an asset coverage test in respect of the Covered Bonds. Accordingly, for so long as Covered Bonds remain outstanding, the LLP and the Members (other than the Liquidation Member) must ensure that on each Calculation Date, the Adjusted Aggregate Loan Amount will be in an amount equal to or in excess of the aggregate Principal Amount Outstanding of the Covered Bonds from time to time. The Asset Coverage Test will be tested by the Cash Manager on each Calculation Date. A breach of the Asset Coverage Test will constitute an HBOS Event of Default, which will entitle the Bond Trustee to serve an HBOS Acceleration Notice on the Issuer and the Group Guarantors and, upon service of such notice, the Bond Trustee shall serve a Notice to Pay on the LLP under the Covered Bond Guarantee.
- *Amortisation Test:* In addition, following service of a Notice to Pay on the LLP (but prior to service of an LLP Acceleration Notice) and, for so long as Covered Bonds remain outstanding, the LLP and the Members (other than the Liquidation Member) must ensure that on each Calculation Date following an HBOS Event of Default, the Amortisation Test Aggregate Loan Amount will be in an amount at least equal to the aggregate Principal Amount Outstanding of the Covered Bonds from time to time. The Amortisation Test will be tested by the Cash Manager on each Calculation Date following an HBOS Event of Default. A breach of the Amortisation Test will constitute an LLP Event of Default, which will entitle the Bond Trustee to serve an LLP Acceleration Notice on the Issuer and LLP declaring the Covered Bonds immediately due and repayable and entitle the Security Trustee to enforce the Security over the Charged Property.

- *Servicing*: In its capacity as Original Servicer, the Original Seller has entered into the Original Servicing Agreement with the LLP and the Security Trustee, pursuant to which the Original Servicer has agreed to provide administrative services in respect of the Loans and their Related Security sold by the Original Seller to the LLP and the Loans and their Related Security sold by New Sellers to the LLP, unless any New Seller and the Original Servicer agree that such New Seller shall act as Servicer in relation to the Loans and their Related Security sold by such New Seller to the LLP.
- *New Sellers*: Subject to meeting certain conditions precedent set out in the Transaction Documents, New Sellers will accede to the Programme by, amongst other things:
  - acceding to the terms of the Mortgage Sale Agreement and, accordingly, selling Loans and their Related Security to the LLP pursuant to the terms of the Mortgage Sale Agreement;
  - acceding to the terms of the LLP Deed;
  - if any New Seller and the Original Servicer agree that such New Seller shall act as Servicer in relation to the Loans and their Related Security sold by such New Seller to the LLP, entering into a New Servicing Agreement with the LLP and the Security Trustee on substantially the same terms as the Original Servicing Agreement; and
  - acceding to the terms of the Programme Agreement.

The prior consent of the Bond Trustee on behalf of the Covered Bondholders and/or the Security Trustee will not be required and will not be obtained in relation to the accession of any New Seller to the Programme, provided that the relevant conditions precedent are satisfied at the time of the intended accession.

- *Further Information*: For a more detailed description of the transactions summarised above relating to the Covered Bonds see, amongst other relevant sections of this Offering Circular, *General Description of the Programme, Terms and Conditions of the Covered Bonds, Summary of the Principal Documents, Credit Structure, Cashflows and The Portfolio*, below.

### Ownership Structure of HBOS Covered Bonds LLP

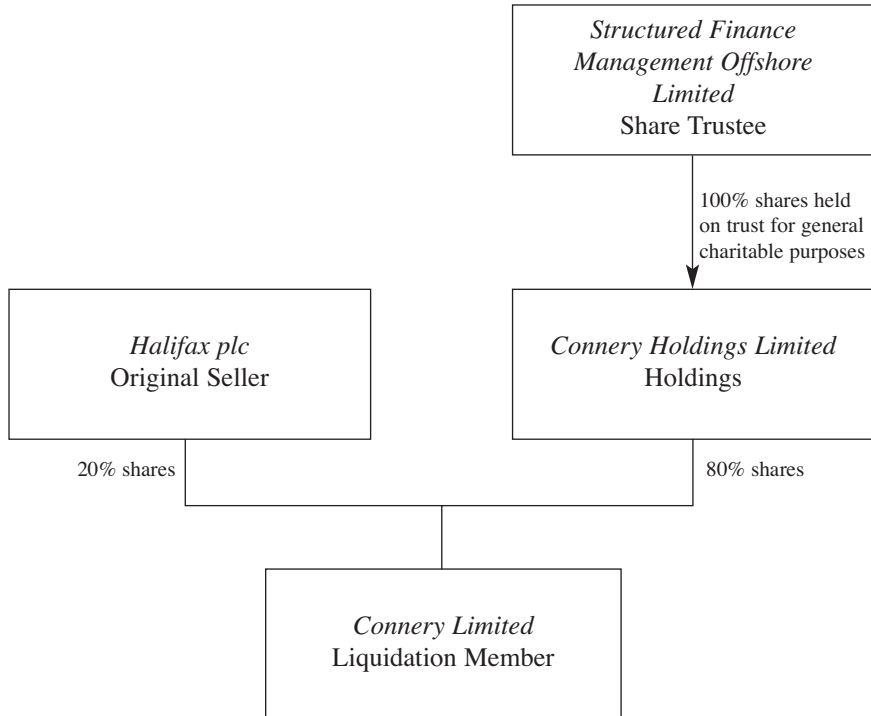


- As at the date hereof the Members of the LLP are the Original Seller, the Issuer and the Liquidation Member.
- Any New Seller that wishes to sell Loans and their Related Security to the LLP will, amongst other things, become a Member of the LLP and will accede to, *inter alia*, the LLP Deed.
- Other than in respect of those decisions reserved to the Members, the Management Board (comprised of, as at the date hereof, directors and/or employees of the Original Seller and the Issuer) will manage



and conduct the business of the LLP and will have all the rights, power and authority to act at all times for and on behalf of the LLP.

### Ownership Structure of Connery Limited



## GENERAL DESCRIPTION OF THE PROGRAMME

*The following general description does not purport to be complete and is taken from, and is qualified in its entirety by, the remainder of this Offering Circular and, in relation to the terms and conditions of any particular Tranche of Covered Bonds, the applicable Final Terms. Words and expressions defined elsewhere in this Offering Circular shall have the same meanings in this general description. An index of certain defined terms is contained at the end of this Offering Circular.*

*Under the terms of the Programme, the Issuer may from time to time issue Covered Bonds including, without limitation, Index Linked Covered Bonds, Dual Currency Covered Bonds and Zero Coupon Covered Bonds in accordance with and subject to all applicable laws and regulations and denominated in any currency, subject as set out herein. The applicable terms of any Covered Bonds will be agreed between the Issuer and the relevant Dealer prior to the issue of the Covered Bonds and will be set out in the Terms and Conditions of the Covered Bonds endorsed on, attached to, or incorporated by reference into, the Covered Bonds, as modified and supplemented by the applicable Final Terms document attached to, or endorsed on, such Covered Bonds, as more fully described under Form of the Covered Bonds.*

**Issuer:** HBOS Treasury Services plc (or, as applicable, the successor to its business pursuant to the HBOS Group Reorganisation Act 2006), (**HBOSTS**) incorporated in England and Wales with limited liability (registered no. 2692890). The Issuer is a direct wholly-owned subsidiary of Bank of Scotland.

It is expected that on the Effective Date, the existing undertakings, including all assets and liabilities, of HBOSTS will be transferred to Bank of Scotland plc. HBOSTS will cease to exist on the day on which, in pursuance of a request made by or on behalf of Bank of Scotland plc at any time after the Effective Date, the registrar of companies strikes HBOSTS off the register. See “HBOS Group Reorganisation” below.

For a more detailed description of the Issuer see *The Issuer*, below.

**Group Guarantors:** HBOS and Bank of Scotland. HBOS, a public limited company incorporated in Scotland (registered no. SC218813) and Bank of Scotland, established by an Act of the Parliament of Scotland in 1695, have unconditionally guaranteed on a joint and several basis all Covered Bonds issued from time to time under the Programme and all other obligations of the Issuer under the Trust Deed.

Pursuant to the provisions of the HBOS Group Reorganisation Act, it is expected that on the Effective Date (as defined below) Bank of Scotland will become registered as a public limited company under the Companies Act and will change its corporate name to Bank of Scotland plc. In addition, the existing undertakings, including all assets and liabilities, of the Transferor Entities (as defined below) will be transferred to Bank of Scotland plc, at which point Bank of Scotland plc shall assume any existing obligations relating to the Transferor Entities, including the obligations of HBOSTS in respect of Covered Bonds issued by it prior to the Effective Date.

As of the Effective Date, the guarantee given by Bank of Scotland prior to the Effective Date will be discharged as a consequence of Bank of Scotland plc both assuming HBOSTS' obligations as Issuer prior to the Effective Date and being unable to maintain an action against itself. Notwithstanding this, as of the Effective Date, the guarantee given by HBOS prior to the Effective Date will continue to survive.

Any references in this Offering Circular to "Bank of Scotland" prior to the Effective Date shall be to The Governor and Company of the Bank of Scotland, and any references in this Offering Circular to "Bank of Scotland" from and after the Effective Date shall be to Bank of Scotland plc.

For a more detailed description of the Group Guarantors see *The Group Guarantors*, below.

The LLP:

HBOS Covered Bonds LLP, a limited liability partnership incorporated in England and Wales (registered no. OC304674). The LLP is a subsidiary of the Original Seller, and its Members on the date hereof are the Original Seller, the Issuer and the Liquidation Member. (It is expected that as of the Effective Date, the LLP's Members will be Bank of Scotland plc (as successor to the businesses of the Original Seller and the Issuer) and the Liquidation Member.) The LLP is a special purpose vehicle whose business is to acquire, *inter alia*, Loans and their Related Security from the relevant Sellers pursuant to the terms of the Mortgage Sale Agreement. The LLP will hold the Portfolio and the other Charged Property in accordance with the terms of the Transaction Documents.

The LLP has provided the Covered Bond Guarantee covering all Guaranteed Amounts when the same shall become Due for Payment, but only following the occurrence of an HBOS Event of Default, the service of an HBOS Acceleration Notice on the Issuer and the Group Guarantors and service on the LLP of a Notice to Pay. The obligations of the LLP under the Covered Bond Guarantee and the other Transaction Documents to which it is a party are secured by the assets from time to time of the LLP and recourse against the LLP is limited to such assets.

For a more detailed description of the LLP see *The LLP*, below.

Original Seller:

Halifax plc (or, as applicable, the successor to its business pursuant to the HBOS Group Reorganisation Act 2006) (**Halifax**), a bank incorporated in England and Wales (registered no. 2367076), which is in the business of originating residential mortgage loans and carrying on other banking activities.

It is expected that on the Effective Date, the existing undertakings, including all assets and liabilities of Halifax will be transferred to Bank of Scotland plc. Halifax will cease to exist on the day on

which, in pursuance of a request made by or on behalf of Bank of Scotland plc at any time after the Effective Date, the registrar of companies strikes Halifax off the register. For a more detailed description see *HBOS Group Reorganisation* below.

For a more detailed description of Halifax see *The Original Seller*, below.

**New Sellers:** Any other member of the HBOS Group which accedes to, amongst other things, the Mortgage Sale Agreement, the LLP Deed and the Programme Agreement from time to time.

For a more detailed description of the HBOS Group see *HBOS*, below.

**Sellers:** The Original Seller (or, as applicable, the successor to its business pursuant to the HBOS Group Reorganisation Act 2006) and any New Sellers.

**Original Servicer:** Pursuant to the terms of the Original Servicing Agreement, Halifax has been appointed to service, on behalf of the LLP, the Loans and their Related Security sold by the Original Seller and the Loans and their Related Security sold by New Sellers to the LLP, unless any New Seller and the Original Servicer agree that such New Seller shall act as servicer in relation to the Loans and their Related Security sold by such New Seller to the LLP.

**New Servicers:** Each New Seller may be appointed to service, on behalf of the LLP, the Loans and their Related Security sold by such New Seller to the LLP pursuant to the terms of a New Servicing Agreement.

**Servicers:** As applicable, the Original Servicer and/or each New Servicer.

**Cash Manager:** Halifax has also been appointed to, *inter alia*, provide cash management services to the LLP and to monitor compliance by the LLP with the Asset Coverage Test and the Amortisation Test pursuant to the terms of the Cash Management Agreement.

**Issuing and Principal Paying Agent, Bond Registrar and Agent Bank:** Citibank, N.A., London Branch, acting through its offices at 21st Floor, Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB, has been appointed pursuant to the Agency Agreement as issuing and principal paying agent, bond registrar and agent bank.

**Bond Trustee:** Citicorp Trustee Company Limited, having its registered office at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB, has been appointed to act as bond trustee on behalf of the Covered Bondholders in respect of the Covered Bonds and holds the benefit of, *inter alia*, the Covered Bond Guarantee on behalf of the Covered Bondholders pursuant to the terms of the Trust Deed.

**Security Trustee:** Citicorp Trustee Company Limited, having its registered office at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB, has been appointed to act as Security Trustee to hold the benefit of

the security granted by the LLP to the security trustee (for itself, the Covered Bondholders and other Secured Creditors) under the Deed of Charge.

Asset Monitor: KPMG Audit Plc, having its registered office at 8 Salisbury Square, London, EC4Y 8BB, has been appointed pursuant to the Asset Monitor Agreement as an independent monitor to perform tests in respect of the Asset Coverage Test and the Amortisation Test when required.

Covered Bond Swap Provider: HBOS Treasury Services plc (or, as applicable, the successor to its business pursuant to the HBOS Reorganisation Act 2006) (in its capacity as the Covered Bond Swap Provider) has agreed to act as Covered Bond Swap Provider to the LLP to hedge (after service on the LLP of a Notice to Pay) certain interest rate, currency and/or other risks in respect of amounts received by the LLP under the Loans and the Interest Rate Swaps and amounts payable by the LLP under the Covered Bond Guarantee in respect of the Covered Bonds by entering into Covered Bond Swaps with the LLP and the Security Trustee under the Covered Bond Swap Agreements. The Covered Bond Swap Provider will be required to obtain a guarantee of its obligations or put in place some other arrangement in the event that the ratings or the Deemed Ratings, as applicable, of the Covered Bond Swap Provider fall below a specified ratings level.

For a more detailed description of the Covered Bond Swap Provider, see *The Issuer*, below.

Original Interest Rate Swap Provider: Halifax (in its capacity as the Original Interest Rate Swap Provider) has agreed to act as a swap provider to the LLP in respect of possible variances between the rates of interest payable on the Loans sold by the Original Seller to the LLP and the rate of interest applicable to the relevant Term Advances by entering into the Original Interest Rate Swap with the LLP and the Security Trustee under the Original Interest Rate Swap Agreement. The Original Interest Rate Swap Provider will be required to obtain a guarantee of its obligations or put in place some other arrangement in the event that the ratings of the Original Interest Rate Swap Provider fall below a specified ratings level.

For a more detailed description of the Original Interest Rate Swap Provider, see *The Original Seller*, below.

New Interest Rate Swap Providers: Each New Seller (in its capacity as a New Interest Rate Swap Provider) will act as a swap provider to the LLP in respect of possible variances between the rates of interest payable on the Loans sold by the relevant New Seller to the LLP and the rate of interest applicable to the relevant Term Advances by entering into a New Interest Rate Swap with the LLP and the Security Trustee under a New Interest Rate Swap Agreement. Each New Interest Rate Swap Provider will be required to obtain a guarantee of its obligations or to put in place some other arrangement in the event

	that the ratings of the relevant New Interest Rate Swap Provider falls below a specified ratings level.
Interest Rate Swap Providers:	The Original Interest Rate Swap Provider and any New Interest Rate Swap Providers.
GIC Provider:	Bank of Scotland has agreed to act as GIC Provider to the LLP pursuant to the terms of the Guaranteed Investment Contract.
Stand-by GIC Provider:	Citibank, N.A. has agreed to act as Stand-by GIC Provider to the LLP pursuant to the terms of the Stand-by Guaranteed Investment Contract.
Account Bank:	Bank of Scotland has agreed to act as Account Bank to the LLP pursuant to the terms of the Bank Account Agreement.
Stand-by Account Bank:	Citibank, N.A. has agreed to act as Stand-by Account Bank to the LLP pursuant to the terms of the Stand-by Bank Account Agreement and, in certain circumstances giving rise to the termination of the Bank Account Agreement, will perform the duties set out in the Stand-by Bank Account Agreement.
Liquidation Member:	Connery Limited (the <b>Liquidation Member</b> ), a special purpose vehicle incorporated in Jersey as a private limited company (registered no. 85666). The Liquidation Member is 20 per cent. owned by Halifax and 80 per cent. owned by Holdings.
Holdings:	Connery Holdings Limited ( <b>Holdings</b> ), a special purpose vehicle incorporated in Jersey as a private limited company (registered no. 85667). All of the shares of Holdings are held by a trustee (the <b>Share Trustee</b> ) on trust for general charitable purposes.
Share Trustee:	Structured Finance Management Offshore Limited, having its registered office at 47 Esplanade, St. Helier, Jersey JE1 0BD.
Corporate Services Provider:	Structured Finance Management Offshore Limited, having its registered office at 47 Esplanade, St. Helier, Jersey JE1 0BD, has been appointed to provide certain corporate services to the Liquidation Member and Holdings pursuant to the Corporate Services Agreement.
Description:	Covered Bond Programme
Arranger:	HBOS Treasury Services plc
Dealers:	Citigroup Global Markets Limited Dresdner Bank Aktiengesellschaft  and any other Dealers appointed from time to time in accordance with the Programme Agreement.
Certain Restrictions:	Each issue of Covered Bonds denominated in a currency in respect of which particular laws, guidelines, regulations, restrictions or reporting requirements apply will only be issued in circumstances



which comply with such laws, guidelines, regulations, restrictions or reporting requirements from time to time (see *Subscription and Sale and Transfer and Selling Restrictions*).

Programme Size:	Up to €60 billion (or its equivalent in other currencies calculated as described in the Programme Agreement) outstanding at any time. The Issuer and the Guarantors may increase the amount of the Programme in accordance with the terms of the Programme Agreement.
Distribution:	Covered Bonds may be distributed by way of private or public placement and in each case on a syndicated or non-syndicated basis, subject to the restrictions set forth in <i>Subscription and Sale and Transfer and Selling Restrictions</i> , below.
Specified Currencies:	Subject to any applicable legal or regulatory restrictions, such currencies as may be agreed between the Issuer and the relevant Dealer(s) (as set out in the applicable Final Terms).
Redenomination:	The applicable Final Terms may provide that certain Covered Bonds may be redenominated in euro.
Maturities:	<p>Such maturities as may be agreed between the Issuer and the relevant Dealer(s), subject to such minimum or maximum maturities as may be allowed or required from time to time by the relevant central bank or regulatory authority (or equivalent body) or any laws or regulations applicable to the Issuer or the relevant Specified Currency.</p> <p>Under the Luxembourg Act on Prospectuses for Securities which implements the Prospectus Directive, prospectuses for the listing of money market instruments having a maturity at issue of less than 12 months and complying also with the definition of securities are not subject to the approval provisions of Part II of such Act.</p>
Issue Price:	Covered Bonds may be issued on a fully-paid or a partly-paid basis and at an issue price which is at par or at a discount to, or premium over, par.
Form of Covered Bonds:	The Covered Bonds will be issued in bearer or registered form, as described in <i>Form of the Covered Bonds</i> . Registered Covered Bonds will not be exchangeable for Bearer Covered Bonds and vice versa.
Fixed Rate Covered Bonds:	Fixed interest will be payable on such date or dates as may be agreed between the Issuer and the relevant Dealer(s) and on redemption and will be calculated on the basis of such Day Count Fraction as may be agreed between the Issuer and the relevant Dealer(s) (as set out in the applicable Final Terms).
Floating Rate Covered Bonds:	<p>Floating Rate Covered Bonds will bear interest at a rate determined:</p> <p>(i) on the same basis as the floating rate under a notional interest rate swap transaction in the relevant Specified Currency</p>

governed by an agreement incorporating the 2000 ISDA Definitions (as published by the International Swaps and Derivatives Association, Inc., (ISDA) and as amended and updated as at the Issue Date of the first Tranche of Covered Bonds of the relevant Series); or

- (ii) on the basis of a reference rate appearing on the agreed screen page of a commercial quotation service; or
- (iii) on such other basis as may be agreed between the Issuer and the relevant Dealer(s) (as set out in the applicable Final Terms).

The margin (if any) relating to such floating rate will be agreed between the Issuer and the relevant Dealer(s) for each Series of Floating Rate Covered Bonds.

Index Linked Covered Bonds: Payments of principal in respect of Index Linked Redemption Covered Bonds or of interest in respect of Index Linked Interest Covered Bonds will be calculated by reference to such index and/or formula or to changes in the prices of securities or commodities or to such other factors as the Issuer and the relevant Dealer(s) may agree (as set out in the applicable Final Terms).

Other provisions in relation to Floating Rate Covered Bonds and Index Linked Interest Covered Bonds: Floating Rate Covered Bonds and Index Linked Interest Covered Bonds may also have a maximum interest rate, a minimum interest rate or both. Interest on Floating Rate Covered Bonds and Index Linked Interest Covered Bonds in respect of each Interest Period, as agreed prior to issue by the Issuer and the relevant Dealer(s), will be payable on such Interest Payment Dates, and will be calculated on the basis of such Day Count Fraction, as may be agreed between the Issuer and the relevant Dealer(s).

Dual Currency Covered Bonds: Payments (whether in respect of principal or interest and whether at maturity or otherwise) in respect of Dual Currency Covered Bonds will be made in such currencies, and based on such rates of exchange, as the Issuer and the relevant Dealer(s) may agree (as set out in the applicable Final Terms).

Zero Coupon Covered Bonds: Zero Coupon Covered Bonds may be offered and sold at a discount to their nominal amount and will not bear interest except in the case of late payment, as described in Condition 6(h).

Redemption: The applicable Final Terms will indicate either that the relevant Covered Bonds cannot be redeemed prior to their stated maturity (other than in specified instalments, if applicable, or for taxation reasons or if it becomes unlawful for any Term Advance to remain outstanding or following an HBOS Event of Default or an LLP Event of Default) or that such Covered Bonds will be redeemable at the option of the Issuer upon giving notice to the Covered Bondholders, on a date or dates specified prior to such stated maturity and at a price or prices and on such other terms as may be

agreed between the Issuer and the relevant Dealer(s) (as set out in the applicable Final Terms).

The applicable Final Terms may provide that Covered Bonds may be redeemable in two or more instalments of such amounts and on such dates as are indicated in the applicable Final Terms.

Denomination of Covered Bonds:

Covered Bonds will be issued in such denominations as may be agreed between the Issuer and the relevant Dealer(s) save that the minimum denomination of each Covered Bond will be such as may be allowed or required from time to time by the relevant central bank or regulatory authority (or equivalent body) or any laws or regulations applicable to the relevant Specified Currency and save that the minimum denomination of each Covered Bond admitted to trading on a regulated market within the European Economic Area or offered to the public in a Member State of the European Economic Area in circumstances which require the publication of a prospectus under the Prospectus Directive will be €50,000 (or, if the Covered Bonds are denominated in a currency other than euro, the equivalent amount in such currency).

Unless otherwise stated in the applicable Final Terms, the minimum denomination of each Definitive IAI Registered Covered Bond will be U.S.\$500,000 or its approximate equivalent in other Specified Currencies and the minimum denomination of each Definitive Rule 144A Covered Bond will be U.S.\$100,000 or its approximate equivalent in other Specified Currencies.

Taxation:

All payments in respect of the Covered Bonds will be made without withholding or deduction for or on account of taxes imposed by any Tax Jurisdiction, subject as provided in Condition 8. In the event that any such withholding or deduction is made, the Issuer or, as the case may be, the Group Guarantors will, save in certain limited circumstances provided in Condition 8, be required to pay additional amounts to cover the amounts so deducted. The LLP will not be liable to pay any such additional amounts under the Covered Bond Guarantee.

Cross Default:

Each Series of Covered Bonds will cross accelerate at the same time but will not otherwise contain a cross default provision.

Status of the Covered Bonds:

The Covered Bonds issued from time to time in accordance with the Programme will constitute direct, unconditional, unsubordinated and unsecured obligations of the Issuer and will rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations (other than subordinated obligations, if any) of the Issuer, from time to time outstanding.

Guarantees:

The Covered Bonds will be unconditionally and jointly and severally guaranteed by the Group Guarantors. The obligations of the Group Guarantors under their guarantee constitute direct,

unconditional, unsubordinated and unsecured obligations of each Group Guarantor and rank *pari passu* and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations (other than subordinated obligations, if any) of the relevant Group Guarantor from time to time outstanding.

It is expected that on the Effective Date, the existing undertakings, including all assets and liabilities of HBOSTS will be transferred to Bank of Scotland plc which will assume any existing obligations of HBOSTS. As a consequence of Bank of Scotland plc assuming the obligations of HBOSTS, in its capacity as Issuer prior to the Effective Date, and Bank of Scotland plc being unable to maintain an action against itself, the guarantee given by Bank of Scotland prior to the Effective Date will be discharged as of the Effective Date. The guarantee given by HBOS prior to the Effective Date, on the other hand, will survive the HBOS Group Reorganisations.

Payment of Guaranteed Amounts in respect of the Covered Bonds when Due for Payment will be irrevocably and severally (as between the Group Guarantors and the LLP) guaranteed by the LLP. The obligations of the LLP to make payment in respect of the Guaranteed Amounts when Due for Payment are subject to the condition that an HBOS Event of Default occurs, an HBOS Acceleration Notice is served on the Issuer and the Group Guarantors and a Notice to Pay is served on the LLP. The obligations of the LLP under its guarantee constitute direct obligations of the LLP secured against the assets from time to time of the LLP and recourse against the LLP is limited to such assets.

Approval, Listing and Admission to Trading:

Application has been made to the CSSF to approve this document as a base prospectus. Application has also been made to the Luxembourg Stock Exchange for Covered Bonds issued under the Programme to be admitted to trading on the Luxembourg Stock Exchange's regulated market and to be listed on the Official List of the Luxembourg Stock Exchange. The Covered Bonds may also be listed or admitted to trading, as the case may be, on other or further stock exchange(s) or markets as may be agreed between the Issuer and the relevant Dealer(s) in relation to each Series.

Covered Bonds which are neither listed nor admitted to trading on any market may also be issued.

The applicable Final Terms will state whether or not the relevant Covered Bonds are to be listed and/or admitted to trading and, if so, on which stock exchange(s) and/or markets.

The United Kingdom Finance Bill 2007 includes a new statutory meaning of the term "listed on a recognised stock exchange". If the draft legislation is enacted in its current form, from the date on which the Finance Bill 2007 received Royal Assent, securities will be treated as listed on a recognised stock exchange if (and only if) they are admitted to trading on that exchange and either they are

included in the United Kingdom official list (within the meaning of Part 6 of the Financial Services and Markets Act 2000) or they are officially listed, in accordance with provisions corresponding to those generally applicable in European Economic Area states, in a country outside the United Kingdom in which there is a recognised stock exchange.

- Governing Law: The Covered Bonds will be governed by, and construed in accordance with, English law.
- Selling Restrictions: There are restrictions on the offer, sale and transfer of the Covered Bonds in the United States, the European Economic Area (including the United Kingdom and The Netherlands) and Japan. Other restrictions may apply in connection with the offering and sale of a particular Tranche of Covered Bonds. See *Subscription and Sale and Transfer and Selling Restrictions*.
- HBOS Group Reorganisation: On 21 June 2006, the HBOS Group Reorganisation Act 2006 (the **HBOS Group Reorganisation Act**) received Royal Assent. Pursuant to the provisions of the HBOS Group Reorganisation Act, on a date to be determined by HBOS, which is currently expected to be 17 September 2007 (the **Effective Date**), Bank of Scotland will become registered as a public limited company under the Companies Act 1985 and will change its corporate name to Bank of Scotland plc. In addition, the existing undertakings, including all assets and liabilities, of Capital Bank plc, Halifax and HBOS Treasury Services plc (the **Transferor Entities**) will be transferred to Bank of Scotland plc, at which point Bank of Scotland plc shall assume any existing obligations relating to the Transferor Entities. The Transferor Entities will cease to exist on the day on which, in pursuance of a request made by or on behalf of Bank of Scotland plc at any time after the Effective Date, the registrar of companies strikes the Transferor Entities off the register. This series of transactions is referred to as the **HBOS Group Reorganisation**.

## RISK FACTORS

*This section describes the principal risk factors associated with an investment in the Covered Bonds. Prospective purchasers of Covered Bonds should consider carefully all the information contained in this document, including the considerations set out below, before making any investment decision. This section of the Offering Circular is split into two main sections – General Risk Factors and Risk Factors relating to the LLP.*

### GENERAL RISK FACTORS

#### Issuer and Group Guarantors liable to make payments when due on the Covered Bonds

The Issuer and the Group Guarantors are liable to make payments when due on the Covered Bonds. The obligations of the Issuer and the Group Guarantors under the Covered Bonds are direct, unsecured, unsubordinated and unconditional obligations, ranking *pari passu* with their respective other direct, unsecured, unconditional and unsubordinated obligations.

The LLP has no obligation to pay the Guaranteed Amounts payable under the Covered Bond Guarantee until the occurrence of an HBOS Event of Default, service by the Bond Trustee on the Issuer and the Group Guarantors of an HBOS Acceleration Notice and on the LLP of a written demand to pay under the Covered Bond Guarantee (a **Notice to Pay**) or, if earlier, following the occurrence of an LLP Event of Default and service by the Bond Trustee of an LLP Acceleration Notice. The occurrence of an HBOS Event of Default does not constitute an LLP Event of Default. However, failure by the LLP to pay amounts due under the Covered Bond Guarantee would constitute an LLP Event of Default which would entitle the Bond Trustee to accelerate the obligations of the Issuer under the Covered Bonds (if they have not already become due and payable) and the obligations of the LLP under the Covered Bond Guarantee and entitle the Security Trustee to enforce the Security.

#### Group Guarantee may be withdrawn

The Group Guarantee may be withdrawn if the Issuer becomes a rated entity and the long-term unsecured, unguaranteed and unsubordinated debt obligations of the Issuer are rated by the Rating Agencies at least equal to the then highest ratings of the Group Guarantors (the **Requisite Ratings**) or a further guarantee is provided by another member of the HBOS Group which is on substantially similar terms to the Group Guarantee and the long-term unsecured, unguaranteed and unsubordinated debt obligations of such member providing such further guarantee has the Requisite Ratings.

In addition, any one Group Guarantor may withdraw as a Group Guarantor if, at the time, either the Issuer or the remaining Group Guarantor has the Requisite Ratings or, if that is not the case, if another member of the HBOS Group which provides a further guarantee on terms substantially similar to those of the Group Guarantee has the Requisite Ratings at the relevant time.

#### Obligations under the Covered Bonds

The Covered Bonds will not represent an obligation or be the responsibility of Halifax, Citigroup Global Markets Limited, Dresdner Bank Aktiengesellschaft, the Bond Trustee, the Security Trustee or any other party to the Programme, their officers, members, directors, employees, security holders or incorporators, other than the Issuer and the Guarantors. The Issuer and the Guarantors will be liable solely in their corporate capacity for their obligations in respect of the Covered Bonds and such obligations will not be the obligations of their respective officers, members, directors, employees, security holders or incorporators.



## **Covered Bonds issued under the Programme**

Covered Bonds issued under the Programme will either be fungible with an existing Series of Covered Bonds or have different terms from an existing Series of Covered Bonds (in which case they will constitute a new Series). All Covered Bonds issued from time to time will rank *pari passu* with each other in all respects and will share equally in the security granted by the LLP under the Deed of Charge. If an HBOS Event of Default occurs, all Covered Bonds of all Series will accelerate at the same time as against the Issuer and Group Guarantors (following service of an HBOS Acceleration Notice) but (following service on the LLP of a Notice to Pay) will be subject to, and entitled to, payments made on the due dates thereof by the LLP under the Covered Bond Guarantee. If an LLP Event of Default occurs, all Covered Bonds of each Series will accelerate at the same time against the Issuer and the Group Guarantors (if not already accelerated following an HBOS Event of Default) and all corresponding obligations of the LLP under the Covered Bond Guarantee will accelerate at the same time as against the LLP (following service of an LLP Acceleration Notice). In order to ensure that any further issue of Covered Bonds under the Programme does not adversely affect existing Covered Bondholders:

- the Issuer will be obliged to apply the proceeds of any issue of Covered Bonds to make a Term Advance to the LLP. The LLP will use the proceeds of such Term Advance (i) to acquire Loans and their Related Security from the Sellers and/or (ii) to acquire Substitution Assets up to the prescribed limit, and/or (iii) if an existing Series, or part of an existing Series, of Covered Bonds is being refinanced by such issue of Covered Bonds, to repay the Term Advance(s) corresponding to the Covered Bonds being so refinanced and/or (iv) to make a deposit in the GIC Account; and
- the Asset Coverage Test will be required to be met both before and immediately after any further issue of Covered Bonds; and
- on or prior to the date of issue of any further Covered Bonds, the Issuer will be obliged to obtain written confirmation from the Rating Agencies (addressed to the Issuer, the Bond Trustee and the Security Trustee) that such further issue would not adversely affect the then current ratings of the existing Covered Bonds.

## **Security Trustee's powers may affect the interests of the Covered Bondholders**

In the exercise of its powers, trusts, authorities and discretions, the Deed of Charge requires the Security Trustee to consider the interests of each of the Secured Creditors. In the event that with respect to the exercise of any of its powers, trusts, authorities or discretions the Security Trustee determines in its absolute discretion that any of the Secured Creditors (other than the Covered Bondholders) would be materially prejudiced thereby or any such Secured Creditor informs the Security Trustee in writing that it would be materially prejudiced thereby, the Security Trustee shall only exercise the same with the written consent of such Secured Creditor(s) and provided that the Security Trustee is satisfied that such exercise will not be materially prejudicial to the interests of the Covered Bondholders.

If, in connection with the exercise of its powers, trusts, authorities or discretions, the Security Trustee is of the opinion that the interests of the holders of the Covered Bonds of any one or more Series would be materially prejudiced thereby, the Security Trustee shall not exercise such power, trust, authority or discretion without the approval of such Covered Bondholders by Extraordinary Resolution or by a written resolution of such Covered Bondholders of not less than fifty per cent. of the Principal Amount Outstanding of Covered Bonds of the relevant Series then outstanding.

## **Ratings of the Covered Bonds**

The ratings assigned to the Covered Bonds address the likelihood of full and timely payment to Covered Bondholders of all payments of interest on each Interest Payment Date. The ratings also address the likelihood of timely payment of principal in relation to the Hard Bullet Covered Bonds on the Final Maturity Date thereof but may only address the likelihood of ultimate payment of principal in relation to other types of Covered Bonds. The expected ratings of the Covered Bonds are set out in the relevant Final Terms for each Series of Covered Bonds. Any Rating Agency may lower its rating or withdraw its rating if, in the sole judgement of the Rating Agency, the credit quality of the Covered Bonds has declined or is in question. If any rating assigned to the Covered Bonds is lowered or withdrawn, the market value of the Covered Bonds may be reduced. A credit rating may not reflect the potential impact of all risks related to structure, market, additional factors discussed above, and other factors that may affect the value of the Covered Bonds. A credit rating is not a recommendation to buy, sell or hold securities.

## **The Security Trustee may agree to modifications to the Transaction Documents without the Secured Creditors' prior consent**

Pursuant to the terms of the Deed of Charge, the Security Trustee may, without the consent or sanction of the Secured Creditors, concur with any person in making or sanctioning any modification to the Transaction Documents to which the Security Trustee is a party:

- provided that the Security Trustee is of the opinion that such modification will not be materially prejudicial to the interests of any of the Secured Creditors or, if it is not of that opinion in relation to any Secured Creditor or any Secured Creditor has informed the Security Trustee in writing that such modification will be materially prejudicial to its interests, such Secured Creditor has given its written consent to such modification; or
- which in the opinion of the Security Trustee are made to correct a manifest error or an error established as such to the satisfaction of the Security Trustee or are of a formal, minor or technical nature or are made to comply with mandatory provisions of law.

## **The Bond Trustee may agree to modifications to the Transaction Documents without the Covered Bondholders' or other Secured Creditors' prior consent**

Pursuant to the terms of the Trust Deed, the Bond Trustee may, without the consent or sanction of any of the Covered Bondholders or any of the other Secured Creditors (other than the Security Trustee (where applicable)), concur with any person in making or sanctioning any modifications to the Transaction Documents:

- provided that the Bond Trustee is of the opinion that such modification will not be materially prejudicial to the interests of any of the Secured Creditors or, if it is not of that opinion in relation to any Secured Creditor or any Secured Creditor has informed the Bond Trustee in writing that such modification will be materially prejudicial to its interests, such Secured Creditor has given its written consent to such modification; or
- which in the opinion of the Bond Trustee are made to correct a manifest error or an error established as such to the satisfaction of the Bond Trustee or are of a formal, minor or technical nature or are made to comply with mandatory provisions of law.

### **Certain decisions of Covered Bondholders taken at Programme level**

Any Extraordinary Resolution to direct the Bond Trustee to serve an HBOS Acceleration Notice following an HBOS Event of Default, to direct the Bond Trustee to serve an LLP Acceleration Notice following an LLP Event of Default and any direction to the Bond Trustee or Security Trustee to take any enforcement action must be passed at a single meeting of the holders of all Covered Bonds of all Series then outstanding.

### **European Monetary Union**

If the United Kingdom joins the European Monetary Union prior to the maturity of the Covered Bonds, there is no assurance that this would not adversely affect the realisable value of the Portfolio or any part thereof or, pending such realisation (or if the Portfolio or any part thereof cannot be sold), the ability of the LLP to make payments of interest and principal on the Covered Bonds.

It is possible that, prior to the maturity of the Covered Bonds, the United Kingdom may become a participating member state in the European economic and monetary union and that the euro may become the lawful currency of the United Kingdom. In that event, (a) all amounts payable in respect of any Covered Bonds denominated in pounds sterling may become payable in euro; (b) the law may allow or require the Covered Bonds to be re-denominated into euro and additional measures to be taken in respect of such Covered Bonds; and (c) there may no longer be available published or displayed rates for deposits in pounds sterling used to determine the rates of interest on such Covered Bonds or there may be changes in the way those rates are calculated, quoted and published or displayed. The introduction of the euro could also be accompanied by a volatile interest rate environment which could adversely affect a Borrower's ability to repay its Loan as well as adversely affect investors. It cannot be said with certainty what effect, if any, adoption of the euro by the United Kingdom will have on investors in the Covered Bonds.

### **Changes of law**

The structure of the issue of the Covered Bonds and the ratings which are to be assigned to them are based on English law and, in relation to the Scottish Loans, Scots law in effect as at the date of this Offering Circular. No assurance can be given as to the impact of any possible change to English law or Scots law or administrative practice in the United Kingdom after the date of this Offering Circular.

### ***Insolvency Act 2000***

Significant changes to the United Kingdom insolvency regime have been enacted in the last five years, including the Insolvency Act 2000, the relevant provisions of which came into force on 1 January 2003. The Insolvency Act 2000 allows certain "small" companies to seek protection from their creditors for a period of 28 days for the purposes of putting together a company voluntary arrangement with the option for creditors to extend the moratorium for a further two months. Prior to 1 October 2005, there was some doubt as to whether the moratorium provisions of the Insolvency Act 2000 applied to limited liability partnerships (such as the LLP). However, on 1 October 2005, the Limited Liability Partnership (Amendment) Regulations 2005 made it clear that the moratorium provisions apply to limited liability partnerships subject to certain modifications.

A "small" company is defined as one which satisfies two or more of the following criteria: (i) its turnover is not more than £5.6 million, (ii) its balance sheet total is not more than £2.8 million and (iii) the number of employees is not more than 50. It appears that the same definitions would apply in respect of a limited liability partnership. The position as to whether or not a company is a "small" company may change from time to time and consequently no assurance can be given that the Issuer or the LLP will not, at any

given time, be determined to be a “small” company. The United Kingdom Secretary of State for Trade and Industry may by regulation modify the eligibility requirements for “small” companies and can make different provisions for different cases. No assurance can be given that any such modification or different provisions will not be detrimental to the interests of Covered Bondholders.

Certain special purpose companies in relation to capital markets transactions are excluded from the optional moratorium provisions. Such exclusions include (a) a company which, at the time of filing for a moratorium, is a party to an agreement which is or forms part of a “capital market arrangement” (as defined in paragraph 4D of Schedule A1 to the Insolvency Act 1986 (the **Insolvency Act**)) under which a party has incurred, or when the agreement was entered into was expected to incur, a debt of at least £10 million and which involves the issue of “capital market investment” (also defined but generally a rated, listed or traded bond) and (b) a company which, at the time of filing for a moratorium, has incurred a liability (including a present, future or contingent liability and a liability payable wholly or partly in a foreign currency) of at least £10 million. While both the Issuer and the LLP are expected to fall within one of the exceptions there is no guidance as to how the legislation will be interpreted and the Secretary of State for Trade and Industry may by regulation modify the exceptions. No assurance can be given that any modification of the exceptions will not be detrimental to the interests of Covered Bondholders. Correspondingly, if the Issuer is determined to be a “small” company and determined not to fall within one of the exceptions, then certain actions in respect of the Issuer may, for a period, be prohibited by the imposition of a moratorium.

If the LLP is determined to be a “small” limited liability partnership and determined not to fall within one of the exceptions (by reason of modification of the exceptions or otherwise), then the enforcement of the Security by the Security Trustee may, for a period, be prohibited by the imposition of a moratorium.

### ***Enterprise Act 2002***

On 15 September 2003, the corporate insolvency provisions of the Enterprise Act 2002 came into force, amending certain provisions of the Insolvency Act and, in particular, the administration provisions which were reformed by introducing a new Schedule B1 to the Insolvency Act. These provisions introduced significant reforms to corporate insolvency law. In particular, the reforms restrict the right of the holder of a floating charge to appoint an administrative receiver (unless the floating charge was created prior to 15 September 2003 or an exception applies) and instead give primacy to collective insolvency procedures (in particular, administration). Previously, the holder of a floating charge over the whole or substantially the whole of the assets of a company had the ability to block the appointment of an administrator by appointing an administrative receiver, who would act primarily in the interests of the floating charge holder appointing him.

From 1 October 2005, the Limited Liability Partnership (Amendment) Regulations 2005 have applied the new administration provisions in Schedule B1 to the Insolvency Act to limited liability partnerships (such as the LLP) with certain modifications.

The prohibition on appointing an administrative receiver in the Enterprise Act 2002 does not apply to a “qualifying floating charge” created before 15 September 2003. A qualifying floating charge is one which (amongst other things) purports to empower the holder to appoint an administrative receiver and which relates (together with other charges) to the whole or substantially the whole of the LLP’s property. As the Deed of Charge was created prior to 15 September 2003 and so the floating charge granted by the LLP in the Deed of Charge was created prior to this date, the restriction on appointing an administrative receiver will not apply and it will still be possible for the Security Trustee to appoint an administrative receiver in respect of the LLP.

The Insolvency Act also contains a new out-of-court route into administration for a qualifying floating charge holder, the directors or the relevant company itself. These provisions have been applied to limited liability partnerships (such as the LLP) with certain modifications from 1 October 2005. The relevant provisions provide for a notice period during which the holder of the floating charge can either appoint an administrative receiver (if an exception applies), agree to the appointment of the administrator proposed by the LLP or appoint an alternative administrator, although a moratorium on enforcement of the relevant security will take effect immediately after notice is given. If the qualifying floating charge holder does not respond to the LLP's, notice of intention to appoint, the LLP's, appointee will automatically take office after the notice period has elapsed provided that paragraph 29 of Schedule B1 to the Insolvency Act has been complied with (i.e. the notice of appointment has been filed with the court). Where the holder of a qualifying floating charge which was created prior to 15 September 2003 retains the power to appoint an administrative receiver, such holder may prevent the appointment of an administrator (either by the new out-of-court route or by the court-based procedure) by appointing an administrative receiver prior to the appointment of the administrator being completed.

The new administration provisions of the Insolvency Act give primary emphasis to the rescue of a company as a going concern and achieving a better result for the creditors as a whole. The purpose of realising property to make a distribution to secured creditors is secondary. As noted above, these new administration provisions will now apply to limited liability partnerships (such as the LLP) and have done so from 1 October 2005. From this date, no assurance could be given that the primary purpose of the new provisions would not conflict with the interests of Covered Bondholders were the LLP ever subject to administration.

In addition to the introduction of a prohibition on the appointment of an administrative receiver as set out above, section 176A of the Insolvency Act provides that any receiver (including an administrative receiver), liquidator or administrator of a company is required to make a "prescribed part" of the company's "net property" available for the satisfaction of unsecured debts in priority to the claims of the floating charge holder. These provisions apply to the LLP as if it were a company incorporated under the Companies Act 1985. However, the provisions do not apply to any floating charge which was created prior to 15 September 2003 and so will not be relevant in respect of any floating charge restrictions under the Deed of Charge.

### **Exchange of the Covered Bonds following any Covered Bond legislation coming into force in the United Kingdom**

The Terms and Conditions of the Covered Bonds permit the Issuer to exchange, without the consent of the Bond Trustee, the Security Trustee or the Covered Bondholders, any existing Covered Bonds then outstanding for new Covered Bonds following the coming into force in the United Kingdom of any legislation similar to covered bond legislation in force in any other European Union country or any rules, regulations or guidelines published by any governmental authority that provides for bonds issued by United Kingdom issuers to qualify for the same benefits available pursuant to covered bond legislation in force in any other European Union country provided that, amongst other things, each of the Rating Agencies then rating the existing Covered Bonds confirms in writing that any such new Covered Bonds will be assigned the same ratings as are then applicable to the existing Covered Bonds. Any such new Covered Bonds will qualify as covered bonds under such new legislation, rules, regulations or guidelines and will be in identical form, amounts and denominations and will be subject to the same economic terms and conditions as the existing Covered Bonds then outstanding.

### **Integral multiples of less than €50,000**

Although Covered Bonds which are admitted to trading on a regulated market in the European Economic Area or offered to the public in a member state of the European Economic Area in circumstances

which require the publication of a prospectus under the Prospectus Directive are required to have a minimum denomination of €50,000 (or, where the specified currency is not euro, its equivalent in the specified currency) (the **Minimum Specified Denomination**), it is possible that the Covered Bonds may be traded in the clearing systems in amounts in excess of €50,000 (or its equivalent in alternate currencies) that are not integral multiples of €50,000 (or its equivalent in alternate currencies). In relation to any issue of Covered Bonds that have a denomination consisting of the Minimum Specified Denomination plus a higher integral multiple of another smaller amount, it is possible that the Covered Bonds may be traded in amounts in excess of €50,000 (or its equivalent) that are not integral multiples of €50,000 (or its equivalent). In such a case a Covered Bondholder, who, as a result of trading such amounts, holds a principal amount of less than the Minimum Specified Denomination may not receive definitive Covered Bonds in respect of such holding (should definitive Covered Bonds be printed) and may need to purchase a principal amount of Covered Bonds such that its holding is at least the Minimum Specified Denomination.

If definitive Covered Bonds are issued, Covered Bondholders should be aware that definitive Covered Bonds that have a denomination that is not an integral multiple of the Minimum Specified Denomination may be illiquid and difficult to trade.

### **Factors which are material for the purpose of assessing the market risks associated with Covered Bonds issued under the Programme**

#### ***The Covered Bonds may not be a suitable investment for all investors***

Each potential investor in the Covered Bonds must determine the suitability of that investment in light of its own circumstances. In particular, each potential investor should:

- (i) have sufficient knowledge and experience to make a meaningful evaluation of the Covered Bonds, the merits and risks of investing in the Covered Bonds and the information contained or incorporated by reference in this Offering Circular or any applicable supplement;
- (ii) have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Covered Bonds and the impact the Covered Bonds will have on its overall investment portfolio;
- (iii) have sufficient financial resources and liquidity to bear all of the risks of an investment in the Covered Bonds, including Covered Bonds with principal or interest payable in one or more currencies, or where the currency for principal or interest payments is different from the potential investor's currency;
- (iv) understand thoroughly the terms of the Covered Bonds and be familiar with the behaviour of any relevant indices and financial markets; and
- (v) be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

Some Covered Bonds are complex financial instruments. Sophisticated institutional investors generally do not purchase complex financial instruments as stand-alone investments. They purchase complex financial instruments as a way to reduce risk or enhance yield with an understood, measured, appropriate addition of risk to their overall portfolios. A potential investor should not invest in Covered Bonds which are complex financial instruments unless it has the expertise (either alone or with a financial adviser) to evaluate how the Covered Bonds will perform under changing conditions, the resulting effects on the value of the Covered Bonds and the impact this investment will have on the potential investor's overall investment portfolio.



### ***Risks related to the structure of a particular issue of Covered Bonds***

A wide range of Covered Bonds may be issued under the Programme. A number of these Covered Bonds may have features which contain particular risks for potential investors. Set out below is a description of the most common such features:

#### *Covered Bonds subject to optional redemption by the Issuer*

An optional redemption feature of Covered Bonds is likely to limit their market value. During any period when the Issuer may elect to redeem Covered Bonds, the market value of those Covered Bonds generally will not rise substantially above the price at which they can be redeemed. This also may be true prior to any redemption period.

The Issuer may be expected to redeem Covered Bonds when its cost of borrowing is lower than the interest rate on the Covered Bonds. At those times, an investor generally would not be able to reinvest the redemption proceeds at an effective interest rate as high as the interest rate on the Covered Bonds being redeemed and may only be able to do so at a significantly lower rate. Potential investors should consider reinvestment risk in light of other investments available at that time.

#### *Index Linked Covered Bonds and Dual Currency Covered Bonds*

The Issuer may issue Covered Bonds with principal or interest determined by reference to an index or formula, to changes in the prices of securities or commodities, to movements in currency exchange rates or other factors (each, a **Relevant Factor**). In addition, the Issuer may issue Covered Bonds with principal or interest payable in one or more currencies which may be different from the currency in which the Covered Bonds are denominated. Potential investors should be aware that:

- (i) the market price of such Covered Bonds may be volatile;
- (ii) they may receive no interest;
- (iii) payment of principal or interest may occur at a different time or in a different currency from that expected;
- (iv) they may lose all or a substantial portion of their principal;
- (v) a Relevant Factor may be subject to significant fluctuations that may not correlate with changes in interest rates, currencies or other indices;
- (vi) if a Relevant Factor is applied to Covered Bonds in conjunction with a multiplier greater than one or contains some other leverage factor, the effect of changes in the Relevant Factor on principal or interest payable likely will be magnified; and
- (vii) the timing of changes in a Relevant Factor may affect the actual yield to investors, even if the average level is consistent with their expectations. In general, the earlier the change in the Relevant Factor, the greater the effect on yield.

The historical experience of an index should not be viewed as an indication of the future performance of such index during the term of any Index Linked Covered Bonds. Accordingly, an investor should consult its own financial, tax and legal advisers about the risk entailed by an investment in any Index Linked Covered Bonds and the suitability of such Covered Bonds in light of their particular circumstances.

### *Partly-paid Covered Bonds*

The Issuer may issue Covered Bonds where the issue price is payable in more than one instalment. Failure to pay any subsequent instalment could result in an investor losing all of his investment.

### *Variable rate Covered Bonds with a multiplier or other leverage factor*

Covered Bonds with variable interest rates can be volatile investments. If they are structured to include multipliers or other leverage factors, or caps or floors, or any combination of those features or other similar related features, their market values may be even more volatile than those for securities that do not include those features.

### *Inverse Floating Rate Covered Bonds*

Inverse Floating Rate Covered Bonds have an interest rate equal to a fixed rate minus a rate based upon a reference rate such as LIBOR. The market values of those Covered Bonds typically are more volatile than market values of other conventional floating rate debt securities based on the same reference rate (and with otherwise comparable terms). Inverse Floating Rate Covered Bonds are more volatile because an increase in the reference rate not only decreases the interest rate of the Covered Bonds, but may also reflect an increase in prevailing interest rates, which further adversely affects the market value of these Covered Bonds.

### *Fixed/Floating Rate Covered Bonds*

Fixed/Floating Rate Covered Bonds may bear interest at a rate that converts from a fixed rate to a floating rate, or from a floating rate to a fixed rate. Where the Issuer has the right to effect such a conversion, this will affect the secondary market and the market value of the Covered Bonds since the Issuer may be expected to convert the rate when it is likely to produce a lower overall cost of borrowing. If the Issuer converts from a fixed rate to a floating rate in such circumstances, the spread on the Fixed/Floating Rate Covered Bonds may be less favourable than then prevailing spreads on comparable Floating Rate Covered Bonds tied to the same reference rate. In addition, the new floating rate at any time may be lower than the rates on other Covered Bonds. If the Issuer converts from a floating rate to a fixed rate in such circumstances, the fixed rate may be lower than then prevailing rates on its Covered Bonds.

### *Covered Bonds issued at a substantial discount or premium*

The market values of securities issued at a substantial discount or premium from their principal amount tend to fluctuate more in relation to general changes in interest rates than do prices for conventional interest-bearing securities. Generally, the longer the remaining term of the securities, the greater the price volatility as compared to conventional interest-bearing securities with comparable maturities.

### ***Risks related to Covered Bonds generally***

Set out below is a brief description of certain risks relating to the Covered Bonds generally:

#### *Modification, waivers and substitution*

The conditions of the Covered Bonds contain provisions for calling meetings of Covered Bondholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Covered Bondholders including Covered Bondholders who did not attend and vote at the relevant meeting and Covered Bondholders who voted in a manner contrary to the majority.

The conditions of the Covered Bonds also provide that the Bond Trustee may, without the consent of Covered Bondholders, agree to (i) any modification of, or to the waiver or authorisation of any breach or proposed breach of, any of the provisions of Covered Bonds or (ii) determine at its discretion whether certain events of default shall not be treated as such or (iii) the substitution of either Group Guarantor as principal debtor under any Covered Bonds in place of the Issuer, in the circumstances described in Condition 15 of the conditions of the Covered Bonds.

#### *EU Savings Directive*

Under EC Council Directive 2003/48/EC on the taxation of savings income, each Member State of the European Union is required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State. However, for a transitional period, Belgium, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange within certain other countries). A number of non-European Union countries and territories including Switzerland have agreed to adopt similar measures (a withholding system in the case of Switzerland).

If a payment were to be made or collected through a Member State of the European Union which has opted for a withholding system and an amount of or in respect of tax were to be withheld from that payment, neither the Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Covered Bond as a result of the imposition of such withholding tax. If a withholding tax is imposed on a payment made by a Paying Agent following implementation of this Directive, the Issuer will be required to maintain a Paying Agent in a Member State of the European Union that will not be obliged to withhold or deduct tax pursuant to the Directive.

#### *Trading in the clearing systems*

In relation to issue of any Covered Bonds which have a minimum denomination and are tradeable in the clearing systems in amounts above such minimum denomination which are smaller than that minimum denomination, should definitive Covered Bonds be required to be issued, a holder who does not have an integral multiple of the minimum denomination in his account with the relevant clearing system at the relevant time may not receive all of his entitlement in the form of definitive Covered Bonds unless and until such time as his holding becomes an integral multiple of the minimum denomination.

#### ***Risks related to the market generally***

Set out below is a brief description of the principal market risks, including liquidity risk, exchange rate risk, interest rate risk and credit risk:

#### *The secondary market generally*

Covered Bonds may have no established trading market when issued, and one may never develop. If a market does develop, it may not be very liquid and may not continue for the life of the Covered Bonds. Therefore, investors may not be able to sell their Covered Bonds easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market. This is particularly the case for Covered Bonds that are especially sensitive to interest rate, currency or market risks, are designed for specific investment objectives or strategies or have been structured to meet the investment requirements of limited categories of investors. These types of Covered Bonds generally would have a more

limited secondary market and more price volatility than conventional debt securities. Illiquidity may have a severely adverse effect on the market value of Covered Bonds.

#### *Exchange rate risks and exchange controls*

The Issuer will pay principal and interest on the Covered Bonds and the Guarantors will make any payments under the Group Guarantee and Covered Bond Guarantee in the Specified Currency. This presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the **Investor's Currency**) other than the Specified Currency. These include the risk that exchange rates may significantly change (including changes due to devaluation of the Specified Currency or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to the Specified Currency would decrease (1) the Investor's Currency-equivalent yield on the Covered Bonds, (2) the Investor's Currency-equivalent value of the principal payable on the Covered Bonds and (3) the Investor's Currency-equivalent market value of the Covered Bonds.

Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. As a result, investors may receive less interest or principal than expected, or no interest or principal.

#### *Interest rate risks*

Investment in Fixed Rate Covered Bonds involves the risk that subsequent changes in market interest rates may adversely affect the value of the Fixed Rate Covered Bonds.

#### *Legal investment considerations may restrict certain investments*

The investment activities of certain investors are subject to legal investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisers to determine whether and to what extent (1) Covered Bonds are legal investments for it, (2) Covered Bonds can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of any Covered Bonds. Financial institutions should consult their legal advisers or the appropriate regulators to determine the appropriate treatment of Covered Bonds under any applicable risk-based capital or similar rules.

### **RISKS RELATING TO THE ISSUER AND GROUP GUARANTORS**

#### *The financial performances are affected by borrower credit quality and general economic conditions, 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 the Issuer's and Group Guarantors' businesses. Adverse changes in the credit quality of the Issuer's and Group Guarantors' borrowers and counterparties or a general deterioration in the UK or global economic conditions, or arising from systemic risks in the financial systems, could affect the recoverability and value of the Issuer's and Group Guarantors' assets and require an increase in the Issuer's and Group Guarantors' impairment provisions for bad and doubtful debts and other provisions.

***Changes in interest rates, foreign exchange rates, equity prices, house prices and other market factors affect the Issuer's and Group Guarantors' business.***

The most significant market risks the Issuer and Group Guarantors face are interest rate, foreign exchange and bond, equity and house price risks. Changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs. Changes in currency rates affect the value of assets and liabilities denominated in foreign currencies and affect earnings reported by the relevant Issuer's and Group Guarantors' non-UK subsidiaries, and may affect income from foreign exchange dealing. The performance of financial markets may cause changes in the value of the Issuer's and Group Guarantors' investment and trading portfolios. The Issuer and Group Guarantors have implemented risk management methods to mitigate and control these and other market risks to which they are exposed. However, it is difficult to predict with accuracy changes in economic or market conditions and to anticipate the effects that such changes could have on the Issuer's and Group Guarantors' financial performance and business operations.

***The Issuer and Group Guarantors are subject to capital requirements that could limit their operations.***

The Issuer and Group Guarantors are subject to capital adequacy requirements adopted by the Financial Services Authority (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. If the Issuer and Group Guarantors fail to comply with the requirements, this may result in administrative actions or sanctions against them which may affect their ability to fulfil their obligations under the Covered Bonds.

The risk-adjusted capital guidelines promulgated by the Basel Committee on Banking Supervision (the **Basel Committee**), which form the basis for the EU's and thus the FSA's capital adequacy requirements, have recently been revised (**Basel II**). They are being implemented in stages, from the beginning of 2007 to the implementation of more advanced techniques at the start of 2008. The principal changes effected by the revised requirements include the application of risk-weighting (depending upon the credit status of certain customers, using an "internal ratings-based" approach to credit risk, and subject to approval of supervising authorities), allocation of risk assets in relation to operational risk and supervisory review of the process of evaluating risk measurement and capital ratios. At this time, the Issuer and the Group Guarantors are unable to predict how the revised requirements will affect their calculations of capital and the impact of these revisions on other aspects of its operations.

***Operational risks are inherent in the Issuer's and Group Guarantors' businesses***

The Issuer's and Group Guarantors' businesses are dependent on the ability to process a very large number of transactions efficiently and accurately. Operational risks and losses can result from fraud, errors by employees, failure to document transactions properly or to obtain proper internal authorisation, failure to comply with regulatory requirements and conduct of business rules, equipment failures, natural disasters or the failure of external systems, for example, those of the Issuer's and Group Guarantors' suppliers or counterparties. Although the Issuer and Group Guarantors have implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures and to staff training, it is only possible to be reasonably, but not absolutely, certain that such procedures will be effective in controlling each of the operational risks.

*There may be risks associated with the Issuer's and Group Guarantors' adoption of IFRS, which differs in significant respects from U.K. GAAP and U.S. GAAP*

From 1 January 2005, all listed companies in the European Union are required to produce consolidated accounts prepared under IFRS. Until 1 January 2005, the Issuer and the Group Guarantors prepared their financial statements in accordance with U.K. GAAP. Each of the Issuer and the Group Guarantors has implemented IFRS from 1 January 2005 and produced full consolidated financial statements for the years ended 31 December 2005 and 31 December 2006..

HBOS's financial statements that are prepared in accordance with IFRS differ from the financial statements previously prepared in accordance with U.K. GAAP. In addition, HBOS expects that the standards, interpretation and policies adopted by it under IFRS will vary in certain significant respects from those generally accepted in the United States. See Annex A to this Offering Circular, for a discussion of certain differences among IFRS, U.K. GAAP and U.S. GAAP.

## **RISK FACTORS RELATING TO THE LLP**

### **LLP only obliged to pay Guaranteed Amounts when the same are Due for Payment**

Following service of an HBOS Acceleration Notice on the Issuer and the Group Guarantors, a Notice to Pay will be served by the Bond Trustee on the LLP. Following service of a Notice to Pay on the LLP, under the terms of the Covered Bond Guarantee the LLP will be obliged to pay Guaranteed Amounts as and when the same are Due for Payment on each Scheduled Payment Date. In these circumstances, the LLP will not be obliged to pay any other amounts which become payable for any other reason.

Payments by the LLP will be made subject to any applicable withholding or deduction and the LLP will not be obliged to pay any additional amounts as a consequence. The LLP will not be obliged to make any payments in respect of broken funding indemnities, penalties, premiums, default interest or interest on interest which may accrue on or in respect of the Covered Bonds.

If the LLP fails to make a payment when due under the Covered Bond Guarantee or any other LLP Event of Default occurs, then the Bond Trustee may accelerate the Covered Bonds (if not already accelerated) by service of an LLP Acceleration Notice, whereupon the Bond Trustee will have a claim under the Covered Bond Guarantee for the Early Redemption Amount of each Covered Bond, together with accrued interest and all other amounts then due under the Covered Bonds, although in such circumstances the LLP will not be obliged to gross up in respect of any withholding which may be required in respect of any payment. Following service of an LLP Acceleration Notice, the Security Trustee may enforce the Security over the Charged Property. The proceeds of enforcement of the Security shall be applied by the Security Trustee in accordance with the Post-Enforcement Priority of Payments in the Deed of Charge, and Covered Bondholders will receive amounts from the LLP on an accelerated basis.

### **Excess Proceeds received by the Bond Trustee**

Following the occurrence of an HBOS Event of Default, the Bond Trustee may receive moneys from the Issuer, the Group Guarantors or any administrator, administrative receiver, receiver, liquidator, trustee in sequestration or other similar official appointed in relation to the Issuer or the Group Guarantors (the **Excess Proceeds**). The Excess Proceeds shall be paid by the Bond Trustee on behalf of the Covered Bondholders of the relevant Series to the LLP for its own account, as soon as practicable, and shall be held by the LLP in the GIC Account and the Excess Proceeds shall thereafter form part of the Security and shall be used by the LLP in the same manner as all other moneys from time to time standing to the credit of the GIC Account. Any Excess Proceeds received by the Bond Trustee shall discharge the obligations of the Issuer in respect of the Covered Bonds, Receipts and Coupons and the obligations of the Group Guarantors under the Group



Guarantee. However, the obligations of the LLP under the Covered Bond Guarantee are unconditional and irrevocable and the receipt by the Bond Trustee of any Excess Proceeds shall not reduce or discharge any such obligations.

By subscribing for Covered Bond(s), each Covered Bondholder shall be deemed to have irrevocably directed the Bond Trustee to pay the Excess Proceeds to the LLP in the manner as described above.

### **Finite resources available to the LLP to make payments due under the Covered Bond Guarantee**

Following the occurrence of an HBOS Event of Default and service of an HBOS Acceleration Notice on the Issuer and Group Guarantors, all amounts payable under the Covered Bonds will be accelerated by the Bond Trustee as against the Issuer and the Group Guarantors following which a Notice to Pay will be served by the Bond Trustee on the LLP. The LLP's ability to meet its obligations under the Covered Bond Guarantee will depend on the realisable value of Selected Loans and their Related Security in the Portfolio, the amount of Revenue Receipts and Principal Receipts generated by the Portfolio and the timing thereof and amounts received from the Swap Providers. The LLP will not have any other source of funds available to meet its obligations under the Covered Bond Guarantee.

If an LLP Event of Default occurs and the Security created by or pursuant to the Deed of Charge is enforced, the Charged Property may not be sufficient to meet the claims of all the Secured Creditors, including the Covered Bondholders.

If, following enforcement of the Security constituted by or pursuant to the Deed of Charge, the Secured Creditors have not received the full amount due to them pursuant to the terms of the Transaction Documents, then they may still have an unsecured claim against the Issuer and the Group Guarantors for the shortfall. There is no guarantee that the Issuer and the Group Guarantors will have sufficient funds to pay that shortfall.

Covered Bondholders should note that the Asset Coverage Test has been structured to ensure that the Adjusted Aggregate Loan Amount is greater than the aggregate Principal Amount Outstanding of the Covered Bonds for so long as Covered Bonds remain outstanding, which should reduce the risk of there ever being a shortfall (although there is no assurance of this) (see *Summary of the Principal Documents – LLP Deed – Asset Coverage Test and Credit Structure – Asset Coverage Test*).

### **Reliance of the LLP on third parties**

The LLP has entered into agreements with a number of third parties, which have agreed to perform services for the LLP. In particular, but without limitation, the Original Servicer has been (and New Servicers may be) appointed to service Loans in the Portfolio sold to the LLP and the Cash Manager has been appointed to monitor compliance with the Asset Coverage Test and the Amortisation Test and to provide cash management services to the LLP. In the event that any of those parties fails to perform its obligations under the relevant agreement to which it is a party, the realisable value of the Portfolio or any part thereof or pending such realisation (if the Portfolio or any part thereof cannot be sold) the ability of the LLP to make payments under the Covered Bond Guarantee may be affected. For instance, if a Servicer has failed to administer the Loans adequately, this may lead to higher incidences of non-payment or default by Borrowers. The LLP is also reliant on the Swap Providers to provide it with the funds matching its obligations under the Intercompany Loan Agreement and the Covered Bond Guarantee, as described in the following two risk factors.

If a Servicer Event of Default occurs pursuant to the terms of a Servicing Agreement, then the LLP and/or the Security Trustee will be entitled to terminate the appointment of the relevant Servicer and appoint a New Servicer in its place. There can be no assurance that a substitute servicer with sufficient experience of administering mortgages of residential properties would be found who would be willing and able to



service the Loans, as a New Servicer, on the terms of the Servicing Agreement. In addition, as described below, any substitute servicer may be required to be authorised under the Financial Services and Markets Act 2000, as amended (the **FSMA**). The ability of a substitute servicer to perform fully the required services would depend, among other things, on the information, software and records available at the time of the appointment. Any delay or inability to appoint a substitute servicer may affect the realisable value of the Portfolio or any part thereof, and/or the ability of the LLP to make payments under the Covered Bond Guarantee. However, if a Servicer ceases to be assigned a long-term unsecured, unguaranteed and unsubordinated debt obligation rating by Moody's of at least Baa3 or by Standard & Poor's of at least BBB- or by Fitch of at least BBB-, it will use reasonable efforts to enter into a master servicing agreement with a third party.

None of the Servicers have (or will have, as applicable) any obligation themselves to advance payments that Borrowers fail to make in a timely fashion. Covered Bondholders will have no right to consent to or approve of any actions taken by a Servicer under a Servicing Agreement.

Neither the Security Trustee nor the Bond Trustee is obliged in any circumstances to act as a Servicer or to monitor the performance by any Servicer of its obligations.

### **Reliance on Swap Providers**

To provide a hedge against possible variances in the rates of interest payable on the Loans in the Portfolio (which may, for instance, include variable rates of interest, discounted rates of interest, fixed rates of interest or rates of interest which track a base rate) and the rate of interest payable on the outstanding Term Advances, the LLP has entered into the Original Interest Rate Swap Agreement with the Original Interest Rate Swap Provider and, if any New Seller accedes to the Programme, the LLP will enter into a New Interest Rate Swap Agreement with the New Interest Rate Swap Provider. In addition, to provide a hedge (following service on the LLP of a Notice to Pay) against interest rate, currency and/or other risks in respect of amounts received by the LLP under the Loans and the Interest Rate Swaps and amounts paid by the LLP under the Covered Bond Guarantee in respect of the Covered Bonds, the LLP will enter into the Covered Bond Swap Agreements (together with the Interest Swap Agreements, the **Swap Agreements** and each a **Swap Agreement**) with the Covered Bond Swap Provider (together with the Interest Swap Providers, the **Swap Providers** and each a **Swap Provider**).

If the LLP fails to make timely payments of amounts due under any Swap Agreement, then it will have defaulted under that swap. A Swap Provider is only obliged to make payments to the LLP as long as the LLP complies with its payment obligations under the relevant Swap Agreement. If the Swap Provider is not obliged to make payments or if it defaults in its obligations to make payments of amounts in the relevant currency equal to the full amount to be paid to the LLP on the payment date under the Swap Agreements, the LLP will be exposed to changes in the relevant currency exchange rates to sterling and to any changes in the relevant rates of interest. Unless a replacement swap is entered into, the LLP may have insufficient funds to make payments under the Covered Bond Guarantee.

If a Swap terminates, then the LLP may be obliged to make a termination payment to the relevant Swap Provider. There can be no assurance that the LLP will have sufficient funds available to make a termination payment under the relevant Swap Agreement, nor can there be any assurance that the LLP will be able to enter into a replacement swap agreement, or if one is entered into, that the credit rating of the replacement swap counterparty will be sufficiently high to prevent a downgrade of the then current ratings of the Covered Bonds by the Rating Agencies.

If the LLP is obliged to pay a termination payment under any Swap Agreement, such termination payment will rank ahead of amounts due on the Covered Bonds (in respect of the Interest Rate Swaps) and

*pari passu* with amounts due on the Covered Bonds (in respect of the Covered Bond Swaps), except where default by, or downgrade of, the relevant Swap Provider has caused the relevant Swap to terminate. The obligation to pay a termination payment may adversely affect the ability of the LLP to meet its obligations under the Covered Bond Guarantee.

### **Differences in timings of obligations of the LLP and the Covered Bond Swap Provider under the Covered Bond Swaps**

With respect to the Covered Bond Swaps, the LLP will pay a monthly amount, on each LLP Payment Date (following an HBOS Event of Default and service of a Notice to Pay on the LLP), to the Covered Bond Swap Provider based on one-month sterling deposits. The Covered Bond Swap Provider will not be obliged to make corresponding swap payments to the LLP under a Covered Bond Swap for up to twelve months until amounts are Due for Payment by the LLP under the Covered Bond Guarantee. If the Covered Bond Swap Provider does not meet its payment obligations to the LLP under the relevant Covered Bond Swap and the Covered Bond Swap Provider does not make a termination payment that has become due from it to the LLP, the LLP may have a larger shortfall in funds with which to make payments under the Covered Bond Guarantee with respect to the Covered Bonds than if the Covered Bond Swap Provider's payment obligations coincided with LLP's payment obligations under the Covered Bond Guarantee. Hence, the difference in timing between the obligations of the LLP and the Covered Bond Swap Provider under the Covered Bond Swaps may affect the LLP's ability to make payments under the Covered Bond Guarantee with respect to the Covered Bonds.

### **Limited description of the Portfolio**

Covered Bondholders will not receive detailed statistics or information in relation to the Loans in the Portfolio because it is expected that the constitution of the Portfolio may constantly change due to, for instance:

- the Sellers selling Loans and their Related Security (or new types of Loans and their Related Security) to the LLP;
- New Sellers acceding to the Transaction and selling Loans and their Related Security (or new types of Loans and their Related Security) to the LLP; and
- each Seller repurchasing Loans and their Related Security pursuant to its obligations under, or its right of pre-emption under, the Mortgage Sale Agreement.

However, each Loan will be required to meet the Eligibility Criteria and the Representations and Warranties set out in the Mortgage Sale Agreement – see *Summary of the Principal Documents – Mortgage Sale Agreement – Sale by Sellers of Loans and Related Security* (although the Eligibility Criteria and Representations and Warranties may change in certain circumstances – see *The Security Trustee may agree to modifications to the Transaction Documents without the Secured Creditors' prior consent* above). In addition, the Asset Coverage Test is intended to ensure that the Adjusted Aggregate Loan Amount is an amount equal to or in excess of the aggregate Principal Amount Outstanding of the Covered Bonds for so long as Covered Bonds remain outstanding and the Cash Manager will provide monthly reports that will set out certain information in relation to the Asset Coverage Test.

### **Scottish and Northern Irish Loans**

It should be noted that Loans and their Related Security governed by Scots law and relating to Scottish properties were included in the Portfolio on the First Transfer Date and may also be sold to the LLP in the future. It is also intended to add Loans and their Related Security governed by Northern Irish law and relating

to Northern Irish properties in the future. The consent of Covered Bondholders will not be obtained in relation to any changes required to the Transaction Documents in order to include Northern Irish loans in the Portfolio.

### **Fixed charges may take effect under English law as floating charges**

Pursuant to the terms of the Deed of Charge, the LLP has purported to grant fixed charges over, amongst other things, its interests in the English Loans and their Related Security, the Substitution Assets and its rights and benefits in the LLP Accounts and all Authorised Investments purchased from time to time.

The law in England and Wales relating to the characterisation of fixed charges is unsettled. The fixed charges purported to be granted by the LLP may take effect under English law as floating charges only, if, for example, it is determined that the Security Trustee does not exert sufficient control over the Charged Property for the security to be said to “fix” over those assets. If the charges take effect as floating charges instead of fixed charges, then the claims of the Security Trustee will be subject to the matters which are given priority over a floating charge by law, including (*inter alia*) prior charges, certain subsequent charges, the prescribed part referred to above, the expenses of any administration, the claims of preferential creditors and, following the changes made by the Companies Act 2006, the expenses of any winding up.

The Enterprise Act 2002 abolished the preferential status of certain Crown debts (including the claims of the United Kingdom tax authorities). However, certain employee claims (in respect of contributions to pension schemes and wages) still have preferential status. In this regard, it should be noted that the LLP has agreed in the Transaction Documents not to have any employees. In addition, any administrative receiver, administrator or liquidator appointed in respect of the LLP will be required to set aside the prescribed percentage or percentages of the floating charge realisations (as described above, under the *Enterprise Act 2002*) in respect of the floating charges contained in the Deed of Charge.

For further information on the effect of the Enterprise Act 2002 coming into effect, see *Changes of law – Enterprise Act 2002* above.

### **Maintenance of Portfolio**

*Asset Coverage Test:* Pursuant to the terms of the Mortgage Sale Agreement, each Seller will agree to use all reasonable efforts to transfer Loans and their Related Security to the LLP in order to ensure that the Portfolio is in compliance with the Asset Coverage Test. In consideration thereof, the relevant Seller will receive a combination of (i) a cash payment paid by the LLP and/or (ii) the relevant Seller will be treated as having made a Capital Contribution to the LLP (in an amount up to the difference between the Current Balance of the Loans sold by the relevant Seller to the LLP as at the relevant Transfer Date and the cash payment (if any) paid by the LLP for such Loans) and (iii) Deferred Consideration.

Alternatively, the Members of the LLP (other than the Liquidation Member) may make a Cash Capital Contribution to the LLP pursuant to the LLP Deed in order to ensure that the LLP is in compliance with the Asset Coverage Test. If a breach of the Asset Coverage Test occurs which is not cured on the next Calculation Date, this would constitute an HBOS Event of Default. There is no specific recourse by the LLP to the Sellers in respect of the failure to sell Loans and their Related Security to the LLP nor is there any specific recourse to the Members if they do not make Cash Capital Contributions to the LLP.

*Amortisation Test:* Pursuant to the LLP Deed, the LLP and the Members (other than the Liquidation Member) must ensure that on each Calculation Date following service of a Notice to Pay on the LLP but prior to the service of an LLP Acceleration Notice, the Amortisation Test Aggregate Loan Amount is in an amount at least equal to the aggregate Principal Amount Outstanding under the Covered Bonds. The

Amortisation Test is intended to ensure that the assets of the LLP do not fall below a certain threshold to ensure that the assets of the LLP are sufficient to meet its obligations under the Covered Bond Guarantee.

If the collateral value of the Portfolio has not been maintained in accordance with the terms of the Asset Coverage Test or the Amortisation Test, then that may affect the realisable value of the Portfolio or any part thereof (both before and after the occurrence of an LLP Event of Default) and/or the ability of the LLP to make payments under the Covered Bond Guarantee.

Prior to the occurrence of an HBOS Event of Default, the Asset Monitor will test the calculations performed by the Cash Manager in respect of the Asset Coverage Test once each year on the Calculation Date immediately preceding each anniversary of the Programme Date and more frequently in certain circumstances. Following the occurrence of an HBOS Event of Default, the Asset Monitor will be required to test the calculations performed by the Cash Manager in respect of the Amortisation Test. See further – *Summary of Principal Documents – Asset Monitor Agreement*.

The Security Trustee shall not be responsible for monitoring compliance with, nor the monitoring of, the Asset Coverage Test, the Pre-Maturity Liquidity Test or the Amortisation Test or any other test, or supervising the performance by any other party of its obligations under any Transaction Document.

#### **Sale of Selected Loans and their Related Security prior to maturity of Hard Bullet Covered Bonds where Pre-Maturity Test is breached or following the occurrence of an HBOS Event of Default**

If the Pre-Maturity Test is breached, the LLP is obliged to sell Selected Loans and their Related Security (selected on a random basis) to seek to generate sufficient cash to enable the LLP to pay the final redemption amount, on any Hard Bullet Covered Bond, should the Issuer or Group Guarantors fail to pay. If a Notice to Pay is served on the LLP, then the LLP will be obliged to sell Selected Loans and their Related Security (selected on a random basis) in order to make payments to the LLP's creditors including to make payments under the Covered Bond Guarantee (see *Summary of the Principal Documents – LLP Deed – Sale of Selected Loans and their Related Security following an HBOS Event of Default*).

There is no guarantee that a buyer will be found to acquire Selected Loans and their Related Security at the times required and there can be no guarantee or assurance as to the price which may be able to be obtained, which may affect payments under the Covered Bond Guarantee.

#### **Realisation of Charged Property following the occurrence of an LLP Event of Default**

If an LLP Event of Default occurs and an LLP Acceleration Notice is served on the LLP, then the Security Trustee will be entitled to enforce the Security created under and pursuant to the Deed of Charge and the proceeds from the realisation of the Charged Property (together with all other amounts standing to the credit of the LLP Accounts) will be applied by the Security Trustee towards payment of all secured obligations in accordance with the Post-Enforcement Priority of Payments described in *Cashflows* below.

There is no guarantee that the proceeds of realisation of the Charged Property will be in an amount sufficient to repay all amounts due to the Secured Creditors (including the Covered Bondholders) under the Transaction Documents.

If an LLP Acceleration Notice is served on the LLP, then the Covered Bonds may be repaid sooner or later than expected or not at all.

**Factors that may affect the realisable value of the Portfolio or any part thereof or the ability of the LLP to make payments under the Covered Bond Guarantee**

Following the occurrence of an HBOS Event of Default and the service on the LLP of a Notice to Pay, the realisable value of Selected Loans and their Related Security comprised in the Portfolio may be reduced (which may affect the ability of the LLP to make payments under the Covered Bond Guarantee) by:

- no representations or warranties being given by the LLP or (unless otherwise agreed with the relevant Seller) the Sellers;
- default by Borrowers of amounts due on their Loans;
- changes to the lending criteria of the Sellers;
- the Loans of New Sellers being included in the Portfolio;
- the LLP not having legal title to the Loans in the Portfolio;
- set-off risks in relation to some types of Loans in the Portfolio;
- limited recourse to the Sellers;
- certain regulatory considerations that could lead to some of the Loans or their Related Security being unenforceable, cancellable or subject to set-off, or some of their terms being unenforceable; and
- decisions of the Ombudsman, which could lead to some terms of the Loans being varied.

Each of these factors is considered in more detail below. However, it should be noted that the Asset Coverage Test, the Amortisation Test and the Eligibility Criteria are intended to ensure that there will be an adequate amount of Loans in the Portfolio and moneys standing to the credit of the GIC Account to enable the LLP to repay the Covered Bonds following an HBOS Event of Default and service of a Notice to Pay on the LLP and accordingly it is expected (but there is no assurance) that Selected Loans and their Related Security could be realised for sufficient values to enable the LLP to meet its obligations under the Covered Bond Guarantee.

***No warranties to be given by the LLP or the Sellers if Selected Loans and their Related Security are to be sold***

Following a breach of the Pre-Maturity Test (see *Credit Structure – Pre-Maturity Liquidity* below) and/or the occurrence of an HBOS Event of Default, the LLP will be obliged to sell Selected Loans and their Related Security to third party purchasers, subject to a right of pre-emption enjoyed by the Sellers pursuant to the terms of the Mortgage Sale Agreement (see *Summary of the Principal Documents – LLP Deed – Method of Sale of Selected Loans and their Related Security*). In respect of any sale of Selected Loans and their Related Security to third parties, however, the LLP will not be permitted to give warranties or indemnities in respect of those Selected Loans and their Related Security (unless expressly permitted to do so by the Security Trustee). There is no assurance that the Sellers would give any warranties or representations in respect of the Selected Loans and their Related Security. Any Representations or Warranties previously given by the Sellers in respect of the Loans in the Portfolio may not have value for a third party purchaser if the Sellers are then insolvent. Accordingly, there is a risk that the realisable value of the Selected Loans and their Related Security could be adversely affected by the lack of representations and warranties which in turn could adversely affect the ability of the LLP to meet its obligations under the Covered Bond Guarantee.

### ***Default by Borrowers in paying amounts due on their Loans***

Borrowers may default on their obligations due under the Loans. Defaults may occur for a variety of reasons. The Loans are affected by credit, liquidity and interest rate risks. Various factors influence mortgage delinquency rates, prepayment rates, repossession frequency and the ultimate payment of interest and principal, such as changes in the national or international economic climate, regional economic or housing conditions, changes in tax laws, interest rates, inflation, the availability of financing, yields on alternative investments, political developments and government policies. Other factors in Borrowers' individual, personal or financial circumstances may affect the ability of Borrowers to repay the Loans. Loss of earnings, illness, divorce and other similar factors may lead to an increase in delinquencies by and bankruptcies of Borrowers, and could ultimately have an adverse impact on the ability of Borrowers to repay the Loans. In addition, the ability of a Borrower to sell a property given as security for a Loan at a price sufficient to repay the amounts outstanding under that Loan will depend upon a number of factors, including the availability of buyers for that property, the value of that property and property values in general at the time.

Prior to the occurrence of an HBOS Event of Default or an LLP Event of Default and following receipt of a Defaulted Loans Notice (as defined below) each Seller has agreed or will agree, as applicable, to repurchase each Defaulted Loan sold by it to the LLP for an amount equal to the Current Balance of the relevant Loan plus expenses. Defaulted Loans that are not repurchased will be omitted from any calculation of the Asset Coverage Test.

### ***Changes to the Lending Criteria of the Sellers***

Each of the Loans originated by each Seller will have been originated in accordance with its Lending Criteria at the time of origination. It is expected that each Seller's Lending Criteria will generally consider type of property, term of loan, age of applicant, the loan-to-value ratio, mortgage indemnity guarantee policies, high loan-to-value fees, status of applicants and credit history. In the event of the sale or transfer of any Loans and Related Security (sold by any Seller) to the LLP, each Seller will warrant only that such Loans and Related Security were originated in accordance with such Seller's Lending Criteria applicable at the time of origination. Each Seller retains the right to revise its Lending Criteria from time to time. If the Lending Criteria change in a manner that affects the creditworthiness of the Loans, that may lead to increased defaults by Borrowers and may affect the realisable value of the Portfolio, or part thereof, and the ability of the LLP to make payments under the Covered Bond Guarantee. As noted above, however, Defaulted Loans that are not repurchased by the relevant Seller thereof will be excluded from the calculation of the Asset Coverage Test.

### ***The Loans of New Sellers may be included in the Portfolio***

New Sellers may sell Loans and their Related Security to the LLP. However, this would only be permitted if the conditions precedent relating to New Sellers acceding to the Transaction (more fully described under *Summary of the Principal Documents – Mortgage Sale Agreement – Original Seller and New Sellers*, below) are met.

Any Loans originated by a New Seller will have been originated in accordance with the Lending Criteria of the New Seller, which may differ from the Lending Criteria of Loans originated by the Original Seller. If the Lending Criteria differ in a way that affects the creditworthiness of the Loans, that may lead to increased defaults by Borrowers and may affect the realisable value of the Portfolio or any part thereof or the ability of the LLP to make payments under the Covered Bond Guarantee. As noted above, however, Defaulted Loans that are not repurchased by the relevant Seller thereof will be excluded from the calculation of the Asset Coverage Test.



***The LLP does not have legal title to the Loans in the Portfolio on the relevant Transfer Date***

The sale by the Sellers to the LLP of English Loans and their Related Security will take effect by way of an equitable assignment. The sale by the Sellers to the LLP of Scottish Loans will be given effect by way of Scottish Declarations of Trust under which the beneficial interest in the Scottish Loans will be transferred to the LLP. As a result, legal title to English Loans and their Related Security and Scottish Loans and their Related Security will remain with the relevant Seller. The LLP, however, will have the right to demand that the relevant Seller give it legal title to the Loans and the Related Security in the circumstances described in *Summary of the Principal Documents – Mortgage Sale Agreement – Transfer of title to the Loans to the LLP* and until then the LLP will not give notice of the sale of the English Loans and their Related Security to any Borrower or apply to the Land Registry or the Central Land Charges Registry to register or record its equitable interest in the Loans and their Related Security or take any steps to perfect its title to the Scottish Loans and their Related Security.

Since the LLP has not obtained legal title to the Loans or their Related Security, the following risks exist:

- first, if the relevant Seller wrongly sells a Loan and its Related Security, which has already been sold to the LLP, to another person and that person acted in good faith and did not have notice of the interests of the LLP in the Loan and its Related Security, then she or he might obtain good title to the Loan and its Related Security, free from the interests of the LLP. If this occurred then the LLP would not have good title to the affected Loan and its Related Security and it would not be entitled to payments by a Borrower in respect of that Loan. However, the risk of third party claims obtaining priority to the interests of the LLP would be likely to be limited to circumstances arising from a breach by the relevant Seller of its contractual obligations or fraud, negligence or mistake on the part of the relevant Seller or the LLP or their respective personnel or agents;
- second, the rights of the LLP may be subject to the rights of the Borrowers against the relevant Seller, such as rights of set-off, which occur in relation to transactions or deposits made between Borrowers and the relevant Seller, and the rights of Borrowers to redeem their mortgages by repaying the Loans directly to the relevant Seller; and
- third, unless the LLP has perfected the assignment or assignation (as appropriate) of the Loans (which it is only entitled to do so in certain circumstances), the LLP would not be able to enforce any Borrower's obligations under any Loan or mortgage itself but would have to join the relevant Seller as a party to any legal proceedings.

If any of the risks described in the above three bullet points were to occur then the realisable value of the Portfolio or any part thereof and/or the ability of the LLP to make payments under the Covered Bond Guarantee may be affected.

Once notice has been given to the Borrowers of the assignment or assignation (as appropriate) of the Loans and their Related Security to the LLP, independent set-off rights which a Borrower has against a Seller (such as, for example, set-off rights associated with Borrowers holding deposits with Sellers) will crystallise and further rights of independent set-off would cease to accrue from that date and no new rights of independent set-off could be asserted following that notice. Set-off rights arising under "transaction set-off" (which are set-off claims arising out of a transaction connected with the Loan) will not be affected by that notice.

It should be noted, however, that the Asset Coverage Test seeks to take account of the potential set-off risk associated with Borrowers holding deposits with the Sellers (although there is no assurance that all such risks will be accounted for). Further, for so long as the LLP does not have legal title, each Seller will



undertake for the benefit of the LLP and the Secured Creditors that it will lend its name to, and take such other steps as may be reasonably required by the LLP and/or the Security Trustee in relation to, any legal proceedings in respect of the Loans and their Related Security.

***Set-off risks in relation to some types of Loans may adversely affect the value of the Portfolio or any part thereof***

As described in the immediately preceding risk factor, the sale by each Seller to the LLP of English Loans will be given effect by an equitable assignment, with each sale of Scottish Loans being given effect by a Scottish Declaration of Trust. As a result, legal title to both the English Loans and the Scottish Loans and their Related Security sold by Sellers to the LLP will remain with the relevant Seller. Therefore, the rights of the LLP may be subject to the direct rights of the Borrowers against the relevant Seller, including rights of set-off existing prior to notification to the Borrowers of the assignment or assignment (as appropriate) of the Loans. Some of the Loans in the Portfolio may have increased risks of set-off, because the relevant Seller is required to make payments under them to the Borrowers. For instance:

- under a Flexible Loan, the Borrower is permitted to make larger repayments than are due on a given payment date or draw further amounts under the Loan in some circumstances. Any drawings under Flexible Loans will be funded solely by the relevant Seller;
- under a delayed cashback loan, the Borrower is entitled to receive a payment from the relevant Seller as an incentive for entering into the Loan at a specified time following completion of the Loan. Any such payment will be funded solely by the relevant Seller.

In addition, the Original Seller offers a further advance product called Home Cash Reserve, which is a facility linked to a Borrower's mortgage whereby a Borrower may draw additional funds from time to time. A Borrower must have had a Halifax mortgage for a minimum of three months to qualify for the Home Cash Reserve. Where originated by the Original Seller before 31 October 2004, the total amount of the facility was not permitted to be less than £25,005. Borrowers must draw down amounts of at least £1,000 at a time. Funds drawn under the Home Cash Reserve are added to the mortgage loan. No redraw facility is available under the Home Cash Reserve.

None of the loans in the expected portfolio obliges the Original Seller to make further advances save for retentions and Home Cash Reserve withdrawals. However, some loans in the expected portfolio may have further advances made on them prior to their being sold to the mortgages trustee and new loans added to the portfolio in the future may have had further advances made on them prior to that time.

New products offered by the Sellers in the future may have similar characteristics involving payments due by the relevant Seller to the Borrower.

Set-off rights may occur if a Seller fails to make the payments due to the Borrower – for example, where the relevant Seller fails to advance to a Borrower a drawing under a Flexible Loan or a drawing under a Home Cash Reserve Loan which the Borrower is entitled to draw or if a Seller fails to pay to a Borrower any delayed cashback which the relevant Seller had agreed to pay to that Borrower after completion of the relevant Loan.

If the relevant Seller fails to make the payment due, then the relevant Borrower may set off the amount of any damages claim arising from that Seller's breach of contract against the relevant Seller's (and, as assignee of the Loans, the LLP's) claim for payment of principal and/or interest under the Loan as and when it becomes due. These set-off claims will constitute "transaction set-off" as described in the immediately preceding risk factor.

The amount of the damages claim in respect of a failure by the relevant Seller to make the payment due will, in many cases, be the cost to the Borrower of finding an alternative source of finance. The Borrower may obtain a Loan elsewhere in which case the damages would be equal to any difference in the borrowing costs together with any consequential losses, namely the associated costs of obtaining alternative funds (for example, legal fees and survey fees). If the Borrower is unable to obtain an alternative loan, he or she may have a claim in respect of other losses arising from the relevant Seller's breach of contract where there are special circumstances communicated by the Borrower to the Seller at the time the Loan was taken out.

In respect of a delayed cashback loan, the damages claim of the relevant Borrower is likely to be in an amount equal to the amount due under the delayed cashback loan together with interest and expenses and consequential losses (if any).

Further there may be circumstances in which:

- a Borrower may seek to argue that certain drawings under Flexible Loans and Home Cash Reserve Loans are unenforceable by virtue of non-compliance with the Consumer Credit Act 1974 (the CCA); or
- certain drawings may rank behind liens created by a Borrower after the date on which the Borrower entered into its mortgage with a Seller.

A Borrower may also attempt to set off against his or her mortgage payments an amount greater than the amount of his or her damages claim. In that case, the relevant Servicer will be entitled to take enforcement proceedings against the Borrower although the period of non-payment by the Borrower is likely to continue until a judgment or decree is obtained.

The exercise of set-off rights by Borrowers may adversely affect the realisable value of the Portfolio and/or the ability of the LLP to make payments under the Covered Bond Guarantee. The Asset Coverage Test seeks to take account of the set-off risk including any set-off risk relating to Flexible Loans in the Portfolio (although there is no assurance that such risks will be accounted for).

### ***Limited recourse to the Sellers***

The LLP will not, and the Bond Trustee and the Security Trustee will not, undertake any investigations, searches or other actions on any Loan or its Related Security and will rely instead on the Representations and Warranties given in the Mortgage Sale Agreement by the relevant Sellers in respect of the Loans sold by them to the LLP.

If any Loan sold by a Seller does not materially comply with any of the Representations and Warranties made by that Seller as at the Transfer Date of that Loan, then the relevant Seller will be required to remedy the breach within 20 London Business Days of that Seller becoming aware of the same or of receipt by it of a notice from the LLP requiring the Seller to remedy the breach.

If the relevant Seller fails to remedy the breach of a Representation and Warranty within 20 London Business Days, then that Seller will be required to repurchase on or before the next following Calculation Date (or such other date that may be agreed between the LLP and the Seller) the relevant Loan or Loans under the relevant Mortgage Account and their Related Security at their Current Balance as of the date of repurchase together with expenses.

In addition, each Seller will be required to repurchase Defaulted Loans in the Portfolio sold by it to the LLP, within 20 London Business Days of that Seller becoming aware of the Defaulted Loan in the Portfolio or of receipt by it of a notice from the LLP. The relevant Seller will be required to repurchase the relevant

Loan or Loans under the relevant Mortgage Account and their Related Security at their Current Balance as at the date of repurchase together with expenses.

There can be no assurance that the relevant Seller will have the financial resources to repurchase the Loan or Loans under the relevant Mortgage Account and their Related Security. However, if the relevant Seller does not repurchase those Loans and their Related Security which are in breach of the Representations and Warranties or does not repurchase those Loans and their Related Security which are Defaulted Loans, then the Current Balance of those Loans will be excluded from the Calculation of the Asset Coverage Test. There is no further recourse to the Seller or the Issuer in respect of a breach of a Representation or Warranty or failure to buy back a Defaulted Loan. There is no other recourse to the assets of the Sellers if an HBOS Event of Default occurs or an LLP Event of Default occurs.

### ***Certain Regulatory Considerations***

#### *Office of Fair Trading, Financial Services Authority and other regulatory authorities*

In the United Kingdom, the Office of Fair Trading (the **OFT**) is responsible for the issue of licences under, and the superintendence of the working and enforcement of, the CCA, related consumer credit regulations and other consumer protection legislation. The OFT may review businesses and operations, provide guidelines to follow and take actions when necessary with regard to the mortgage market in the United Kingdom.

Currently, a credit agreement is regulated by the CCA where: (a) the borrower is or includes an individual; (b) the amount of “credit” as defined in the CCA does not exceed the financial limit, which is £25,000 for credit agreements made on or after 1 May 1998, or lower amounts for credit agreements made before that date; and (c) the credit agreement is not an exempt agreement under the CCA (for example, it is intended that a Regulated Mortgage Contract under the FSMA is an exempt agreement under the CCA).

Any credit agreement that is wholly or partly regulated by the CCA or treated as such has to comply with requirements under the CCA as to licensing of lenders and brokers, documentation and procedures of credit agreements, and (in so far as applicable) pre-contract disclosure. If it does not comply with those requirements, then to the extent that the credit agreement is regulated by the CCA or treated as such, it is unenforceable against the borrower: (a) without an order of the OFT, if the lender or any broker does not hold the required licence at the relevant time; (b) totally, if the credit agreement is made before 6 April 2007 and if the form to be signed by the borrower is not signed by the borrower personally or omits or mis-states a “prescribed term”; or (c) without a court order in other cases and, in exercising its discretion whether to make the order, the court would take into account any prejudice suffered by the borrower and any culpability of the lender.

Any credit agreement intended to be a Regulated Mortgage Contract under the FSMA or unregulated might instead be wholly or partly regulated by the CCA or treated as such because of technical rules on: (a) determining whether any credit under the CCA arises, or whether the financial limit of the CCA is exceeded; (b) determining whether the credit agreement is an exempt agreement under the CCA; and (c) changes to credit agreements.

A court order under Section 126 of the CCA is necessary to enforce a land mortgage (including, in Scotland, a standard security) securing a credit agreement to the extent that the credit agreement is regulated by the CCA or treated as such. In dealing with such application, the court has the power, if it appears just to do so, to amend the credit agreement or to impose conditions upon its performance or to make a time order (for example, giving extra time for arrears to be cleared).

Under Section 75 of the CCA in certain circumstances: (a) the lender is liable to the borrower in relation to misrepresentation and breach of contract by a supplier in a transaction financed by the lender, where the related credit agreement is or is treated as entered into under pre-existing arrangements, or in contemplation of future arrangements, between the lender and the supplier; and (b) the lender has a statutory indemnity from the supplier against such liability, subject to any agreement between the lender and the supplier. The borrower may set off the amount of the claim against the lender against the amount owing by the borrower under the loan or under any other loan that the borrower has taken. Any such set-off may adversely affect the realisable value of the Loans in the Portfolio and accordingly the ability of the LLP to meet its obligations under the Covered Bond Guarantee.

The Consumer Credit Act 2006 (the **CCA 2006**) was enacted on 30 March 2006. As and when implemented, the CCA 2006 updates and augments the CCA.

From 6 April 2007, the “extortionate credit” regime has been replaced by an “unfair relationship” test, which will have retrospective effect in some cases, explicitly imposing liability to repay the borrower on both the originator and any assignee, such as the LLP. In applying the new unfair relationship test, the courts will be able to consider a wider range of circumstances surrounding the transaction, including the creditor’s conduct before and after making the agreement. There is no statutory definition of the word “unfair”, as the intention is for the test to be flexible and subject to judicial discretion.

The courts may, but are not obliged to, look solely to the CCA 2006 for guidance. The FSA principles for businesses may also be relevant, and apply to the way contract terms are used in practice and not just the way they are drafted. Importantly, the test has retrospective application after a transitional period. Once the debtor alleges that an unfair relationship exists, then the burden of proof is on the creditor to prove the contrary.

An alternative dispute resolution scheme for consumer credit matters is run by the Ombudsman (as described below). From April 2007, the scheme is mandatory for all businesses licensed under the CCA. The CCA 2006 also introduces an independent Consumer Credit Appeals Tribunal.

The UK Department of Trade and Industry (the **DTI**) has indicated that, from 6 April 2008, the statutory upper financial limit of £25,000 for CCA regulation will be removed, thereby widening the scope of the CCA’s regulation. For example, the CCA would then regulate potentially most buy-to-let loans, although the DTI has indicated that it intends to address this consequence for buy-to-let loans.

The OFT is to be given far broader powers under the CCA 2006. For instance, it will be able to apply civil penalties, will have far greater powers of investigation and be able to issue indefinite standard licences. The CCA 2006 obliges creditors to comply with more stringent information requirements. The DTI has indicated that, from 2008, lenders will be obliged to give customers clearer and more regular information on their credit accounts.

These changes to the CCA may adversely affect the ability of the LLP to meet its obligations under the Covered Bond Guarantee.

The Sellers have interpreted certain technical rules under the CCA in a way common with many other lenders in the mortgage market. If such interpretation were held to be incorrect by a court or the Ombudsman, then a credit agreement, to the extent that it is regulated by the CCA or treated as such, would be unenforceable as described above. If such interpretation were challenged by a significant number of Borrowers, then this could lead to significant disruption and shortfall in the income of the LLP. Court decisions have been made on technical rules under the CCA against certain mortgage lenders, but such decisions are very few and are generally county court decisions not binding on other courts.

The Sellers have given or, as applicable, will give warranties to the LLP in the Mortgage Sale Agreement that, among other things, each Loan and its Related Security is enforceable (subject to certain exceptions). If a Loan or its Related Security does not comply with these warranties, and if the default cannot be or is not cured within 20 London business days, then the relevant Seller will be required to repurchase the Loans under the relevant mortgage account and their Related Security from the LLP.

In the United Kingdom, regulation of residential mortgage business by the FSA under the FSMA came into force on 31 October 2004, the date known as “N(M)”. Entering into, arranging or advising in respect of and administering Regulated Mortgage Contracts, and agreeing to do any of these things, are (subject to applicable exemptions) regulated activities under the FSMA.

A credit agreement is a **Regulated Mortgage Contract** under the FSMA if, at the time it is entered into on or after N(M): (a) the Borrower is an individual or trustee; (b) the contract provides for the obligation of the borrower to repay to be secured by a first legal mortgage or, in Scotland, a first ranking standard security on land (other than timeshare accommodation) in the UK; and (c) at least 40 per cent. of that land is used, or is intended to be used, as or in connection with a dwelling by the borrower or (in case of credit provided to trustees) by an individual who is a beneficiary of the trust, or by a related person.

The main effects are that, on or after N(M), unless an exclusion or exemption applies: (a) each entity carrying on a regulated mortgage activity by way of business has to hold authorisation and permission from the FSA to carry on that activity; and (b) generally, each financial promotion in respect of an agreement relating to qualifying credit has to be issued or approved by a person holding authorisation and permission from the FSA. If requirements as to authorisation and permission of lenders and brokers or as to issue and approval of financial promotions are not complied with, a Regulated Mortgage Contract will be unenforceable against the borrower except with the approval of a court. An unauthorised person who administers a Regulated Mortgage Contract entered into on or after N(M) may commit a criminal offence, but this will not render the contract unenforceable against the Borrower.

Any credit agreement intended to be a Regulated Mortgage Contract under the FSMA might instead be wholly or partly regulated by the CCA or treated as such, or unregulated, and any credit agreement intended to be unregulated might instead be a Regulated Mortgage Contract under the FSMA, because of technical rules on: (a) determining whether the credit agreement or any part of it falls within the definition of “Regulated Mortgage Contract”; and (b) changes to credit agreements.

The Sellers are required to hold, and hold, authorisation and permission to enter into and to administer and, where applicable, to advise in respect of Regulated Mortgage Contracts. Subject to any exemption, brokers will be required to hold authorisation and permission to arrange and, where applicable, to advise in respect of Regulated Mortgage Contracts.

The Issuer and LLP are not and do not propose to be authorised persons under the FSMA. The Issuer and LLP do not require authorisation in order to acquire legal or beneficial title to a Regulated Mortgage Contract. The Issuer and LLP do not carry on the regulated activity of administering in relation to Regulated Mortgage Contracts by having them administered pursuant to an administration agreement by an entity having the required FSA authorisation and permission. If such administration agreement terminates, however, the Issuer and LLP will have a period of not more than one month in which to arrange for mortgage administration to be carried out by a replacement servicer having the required FSA authorisation and permission. In addition, on and after N(M) no variation has been or will be made to the Loans and no Further Advance or Product Switch has been or will be made in relation to a Loan, where it would result in the Issuer or the LLP arranging or advising in respect of, administering or entering into a Regulated Mortgage Contract or agreeing to carry on any of these activities, if the Issuer or the LLP would be required to be authorised under the FSMA to do so.



The FSA Mortgages and Home Finance: Conduct of Business Sourcebook (**MCOB**), which sets out its rules for regulated mortgage activities, came into force on 31 October 2004. These rules cover, *inter alia*, certain pre-origination matters such as financial promotion and pre-application illustrations, pre-contract and start-of-contract and post-contract disclosure, contract changes, charges, and arrears and repossessions. FSA rules for prudential and authorisation requirements for mortgage firms, and for extending the appointed representatives regime for mortgages, came into force on 31 October 2004.

A borrower who is a private person is entitled to claim damages for loss suffered as a result of any contravention by an authorised person of an FSA rule, and may set off the amount of the claim against the amount owing by the borrower under the loan or any other loan that the borrower has taken (or exercise analogous rights in Scotland). Any such set-off may adversely affect the realisable value of the Loans in the Portfolio and accordingly the ability of the LLP to meet its obligations under the Covered Bond Guarantee.

So as to avoid dual regulation, it is intended that Regulated Mortgage Contracts will not be regulated by the CCA, and the relevant regulations under the FSMA are designed to clarify the position in this regard. This exemption only affects credit agreements made on or after N(M), and credit agreements made before N(M) but subsequently changed such that a new contract is entered into on or after N(M) and constitutes a separate Regulated Mortgage Contract. A court order under Section 126 of the CCA is, however, necessary to enforce a land mortgage (including, in Scotland, a standard security) securing a Regulated Mortgage Contract to the extent that it would, apart from this exemption, be regulated by the CCA or be treated as such.

No assurance can be given that additional regulatory changes by the OFT, the FSA or any other regulatory authority will not arise with regard to the mortgage market in the United Kingdom generally, any Seller's particular sector in that market or specifically in relation to the Sellers. Any such action or developments or compliance costs may have a material adverse effect on the Sellers, the Issuer, the Servicers, the LLP and their respective businesses and operations. This may adversely affect the ability of the LLP to dispose of the Portfolio or any part thereof in a timely manner and/or the realisable value of the Portfolio or any part thereof, and accordingly affect the ability of the LLP to meet its obligations under the Covered Bond Guarantee when due.

Prior to N(M), in the United Kingdom, self-regulation of mortgage business existed under the Mortgage Code (the **CML Code**) issued by the Council of Mortgage Lenders (the **CML**). The Original Seller subscribed to the CML Code and on and from N(M), as an authorised person, has been subject to the FSA requirements in MCOB. Membership of the CML and compliance with the CML Code were voluntary. The CML Code set out minimum standards of good mortgage business practice, from marketing to lending procedures and dealing with borrowers experiencing financial difficulties. Since 30 April 1998 lender-subscribers to the CML Code could not accept mortgage business introduced by intermediaries who were not registered with (before 1 November 2000) the Mortgage Code Register of Intermediaries or (on and after 1 November 2000 until 31 October 2004) the Mortgage Code Compliance Board. Complaints relating to breach of the CML Code were dealt with by the relevant scheme, such as the Banking Ombudsman Scheme or the Mortgage Code Arbitration Scheme.

In September 2002, the European Commission published a proposal for a directive of the European Parliament and of the Council on consumer credit. In its original form, the proposal applied to certain mortgage products. This proposal, and an amended proposal published in October 2004, were met with significant opposition.

In July 2005, the European Commission published a Green Paper on mortgage credit, in which it announced its intention that loans secured by a mortgage on land will be excluded from the proposed Directive but will be covered by any initiatives resulting from the Green Paper process. The European Commission held a public hearing on the Green Paper and the responses to it in December 2005 and expects to publish a White Paper in September 2007, setting out its consultation findings, which may possibly

include a mortgage directive. In October 2005, the European Commission published a further amended form of the proposed consumer credit directive, which provides that (subject to certain exceptions) loans not exceeding Euro 50,000 will be regulated, but that loans secured by a mortgage on land will be excluded from the proposed Directive. When the proposed Directive, which may be further substantially amended before it is brought into effect, is adopted Member States will then have a further two years in which to bring national implementing legislation into force.

Until the final text of the Directive and any initiatives resulting from the Green Paper process and any White Paper, are decided and the details of the United Kingdom implementing legislation are published, it is not certain what effect the adoption and implementation of the Directive or initiatives would have on the Sellers, the Issuer, the Servicers, the LLP and their respective businesses and operations. This may adversely affect the ability of the LLP to dispose of the Portfolio or any part thereof in a timely manner and/or the realisable value of the Portfolio or any part thereof, and accordingly affect the ability of the LLP to meet its obligations under the Covered Bond Guarantee when due.

#### *Distance Marketing*

The Financial Services (Distance Marketing) Regulations 2004 apply to, *inter alia*, credit agreements entered into on or after 31 October 2004 by means of distance communication (i.e. without any substantive simultaneous physical presence of the originator and the borrower). A Regulated Mortgage Contract under the FSMA, if originated by a UK lender from an establishment in the UK, will not be cancellable under these regulations. Certain other credit agreements will be cancellable under these regulations if the borrower does not receive prescribed information at the prescribed time. Where the credit agreement is cancellable under these regulations, the borrower may send notice of cancellation at any time before the end of the fourteenth day after the day on which the cancellable agreement is made, where all the prescribed information has been received, or, if later, the borrower receives the last of the prescribed information.

If the borrower cancels the credit agreement under these regulations then:

- (a) the borrower is liable to repay the principal and any other sums paid by the originator to the borrower under or in relation to the cancelled agreement, within 30 days beginning with the day of the borrower sending the notice of cancellation or, if later, the originator receiving notice of cancellation;
- (b) the borrower is liable to pay interest, or any early repayment charge or other charge for credit under the cancelled agreement, only if the borrower received certain prescribed information at the prescribed time and if other conditions are met; and
- (c) any security provided in relation to the contract is to be treated as never having had effect.

#### *Unfair Terms in Consumer Contracts Regulations 1994 and 1999*

In the United Kingdom, the Unfair Terms in Consumer Contracts Regulations 1999 as amended (the **1999 Regulations**), which, together with (in so far as applicable) the Unfair Terms in Consumer Contracts Regulations 1994 (together with the 1999 Regulations, the **UTCCR**), apply to agreements made on or after 1 July 1995 and affect all or almost all of the Loans, provide that:

- a consumer may challenge a standard term in an agreement on the basis that it is “unfair” within the UTCCR and therefore not binding on the consumer; and
- the OFT and any “qualifying body” within the 1999 Regulations (such as the FSA) may seek to enjoin (or in Scotland interdict) a business from relying on unfair terms.



The UTCCR will not generally affect “core terms” which define the main subject matter of the contract, such as the borrower’s obligation to repay the principal (provided that these terms are written in plain and intelligible language and are drawn adequately to the consumer’s attention), but may affect terms that are not considered to be core terms, such as the lender’s power to vary the interest rate.

For example, if a term permitting the lender to vary the interest rate (as the Original Seller is permitted to do) is found to be unfair, the borrower will not be liable to pay interest at the increased rate or, to the extent that the borrower has paid it, will be able, as against the lender, or any assignee such as the LLP, to claim repayment of the extra interest amounts paid or to set off the amount of the claim against the amount owing by the borrower under the loan or any other loan that the borrower has taken. Any such non-recovery, claim or set-off may adversely affect the realisable value of the Loans in the Portfolio and accordingly the ability of the LLP to meet its obligations under the Covered Bond Guarantee.

In February 2000, the OFT issued a guidance note on what the OFT considers to be fair terms and unfair terms for interest variation in mortgage contracts. Where the interest variation term does not provide for precise and immediate tracking of an external rate outside the lender’s control, and if the borrower is locked in, for example by an early repayment charge that is considered to be penalty, the term is likely to be regarded as unfair under the UTCCR unless the lender (i) notifies the affected borrower in writing at least 30 days before the rate change and (ii) permits the affected borrower to repay the whole loan during the next three months after the rate change, without paying the early repayment charge. The Original Seller has reviewed the guidance note and has concluded that its compliance with it will have no material adverse effect on the loans or its business. The guidance note has been withdrawn from the OFT website but may remain in effect as the OFT’s view and a factor that the FSA may take into account.

The division of responsibilities between the OFT and the FSA for enforcing the UTCCR is set out in concordats made between them in October 2001 and in July 2006. Generally, the FSA is responsible for enforcement of the UTCCR in Regulated Mortgage Contracts under the FSMA and other mortgage loans originated by lenders authorised by the FSA, and the OFT is responsible for enforcement of the UTCCR in other mortgage contracts.

In May 2005, the FSA issued a statement of good practice on fairness of terms in consumer contracts, which is relevant to firms authorised and regulated by the FSA in relation to products and services within the FSA’s regulatory scope. This statement provides that, for locked-in borrowers, a firm may consider drafting the contract to permit a change in the contract to be made only where any lock-in clause is not exercised. In the context of the OFT’s investigation into credit card default charges, the OFT on 5 April 2006 publicly announced that the principles the OFT considers should be applied in assessing the fairness of credit card default charges shall apply (or are likely to apply) also to analogous default charges in other agreements, including those for mortgages. In January 2007, the FSA issued a statement of good practice on mortgage exit administration fees. This statement provides that the lender should ensure that the fee represents in fact the cost of the administration services that the lender provides when a borrower exits the mortgage.

In August 2002, the Law Commission for England and Wales and the Scottish Law Commission issued a joint consultation LCCP No. 166/SLCDP 119 on proposals to rationalise the UK’s Unfair Contract Terms Act 1977 and the 1999 Regulations into a single piece of legislation and a final report, together with a draft bill on unfair terms, was published in February 2005. It is not proposed that there should be any significant increase in the extent of controls over terms in consumer contracts. Some changes are proposed, however, such as that (a) a consumer may also challenge a negotiated term in an agreement on the basis that it is “unfair” and “unreasonable” within the legislation and therefore not binding on the consumer; and (b) in any challenge by a consumer (but not by the OFT or a qualifying body) of a standard term or a negotiated term, the burden of proof lies on the business to show that the term is fair and reasonable. It is too early to tell how the proposals, if enacted, would affect the Loans.

No assurance can be given that changes in the 1999 Regulations, if enacted, or guidance on interest variation terms, will not have a material adverse effect on the Sellers, the Issuer, the Servicers, the LLP and their respective businesses and operations. This may adversely affect the ability of the LLP to dispose of the Portfolio or any part thereof in a timely manner and/or the realisable value of the Portfolio or any part thereof, and accordingly affect the ability of the LLP to meet its obligations under the Covered Bond Guarantee when due.

### ***Unfair Commercial Practices Directive 2005***

In May 2005, the European Parliament and the Council adopted a directive on unfair business-to-consumer commercial practices (the **Unfair Practices Directive**). Generally, this directive applies full harmonisation, which means that Member States may not impose more stringent provisions in the fields to which full harmonisation applies. By way of exception, this directive permits Member States to impose more stringent provisions in the fields of financial services and immovable property, such as mortgage loans.

The Unfair Practices Directive provides that enforcement bodies may take administrative action or legal proceedings against a commercial practice on the basis that it is “unfair” within the directive. This directive is intended to protect only collective interests of consumers, and so is not intended to give any claim, defence or right of set-off to an individual consumer.

The DTI published in December 2005 a consultation on implementing the Unfair Practices Directive into UK law, and in December 2006 a consultation on criminal sanctions under the implementing legislation. The FSA is taking the Unfair Practices Directive into account in reviewing its relevant rules, such as MCOB. Member States have until 12 June 2007 in which to bring national implementing legislation into force, subject to a transitional period until 12 June 2013 for applying full harmonisation in the fields to which it applies. It is too early to predict what effect the implementation of the Unfair Practices Directive would have on the Loans.

### ***Financial Ombudsman Service***

Under the FSMA, the Financial Ombudsman Service is required to make decisions on, among other things, complaints relating to activities and transactions under its jurisdiction on the basis of what, in the Ombudsman’s opinion, would be fair and reasonable in all circumstances of the case, taking into account, among other things, law and guidance. Transitional provisions exist by which certain complaints relating to breach of the CML Code occurring before N(M) may be dealt with by the Financial Ombudsman Service. Complaints brought before the Financial Ombudsman Service for consideration must be decided on a case-by-case basis, with reference to the particular facts of any individual case. Each case would first be adjudicated by an adjudicator. Either party to the case may appeal against the adjudication. In the event of an appeal, the case proceeds to a final decision by the Ombudsman.

As the Financial Ombudsman Service is required to make decisions on the basis of, among other things, the principles of fairness, and may order a money award to the borrower, it is not possible to predict how any future decision of the Financial Ombudsman Service would affect the realisable value of the Loans in the Portfolio and accordingly the ability of the LLP to meet its obligations under the Covered Bond Guarantee.

### **Decisions of the Ombudsman could lead to some terms of the Loans being varied, which may adversely affect payments under the Covered Bond Guarantee**

In January 2002, the Ombudsman made a determination on Halifax’s appeal to an earlier decision by an adjudicator at the Financial Ombudsman Service concerning a case involving HVR 1 and HVR 2 (a second Variable Base Rate that was made available to Borrowers by Halifax between 1 March 2001 and

1 February 2002). In March 2001, two joint Borrowers with a capped rate loan originated when Halifax offered only a single standard variable base rate contacted Halifax and requested that their loan be linked to HVR 2. Halifax informed the Borrowers that, because they were still in their product period, they could either transfer to HVR 2 when their product period expired or transfer to HVR 2 immediately and pay the applicable early repayment fee. The Borrowers complained to the Financial Ombudsman Service and, on 29 January 2002, on appeal by Halifax, the Ombudsman determined in the Borrowers' favour and recommended that Halifax recalculate the Borrowers' mortgage by reference to HVR 2 from the date when Halifax should have granted their request in March 2001, refund any overpayments and pay £150 for any inconvenience caused. HVR 2 was withdrawn and ceased to be available to new Borrowers with effect from 1 February 2002.

The Ombudsman's decision only applies to the two Borrowers and their particular circumstances, though other Borrowers may also complain to the Ombudsman. In March 2002, Halifax announced that Borrowers under loans who were in similar circumstances and who had asked to be transferred to HVR 2 when it was available would be invited to make a Product Switch to HVR 2 and to obtain a refund for all overpayments of interest since the date they had asked to be transferred. For each of those loans, the Borrowers would also receive £150 for any inconvenience caused. The Borrowers under loans who requested to be transferred after HVR 2 was withdrawn and before the announcement in March 2002 were not offered a switch or a refund, though Halifax has given or will give each of these customers an *ex gratia* payment of £100.

Since then, the Ombudsman has, in similar cases, confirmed that affected Borrowers were only entitled to a refund of overpayments of interest from the date when they asked to be transferred to HVR 2 and not from the date when HVR 2 first became available, and also that affected Borrowers were not entitled to apply to be transferred to HVR 2 after it was withdrawn.

Halifax does not believe that any decision of the Ombudsman to date or any other decision by any competent authority in the future (in respect of Halifax's two former variable base rates, HVR 1 and HVR 2) would affect the yield on the Loans in such a way as to have a material adverse effect on the ability of the LLP to meet its obligations under the Covered Bond Guarantee when due.

As regards other Borrowers, in the event that a decision (in respect of Halifax's Variable Base Rate) by the Ombudsman or any other competent authority finds that a Borrower's Loan should be linked to HVR 2, then that Borrower may set off the overpaid sum against the amount owing under his or her Loan if the Original Seller does not reimburse that Borrower. Any such non-recovery, claim or set-off ultimately may adversely affect the LLP's ability to make payments under the Covered Bond Guarantee.

### **Limited Liability Partnerships**

The LLP is a limited liability partnership. Limited liability partnerships, created by statute pursuant to the LLPA 2000, are bodies corporate and have unlimited capacity. A general description of limited liability partnerships is set out below under *Description of Limited Liability Partnerships*. This area of the law is relatively undeveloped. Accordingly, there is a risk that as the law develops, new case law or new regulations made under or affecting the LLPA 2000 or relating to limited liability partnerships could adversely affect the ability of the LLP to perform its obligations under the Transaction Documents which could, in turn, adversely affect the interests of Covered Bondholders.

### **Pensions Act 2004**

Under the Pensions Act 2004 a person that is 'connected with' or an 'associate' of an employer under an occupational pension scheme, can be subject to either a contribution notice or a financial support

direction. As the LLP is a member of the HBOS Group, it may be treated as ‘connected to’ an employer under an occupational pension scheme which is within the HBOS Group.

A contribution notice could be served on the LLP if it was party to an act, or a deliberate failure to act, the main purpose or one of the main purposes of which was either (i) to prevent the recovery of the whole or any part of a debt which was, or might become, due from the employer under Section 75 of the Pensions Act 1995 or (ii) otherwise than in good faith, to prevent such a debt becoming due, to compromise or otherwise settle such a debt, or to reduce the amount of such a debt which would otherwise become due.

A financial support direction could be served on the LLP where the employer is either a service company or insufficiently resourced. An employer is insufficiently resourced if the value of its resources is less than 50 per cent. of the pensions scheme's deficit calculated on an annuity buy-out basis and there is a connected or associated person whose resources at least cover that difference. A financial support direction can only be served where the Pensions Regulator considers it is reasonable to do so, having regard to a number of factors.

If a contribution notice or financial support direction were to be served on the LLP this could adversely affect investors in the Covered Bonds.

## SELECTED CONSOLIDATED FINANCIAL INFORMATION OF HBOS

### ***IFRS***

The statutory financial information set out on the following pages 60 to 62 as at the end of and for each of the three years ended 31 December 2006, 2005 and 2004 has been extracted from the Consolidated Financial Statements and the notes thereto of the HBOS Group for the years ended 31 December 2006 and 31 December 2005. These Consolidated Financial Statements and notes thereto have been placed on display at the specified office of the Principal Paying Agent and at the offices of Shepherd and Wedderburn LLP, Level 2, Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ET.

The Consolidated Financial Statements and notes thereto have been audited by KPMG Audit Plc, independent auditors. KPMG Audit Plc is a firm of chartered accountants and registered auditors.

### ***2006 financial information***

The 2006 financial information has been prepared on the basis of the accounting policies adopted in the 2006 IFRS Financial Statements. These are set forth in the 2006 IFRS Financial Statements, and there are no significant changes to the accounting policies adopted for the 2005 financial information.

Subsequently, as of the date of this Offering Circular, there have been no significant changes to the accounting policies adopted in the 2006 IFRS Financial Statements.

### ***2005 financial information***

The 2005 financial information was prepared on the basis of the recognition and measurement requirements of IFRS that were endorsed by the EU and effective at 31 December 2005. The accounting policies that the Directors applied to the preparation of the first annual IFRS financial statements for the year ended 31 December 2005 are set out in the 2005 Financial Statements. These were the Group's first annual consolidated financial statements prepared in accordance with IFRS.

The standards adopted by the Group were those endorsed by the EU and effective at the date the consolidated 2005 IFRS Financial Statements were approved by the Board.

The 2005 IFRS Financial Statements also comply with the relevant provisions of Part VII of the Companies Act 1985, as amended by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004. Additionally the Group has applied Financial Reporting Standard 27 "Life Assurance" issued by the UK Accounting Standards Board as appropriate.

The 2005 IFRS Financial Statements were prepared under the historical cost basis, except that the following assets and liabilities were stated at their fair values: derivatives, financial instruments held for trading, financial instruments designated at fair value through the income statement, financial instruments classified as available for sale and investment properties.

The Group adopted the following exemptions set out in IFRS 1, "First-time adoption of International Financial Reporting Standards":

- IFRS 3, "Business Combinations" was not applied retrospectively to business combinations that occurred before 1 January 2004. Accumulated amortisation on goodwill arising before 1 January 2004 was therefore not reversed.
- All cumulative actuarial gains and losses to 1 January 2004 arising from the Group's defined benefit schemes were recognised in equity at 1 January 2004.

- Cumulative translation differences for all foreign operations were deemed to be zero at 1 January 2004. Any gain or loss on the subsequent disposal of a foreign operation excluded translation differences that arose before 1 January 2004, but included later translation differences.

The Group did not apply certain International Accounting Standards and amendments that were adopted by the EU:

- IFRS 7, “Financial instruments: Disclosure” and the “Capital disclosure amendment” to IAS 1 “Presentation of financial statements” which are applicable for periods commencing on or after 1 January 2007 were not applied. The application of these standards in 2005 would not have affected the balance sheet or income statement as they are only concerned with disclosure.

#### ***2004 statutory comparative financial information***

The 2004 statutory comparative financial information is prepared under the IFRS reporting basis for statutory comparatives. This basis reflects all standards, with the exception of IAS 32, “Financial Instruments: Disclosure and Presentation”, IAS 39 “Financial Instruments: Recognition and Measurement” and IFRS 4 “Insurance Contracts”. These standards only became effective from 1 January 2005 and transitional concessions granted by the International Accounting Standards Board permitted the Group to report the comparatives for areas covered by these standards on a U.K. GAAP basis for 2004 only. The transitional concessions include accounting policies for loans and advances, debt securities, equities, derivatives and insurance. In preparing the 2004 comparative information the Group has adjusted amounts previously reported in financial statements under U.K. GAAP. Full details of the accounting policies applied are given in the 2005 IFRS Financial Statements.

#### ***2004 pro forma comparative financial information***

As indicated above, because the 2004 statutory comparative financial information was prepared without reflection of certain accounting standards that became effective 1 January 2005, the 2004 statutory comparative financial information is not, in certain respects, fully comparable with the 2005 financial information. Accordingly, the Group prepared the 2004 unaudited pro forma comparative financial information, which includes the impact of IAS 32, IAS 39 and IFRS 4 that only became effective from 1 January 2005. This information is unaudited. The 2004 pro forma income statement does not reflect the impact of derivative hedge accounting because the necessary documentation was not in place given the late finalization of the IFRS standard. For the avoidance of doubt, the 2004 financial information labelled as pro forma does not constitute pro forma financial information for the purpose of Article 5 of Regulation (EC) No. 809/2004 or Regulation S-X under the Securities Act.

## Summary Consolidated Income Statement of HBOS

	Year ended December 31,			
	2006 (statutory)	2005 (statutory)	2004 (statutory)	2004 (pro forma)
	(in £ millions, except per share)			
Net interest income .....	7,400	6,829	5,885	6,278
Non-interest income .....	15,314	16,788	16,610	10,285
Net operating income (continuing operations) .....	22,714	23,617	22,495	16,563
Operating expenses .....	(15,571)	(17,244)	(16,811)	(11,304)
Impairment losses on loans and advances .....	(1,742)	(1,599)	(1,201)	(1,255)
Impairment on investment securities .....	(71)	(51)	(21)	(22)
Operating profit (continuing operations) .....	5,330	4,723	4,462	3,982
Share of profits of jointly controlled entities .....	112	29	55	41
Share of operating profits of associated undertakings ....	14	10	69	66
Non-operating income.....	250	46	23	23
Profit before taxation.....	5,706	4,808	4,609	4,112
Tax on profit .....	(1,772)	(1,546)	(1,272)	(1,203)
Profit after taxation .....	3,934	3,262	3,337	2,909
Profit of disposal group classified as held for sale .....	5			
Profit for the year .....	3,939	3,262	3,337	2,909
Attributable to:				
Parent company shareholders (including certain non-equity interests in 2004 (statutory)).....	3,879	3,230	3,118	2,898
Minority Interests (equity) .....	60	32	45	11
(non-equity) .....		–	174	–
	3,939	3,262	3,337	2,909
Pence per share				
Basic earnings per share – continuing operations.....	100.5p	82.2p	79.7p	74.9p
Basic earnings per share – disposal group .....	0.1p			
Basic earnings per share – total .....	100.6p	82.2p	79.7p	74.9p
Diluted earnings per share – continuing operations ....	99.4p	81.3p	79.2p	74.5p
Diluted earnings per share – disposal group.....	0.1p			
Diluted earnings per share – total .....	99.5p	81.3p	79.2p	74.5p



## Summary Consolidated Balance Sheet of HBOS

	Year ended December 31,			
	2006 (statutory)	2005 (statutory)	2004 (statutory)	2004 (pro forma)
	(in £ millions, except per share)			
<b>Shareholders' Equity</b>				
Issued share capital .....	1,139	1,157	1,381	981
Reserves.....	19,546	17,108	15,881	15,541
Shareholders' equity (excluding minority interests) (includes certain non-equity interests in 2004) (statutory) .....	20,685	18,265	17,262	16,522
Minority interests (equity) .....	486	191	295	159
Shareholders' equity (including minority interests) (includes certain non-equity interests in 2004).....	21,171	18,456	17,557	16,681
Minority and other interests (non-equity) (statutory) ..			2,617	
Total shareholders' equity .....	21,171	18,456	20,174	16,681
Other borrowed funds .....	19,692	20,254	14,633	18,257
Deposits by banks, customer accounts and debt securities in issue.. .....	426,064	390,950	338,799	352,978
Loans and advances to banks and customers .....	388,401	361,124	306,669	331,752
Impairment losses on loans and advances .....	3,089	2,938	2,494	2,536
Total assets .....	591,029	540,873	448,165	479,674
Net assets per share .....	516p	452p	440p	421p

## Other Annual Financial Data of HBOS

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions) (except per share)		
Group post-tax return on mean equity <sup>(1)</sup> .....	20.8%	19.6%	19.6%
Net interest margin .....	1.78%	1.80%	1.79%
Cost: income ratio <sup>(2)</sup> .....	40.9%	42.2%	44.7%
Capital Adequacy			
Tier 1 capital .....	8.1%	8.1%	7.9%
Total capital.....	12.0%	12.4%	12.3%
Total impairment provisions as a percentage of closing advances....	0.82%	0.85%	0.81%

(1) Post tax return on mean equity is calculated by dividing underlying profit attributable to ordinary shareholders by the monthly average of ordinary shareholders' funds.

(2) The cost: income ratio is calculated on an underlying basis as follows:

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Operating expenses .....	15,571	17,244	11,304
Retail rationalisation costs .....		(84)	
Merger integration costs .....			(48)
Mortgage endowment compensation .....	(95)	(260)	(130)
Goodwill impairment .....	(55)		(6)
	15,421	16,900	11,120
Operating lease depreciation.....	(812)	(561)	(42)
Change in investment contract liabilities .....	(2,910)	(5,089)	(1,753)
Net claims paid on insurance contracts .....	(2,328)	(2,019)	(2,388)
Net change in insurance contract liabilities .....	(3,894)	(4,220)	(2,190)
Change in unallocated surplus .....	(569)	(369)	
<b>Underlying operating expenses</b> .....	<b>4,908</b>	<b>4,642</b>	<b>4,361</b>
Net operating income .....	22,714	23,617	16,563
Gross up for policyholder tax .....	(220)	(200)	
Short term fluctuations .....	81	(110)	(17)
	22,575	23,307	16,546
Impairment on investment securities .....	(71)	(51)	(22)
Operating lease depreciation.....	(812)	(561)	(428)
Change in investment contract liabilities .....	(2,910)	(5,089)	(1,753)
Net claims incurred on insurance contracts .....	(2,328)	(2,019)	(2,388)
Net change in insurance contract liabilities .....	(3,894)	(4,220)	(2,190)
Change in unallocated surplus .....	(569)	(369)	
<b>Underlying operating income</b> .....	<b>11,991</b>	<b>10,998</b>	<b>9,765</b>

## ***U.K. GAAP***

The U.K. GAAP financial information set out on the following pages 64 to 65 as at the end of and for each of the financial years ended 31 December 2004 and 2003 unless otherwise stated has been extracted from the audited consolidated financial statements and notes thereto of the HBOS Group for those years.

The U.K. GAAP financial information for 2002 has been restated from the information contained in the published 2002 audited consolidated financial statements to reflect the adoption of UITF Abstract 37 “Purchases and sales of own shares” and UITF Abstract 38 “Accounting for ESOP trusts.” Own shares held for the purpose of satisfying obligations arising from certain share based compensation schemes amounted to £17 million at 31 December 2002. Previously these were presented within other assets within the consolidated balance sheet. Own shares held by the long term assurance business policyholders’ fund amounted to £33 million at December 31, 2002. Previously these were presented within long-term assurance assets attributable to policyholders within the consolidated balance sheet. In accordance with UITF 37 and UITF 38, these own shares have been reclassified and are now shown within other reserves as a deduction from Shareholders’ Funds.

The Group’s audited consolidated financial statements from which the following information is drawn have been prepared in accordance with U.K. GAAP, which differs in certain significant respects from U.S. GAAP. See “Description of Certain Differences Among IFRS, U.K. GAAP and U.S. GAAP” at Annex A for a description of certain differences among IFRS, U.K. GAAP and U.S. GAAP.

The financial information set out on the following pages as at the end of and for each of the financial years ended 31 December 2004, 2003 and 2002 has been extracted without material adjustment from the audited consolidated financial statements and notes thereto of the HBOS Group for those years, except that where information for the financial year ended December 31, 2002 has been restated, this has been extracted without material adjustment from the published annual report and accounts to the financial year ended 31 December 2003.

## Summary Consolidated Profit and Loss Account of HBOS

	Year ended 31 December,		
	2004	2003	2002 (Restated)
	(in £ millions, (except per share))		
Net interest income .....	5,940	5,459	4,770
Non-interest income .....	4,287	3,487	2,776
Total income .....	10,227	8,946	7,546
Operating expenses .....	(4,322)	(4,087)	(3,762)
General insurance claims .....	(215)	(99)	(79)
Provisions for bad and doubtful debts .....	(1,201)	(1,025)	(832)
Amounts written off fixed asset investments .....	(21)	(29)	(24)
Total operating profit .....	4,468	3,706	2,849
Share of operating profits of joint ventures .....	41	31	8
Share of operating profits of other associated undertakings .....	60	29	27
Profit on sale of fixed assets .....	23	–	–
Profit on disposal of business .....	–	–	25
Profit before taxation .....	4,592	3,766	2,909
Taxation.....	(1,310)	(1,091)	(835)
Attributable to minority interests .....	(225)	(223)	(158)
Profit attributable to shareholders.....	3,057	2,452	1,916
<i>Dividends</i>			
Preference .....	(37)	(37)	(37)
Ordinary .....	(1,286)	(1,183)	(1,140)
Retained profit .....	1,734	1,232	739
Pence per share			
Underlying earnings per share <sup>(1)</sup> .....	84.3p	68.5p	56.1p
Basic earnings per share .....	78.1p	63.6p	50.6p
Diluted earnings per share .....	77.6p	63.2p	50.2p

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

## Summary Consolidated Balance Sheet of HBOS

	As at 31 December,		
	2004	2003	2002 (Restated)
	(in £ millions, (except per share))		
<i>Capital and Reserves</i>			
Ordinary shares .....	981	963	946
Preference shares (non-equity) .....	400	400	400
Reserves .....	16,242	14,005	12,373
Shareholders' funds (including non-equity interests).....	17,623	15,368	13,719
Minority interests (equity and non-equity).....	2,912	2,611	2,139
Capital and reserves .....	20,535	17,979	15,858
Subordinated undated loan capital .....	6,401	5,142	3,437
Subordinated dated loan capital .....	8,232	7,740	5,690
Deposits by banks, customer accounts and debt securities in issue..	338,695	314,119	276,629
Loans and advances to customers and banks .....	305,267	282,330	246,153
Cumulative provisions for bad and doubtful debts .....	2,494	2,252	2,024
Total assets .....	442,881	408,413	355,030
Net assets per share .....	439p	389p	353p

## Other Annual Financial Data of HBOS

	Year ended 31 December,		
	2004	2003	2002 (Restated)
	(in £ millions, (except per share))		
Post-tax return on mean equity <sup>(1)</sup> .....	19.7%	17.7%	15.9%
Net interest margin <sup>(2)</sup> .....	1.70%	1.77%	1.83%
Cost to total income ratio <sup>(3)</sup> .....	37.9%	41.6%	45.2%
Capital Adequacy <sup>(4)</sup>			
Tier 1 capital .....	8.1%	7.6%	7.9%
Total capital.....	11.8%	11.1%	10.4%
Closing provisions as a percentage of year end customer advances <sup>(5)</sup>			
Specific .....	0.53%	0.51%	0.55%
General .....	0.26%	0.28%	0.29%
Total .....	0.79%	0.79%	0.84%

- (1) Profit attributable to ordinary shareholders before exceptional items expressed as a percentage of mean equity shareholders' funds. Mean equity shareholders' funds are calculated on a monthly average basis.
- (2) Net interest income expressed as a percentage of average balance of interest earning assets (excluding trading assets). The average balance of interest earning assets is calculated before the deduction of average loans and advances subject to non-returnable finance.
- (3) Underlying operating expenses excluding exceptional items, goodwill amortization and operating lease depreciation divided by underlying operating income after deducting operating lease depreciation, amounts written off fixed asset investments and general insurance claims.
- (4) Tier 1 and total capital expressed as a percentage of risk weighted assets, including off-balance sheet items calculated in accordance with the Basel Guidelines.
- (5) Annualized.

## CAPITALIZATION AND INDEBTEDNESS OF HBOS

The following table and notes thereto show the capitalisation and indebtedness of the HBOS Group as at the date set forth below.

	As at 31 December 2006
	(£ millions)
<b>Authorised capital</b>	
6.0884% Non-cumulative Preference Shares (of £1 each) .....	1
6.475% Non-cumulative Preference Shares (of £1 each) .....	198
6.125% Non-cumulative Redeemable Preference Shares (of £1 each) .....	200
Sterling Preference Shares (of £1 each) .....	2,597
8.117% Non-cumulative Perpetual Preference Shares Class "A" (of £10 each).....	3
7.754% Non-cumulative Perpetual Preference Shares Class "B" (of £10 each).....	1
Ordinary Shares (of 25p each) .....	1,185
9¼% Non-cumulative Irredeemable Preference Shares (of £1 each) .....	300
9¾% Non-cumulative Irredeemable Preference Shares (of £1 each) .....	100
	4,585
	As at 31 December 2006
	(€ millions)
Euro Preference Shares (of €1 each) .....	3,000
	3,000
	As at 31 December 2006
	(U.S.\$ millions)
U.S.\$ Preference Shares (of U.S.\$1 each) .....	4,498
6.413% preference shares series "A" (of U.S.\$1 each) .....	1
5.92% preference shares series "B" (of U.S.\$1 each) .....	1
	4,500
	As at 31 December 2006
	(Aus\$ millions)
Aus\$ Preference Shares (of Aus\$1 each) .....	1,000
	1,000



	As at 31 December 2006
	(Can\$ millions)
Can\$ Preference Shares (of Can\$1 each) .....	1,000
	<u>1,000</u>
	As at 31 December 2006
	(£ millions)
<b>Issued Share Capital</b>	
6.475% Non-cumulative Preference Shares (of £1 each) .....	198
Ordinary Shares (of 25p each).....	941
	<u>1,139</u>
Allotted, called up and fully paid share capital .....	19,546
Reserves .....	<u>20,685</u>
Shareholders' equity (excluding minority interests) .....	486
Minority interests (equity) .....	<u>21,171</u>
Total Shareholders' Equity .....	30,557
Deposits by banks .....	211,857
Customer accounts .....	22,334
Financial liabilities held for trading.....	909
Disposal group liabilities held for sale .....	10,755
Derivative liabilities .....	857
Notes in circulation .....	24,977
Insurance contract liabilities .....	49,486
Investment contract liabilities .....	1,543
Unallocated surplus .....	912
Net post retirement liabilities.....	79
Current tax liabilities .....	2,591
Deferred tax liabilities .....	6,387
Other liabilities.....	3,071
Accruals and deferred income .....	201
Other provisions .....	183,650
Debt securities in issue .....	15,373
Subordinated liabilities .....	4,319
Other borrowed funds <sup>(1)</sup> .....	<u>569,858</u>
Total Indebtedness .....	<u><b>591,029</b></u>

1 Other borrowings also include those preference shares which are defined as liabilities: £300,000,000 of 9¼ per cent. Non-cumulative Irredeemable Preference Shares, £100,000,000 of 9¼ per cent. Non-cumulative Irredeemable Preference Shares, US\$ 750m 6.413 per cent. Fixed to Floating rate US\$1 Preference Shares Series 'A', US\$750m 5.92 per cent. Fixed to Floating rate US\$1 Preference Shares Series 'B',

Save for £3,324 million of the HBOS Group's debt securities in issue which are unguaranteed but secured on advances to customers and certain other assets of the HBOS Group and £60,581 million of the HBOS Group's debt securities in issue which are unguaranteed but secured on asset backed securities of the HBOS Group, none of the other borrowings, at 31 December 2006, are secured or guaranteed. As at 31 December 2006, the HBOS Group had contingent liabilities (including guarantees) of £5,130 million. No account has been taken of intra group guarantees.

There have been no material changes in the capitalization, indebtedness and contingent liabilities (including guarantees) of HBOS Group since 31 December 2006.

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

The following discussion is based on the 2006 and 2005 IFRS Financial Statements included herein and, except where otherwise indicated, the pro forma financial information for 2004. See “—Accounting Policies” below. The 2006 IFRS Financial Statements are prepared under IFRS, which differs in certain significant respects from U.S. GAAP. For an explanation of certain differences, see Annex A to this Offering Circular.

### Accounting Policies

#### *2006 financial information*

The 2006 financial information has been prepared on the basis of the accounting policies adopted in the 2006 IFRS Financial Statements. These are set forth in the 2006 IFRS Financial Statements, and there are no significant changes to the accounting policies adopted for the 2005 financial information.

Subsequently, as of the date of this Offering Circular, there have been no significant changes to the accounting policies adopted in the 2006 IFRS Financial Statements.

#### *2005 financial information*

The 2005 financial information was prepared on the basis of the recognition and measurement requirements of IFRS that were endorsed by the EU and effective at 31 December 2005. The accounting policies that the Directors applied to the preparation of the first annual IFRS financial statements for the year ended 31 December 2005 are set out in the 2005 IFRS Financial Statements. These were the Group's first annual consolidated financial statements prepared in accordance with IFRS.

The standards adopted by the Group were those endorsed by the EU and effective at the date the consolidated 2005 IFRS Financial Statements were approved by the Board.

The 2005 IFRS Financial Statements also comply with the relevant provisions of Part VII of the Companies Act 1985, as amended by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004. Additionally the Group has applied Financial Reporting Standard 27 “Life Assurance” issued by the UK Accounting Standards Board as appropriate.

The 2005 IFRS Financial Statements were prepared under the historical cost basis, except that the following assets and liabilities were stated at their fair values: derivatives, financial instruments held for trading, financial instruments designated at fair value through the income statement, financial instruments classified as available for sale and investment properties.

The Group adopted the following exemptions set out in IFRS 1, “First-time adoption of International Financial Reporting Standards”:

- IFRS 3, “Business Combinations” was not applied retrospectively to business combinations that occurred before 1 January 2004. Accumulated amortization on goodwill arising before 1 January 2004 was therefore not reversed.
- All cumulative actuarial gains and losses to 1 January 2004 arising from the Group's defined benefit schemes were recognized in equity at 1 January 2004.
- Cumulative translation differences for all foreign operations were deemed to be zero at 1 January 2004. Any gain or loss on the subsequent disposal of a foreign operation excluded

translation differences that arose before 1 January 2004, but included later translation differences.

The Group did not apply certain International Accounting Standards and amendments that were adopted by the EU:

- IFRS 7, “Financial instruments: Disclosure” and the “Capital disclosure amendment” to IAS 1 Presentation of financial statements” which are applicable for periods commencing on or after 1 January 2007 were not applied. The application of these standards in 2005 would not have affected the balance sheet or income statement as they are only concerned with disclosure.

#### ***2004 statutory comparative financial information***

The 2004 statutory comparative financial information is prepared under the IFRS reporting basis for statutory comparatives. This basis reflects all standards, with the exception of IAS 32, “Financial Instruments: Disclosure and Presentation”, IAS 39 “Financial Instruments: Recognition and Measurement” and IFRS 4 “Insurance Contracts”. These standards only became effective from 1 January 2005 and transitional concessions granted by the International Accounting Standards Board permitted the Group to report the comparatives for areas covered by these standards on a U.K. GAAP basis for 2004 only. The transitional concessions include accounting policies for loans and advances, debt securities, equities, derivatives and insurance. In preparing the 2004 comparative information, the Group adjusted amounts previously reported in financial statements under U.K. GAAP. Full details of the accounting policies applied are given in the 2005 IFRS Financial Statements.

#### ***2004 pro forma comparative financial information***

As indicated above, because the 2004 statutory comparative financial information was prepared without reflection of certain accounting standards that became effective 1 January 2005, the 2004 statutory comparative financial information is not, in certain respects, fully comparable with the 2005 financial information. Accordingly, the Group prepared the 2004 unaudited pro forma comparative financial information, which includes the impact of IAS 32, IAS 39 and IFRS 4 that only became effective from 1 January 2005. This information is unaudited. The 2004 pro forma income statement does not reflect the impact of derivative hedge accounting because the necessary documentation was not in place given the late finalization of the IFRS standard. For the avoidance of doubt, the 2004 financial information labeled as pro forma does not constitute pro forma financial information for the purpose of Article 5 of Regulation (EC) No. 809/2004 or Regulation S-X under the Securities Act.

#### **Divisional Reorganisation**

The European corporate business, currently part of ENA in the Strategy & International division, will move into Corporate division reporting starting with the 2007 half-year results.

In 2005, the Group implemented a divisional reorganisation designed to reflect both the growing importance of its overseas operations and the increasing strength of the distribution links between its UK retail banking and insurance and investment businesses. Accordingly, the Group now reports through five divisions (Retail, Corporate, Insurance & Investment, International and Treasury & Asset Management) plus Group Items. The divisional results for the year end 31 December 2004, were restated to reflect this new divisional structure.

## **Current Market Conditions**

The Group remains optimistic about the UK economy with a generally benign business environment supporting growth in secured Retail products. The Group continues to be cautious, however, about unsecured lending given the cumulative impact of rising interest rates, utility prices and consumer indebtedness.

In mortgages, the timing of cessations in the Group's book points to a first half net lending share below the Group's normal 15 per cent.-20 per cent. range; the Group expects a return to this range in the second half of the year.

In strong corporate lending markets, the Group expects to continue to participate fully in originating assets but also continue its strategy of selective sell down to enhance returns.

In the UK savings and investments markets, the Group estimates that UK liquid savings will exceed, for the first time, £1 trillion by the end of 2007. The Group estimates that total household financial assets (savings, mutual funds, pensions and other collective investments) should grow to £4 trillion by the end of 2007. As the UK's largest savings institution and the UK's number one provider of new investment products, this growth should present the Group with a major opportunity.

## **Interest Rate Developments**

The U.K. economy strengthened in 2006 with GDP growth rising to 3.0 per cent. from 1.9 per cent. in 2005. The U.K. economy has now seen 58 consecutive quarters of economic growth, the longest unbroken increase on record. The main driver of economic growth over the past year has been capital investment, supported by modest growth in both consumer and government spending. Inflation has also increased with the CPI rising by 2.8 per cent. over the year to February 2007, above the Bank of England's 2 per cent. target. A strengthening in the economy along with concerns about the outlook for inflation has seen the Bank of England raise official rates three times in the past year. At 5.25 per cent., the Bank's base rate is at its highest point in more than five years.

U.K. retail sales have risen in recent months in line with the broader strengthening of the U.K. economy. The consumer sector has benefited from continued gains in the labor market (the number of individuals employed in the U.K. remains close to record levels), firm housing activity, rising equity valuations and growth of household disposable incomes.

The recent increases in interest rates are expected to put downward pressure on investment and consumer spending growth which, together with an easing in global economic growth, is likely to result in a modest easing in the pace of U.K. activity over the coming year.

There is still the prospect of further monetary tightening in the U.K. in coming months as the Bank of England remains vigilant in tackling inflation. A failure in the economy to slow, or any up-tick in inflation, could trigger at least one more rate increase. However, a forecast slowing in economic activity later in 2007, potentially slower inflation and wage pressures remaining firmly under control should prevent the need for further rate increases beyond 5.50 per cent. This projected slowdown in activity may even provide scope for a reduction in rates on a twelve-month view.

Economic conditions in the United States are just starting to slow somewhat. Consumer spending has been the main driver of growth in the past year with a slowing housing sector the key drag on U.S. economic performance. The Federal Funds rate has held at its current level of 5.25 per cent. since mid-2006 and, in the near term, current rates are anticipated to be maintained. The Federal Reserve continues to remain concerned about the outlook for inflation, despite more recent mixed economic data. U.S. annual consumer price inflation is currently 2.4 per cent. In contrast to the emerging U.S. economic slowdown, Euro-zone

economic conditions have continued to improve with 3.3 per cent. GDP growth in 2006. The European Central Bank (ECB) raised its refinancing rate by 0.25 per cent. to 3.75 per cent. in March 2007. This is the highest rate in more than five years and the ECB has raised rates seven times in the past 18 months. The ECB may raise interest rates again in coming months in an attempt to stem the high level of Euro-zone credit creation and to prevent a possible build-up of inflation pressures.

## Group Overview

HBOS plc is the holding company of the HBOS Group. The principal activities of the Group are the provision of banking and other financial services in the United Kingdom and overseas.

### *2006 Overview*

For the year ended 31 December 2006, the Group's profit before tax rose by 19 per cent. to £5,706 million (as compared to £4,808 million in 2005) and the Group's underlying profit before tax of £5,537 million increased by 14 per cent. (as compared to £4,842 million in 2005). The Group believes it has taken a disciplined approach to capital management (returning a total of £2 billion of capital to shareholders since it commenced its stock buyback programme in 2005), and that this, combined with profit performance, has driven underlying earnings per share up by 16 per cent. to 100.5p (as compared to 86.4p in 2005).

The Group believes an integral part of its capital management framework is its dividend policy, which currently targets an underlying dividend cover of approximately 2.5 times. Consistent with this framework, the Board has proposed a final dividend of 27.9p (as compared to 24.35p in 2005) which, together with the Group's interim dividend, would result in a full year dividend of 41.4p for 2006 (as compared to 36.1p in 2005), an increase of 15 per cent. compared to 2005.

Lending growth was at the upper end of the Group's target range for 2006, with advances to customers increasing by 10 per cent. to £376.8 billion (as compared to £343.8 billion in 2005). The Group delivered strong growth in mortgages and across its International businesses. However, the Group remains cautious about the returns available from the United Kingdom unsecured market and it is selective in its hold appetite in Corporate given the continuing pressure on margins.

The Group's investment business continued in 2006 to deliver growth in investment sales. The Group is of the view this business is well placed to benefit from its savings franchise and what the Group believes is the growing awareness of the U.K. population of the need to self-provide for retirement.

The Group's post-tax return on equity (RoE) increased in 2006 to 20.8 per cent. (as compared to 19.6 per cent. in 2005), driven by profitable growth in lending, the Group's focus on cost efficiency and the benefits of the stock buyback programme.

The Group's net interest margin decreased slightly, but was broadly stable at 178bps (as compared to 180bps in 2005). In the Retail division, the Group saw a modest decline reflecting its greater appetite for mortgage lending together with increased competition in the buy-to-let market. Margins also fell in the International division reflecting a change in product mix. However, in the Corporate division, margins were higher, benefiting from the division's continued sell down strategy.

In the U.K. investment business, new business profitability (now measured by reference to the full EV basis described on pages 20 to 24 of the HBOS plc Annual Report and Accounts 2006) improved to 27 per cent. (as compared to 24 per cent. in 2005) of APE.

The Group continued to see underlying non-interest income growing at a greater pace than net interest income. In 2006, net interest income rose 8 per cent. and underlying non-interest income rose 10 per cent.,

although, as expected, non-interest income growth in the Retail division slowed, reflecting reduced commission levels from the sale of repayment insurance and the impact of lower credit card default charges, effective from 1 August 2006, in response to an OFT ruling.

Total underlying operating expenses increased by 5.7 per cent. in 2006, falling within the Group's 6 per cent. target for the year, despite substantial ongoing investment in its International and Treasury & Asset Management divisions. Costs in the Group's core U.K. businesses increased by 2.7 per cent. in 2006 (as compared to 2005), below its 3.5 per cent. target.

The Group's cost:income ratio improved in 2006 to 40.9 per cent. (as compared to 42.2 per cent. in 2005), with underlying net operating income up 9 per cent. and underlying operating expenses up 6 per cent. (each as compared to 2005).

In 2006, credit performance developed in line with previous trends. The Group's impairment losses increased slightly to £1,742 million (as compared to £1,599 million in 2005), which represented 0.48 per cent. of average customer advances (as compared to 0.49 per cent. in 2005). Impairments as a percentage of closing advances decreased in 2006 to 2.18 per cent. (as compared to 2.37 per cent. in 2005). The coverage of impaired loans by provisions increased in 2006 to 38 per cent. (as compared to 36 per cent. in 2005).

The Retail division's credit performance is driven by the concentration of well-collateralized secured lending in its loan book, which comprises 93 per cent. of the Retail division's lending. The absolute level of secured arrears fell during 2006 and impairments as a percentage of advances fell in 2006 to 1.84 per cent. (as compared to 2.21 per cent. in 2005).

The growth of impairments in the Retail division's unsecured book moderated in the second half of 2006. However, impairment levels continue to rise in absolute terms and as a percentage of advances increased to 13.2 per cent. (as compared to 11.5 per cent. in 2005). Management remains cautious about future trends given the continued growth in UK personal insolvencies.

Corporate credit experience continues to reflect what is, in the Group's view, the most benign credit environment in approximately 30 years. While the Group is not seeing any material signs of stress, it has maintained prudent exposure limits and continues to price its lending without expectation of incremental returns from equity stakes.

During 2006, the Group bought back £982 million of shares and cancelled 100 million shares in issue. At 8.1 per cent. (unchanged from the 8.1 per cent. ratio in 2005), the Group's 2006 Tier 1 ratio remains above its 8.0 per cent. target level. The Group's 2006 total capital ratio was 12.0 per cent. (as compared to 12.4 per cent. in 2005).

#### *2005 Overview*

For the year ended 31 December 2005, profit before tax rose by 17 per cent. (as compared to 2004 (pro forma)) to £4,808 million and underlying profit before tax increased by 13 per cent. (as compared to 2004 (pro forma)) to £4,842 million. Underlying earnings per share rose 11 per cent. (as compared to 2004 (pro forma)) to 86.4p while basic earnings per share rose 10 per cent. (as compared to 2004 (pro forma)) to 82.2p.

For the year ended 31 December 2005, the Group's RoE was 19.6 per cent., unchanged as compared with a year earlier (based on 2004 (pro forma)) and once again in the middle of the 19-20 per cent. benchmark return range that management of the Group judges as sustainable.

The Group continued to deliver solid volume growth in 2005. An emphasis on asset quality and returns rather than just volume saw the Group make a deliberate choice in favor of measured growth in UK



lending markets with much more rapid growth elsewhere, notably in Ireland and Australia. Overall, customer lending and deposits grew at 9 per cent. and 7 per cent., respectively, relative to 2004 (pro forma). Improving investor sentiment helped the Group's investment businesses to achieve an 18 per cent. increase in sales (as compared to 2004 (pro forma)), while in a comparatively benign trading environment general insurance sales rose 14 per cent. (as compared to 2004 (pro forma)). The Group's UK investment product and general insurance businesses both gained market share in 2005.

Margin trends across the Group were encouraging in 2005. In Banking, the Group net interest margin was virtually unchanged in 2005 at 180bps (as compared to 179bps in 2004 (pro forma)). In the Group's UK investment businesses new business profitability was stable in 2005 at 26 per cent. of annual premium equivalent (as compared with 25 per cent. in 2004 (pro forma)). The underwriting performance of both the Group's household and repayment insurance lines remained strong, matching or bettering that achieved in 2004. In contrast, motor insurance underwriting results reflected intensifying price competition.

Further improvements in operating efficiencies across the Group enabled it to achieve a seven point gap between income and cost growth, bringing the Group's cost:income ratio for 2005 down to 42.2 per cent. (as compared to 44.7 per cent. for 2004 (pro forma)).

Underlying operating income grew by 13 per cent. in 2005 (as compared to 2004 (pro forma)). The general stability of margins saw net interest income rise 9 per cent. (as compared to 2004 (pro forma)) while particularly strong growth in Corporate and Retail enabled the Group to record a 20 per cent. increase in 2005 (as compared to 2004 (pro forma)) in underlying non-interest income. Underlying operating expenses rose by 6 per cent. in 2005 (compared to 2004 (pro forma)). As the Group indicated previously, this growth reflects substantial investment in infrastructure and capability in the Group's International and Treasury & Asset Management businesses. Excluding these divisions, underlying operating expenses across the Group's Retail, Corporate and Insurance & Investment divisions increased by just 2.5 per cent. in 2005 (as compared to 2004 (pro forma)), in line with the target set by the Group.

As expected, credit performance was mixed during 2005. In Retail, the Group saw continued seasoning of its heavily collateralized secured book coupled with a modest deterioration in its unsecured book, in line with general trends in the UK economy. In contrast, Corporate's and International's results in 2005 reflected improving credit environments. Overall, as a percentage of closing customer advances, impaired loans increased to 2.37 per cent. in 2005 (as compared to 2.03 per cent. in 2004 (pro forma)). Closing impairment provisions, as a percentage of closing customer advances, increased modestly to 0.85 per cent. in 2005 (as compared to 0.81 per cent. in 2004 (pro forma)). The Group impairment losses were £1,599 million in 2005 (as compared to £1,255 million in 2004 (pro forma)) representing 0.49 per cent. of average customer advances in 2005 (as compared to 0.42 per cent. in 2004 (pro forma)).

Capital generation in the Group strengthened in 2005. During 2005, £994 million of shares were bought back for cancellation at an average share price of £8.55. In December 2005, the Group announced plans to reduce the risks associated with funding the Group's pension liabilities. These included accelerated funding to reduce and then eliminate the deficit entirely. As at the end of 2005, the Group had set aside £1 billion for this purpose, of which £800 million was paid into the scheme as at 31 December 2006. Even so, the Tier 1 ratio rose to 8.1 per cent. in 2005 (from 7.9 per cent. in 2004 (pro forma)) and the Group's total capital ratio increased to 12.4 per cent. in 2005 (from 12.3 per cent. in 2004 (pro forma)).

The Group believes that 2005 saw the peak in volumes of endowment complaints. However, they continued to run at high levels throughout 2005 and the Group set aside a further £130 million, which brought the total set aside in 2005 to £260 million, representing the Group's best estimate of the cost of compensation.

In the United Kingdom, the Group retained a deliberate degree of caution in its core retail and corporate leading markets. Elsewhere, in general insurance and investment products, sales demonstrated solid growth, particularly in bancassurance and wealth management, reinforcing the Group's position as the United Kingdom's No.1 investment business for total new sales. The Group's International businesses has made significant progress, particularly in Ireland and Australia, as the Group establishes platforms that will challenge retail banking incumbents in those markets.

## **Divisional Overview**

### ***Retail***

#### *2006*

Underlying profit before tax in the Retail division increased in 2006 by 4 per cent. to £2,364 million (as compared to £2,283 million in 2005). Underlying net operating income increased in 2006 by 4 per cent. (as compared to 2005) with net interest income up 4 per cent. (as compared to 2005) and a lower net interest margin at 178bps (as compared to 184bps in 2005), the latter reflecting a greater proportion of mortgage lending, and increased competition in the buy-to-let market.

Underlying non-interest income grew in 2006 by 3 per cent. (as compared to 2005), the pace of growth being moderated in 2006 as a result of reduced repayment insurance commissions as a consequence of planned lower volumes of consumer finance products and the impact of lower credit card default charges.

Strong cost management ensured underlying operating expenses were held at the same level as 2005, delivering a 4 per cent. difference between underlying net operating income and underlying operating expenses growth and a further improvement in the cost:income ratio to 38.4 per cent. (as compared to 39.8 per cent. in 2005).

The 9 per cent. increase in lending (as compared to 2005) was driven by growth in the Retail division's secured book as it continues to take a cautious approach to the returns available from the unsecured market.

In the UK mortgage market, the Group's gross market share for 2006 was stable at 21 per cent. (21 per cent. in 2005). Its share of principal repaid fell from 25 per cent. in 2005 to 24 per cent. in 2006. The combination of these factors has resulted in the Group's share of net lending increasing to 17 per cent. (as compared with 14 per cent. in 2005), comfortably within the 15 per cent.-20 per cent. target it set at the start of 2006. The trend in the second half of the year was, as in 2005, impacted by mortgage cessations relating to prior periods of higher gross lending.

As the UK's largest provider of savings products the Group is well placed to benefit from the increasing savings ratio in the UK. In 2006, as in 2005, the Group acquired around 500,000 new-to-franchise savings customers and increased customer deposits by 9 per cent. (as compared to 2005) to £144.6 billion (as compared to £132.2 billion in 2005) reinforcing its position as the UK's largest provider of savings products with an estimated 16 per cent. share (equivalent to the 16 per cent. share in 2005) of Household Sector Liquid Assets.

In Bank Accounts, the Group believes it continues to innovate and differentiate itself. Its high profile product launches have enabled it to increase its estimated share of new bank accounts to 19 per cent. (as compared to 16 per cent. in 2005), well ahead of its share of stock of 13 per cent. (as compared to 12 per cent. in 2005).

The unsecured lending market has slowed, as U.K. consumers adjust to higher levels of unsecured debt. The Group continues to view certain parts of the unsecured market as currently uneconomic. As such, the Group's reduced appetite saw unsecured personal loan balances in the retail division fall in 2006 by 4

per cent. to £6.6 billion (as compared to £6.9 billion in 2005) and credit card balances also fall in 2006 by 4 per cent. to £7.0 billion (as compared to £7.3 billion in 2005).

Impaired secured loans as a percentage of closing advances decreased in 2006 to 1.84 per cent. (as compared to 2.21 per cent. in 2005). Secured loan impairments fell in 2006 by 9 per cent. (as compared to 2005), reflecting an absolute fall in both mainstream and specialist mortgage arrears. Provisions coverage of impaired secured loans remained stable relative to 2005 at 10 per cent., reflecting the unchanged formulaic calculation of required provisions.

The Group's Retail division continues to focus on strong asset cover in its secured book. Its retention strategy for existing customers and reduced appetite for lower return remortgage business resulted in a modest increase in the loan to value ratio (**LTV**) of new lending to 64 per cent. (as compared to 60 per cent. in 2005). The average LTV across our entire secured lending book in 2006 was stable at 44 per cent. (as compared to 43 per cent. in 2005), reflecting the positive contribution to collateral cover from improving retention.

Unsecured impairments continue to increase but the rate of growth moderated in the second half of 2006. Unsecured impairments as a percentage of closing advances increased in 2006 to 13.2 per cent. (as compared to 11.5 per cent. in 2005), reflecting the residual seasoning of the pre-2004 credit card book and a reduction in balances. The Retail division continues to see an improvement in arrears emergence on business written more recently. The coverage of impaired unsecured loans reduced slightly in 2006 to 71 per cent. (as compared to 73 per cent. in 2005).

## 2005

Measured growth in both secured and unsecured lending markets, with a focus on revenue growth linked to tight cost control, saw the Retail division preserve its strongly positive differential between revenue (up 10 per cent.) and costs (flat) in 2005 (each compared to 2004 (pro forma)). Underlying profit before tax increased by 8 per cent. in 2005 (as compared to 2004 (pro forma)) to £2,283 million.

For 2005, the Retail division produced strong income growth, with net operating income up 10 per cent. for the year (as compared to 2004 (pro forma)). The Retail net interest margin was stable at 184bps in 2005 (as compared to 185bps in 2004 (pro forma)) with net interest income growing by 8 per cent. (as compared to 2004 (pro forma)), largely reflecting the growth in average advances. Non-interest income in Retail rose 16 per cent. in 2005 (as compared to 2004 (pro forma)), benefiting primarily from past volume growth.

Average advances in Retail grew 9 per cent. in 2005 (as compared to 2004 (pro forma)). In mortgages, the Group chose not to chase the growth in the market in the final quarter of 2005. The Group is comfortable that its 21 per cent. share of the gross mortgage market in 2005 (as compared to 23 per cent. in 2004) achieved the right balance between growth and returns. Levels of principal repaid, driven primarily by previous years' higher loan growth, reduced the net lending outcome to a full year 14 per cent. share of the net mortgage market at 31 December 2005 (as compared to 17 per cent. in 2004).

This combined with a strong opening pipeline of new business is expected to result in a higher net lending market share without the need for the Group to change its stance on the balance between measured growth and shareholder returns.

The Group held its market share in a subdued personal loans market, growing balances by 1 per cent. in 2005 compared to 2004. In credit cards, the Group grew balances by 20 per cent. in 2005 (as compared to 2004 (pro forma)).

Impaired secured loans as a percentage of closing advances increased to 2.21 per cent. in 2005 (as compared to 1.45 per cent. in 2004 (pro forma)), reflecting the continued seasoning of the book due to slowing asset growth, the mix of retail business incorporating a market weighting of higher return specialized lending and a lower level of re-mortgages. The provisions coverage of secured impaired loans at 10 per cent. at 31 December 2005 (as compared to 12 per cent. at 31 December 2004 (pro forma)) reflects the Group's unchanged formulaic methodology for impairment provisioning.

As expected there was a leveling off in the growth of mortgage arrears in the second half of 2005 with a marked slowdown initially in mainstream arrears. The Group expects to continue to target strong asset cover with the 'LTV' of new lending during 2005 stable at 60 per cent. (as compared to 59 per cent. in 2004).

Unsecured impairments also reflect the continuing seasoning of the book and a modest deterioration due in large part to the market tightening of credit availability. Impaired unsecured loans as a percentage of closing advances increased to 11.5 per cent. in 2005 (as compared to 10.8 per cent. in 2004). The coverage of impaired unsecured loans by impairment provisions increased to 73 per cent. in 2005 (as compared to 70 per cent. in 2004).

Total operating expenses in Retail in 2005 were held at the 2004 (pro forma) level. The gap between revenue and a cost growth was therefore 10 per cent. in 2005, resulting in a further significant fall in the cost:income ratio to 39.8 per cent. (as compared to 43.6 per cent. in 2004 (pro forma)). The Retail business thus reached its goal of a sub-40 per cent. cost:income ratio two years ahead of plan.

## ***Corporate***

### *2006*

Underlying profit before tax in the Corporate division increased 17 per cent. in 2006 to £1,663 million (as compared to £1,420 million in 2005). Underlying net operating income increased in 2006 by 9 per cent. (as compared to 2005), with net interest income up 10 per cent. (as compared to 2005). The Corporate division's margin increased to 222bps in 2006 from 215bps in 2005.

Underlying non-interest income in the Corporate division increased by 6 per cent. in 2006 (as compared to 2005), benefiting from a 16 per cent. increase in net fees and commissions to £341 million (as compared to £293 million in 2005) and despite a lower contribution in aggregate from dividend receipts, realized gains, impairment on investment securities and other operating income of £293 million (as compared to £366 million in 2005). The Group benefitted from the increase in operating lease income arising from the acquisition of the remaining 50 per cent. of Lex Vehicle Finance on 31 May 2006.

In addition, overall performance was boosted by the emergence of higher profits from the Corporate division's portfolio of associates and joint ventures, which contributed £157 million to profits in 2006 (as compared to £65 million in 2005). The Corporate division expects this portfolio to be a sustainable source of additional profit going forward.

Underlying operating expenses rose in 2006 by 9 per cent. which included the consolidation of Lex Vehicle Finance ('Lex') from 31 May 2006. Excluding Lex, the increase in underlying expenses was 5 per cent..

The Corporate division continues to be cautious of the weaker returns available from lending to certain segments of the U.K. market and it has therefore continued its strategy of selective growth, continuing to focus on its origination and distribution model which it believes has benefited the net interest margin. Growth in lending before sell downs was 16 per cent. in 2006, but the Corporate division's risk and return criteria has seen it sell this down to a hold growth rate of 8 per cent..

Customer deposits decreased by 7 per cent. (as compared to 2005) as the Group's Corporate division completed the move away from expensive short-term deposits towards a base more suitable for funding purposes.

The credit environment continues to remain at what the Group believes are historically benign levels, and the Group's credit performance in Corporate has again improved. Impaired loans as a percentage of closing advances fell in 2006 to 1.32 per cent. (as compared to 1.41 per cent. in 2005). Impairment losses as a percentage of average advances also fell in 2006 to 0.52 per cent. (as compared to 0.56 per cent. in 2005). The coverage of impaired loans by impairment provisions remained constant in 2006 relative to 2005 at 63 per cent.

#### *2005*

Underlying profit before tax increased 21 per cent. in 2005 (as compared to 2004 (pro forma)) to £1,420 million, as the Group's Corporate division continued to benefit from previous periods' higher growth, measured new lending and a favorable credit experience.

There is increasing competition facing the Group's Corporate division, both in terms of price and lending criteria. The Group's strategy in the Corporate division is to maintain a focus on preserving returns with active sell down of underwritten positions enhancing returns. Growth in advances for 2005 was held at 8 per cent. (as compared to 2004 (pro forma)).

The fall in the net interest margin to 215bps for 2005 (as compared to 226bps in 2004 (pro forma)) underscores the current highly competitive nature of the corporate market. The modest fall in the net interest margin in the second half of 2005, however, helped to sustain a 5 per cent. increase in net interest income in 2005 (as compared to 2004 (pro forma)).

The focus on fees and commissions in the Corporate division from new and existing customers during a period of growth restraint led to an increase in non-interest income of 44 per cent. in 2005 (as compared to 2004 (pro forma)). Realizations assisted this growth in the year and the Group expects this to be an ongoing feature of results as its pipeline of unrealized gains was little changed at the end of 2005 versus 2004. The Group therefore expects that the contribution from non-interest income realized in the past few years will remain sustainable going forward.

Overall net operating income in Corporate grew by 19 per cent. in 2005 (as compared to 2004 (pro forma)) and underlying operating expenses by 8 per cent. in 2005 (as compared to 2004 (pro forma)) leading to a further reduction in the cost:income ratio to 28.7 per cent. in 2005 (as compared to 30.8 per cent. in 2004 (pro forma)).

Credit performance in Corporate improved in 2005, as impaired loans as a percentage of closing advances fell to 1.41 per cent. (as compared to 1.85 per cent. in 2004 (pro forma)).

Impairment losses as a percentage of average advances in Corporate likewise fell to 0.56 per cent. in 2005 (as compared to 0.58 per cent. in 2004 (pro forma)). The coverage of impaired loans by impairment provisions increased to 63 per cent. in 2005 (as compared to 53 per cent. in 2004 (pro forma)).

### ***Insurance & Investment***

#### *2006*

Underlying profit before tax increased in 2006 by 19 per cent. to £581 million (as compared to £489 million in 2005).

Underlying profit before tax for the General Insurance business increased in 2006 by 20 per cent. to £304 million (as compared to £254 million in 2005), reflecting the benign underwriting cycle in household insurance which helped alleviate further claims inflation in the division's motor insurance business.

Overall, General Insurance sales fell 4 per cent. in 2006 to £1,894 million, as measured by Gross Written Premiums (**GWP**) (as compared to £1,977 million in 2005). While household insurance sales increased by 11 per cent. in 2006 (as compared to 2005), repayment insurance sales fell 10 per cent. in 2006 (as compared to 2005), reflecting the market-wide slowdown in consumer credit, and motor insurance sales fell 9 per cent. in 2006 (as compared to 2005), reflecting a highly competitive market which has yet to see a sustained increase in prices sufficient to warrant the pursuit of a faster pace of sales growth.

Underlying profit before tax for the division's Investment business increased in 2006 by 18 per cent. to £277 million (as compared to £235 million for 2005), growth again being held back by the increased new business strain arising on the sale of investment contracts.

U.K. Investment sales were strong across all channels, increasing 23 per cent. in 2006 to £1,817 million Annual Premium Equivalent (**APE**) (as compared to £1,473 million APE in 2005). Sales through the bancassurance channel were up 12 per cent., intermediary channel were up 28 per cent. and wealth management were up 58 per cent. (in each case, as compared to 2005), making the Group the United Kingdom's number one retail mortgages provider of new investment products in 2006. New business profitability improved in 2006 to 27 per cent. of 'APE' (as compared to 24 per cent. in 2005).

On pages 20 to 24 of the HBOS plc Annual Report and Accounts 2006, the Group has provided supplementary embedded value (**EV**) information for its UK investment business. This shows that the contribution from new investment business in 2006 on the 'Full EV' basis (i.e. assuming all investment business is EV accounted) was £474 million (as compared to £365 million in 2005), which is higher than the reported IFRS result. On the same basis, the contribution from existing investment business was lower, resulting in a net increase to underlying profit before tax in 2006 of £262 million higher than the reported IFRS result (as compared to £179 million in 2005).

On the Full EV basis, the total net of tax embedded value for the Group's U.K. Investment business in 2006 was £2,525 million higher (as compared to £2,006 million in 2005) than the reported IFRS figure.

## 2005

Both the Group's General Insurance and Investment businesses showed sales growth during 2005. Underlying profit before tax, however, decreased by 1 per cent. in 2005 (as compared to 2004 (pro forma)) to £489 million.

Underlying profits for the General Insurance business increased by 13 per cent. in 2005 (as compared to 2004 (pro forma)) to £254 million, with solid growth in premium income, supported by high retention rates among existing customers and favorable claims experience, particularly on household business.

General Insurance sales overall were up 14 per cent. in 2005 (as compared to 2004) with repayment insurance sales up 18 per cent. in 2005 (as compared to 2004) driven by strong sales in third party business. Sales of household insurance grew 5 per cent. in 2005 (as compared to 2004) with 87 per cent. of new policies now unrelated to Group mortgage sales. Motor insurance sales rose 16 per cent. in 2005 (as compared to 2004), helped by investment in the esure, First Alternative and Sheilas' Wheels brands, although increased competition held back premium rate increases.



In December 2005, the OFT announced a study into Payment Protection Insurance (**PPI**). The Group continues to believe that PPI meets a real need for customers and as a responsible lender, its products meet the requirements of customers and regulators.

Underlying profit before tax in the Investment business fell by 13 per cent. in 2005 (as compared to 2004 (pro forma)) to £235 million. The fall in profits reflects the £100 million of one-off benefits of efficiency improvements and favorable operating experience reported in 2004.

Investment sales rose 18 per cent. in 2005 (as compared to 2004 on an APE basis). Sales through the bancassurance channel increased 22 per cent. in 2005 (as compared to 2004) on the back of further productivity improvements from the Group's advisory team, which now totals over 1,000 advisors. Wealth Management sales increased 25 per cent. in 2005 (APE as compared to 2004) as confidence returned throughout 2005 in the Wealth management market and St. James's Place is well placed to benefit from the advice opportunity created by Pensions 'A' Day legislation.

New business profitability was stable at 26 per cent. of APE in 2005 (as compared to 25 per cent. in 2004).

## ***International***

### *2006*

Underlying profit before tax in the Group's International division increased in 2006 by 34 per cent. to £820 million (as compared to £610 million in 2005), reaffirming the Group's confidence that the ongoing investment in the Group's international markets is the right choice for the Group.

In a strong Australian market, underlying profit before tax increased 24 per cent. in 2006 to £278 million (as compared to £224 million in 2005). Net interest income increased in 2006 by 21 per cent. (as compared to 2005), reflecting strong growth in lending and resilient margins, which fell 6bps in 2006 to 233bps (as compared to 239bps in 2005). Underlying operating expenses increased in 2006 by 10 per cent. (as compared to 2005), primarily because of the division's investment in nine additional commercial business sites on the East Coast of Australia, where the division is seeking to expand its presence. Lending and deposits grew 24 per cent. and 28 per cent., respectively, relative to 2005. Impaired loans as a percentage of closing advances increased to 1.00 per cent. (as compared to 0.66 per cent. in 2005), the increase due in large part to a small number of impaired corporate transactions, where the division expects the ultimate recovery rate to be high. Impairment losses as a percentage of average advances increased in 2006 to 0.27 per cent. (as compared to 0.19 per cent. in 2005).

In Ireland, underlying profit before tax increased by 43 per cent. in 2006 to £149 million (as compared to £104 million in 2005). Performance in 2006 was driven by a buoyant Irish economy, but also, encouragingly, by the performance of the division's business banking and mortgage operations, both of which have benefited from increased customer awareness generated by the division's ongoing investment commitment to the market. Net interest income increased by 32 per cent. in 2006 (as compared to 2005), reflecting the growth in lending and broadly stable margins which fell by 4bps to 173bps (as compared to 177bps in 2005). Underlying operating expenses increased by 39 per cent. in 2006 (as compared to 2005) as a result of the division's investment in the new Retail branch network, which commenced in early 2006. The Group has now opened 24 branches in Ireland and expects to complete the branch opening programme of 46 branches by the end of 2007. Lending and deposits grew by 31 per cent. and 32 per cent., respectively, relative to 2005. Credit conditions remain relatively benign and this is reflected in impairment losses which, as a percentage of average advances, were unchanged from 2005 at 0.20 per cent.. As a percentage of closing advances, impaired loans decreased slightly in 2006 to 1.87 per cent. (as compared to 1.98 per cent. in 2005).

In Europe & North America, underlying profit before tax increased by 39 per cent. in 2006 to £393 million (as compared to £282 million in 2005). Net interest income increased by 17 per cent. (as compared to 2005), reflecting the overall growth in lending, particularly in Corporate Europe and Corporate North America. Margins fell by 39bps in 2006 to 370bps (as compared to 409bps in 2005), as a result of the continued diversification of the Corporate portfolio. Underlying non-interest income increased 64 per cent. in 2006, mainly as a result of the full year impact of consolidating Heidelberger Leben into the International division's results. Underlying operating expenses grew by 33 per cent. in 2006 (as compared to 2005), again reflecting the consolidation of Heidelberger Leben and ongoing investments such as the expansion of the Group's branch network in Spain and the opening of its Corporate Europe office in Stockholm.

In Europe and North America, credit quality in 2006 again reflected the generally benign conditions in most of the markets in which the division operates. Impairment losses as a percentage of average advances improved in 2006 to 1.13 per cent. (as compared to 1.26 per cent. in 2005), and impaired loans as a percentage of closing advances improved in 2006 to 0.62 per cent. (as compared to 1.61 per cent. in 2005). Excluding Drive, impairment losses were only £14 million (as compared to £32 million in 2005), and as a percentage of average advances improved to 0.13 per cent. (as compared to 0.35 per cent. in 2005).

The disposal of the Group's shareholding in Drive was completed in early December 2006 and gave rise to a profit on sale of £180 million, which has not been included in the reporting of underlying results.

## 2005

Underlying profit before tax in International increased by 50 per cent. to £610 million in 2005 (as compared to 2004 (pro forma)). As discussed below, the results reflected the full year consolidation of Drive Financial Services ("Drive") and the inclusion of Heidelberger Leben from July 2005.

In Australia, the Group focused on the expansion of its presence on the east coast of the country. Underlying profit before tax increased 17 per cent. to £224 million in 2005 (as compared to 2004 (pro forma)). Advances and deposits grew 35 per cent. and 50 per cent., respectively, in 2005 (as compared to 2004 (pro forma)). Net interest margin was virtually unchanged at 239bps in 2005 (as compared to 241bps in 2004 (pro forma)). Credit quality remained good with impairment losses and percentage of average advances at 0.19 per cent. in 2005 (as compared to 0.14 per cent. in 2004 (pro forma)). As a percentage of closing advances impaired loans reduced to 0.66 per cent. in 2005 (as compared to 0.76 per cent. in 2004 (pro forma)).

In Ireland, the Group announced plans to develop its retail business alongside the purchase in 2005 of a branch network from the Irish Electricity Supply Board. During a period of significant investment, underlying profit before tax nevertheless increased by 7 per cent. to £104 million in 2005 (as compared to 2004 (pro forma)). Advances and deposits grew 36 per cent. and 13 per cent., respectively, in 2005 (as compared to 2004 (pro forma)). Net interest margins fell to 177bps in 2005 (as compared to 201bps in 2004 (pro forma)) driven primarily by the retail expansion. Impairment losses as a percentage of average advances were 0.20 per cent. in 2005 (as compared to 0.15 per cent. in 2004 (pro forma)) and as a percentage of closing advances, impaired loans fell to 1.98 per cent. in 2005 (as compared to 2.07 per cent. in 2004 (pro forma)).

In Europe and North America, underlying profit before tax increased 135 per cent. to £282 million in 2005 (as compared to 2004 (pro forma)), including the positive impact of the consolidation of Drive from November 2004 and the inclusion of Heidelberger Leben from July 2005. On a "like for like" basis, adjusting for these businesses, underlying profit before tax increased 83 per cent. in 2005 (as compared to 2004 (pro forma)) on the back of strong income growth and improved credit performance.

Credit quality improved substantially in 2005. Impairment losses as a percentage of average advances improved to 1.26 per cent. in 2005 (as compared to 1.81 per cent. in 2004 (pro forma)) and impaired loans as a percentage of closing advances improved to 1.61 per cent. in 2005 (as compared to 2.52 per cent. in 2004 (pro forma)).

Investment sales in 2005 returned back to a more normal level experienced before the tax driven surge in new business in Germany in the final quarter of 2004 and fell by 42 per cent. in 2005 (as compared to 2004 (pro forma)).

### *Treasury & Asset Management*

#### *2006*

Underlying profit before tax in the Treasury & Asset Management division increased by 33 per cent. in 2006 to £350 million (as compared to £263 million in 2005). Net interest income increased by 12 per cent. (as compared to 2005) with the margin remaining broadly stable, and underlying non-interest income increased by 27 per cent. (as compared to 2005). Underlying operating expenses increased by 18 per cent. (as compared to 2005), as the Group continues to invest in the development of its overseas Treasury offices and its Asset Management capabilities.

The Treasury team was active in executing the Group's funding and capital plans in 2006, arranging four capital issues on behalf of HBOS plc and approximately £21 billion of securitisations and covered bonds during the year.

In September 2006, the Group successfully listed its property investment company, Invista Real Estate, on the London Alternative Investment Market ('AIM'), retaining a majority stake of 55 per cent. and recognising a profit of £22 million in connection with the initial public offering. Property funds under management have subsequently increased by 35 per cent. to £9.2 billion at 31 December 2006.

Total funds under management for the Group's Asset Management businesses increased to £107.8 billion in 2006 (as compared to £88.7 billion in 2005), helped by continued progress in the liability driven investment market and above benchmark performance in most asset classes including fixed income and European equities.

#### *2005*

In Treasury & Asset Management underlying profit before tax decreased 4 per cent. to £263 million in 2005 (as compared to 2004 (pro forma)) largely as a result of the £31 million impact from IFRS derivative hedge accounting, £30 million of which relates to timing differences of income recognition. Excluding this factor, underlying profit before tax increased by 7 per cent. in 2005 (as compared to 2004 (pro forma)).

Planned investment in the Group's new Treasury branch in Sydney and the division's Asset Management operational infrastructure resulted in a 17 per cent. increase in 2005 (as compared to 2004 (pro forma)) in operating expenses. These investments resulted in the cost:income ratio moving to 48.5 per cent. in 2005 (as compared to 43.5 per cent. in 2004 (pro forma)).

Approximately 99 per cent. of Treasury interbank and structured investment portfolio assets were of high quality in 2005 being rated A or above, and not requiring any impairment provisions.

Insight's funds under management increased to £88.7 billion in 2005 (as compared to £77.7 billion in 2004 (pro forma)) helped by a strong investment performance in the fixed income asset class. The Group further developed its leading position in the liability driven investment (**LDI**) market consistently being shortlisted for LDI mandates.

## Results of Operations and Related Financial Information (Group)

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

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	(in £ millions) (except per share)		
Operating profit (before impairment losses on loans and advances)	7,072	6,322	5,237
Profit before taxation .....	5,706	4,808	4,112
Total assets .....	591,029	540,873	479,674
Post tax return on mean equity <sup>(1)</sup> .....	20.8%	19.6%	19.6%
Cost:income ratio (operating expenses to total income) <sup>(2)</sup> .....	40.9%	42.2%	44.7%
Total shareholders' equity .....	21,171	18,456	16,681
Tier 1 capital ratio.....	8.1%	8.1%	7.9%
Total capital ratio .....	12.0%	12.4%	12.3%

(1) Post tax return on mean equity is calculated by dividing underlying profit attributable to ordinary shareholders by the monthly average of ordinary shareholders' funds.

(2) The cost:income ratio is calculated excluding exceptional items, and goodwill amortization and after netting operating lease depreciation, amounts written off fixed asset investments and general insurance claims against operating income. The cost:income ratio is calculated on an underlying basis as follows:

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions) (except per share)		
Operating expenses .....	15,571	17,244	11,304
Retail rationalization costs .....	–	(84)	
Merger integration costs .....			(48)
Mortgage endowment compensation .....	(95)	(260)	(130)
Goodwill impairment .....	(55)		(6)
	<u>15,421</u>	<u>16,900</u>	<u>11,120</u>
Operating lease depreciation.....	(812)	(561)	(428)
Change in investment contract liabilities .....	(2,910)	(5,089)	(1,753)
Net claims paid on insurance contracts .....	(2,328)	(2,019)	(2,388)
Net change in insurance contract liabilities .....	(3,894)	(4,220)	(2,190)
Change in unallocated surplus .....	(569)	(369)	
Underlying operating expenses.....	<u>4,908</u>	<u>4,642</u>	<u>4,361</u>
Net operating income .....	22,714	23,617	16,563
Gross up for policyholder tax .....	(220)	(200)	
Short term fluctuations .....	81	(110)	(17)
	<u>22,575</u>	<u>23,307</u>	<u>16,546</u>
Impairment on investment securities .....	(71)	(51)	(22)
Operating lease depreciation.....	(812)	(561)	(428)
Change in investment contract liabilities .....	(2,910)	(5,089)	(1,753)
Net claims incurred on insurance contracts .....	(2,328)	(2,019)	(2,388)
Net change in insurance contract liabilities .....	(3,894)	(4,220)	(2,190)
Change in unallocated surplus .....	(569)	(369)	
Underlying operating income .....	<u>11,991</u>	<u>10,998</u>	<u>9,765</u>

The Group's operating profit before impairment losses on loans and advances increased by 12 per cent. in 2006 to £7,072 million, as compared to £6,322 million for 2005. Operating profit before impairment losses on loans and advances had increased by 21 per cent. in 2005 (as compared to £5,237 million for 2004 (pro forma)).

Total assets increased by 9 per cent. in 2006 to £591 billion, compared to £541 billion in 2005. Total assets had increased by 12 per cent. in 2005 (as compared to £480 billion in 2004 (pro forma)).

The Group's post-tax return on mean equity for 2006 was 20.8 per cent., compared to 19.6 per cent. in 2005. The Group's post-tax return on mean equity of 19.6 per cent. in 2005 was unchanged as compared to 2004 (pro forma).

The Group's cost income ratio for 2006 was 40.9 per cent., compared to 42.2 per cent. for 2005 and 44.7 per cent. for 2004 (pro forma).

The Group's Tier 1 and total capital increased to £22,429 million and £33,154 million, respectively, in 2006, from £20,667 million and £31,726 million, respectively, in 2005 and £18,550 million and £28,987 million, respectively, in 2004 (pro forma). The Tier 1 and total capital ratios were 8.1 per cent. and 12.0 per

cent., respectively, in 2006 compared with 8.1 per cent. and 12.4 per cent., respectively, in 2005 and 7.9 per cent. and 12.3 per cent., respectively, in 2004 (pro forma).

### *Net interest income*

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

#### **Net Interest Income**

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Retail .....	4,188	4,028	3,719
Corporate .....	1,861	1,695	1,617
Treasury & Asset Management .....	205	183	168
Insurance & Investment .....	(93)	(95)	46
International .....	1,239	1,018	728
Net interest income .....	7,400	6,829	6,278

#### **Net Interest Margin**

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in percent)		
Retail .....	1.78%	1.84%	1.85%
Corporate .....	2.22%	2.15%	2.26%
Treasury & Asset Management .....	0.07%	0.08%	0.09%
International .....	2.49%	2.65%	2.41%
Net interest margin .....	1.78%	1.80%	1.79%

Net interest income increased by 8 per cent. in 2006 (as compared to 2005) to £7,400 million, reflecting asset growth of 10 per cent., which was offset by a slightly lower Group net interest margin compared to 2005. The Group net interest margin fell 2bps in 2006, mainly reflecting a reduction in the Retail division net interest margin of 6bps. Net interest income had increased by 9 per cent. in 2005 (compared to 2004 (pro forma)) to £6,829 million, reflecting 8 per cent. (compared to 2004 (pro forma)) growth in average interest earning assets and a slight increase in Group net interest margin compared to 2004 (pro forma).

### *Non-interest income*

The Group's non-interest income consists of net fees and commissions, net earned premiums on insurance contracts, net trading income, change in value of in-force Long Term Assurance Business, net investment income related to insurance and investment business and other operating income.



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

### Non-interest income

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions) (except per share)		
Fees and commissions receivable .....	2,175	2,212	1,789
Fees and commissions payable .....	(1,012)	(1,178)	(916)
Net earned premium on insurance contracts .....	5,648	4,654	3,448
Net trading income .....	279	218	208
Change in value of in-force Long Term Assurance Business .....	282	394	112
Other operating income:			
Profit on sale of investment securities .....	307	172	108
Operating lease rental income .....	1,042	714	618
Net investment income related to insurance and investment business	6,306	9,032	4,635
Other .....	148	260	266
Total non-interest income .....	15,175	16,478	10,268

The Group's non-interest income decreased 8 per cent. in 2006 (compared to 2005) to £15,175 million, as compared to £16,478 million for 2005. The Group's non-interest income had increased 60 per cent. in 2005 (compared to £10,268 million for 2004 (pro forma)).

### Operating expenses

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

### Operating expenses

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Staff costs .....	2,674	2,432	2,289
Expenditure on premises and equipment .....	659	619	643
Depreciation and amortization .....	380	375	385
Other .....	11,708	13,474	7,803
Total .....	15,421	16,900	11,120

The Group's underlying operating expenses increased by 6 per cent. in 2006 (compared to 2005) to £4,908 million, compared to £4,642 million for 2005. The Group's underlying operating expenses had increased by 6 per cent. in 2005 (as compared to £4,361 million for 2004 (pro forma)).

### *Underlying operating expenses*

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

#### **Underlying Operating Expenses**

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	(in £ millions)		
Operating expenses .....	15,571	17,244	11,304
Retail rationalization costs .....		(84)	
Merger integration costs .....			(48)
Mortgage endowment compensation .....	(95)	260	(130)
Goodwill impairment .....	(55)		(6)
	<u>15,421</u>	<u>16,900</u>	<u>11,120</u>
Operating lease depreciation.....	(812)	(561)	(428)
Change in investment contract liabilities .....	(2,910)	(5,089)	(1,753)
Net claims paid on insurance contracts .....	(2,328)	(2,019)	(2,388)
Net change in insurance contract liabilities .....	(3,894)	(4,220)	(2,190)
Change in unallocated surplus .....	(569)	(369)	
<b>Underlying operating expenses .....</b>	<u>4,908</u>	<u>4,642</u>	<u>4,361</u>

Merger integration costs relate to the costs of integrating and reorganizing Bank of Scotland Group and Halifax Group following the merger. Mortgage endowment compensation relates to the estimated costs of redress arising from the sale of mortgage endowments. Retail rationalization costs are the impact of a programme of cost-management initiatives which will deliver significant recurring efficiencies in the Retail division.

### *Provisions for impairment losses on loans and advances*

The Group's accounting policy in respect of the years ended 31 December 2006 and 2005 is to assess impairment individually for financial assets that are significant and individually or collectively for assets that are not significant.

Individual impairment is identified at a counterparty specific level following objective evidence that a financial asset is impaired. This may be after an interest or principal payment is missed or when a banking covenant is breached. The present value of estimated cash flows recoverable is determined after taking into account any security held. The amount of any impairment is calculated by comparing the present value of the cash flows discounted at the loan's original effective interest rate with the balance sheet carrying value. If impaired, the carrying value is adjusted and the difference charged to the income statement.

The written down value of the impaired loan is compounded back to the net realizable balance over time using the original effective interest rate. This is reported through interest receivable within the income statement and represents the unwinding of the discount.

A write-off is made when all or part of a claim is deemed uncollectable or forgiven. Write-offs are charged against previously established provisions for impairment or directly to the income statement.

In circumstances where an asset has been individually assessed for impairment and no objective evidence of impairment exists, then it will be subject to a collective assessment.

Collective impairment is identified for groups of assets that share similar risk characteristics. Collective impairment is assessed using a methodology based on existing risk conditions or events that have a strong correlation with a tendency to default.

The Group's accounting policy in respect of the year to 31 December 2004 was to make specific provisions for advances that are recognized to be bad and doubtful and establish general provisions to cover advances that are latently bad or doubtful, but not yet identified as such.

The following table sets out the cumulative balances of the Group's impairment losses on loans and advances by division as at the dates indicated:

#### Impairment losses on loans and advances

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	(in £ millions)		
Impairment losses on loans and advances .....	3,089	2,938	
<i>Cumulative balances by division (unaudited)</i>			
Retail .....	2,108	1,924	1,556
Corporate .....	709	704	711
International .....	272	310	269
Total .....	3,089	2,938	2,536

The following table sets out the Group's closing provisions as a percentage of closing loans and advances by division as at the dates indicated.

#### Risk provisioning rates

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	(in per cent.)		
Retail .....	0.89	0.88	0.76
Corporate .....	0.83	0.89	0.97
International .....	0.51	0.72	0.83
Total .....	0.82	0.85	0.81

The following table provides an analysis of the movement in the Group's provisions for impairment over the years indicated.

#### Impairment Losses

The total charge for loan impairment losses was £1,742 million in 2006 representing 0.48 per cent. of average balances (compared to £1,599 million in 2005 representing 0.49 per cent. of average balances and £1,255 million in 2004 (pro forma)), representing 0.48 per cent. of average advances.

## Impairment Losses

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Retail .....	1,097	991	668
Corporate .....	424	428	401
International .....	221	180	186
Total provisions.....	1,742	1,599	1,255

The Group's combined individual and collective provision charge for impairment losses on loans and advances increased by 9 per cent. in 2006 to £1,742 million, compared to £1,599 million in 2005 and £1,255 million in 2004 (pro forma).

The combined charge for impairment losses for the Retail division increased 11 per cent. in 2006 to £1,097 million, compared to £991 million in 2005 and £668 million for 2004 (pro forma). The Retail unsecured lending charge increased to £989 million in 2006 from £852 million in 2005 and £657 million in 2004 (pro forma).

The combined charge for impairment losses for the Corporate division decreased by 1 per cent. in 2006 to £424 million, compared to £428 million in 2005 and £401 million in 2004 (pro forma).

## Results of Operations and Related Financial Information (Divisional)

Divisional performance on an underlying basis is summarized below:

### Underlying Profit before taxation by Division

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Retail .....	2,364	2,283	2,123
Corporate .....	1,663	1,420	1,171
Treasury and Asset Management .....	350	263	275
Insurance & Investment .....	581	489	495
International .....	820	610	408
Group Items <sup>(1)</sup> .....	(241)	(223)	(193)
Group underlying profit before tax.....	5,537	4,842	4,279

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

The Group's underlying profit before tax increased by 14 per cent. in 2006 to £5,537 million, compared to £4,842 million for the year ended 31 December 2005 and £4,279 million for the year ended 31 December 2004 (pro forma).

## ***Retail***

Underlying profit before tax in the Retail division increased by 4 per cent. in 2006 to £2,364 million (as compared to £2,283 million in 2005). Underlying net operating income increased by 4 per cent. in 2006, while underlying expenses increased by just £3 million. As a consequence, the 2006 cost:income ratio improved to 38.4 per cent. (as compared to 39.8 per cent. in 2005), more than offsetting a 6bps fall in net interest margin to 1.78 per cent. (as compared to 1.84 per cent. in 2005).

Credit experience continued the trends identified in early 2006, with impairment losses increasing by 11 per cent. (as compared to 2005) but impaired loans falling to 2.72 per cent. of advances (as compared to 2.97 per cent. in 2005). Within this, secured impairments fell and the growth in unsecured impairments slowed.

Sales performance was strong in mortgages, savings and bank accounts, with lower unsecured lending reflecting a smaller market and the division's reduced appetite for such risk.

Financial Performance

Retail

Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	4,188	4,028	3,719
Non-interest income .....	1,350	1,315	1,134
Mortgages & Savings .....	493	421	356
Banking .....	428	431	318
Business Banking .....	31	24	19
Personal Loans .....	109	109	107
Credit Cards .....	286	321	273
Other .....	49	47	70
Fees and commission income .....	1,396	1,353	1,143
Fees and commission expense .....	(66)	(70)	(62)
Other operating income .....	20	32	53
<b>Net operating income</b> .....	<b>5,538</b>	<b>5,343</b>	<b>4,853</b>
<b>Operating expenses</b> .....	<b>(2,127)</b>	<b>(2,124)</b>	<b>(2,118)</b>
Staff .....	(1,056)	(1,023)	(1,005)
Accommodation, repairs and maintenance .....	(10)	(9)	(11)
Technology .....	(54)	(70)	(75)
Marketing and communication .....	(179)	(182)	(194)
Depreciation:			
Tangible and intangible fixed assets .....	(69)	(66)	(63)
Other .....	(101)	(112)	(143)
Sub total .....	(1,469)	(1,462)	(1,491)
Recharges:			
Technology .....	(263)	(262)	(266)
Accommodation .....	(262)	(263)	(250)
Other shared services .....	(133)	(137)	(111)
<b>Operating profit before provisions</b> .....	<b>3,411</b>	<b>3,219</b>	<b>2,735</b>
Impairment losses on loans and advances .....	(1,097)	(991)	(668)
<b>Operating profit</b> .....	<b>2,314</b>	<b>2,228</b>	<b>2,067</b>
Share of profits of associates and jointly controlled entities .....	2	9	33
Non-operating income .....	48	46	23
<b>Underlying profit before tax</b> .....	<b>2,364</b>	<b>2,283</b>	<b>2,123</b>
Net interest margin .....	1.78%	1.84%	1.85%
Impairment losses as a % of average advances .....	0.48%	0.47%	0.34%
Cost: income ratio .....	38.4%	39.8%	43.6%

*Operating income and margins.* Total net operating income grew in 2006 by 4 per cent. to £5,538 million (as compared to £5,343 million in 2005 and £4,853 in 2004 (pro forma)). Net interest income increased in 2006 by 4 per cent. to £4,188 million (as compared to £4,028 million in 2005 and £3,719 million in 2004 (pro forma)) and non-interest income was 3 per cent. higher in 2006 at £1,350 million (as compared to £1,315 million in 2005 and £1,134 million in 2004 (pro forma)). Non-interest income includes commissions received from the Group's Insurance & Investment division in respect of the distribution of repayment insurance business.

Fees and commissions income grew in 2006 by 3 per cent. to £1,396 million (as compared to £1,353 million in 2005 and £1,143 million in 2004 (pro forma)). Growth in fees from mortgages and savings was partially offset in 2006 by lower credit card default fee income and commissions from the sale of repayment insurance in relation to unsecured lending products.

## Retail

### Net Interest Margins and Spreads

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	(in £ millions)		
<b>Net interest income:</b>			
Interest receivable .....	14,331	13,421	11,551
Interest payable .....	(10,284)	(9,555)	(7,977)
Capital earnings .....	141	162	145
	<u>4,188</u>	<u>4,028</u>	<u>3,719</u>
<b>Average Balances:</b>			
Total interest earning assets .....	<u>235,371</u>	<u>219,006</u>	<u>200,941</u>
Interest bearing liabilities			
– deposits .....	145,756	132,043	126,189
– other .....	89,615	86,963	74,752
Total interest bearing liabilities .....	<u>235,371</u>	<u>219,006</u>	<u>200,941</u>
<b>Average Rates:</b>	%	%	%
Gross yield on interest earning assets.....	6.09	6.13	5.75
Cost of interest bearing liabilities.....	(4.37)	(4.36)	(3.97)
<b>Net Interest Spread</b> .....	<u>1.72</u>	<u>1.77</u>	<u>1.78</u>
Capital earnings .....	0.06	0.07	0.07
<b>Net Interest Margin</b> .....	<u>1.78</u>	<u>1.84</u>	<u>1.85</u>



	<u>Basis points</u>
<b>Movement in margin</b>	
Net interest margin for the year ended December 31, 2004 (pro forma) .....	185
Mortgage and savings .....	(5)
Banking .....	1
Personal lending .....	(4)
Credit cards .....	3
Wholesale funding .....	4
Net interest margin for the year ended December 31, 2005 .....	184
Mortgage and savings .....	(9)
Banking .....	2
Business banking .....	1
Unsecured personal loans .....	(1)
Credit cards .....	3
Wholesale funding .....	(1)
Capital earnings .....	(1)
<b>Net interest margin for the year ended 31 December, 2006</b> .....	<u>178</u>

*Margins and Spreads.* In aggregate, product spreads fell in 2006 by 4bps (as compared to 2005). The division's greater appetite for mortgage lending, together with increased competition in the buy-to-let market resulted in the combined mortgages and savings spread narrowing by 9bps. This was partly offset by spread movements in both credit cards and banking, as reflected in the table above.

*Operating Expenses.* Retail's commitment to strong cost management resulted in year on year growth in underlying operating expenses of just £3 million to £2,127 million (as compared to £2,124 million in 2005 and £2,118 million in 2004). This, combined with income growth in 2006 of 4 per cent., enabled the division to further reduce the cost:income ratio to 38.4 per cent. (as compared to 39.8 per cent. in 2005 and 43.6 per cent. in 2004 (pro forma)).

Retail's approach to cost management and the development of information technology processing systems capable of supporting its multiple brands at low cost, together with automated sales systems, helped drive sustained improvements in productivity while maintaining divisional growth. This approach enabled the division to achieve reductions in unit operating costs and to make suitable investments to support future growth.

*Credit quality and provisions.* The overall credit quality of the Retail division's balance sheet at 31 December 2006 remains strong, with 92.7 per cent. of customer loans as compared to 92.2 per cent. in 2005 secured on residential property. Despite continued challenging conditions for consumer lending, total impaired loans fell in 2006 to 2.72 per cent. of closing advances (as compared to 2.97 per cent. in 2005), driven by a fall in secured impairments partly offset by further increases on the unsecured book.

Impairment losses as a percentage of average advances remained broadly stable in 2006 at 0.48 per cent. (as compared to 0.47 per cent. in 2005 and 0.34 per cent. in 2004 (pro forma)). Total impairment losses increased by 11 per cent. in 2006 to £1,097 million (as compared to £991 million in 2005 and £668 million in 2004 (pro forma)), comprising £108 million for secured lending (as compared to £139 million in 2005 and £11 million in 2004 (pro forma)) and £989 million for unsecured lending (as compared to £852 million in 2005 and £657 million in 2004 (pro forma)). Closing provisions as a percentage of total closing advances remained broadly stable in 2006 at 0.89 per cent. (as compared to 0.88 per cent. in 2005 and 0.76 per cent. in 2004 (pro forma)). Total provisions coverage of impaired loans increased in 2006 to 33 per cent. (as

compared to 30 per cent. in 2005 and 35 per cent. in 2004 (pro forma)), reflecting the higher proportion of unsecured loans in the impaired portfolio.

*Secured Impairments.* Total impaired secured loans were £4,047 million in 2006 (as compared to £4,452 million in 2005 and £2,741 million in 2004 (pro forma)), representing 1.84 per cent. of closing advances (as compared to 2.21 per cent. in 2005 and 1.45 per cent. in 2004 (pro forma)). The fall in impairments compares favorably to broadly stable trends in the market, with both the mainstream and specialist portfolios benefiting from the implementation of new scorecards, stricter lending policies and a more efficient collections process. The number of cases in arrears fell in 2006 to 1.17 per cent. of mainstream lending (as compared to 1.30 per cent. in 2005 and 1.06 per cent. in 2004 (pro forma)) and 1.76 per cent. of specialist lending (as compared to 2.32 per cent. in 2005 and 1.57 per cent. in 2004 (pro forma)). In total, the value of cases in arrears but not in possession decreased by 11 per cent. in 2006 to £3,728 million (as compared to £4,203 million in 2005 and £2,635 million in 2004 (pro forma)) or 1.70 per cent. of the value of the total portfolio (as compared to 2.11 per cent. in 2005 and 1.4 per cent. in 2004 (pro forma)).

The 2006 secured impairment charge decreased in 2006 to 0.05 per cent. of average advances (as compared to 0.07 per cent. in 2005 and 0.01 per cent. in 2004 (pro forma)), and closing secured provisions as a percentage of closing advances decreased to 0.19 per cent. (as compared to 0.21 per cent. in 2005 and 0.17 per cent. in 2004 (pro forma)). The average LTV of the impaired mortgage portfolio was reduced slightly in 2006 to 57 per cent. (as compared to 58 per cent. in 2005 and 53 per cent. in 2004). The equivalent 2006 figures for impaired mainstream and specialist mortgages were 52 per cent. (as compared to 52 per cent. in 2005 and 48 per cent. in 2004) and 68 per cent. (as compared to 71 per cent. in 2005 and 67 per cent. in 2004), respectively.

The provisions coverage of impaired secured loans remained stable in 2006 at 10 per cent. (as compared to 10 per cent. in 2005 and 12 per cent. in 2004 (pro forma)), reflecting the Retail division's unchanged, formulaic methodology for provisioning.

*Unsecured impairments.* The rate of growth of impaired unsecured loans (personal loans, credit cards and bank accounts) moderated in the second half of 2006. This growth was driven predominantly by the residual seasoning of the pre-2004 credit card book.

Impaired unsecured loans increased in 2006 to £2,411 million (as compared to £2,049 million in 2005 and £1,761 million in 2004 (pro forma)) representing 13.17 per cent. of closing advances (as compared to 11.51 per cent. in 2005 and 10.80 per cent. in 2004 (pro forma)). Provisions as a percentage of closing advances increased in 2006 to 9.29 per cent. (as compared to 8.43 per cent. in 2005 and 7.79 per cent. in 2004 (pro forma)). Closing provisions cover as a percentage of impaired unsecured loans reduced slightly to 71 per cent. (as compared to 73 per cent. in 2005 and 70 per cent. in 2004 (pro forma)).

Corrective actions taken in 2004 to tighten lending criteria continue to drive improvements in arrears emergence on subsequent business. While encouraging, the division remains cautious about future impairment trends given the continued growth in U.K. personal insolvencies.

*Personal Loans.* Impaired personal loans increased to 17 per cent. of closing advances in 2006 (compared to 15.6 per cent. of closing advances in 2005 and 13.6 per cent. in 2004 (pro forma)), reflecting the combined impact of the book seasoning and modest lending growth as Retail tightened new business underwriting criteria. Provisions as a percentage of closing advances similarly increased to 11.5 per cent. in 2006 (compared to 10.9 per cent. in 2005 and 9.2 per cent. in 2004 (pro forma)).

*Credit Cards.* In 2006, credit card impairments increased to 15.4 per cent. of closing advances (as compared to 10.8 per cent. in 2005 and 9.9 per cent. in 2004 (pro forma)) and provisions increased to 11.4 per cent. of closing advances (as compared to 8.4 per cent. in 2005 and 7.7 per cent. in 2004 (pro forma)),

the rate of growth slowing in the second half of 2006. The main driver of impairment growth in the Retail division's book continues to be the residual seasoning of pre-2004 business. Delinquency and loss experience from business written since 2004 has performed to expectation, reflecting the division's continued focus on the acquisition of better quality business.

While volumes of accounts new to arrears reduced, there was a slight hardening in arrears roll rates with an increase in average loss per case. The division also saw some increase in both credit utilization and overdrawn limits as a result of selectively tightening credit availability to accounts showing signs of stress.

*Bank Accounts.* In 2006, impaired bank accounts decreased to 5.3 per cent. of closing advances (as compared to 6.4 per cent. in 2005 and 7.4 per cent. in 2004 (pro forma)) and provisions reduced to 3.6 per cent. of closing advances (as compared to 4.6 per cent. in 2005 and 4.8 per cent. in 2004(pro forma)), in line with the Retail division's business strategy to focus on the acquisition of full facility bank account customers.

*Business Banking.* Impaired loans and provisions as a proportion of closing advances decreased to 5.3 per cent. (as compared to 8.1 per cent. in 2005 and 6.1 per cent. in 2004 (pro forma)) and 3.5 per cent. (as compared to 7.5 per cent. for 2005 and 4.6 per cent. in 2004 (pro forma)), respectively. This improvement was, however, primarily the result of the amalgamation of a portfolio of business banking loans originated within the Corporate division into the existing Retail division portfolio in the second half of 2006.

*Non-operating income.* Non-operating income of £48 million in 2006 (as compared to £46 million in 2005 and £23 million in 2004 (pro forma)) comprises realized investment gains of £26 million (£nil in 2005 and £nil in 2004 (pro forma)), the major component being the part disposal in the Group's investment in Rightmove, and the profit on the sale and leaseback of premises of £22 million (as compared to £46 million in 2005 and £nil in 2004 (pro forma)). In 2004, non-operating income of £23 million comprises the profit on the disposal of cash machines situated in locations remote from the Group's bank branches.

## Retail

### Balance Sheet and Asset Quality Information

	As at 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
<b>Loans &amp; advances to customers</b> .....	£237.7bn	£219.0bn	£205.8bn
<b>Classification of advances*:</b>	%	%	%
Residential mortgages.....	92.1	91.4	91.9*
Other personal lending:			
Secured Personal Loans .....	0.6	0.8	1.0*
Unsecured Personal Loans .....	3.7	3.8	3.7*
Credit cards .....	3.0	3.3	2.8*
Banking .....	0.6	0.7	0.6*
<b>Total</b> .....	100.0	100.0	100.0*
<b>Impairment provisions on advances</b>	£m	£m	£m
Secured .....	408	424	316
Unsecured .....	1,700	1,500	1,240
<b>Total</b> .....	2,108	1,924	1,556
<b>Impairment provisions as a % of closing advances</b>	%	%	%
Secured .....	0.19	0.21	0.17
Unsecured .....	9.29	8.43	7.79
<b>Total</b> .....	0.89	0.88	0.76
<b>Impairment provisions as a % of impaired loans</b>	%	%	%
Secured .....	10	10	12
Unsecured .....	71	73	70
<b>Total</b> .....	33	30	35
<b>Impaired loans</b>	£m	£m	£m
Secured .....	4,047	4,452	2,741
Unsecured .....	2,411	2,049	1,761
<b>Total</b> .....	6,458	6,501	4,502
<b>Impaired loans as a % of closing advances</b>	%	%	%
Secured .....	1.84	2.21	1.45
Unsecured .....	13.17	11.51	10.80
<b>Total</b> .....	2.72	2.97	2.19
<b>Risk weighted assets</b> .....	£112.4bn	£109.2bn	£103.5bn
<b>Customer deposits</b> .....	£144.6bn	£132.2bn	£128.2bn

\* Before impairment provisions.

*In addition, the Classification of advances figures for 2005 have been restated. The 2004 comparatives, however, have not been similarly restated.*

## *Operational Performance*

*Mortgages.* The Retail division's net residential mortgage lending increased by 58 per cent. in 2006, compared to market growth of 20 per cent.. This strong performance was the result of the division maintaining its appetite for new mortgage business in the larger market, combined with improvements to levels of principal repaid.

Gross mortgage lending was maintained at a level consistent with Group's share of mortgage balances in the United Kingdom. Gross mortgage lending was £73.6 billion in 2006 (as compared to £60.6 billion in 2005 and £66.8 billion in 2004), representing a market share of 21 per cent. (as compared to a market share of 21 per cent. in 2005 and 23 per cent. in 2004). The mortgage book increased by £18.8 billion (as compared to a market share of 2005) to £220 billion, delivering an estimated net mortgage lending market share of 17 per cent. (as compared to 14 per cent. in 2005 and 17 per cent. in 2004), comfortably within the Group's target range for the year of 15 per cent.-20 per cent.. The Group's share of principal repaid, at 24 per cent. for 2006 (as compared to 25 per cent. for 2005 and 26 per cent. in 2004) continues largely to reflect previous levels of gross lending, the benefits of Retail's retention strategy in relation to existing customers having yet to be fully realized.

The Retail division continues to focus on strong asset cover in its secured book. However, its retention strategy for existing customers and reduced appetite for lower return remortgage business resulted in a modest increase in the LTV ratio of new lending to 64 per cent. (as compared to 60 per cent. in 2005 and 59 per cent. in 2004). The average LTV across the Retail division's entire secured lending book was stable at 44 per cent. (compared to 43 per cent. in 2005 and 41 per cent. in 2004) reflecting the positive contribution to collateral cover from improving retention.

*Unsecured Personal Loans.* The Retail division continues to focus on the acquisition of better quality business, maintaining its share of gross lending in 2006 at 10 per cent. (as compared to 10 per cent. in 2005) with balances reducing by 4 per cent. (as compared to 2005) to £6.6 billion (as compared to £6.9 billion in 2005). Acquisition costs continue to reduce as the division concentrates its marketing effort on existing customers with good credit histories.

*Credit Cards.* The Retail division believes its credit card business continues to benefit from multi-brand, multi-channel distribution strengths, enabling the division to grow business volumes in higher quality segments of the market. In 2006, against the background of lower consumer spending and borrowing, the Retail division acquired 743,000 new accounts compared with 1 million acquired in 2005 (961,000 including those acquired through the division's joint venture partners, as compared with 1.2 million acquired in 2005) resulting in an estimated market share of 11 per cent. of new credit card accounts (as compared to an estimated market share of 14 per cent. in 2005).

Outstanding balances declined in 2006 by 4 per cent. (as compared to 2005) to £7.0 billion (as compared to £7.3 billion in 2005 and £6.1 billion in 2004) in line with the market, reflecting less aggressive introductory periods, lower consumer demand and the proactive tightening of credit availability.

The implementation of lower default and late payment fees in August 2006 following the OFT ruling resulted in a reduction in fee income of approximately £25 million in 2006, with an estimated full year impact of £60 million in 2007.

*Retail Savings.* Savings deposits increased in 2006 by 10 per cent. to £124 billion (as compared to £113 billion in 2005 and £109 billion in 2004), compared to market growth estimated to be 8 per cent. over the same period.

Although competition for deposits from both new and existing players increased during the year, growth was achieved across all brands, which the Retail division believes demonstrates the strength and

diversity offered by the division's Retail Savings franchise and reinforces the Group's position as the UK's largest savings provider with an estimated share of the Household Sector Liquid Assets of 16 per cent. (even with the 16 per cent. for both 2005 and 2004). Strong inflows, in particular, were achieved by the Bank of Scotland and Birmingham Midshires brands, and by the Retail division's tax-free range of products, where it now has a 21 per cent. share of balances in the cash ISA market (as compared to 20 per cent. share in 2005).

In addition to net inflows, the Retail division continues to grow its customer base and remains committed to encouraging the next generation of savers. Over 2.7 million new accounts were opened during the year, of which over 380,000 were children's accounts. Retail also attracted over 480,000 new to franchise customers.

*Bank Accounts.* The Retail division acquired 879,000 new bank accounts in 2006 (as compared to 645,000 in 2005), representing an estimated market share of 19 per cent. (as compared to 16 per cent. in 2005), contributing to an increased share of stock of 13 per cent. (as compared to 12 per cent. in 2005). The division's current account book increased by 10 per cent. (as compared to 2005), representing 77 per cent. of its total bank account sales (as compared to 74 per cent. in 2005).

The Retail division believes its sales success in 2006 was driven by continued innovative product launches. The division's high interest current account and its Student Account resulted in sales in 2006 increasing by more than 33 per cent. on 2005. Also in 2006, online banking registrations grew by 31 per cent. and online transaction volumes grew by 40 per cent. (each as compared to 2005).

*Business Banking.* The number of customers switching to Bank of Scotland business banking in 2006 increased by 28 per cent. to 15,800 (as compared to 12,300 in 2005), with both Retail's branch and intermediary sales teams enjoying success as its 'Promise to Beat' proposition proved popular amongst SME customers. Successful new business acquisition helped to drive up business banking revenue by 19 per cent. in 2006 (as compared to 2005).

*Regulatory enquiry into banking charges.* In September 2006, the OFT announced a joint 'fact finding' exercise with the British Bankers' Association (**BBA**) to review the legal basis for banking charges. The Group has participated fully in this exercise through the BBA. As demonstrated in the Group's response to the review of credit card default fees in 2006, it intends to cooperate fully in any ongoing enquiry. The Group supports competition, which it believes provides choice for all its customers, consistent with its growth strategy and the creation of long-term shareholder value.

### **Corporate**

Underlying profit before tax in the Corporate division increased in 2006 by 17 per cent. to £1,663 million (as compared to £1,420 million in 2005 and £1,171 million (pro forma) for 2004 (pro forma)), which represents 30 per cent. of overall group underlying profit before tax. Included within this strong performance, underlying net operating income grew by 9 per cent. (as compared to 2005) and underlying expenses by 9 per cent. (as compared to 2005). Net interest margins improved and impairment losses remained flat year-on-year. Corporate's share of profits from associates and joint ventures increased to £157 million (as compared to £65 million in 2005). Strong markets have resulted in sustained uplifts to the valuation of assets held contributing to profits.



Financial Performance

Corporate

Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	1,861	1,695	1,617
Non-interest income .....	1,709	1,386	964
Commitment fees .....	39	45	36
Guarantee fees .....	23	28	23
International fees .....	49	33	28
Transaction fees* .....	63	62	73*
Underwriting fees* .....	89	61	
Other* .....	99	100	109*
Fees and commission income .....	362	329	269
Fees and commission expense .....	(21)	(36)	(44)
Profit on sale of investment securities .....	224	163	91
Operating lease rental income .....	1,006	682	598
Other operating income .....	138	248	50
<b>Net operating income</b> .....	<b>3,570</b>	<b>3,081</b>	<b>2,581</b>
<b>Operating expenses</b> .....	<b>(1,571)</b>	<b>(1,253)</b>	<b>(1,072)</b>
Staff .....	(447)	(410)	(364)
Accommodation, repairs and maintenance .....	(2)	(2)	(3)
Technology .....	(16)	(2)	(21)
Marketing and communication .....	(31)	(30)	(27)
Depreciation:			
Tangible and intangible fixed assets .....	(31)	(22)	(21)
Other .....	(91)	(92)	(75)
Sub total .....	(618)	(558)	(511)
Recharges:			
Technology .....	(50)	(48)	(47)
Accommodation .....	(53)	(46)	(41)
Other shared services .....	(62)	(65)	(62)
Underlying operating expenses .....	(783)	(717)	(661)
Operating lease depreciation .....	(788)	(536)	(411)
Impairment on investment securities .....	(69)	(45)	(25)
<b>Operating profit before provisions</b> .....	<b>1,930</b>	<b>1,783</b>	<b>1,484</b>
Impairment losses on loans and advances .....	(424)	(428)	(401)
<b>Operating profit</b> .....	<b>1,506</b>	<b>1,355</b>	<b>1,083</b>
Share of profits of associations and jointly controlled entities .....	157	65	88
<b>Underlying profit before tax</b> .....	<b>1,663</b>	<b>1,420</b>	<b>1,171</b>
Net interest margin .....	2.22%	2.15%	2.26%
Impairment losses as a % of average advances .....	0.52%	0.56%	0.58%
Cost: income ratio .....	28.9%	28.7%	30.8%

\* The transaction fees, underwriting fees and other figures for 2005 have been restated. The 2004 comparatives, however, have not been similarly restated.

Underlying net operating income increased by 9 per cent. in 2006 to £2,713 million (as compared to £2,500 million in 2005 and £2,145 million in 2004). Net interest income grew by 10 per cent. to £1,861 million (as compared to £1,695 million in 2005 and £1,617 million in 2004 (pro forma)) and underlying non-interest income grew in 2006 by 6 per cent. to £852 million (as compared to £805 million in 2005 and £528 million in 2004). In a buoyant, competitively-priced market, the Corporate division continues to actively sell down positions that might otherwise dilute returns or result in a concentration of risk, contributing to an improved net interest margin in 2006 of 2.22 per cent. (as compared to 2.15 per cent. in 2005 and 2.26 per cent. in 2004).

Net fees and commission income in the Corporate division increased in 2006 by 16 per cent. to £341 million (as compared to £293 million in 2005 and £225 million in 2004). Realized gains from the Corporate division's diversified investment portfolio increased in 2006 by 37 per cent. to £224 million (as compared to £163 million in 2005 and £91 million in 2004). Notwithstanding this, unrealized gains in the portfolio at the end of the year were higher than at the beginning, providing further confidence that such gains are sustainable going forward. As anticipated, other operating income decreased in 2006 by 44 per cent. to £138 million (as compared to £248 million in 2005 and £50 million in 2004 (pro forma)), 2005 having benefited from a small number of large, non-recurring dividend receipts.

*Operating Expenses.* Cost efficiency continues to be a key differentiator for the Corporate division. In 2006, underlying expenses increased by 9 per cent. to £783 million (as compared to £717 million in 2005 and £661 million in 2004 (pro forma)), with the cost: income ratio moving to 28.9 per cent. in 2006 (as compared to 28.7 per cent. in 2005 and 30.8 per cent. in 2004 (pro forma)). Excluding the impact of Lex, which became a wholly-owned subsidiary of the Group from 31 May 2006, underlying expenses would have increased in 2006 by 5 per cent. and the cost:income ratio would have fallen to 28.3 per cent..

*Credit Quality and Provisions.* Impairment losses remained stable in 2006 at £424 million (as compared to £428 million in 2005 and £401 million in 2004 (pro forma)), comparing favorably to lending growth of 8 per cent. in 2006. As a percentage of average advances, impairment losses improved in 2006 to 0.52 per cent. (as compared to 0.56 per cent. in 2005 and compared to 0.58 per cent. in 2004 (pro forma)) and impairment provisions as a percentage of closing advances improved in 2006 to 0.83 per cent. (as compared to 0.89 per cent. in 2005 and 0.97 per cent. in 2004). This reflects what the Corporate divisions believes to be a prudent balance between the division's market share ambitions and its natural caution at this stage of a benign credit cycle.

*Associates and Jointly Controlled Entities.* Associates and jointly-controlled entities, most of which form part of the Corporate division's investment portfolio, continue to be a key source of profitable activity. Strong markets have resulted in sustained uplifts to the valuation of assets held within these entities, contributing to profits of £157 million in 2006 (as compared to £65 million in 2005 and £88 million in 2004 (pro forma)).

*Lex Vehicle Finance ('Lex'):* On 31 May 2006, the Group acquired the remaining 50 per cent. of shares in Lex. As a wholly-owned subsidiary from that date, it has subsequently been fully consolidated within the Corporate division's income statement. Prior to 31 May 2006, the Group's share of profits from Lex were reported as a jointly controlled entity.

	Year ended 31 December, 2006	Year ended 31 December, 2005
	£m	£m
<b>Net operating income</b> .....	293	
Operating lease depreciation .....	(235)	
Underlying operating expenses .....	(31)	
<b>Operating profit</b> .....	27	
Share of profits of associates and jointly controlled entities .....	8	19
<b>Underlying profit before tax</b> .....	35	19

## Corporate

### Balance Sheet and Asset Quality Information

	As at 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
<b>Loans and advances to customers</b> .....	£85.3bn	£79.2bn	£73.2bn
<b>Impairment provisions on advances</b> .....	£709m	£704m	£711m
<b>Impairment provisions as a % of closing advances</b> .....	0.83%	0.89%	0.97%
<b>Classification of advances*:</b>	%	%	%
Agriculture, forestry and fishing .....	1	1	1
Energy .....	2	1	1
Manufacturing industry .....	5	7	6
Construction and property:			
Property investment .....	18	20	22
Property development.....	6	6	6
Housing associations .....	3	4	4
House builders .....	2	3	3
Other property .....	6	3	3
Hotels, restaurants and wholesale and retail trade.....	10	11	9
Transport, storage and communication .....	7	6	6
Financial .....	5	7	9
Other services.....	19	19	19
Individuals .....	3	2	3
Overseas residents .....	13	10	8
	100	100	100
<b>Impaired loans</b> .....	£1,124m	£1,114m	£1,354m
<b>Impaired loans as a % of closing advances</b> .....	1.32%	1.41%	1.85%
<b>Impairment provisions as a % of impaired loans</b> .....	63%	63%	53%
<b>Risk weighted assets</b> .....	£100.7bn	£92.5bn	£85.8bn
<b>Customer deposits</b> .....	£38.7bn	£41.7bn	£39.0bn

\* Before impairment provisions.

### Operating Performance

*Lending.* The Group believes that the strength of the Corporate division's franchise and its move to an asset class management strategy have enabled it to maintain strong growth in originations. During 2006,

Corporate maintained its stringent lending criteria, focusing on sectors, partners and returns rather than volume, and continued its rigorous approach to portfolio management through active participation in the sell down market. Lending increased by 16 per cent. before sell downs and by 8 per cent. after sell downs in 2006 to £85.3 billion (as compared to £79.2 billion in 2005 and £73.2 billion in 2004 (pro forma)).

Property continues to be the largest concentration within Corporate's lending book, representing 35 per cent. of the portfolio in 2006. The property portfolio consists of property investment (18 per cent. of the Corporate division's portfolio in 2006, as compared with 20 per cent. in 2005), property development (6 per cent. of the Corporate division's portfolio in 2006, even from 6 per cent. in 2005), housing associations (3 per cent. of the Corporate division's portfolio in 2006, as compared with 4 per cent. in 2005), housebuilders (2 per cent. of the Corporate division's portfolio in 2006, as compared with 3 per cent. in 2005) and other property (6 per cent. of the Corporate division's portfolio in 2006, as compared with 3 per cent. in 2005). The Corporate division has significant knowledge of the U.K. property sector and it is of the view that its specialist property lending models, along with considered lending criteria, ensure that the division's portfolio risk is well diversified, both in asset type and tenant concentration.

The other sectors within Corporate's lending book have also performed in line with the division's expectations. The service sectors (financial and others) performed consistently in 2006 and together in 2006 represented 24 per cent. of the Corporate division's portfolio (as compared to 26 per cent. in 2005). The division has also experienced a satisfactory performance from sectors associated with the slowdown in the retail sector such as retail, hotels, restaurants and manufacturing. These sectors represent 15 per cent. of Corporate's portfolio (as compared to 18 per cent. in 2005).

Some 7 per cent. of the Corporate division's lending book supports individual transactions in the private equity market (as compared to 6 per cent. in 2005). This market again saw strong growth in 2006, with an overall increase in leverage levels. The Corporate division's approach continued to be very selective, with a focus on supporting transactions by private equity houses with proven track records across varying economic environments. The UK portfolio management team maintain very close contact with Corporate's origination teams, monitoring the performance of individual customers and private equity houses. The division has also taken advantage of high liquidity in the market to sell down debt positions to hold levels with which it is comfortable, with the average hold level across the portfolio being below £25 million.

The Corporate division believes that it continues to be one of the largest and most efficient players in the motor finance market, with 16 per cent. of its portfolio representing the division's asset finance and motor business in 2006 (even as compared to 16 per cent. in 2005). This covers the whole range of secured debt and leasing from high value aircraft, rail and marine financing to high volume office equipment financing.

As at 31 December 2006, the book value of the division's portfolio of Corporate investments (i.e. equity, preference shares and loan stock held in companies, funds, joint ventures and associates) was £2.5 billion (as compared to £1.9 billion in 2005) and the number of holdings was in excess of 500. Of this portfolio, less than half of the book value was invested in private equity.

*Deposits.* As a consequence of the Corporate division's decision to price away unattractive deposits, customer deposits decreased by 7 per cent. to £38.7 billion (as compared to £41.7 billion in 2005 and £39.0 billion in 2004 (pro forma)). As a corollary, the Corporate division now intends to move forward with a higher-quality deposit book more suited to the division's longer-term funding requirements.

### ***Insurance & Investment***

Underlying profit before tax in the Insurance & Investment division increased in 2006 by 19 per cent. to £581 million (as compared to £489 million in 2005 and £495 million for 2004 (pro forma)), with General Insurance profit increasing in 2006 by 20 per cent. to £304 million (as compared to £254 million in 2005 and

£225 million in 2004) and Investment profit increasing in 2006 by 18 per cent. to £277 million (as compared to £235 million in 2005 and £270 million in 2004). Investment profit on the Full Embedded Value basis increased in 2006 by 30 per cent. to £539 million (as compared to £414 million in 2005).

General Insurance sales, as measured by GWP, decreased in 2006 by 4 per cent. to £1,894 million (as compared to £1,977 million in 2005 and £1,732 million in 2004), reflecting lower sales in repayment insurance (down 10 per cent. over 2005) and motor insurance (down 9 per cent. over 2005), which were offset by a strong performance in household insurance (up 11 per cent. over 2005).

Investment sales, as measured by APE increased in 2006 by 23 per cent. to £1,817 million (as compared to £1,473 million in 2005 and £1,244 million in 2004), with strong growth in all three channels (bancassurance up 12 per cent. over 2005, intermediary up 28 per cent. over 2005 and wealth management up 58 per cent. over 2005).

The division's continued focus on cost efficiency resulted in underlying operating expenses increasing by only 2 per cent. while underlying non-interest income increased by 8 per cent., each relative to 2005.

### *Financial Performance*

#### **Insurance & Investment**

#### **Income Statement**

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	(in £ millions)		
Net interest income .....	(93)	(95)	46
Non-interest income .....	10,773	12,948	7,426
Fees and commission income .....	119	153	261
Fees and commission expense .....	(784)	(804)	(752)
Net earned premiums on insurance contracts .....	5,161	4,467	3,275
Change in value of in-force long term assurance business .....	179	337	4
Investment and other operating incomes .....	6,098	8,795	4,638
<b>Net operating income .....</b>	<b>10,680</b>	<b>12,853</b>	<b>7,472</b>

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
<b>Operating expenses</b> .....	(10,062)	(12,330)	(6,952)
Staff .....	(359)	(327)	(372)
Accommodation, repairs and maintenance .....	(20)	(18)	(20)
Technology .....	(34)	(34)	(50)
Marketing and communication .....	(39)	(34)	(44)
Depreciation:			
Tangible and intangible fixed assets .....	(51)	(47)	(79)
Other .....	(219)	(250)	(148)
Sub total .....	(722)	(710)	(713)
Recharges:			
Technology .....	(45)	(45)	(38)
Accommodation .....	(35)	(31)	(30)
Other shared services .....	(18)	(16)	(19)
Underlying operating expenses .....	(820)	(802)	(800)
Change in investment contract liabilities .....	(2,898)	(5,198)	(1,697)
Net claims incurred on insurance contracts .....	(2,215)	(1,892)	(2,333)
Net change in insurance contract liabilities .....	(3,560)	(4,069)	(2,122)
Change in unallocated surplus* .....	(569)	(369)	
Impairment on investment securities .....			1
<b>Operating profit</b> .....	618	523	521
Share of losses of associates and jointly controlled entities .....	(37)	(34)	(26)
<b>Underlying profit before tax</b> .....	581	489	495

\* The unallocated surplus is the surplus in the with-profit sub-fund of Clerical Medical for which the allocation between policyholders and shareholders had not been determined at the balance sheet date. Following the implementation of FRS 27 from 1 January 2005 this amount is now shown separately.

## General Insurance Business

In a highly competitive market, underlying profit before tax in General Insurance increased in 2006 by 20 per cent. to £304 million (as compared to £254 million in 2005 and £225 million in 2004), reflecting the Insurance & Investment division's continued focus on retention alongside strong underwriting performance. GWP, however, fell in 2006 by 4 per cent. to £1,894 million (as compared to £1,977 million in 2005 and £1,732 million in 2004). Notwithstanding strong price competition, household insurance sales grew in 2006 by 11 per cent. (as compared to 2005), although repayment insurance was down 10 per cent. (as compared to 2005), reflecting reduced unsecured personal lending volumes. In motor insurance, sales were down 9 per cent. (as compared to 2005) in a highly competitive market that has yet to see a sustained increase in prices that would warrant the pursuit of faster sales growth.

Underlying non-interest income increased in 2006 by 14 per cent. to £450 million (as compared to £396 million in 2005 and £287 million in 2004 (pro forma)). Underlying operating expenses increased in 2006 by 3 per cent. to £136 million (as compared to £132 million in 2005 and £116 million in 2004 (pro forma)).



## General Insurance Business

### Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	27	24	81
Non-interest income .....	848	795	521
Fees and commission income .....	16	30	65
Fees and commission expense .....	(546)	(588)	(354)
Net earned premiums on insurance contracts .....	1,315	1,226	694
Change in value of in-force long term assurance business .....	(5)	54	8
Investment and other operating incomes .....	68	73	108
<b>Net operating income</b> .....	<b>875</b>	<b>819</b>	<b>602</b>
<b>Operating expenses</b> .....	<b>(534)</b>	<b>(531)</b>	<b>(350)</b>
Underlying operating expenses .....	(136)	(132)	(116)
Net claims incurred on insurance contracts .....	(352)	(354)	(234)
Net change in insurance contract liabilities .....	(46)	(45)	
<b>Operating profit</b> .....	<b>341</b>	<b>288</b>	<b>252</b>
Share of losses of associates and jointly controlled entities .....	(37)	(34)	(27)
<b>Underlying profit before tax</b> .....	<b>304</b>	<b>254</b>	<b>225</b>

*Household Insurance.* Notwithstanding strong price competition at this stage in the cycle, sales of household insurance increased in 2006 by 11 per cent. to £618 million GWP (as compared to £557 million in 2005 and £483 million in 2004). Policy numbers increased in 2006 by 10 per cent. to 3.2 million (as compared to 2.9 million in 2005 and 2.6 million in 2004), with 53 per cent. of new policy sales being generated from the Group's distribution channels and the balance through third party distributors.

Going forward, the division intends to further leverage the Group's market-leading mortgage position and distribution strengths to drive further growth. Sales through the Retail division's branch network in 2006 increased by 9 per cent. to £139 million (as compared to £127 million in 2005) and internet sales increased by 39 per cent. to £25 million (as compared to £18 million in 2005). Following the sale of the Paymentsshield intermediary business in November 2006, the Group terminated the underwriting agreement with Paymentsshield. This agreement contributed £92 million of GWP in 2006, and consequently the division expect sales through third party channels will reduce in 2007.

Underwriting performance in household insurance has been good, underpinned by continuing benign weather conditions in 2006, but also reflecting the division's continued investment in claims management. This has contributed to what the Group considers to be a very strong household insurance loss ratio of 45 per cent. in 2006 (as compared to 49 per cent. in 2005 and 54 per cent. in 2004 (pro forma)).

*Repayment Insurance.* Sales of repayment insurance fell in 2006 by 10 per cent. to £948 million GWP (as compared to £1,048 million in 2005 and £886 million in 2004 (pro forma)), primarily as a result of lower unsecured personal lending volumes, with sales to Group customers down in 2006 by 7 per cent. to £528 million (as compared to £565 million in 2005 and £610 million in 2004 (pro forma)). While volumes of unsecured personal loan and credit card repayment insurance have fallen, sales of mortgage repayment insurance increased by 4 per cent. to £95 million (as compared to £91 million in 2005).

The division's claims management service continues to receive strong results in industry-wide surveys while also delivering tight control of overall claims costs. The Group believes this level of customer service provides an important competitive advantage in attracting and retaining third party business.

On 7 February 2006, the OFT announced their decision to refer repayment insurance (otherwise known as payment protection) to the Competition Commission (CC). The CC has now commenced an investigation of the repayment insurance market, which will take at least a year but no more than two years to complete. While the OFT recognized that repayment insurance provides worthwhile cover and peace of mind for many customers, they cited a number of market features which could, in their opinion, reduce competition and lead to poor value for money. The Group will participate fully with the CC investigation and in doing so the Group will seek to lead the market in any market or product developments to the benefit of customers and shareholders alike.

In addition, the FSA announced in January 2007 that it would be undertaking a further thematic review of the Repayment Insurance industry. The Group will continue to work with the FSA to ensure that its claims management and sales processes address the needs of its customers.

*Motor.* Sales of motor insurance decreased in 2006 by 9 per cent. to £298 million GWP (as compared to £327 million in 2005 and £282 million in 2004 (pro forma)). Highly competitive conditions have severely restricted scope for premium rate increases in the market for most of 2006, reducing the extent to which customers seek alternative pricing options with different insurers. This reduction in consumer movement has limited the opportunities for the Group to grow market share.

The division has concentrated on retaining existing customers, maintaining underwriting disciplines and maximizing operational efficiency to protect profitability. The Group expects the planned transfer of First Alternative's book of business to ensure to gain the appropriate regulatory and legal approvals in the first half of the 2007, which the Group believes will result in significant capital efficiency gains.

In light of increasing claims inflation and low investment returns, current market pricing is, in the Group's view, not sustainable and the Group therefore expects to see premium rate rises across the industry in 2007. The Group anticipates this will stimulate increased switching activity and the opportunity for renewed sales growth. In the meantime, the Group intends to continue to innovate through brand and product differentiation as a means of generating new sales. The Group views the Sheilas' Wheels brand, targeted at female drivers, as a clear example of success in this area, with sales volumes significantly exceeding the Group's initial expectations.

#### *Investment Business*

Underlying profit before tax in the Investment Business increased in 2006 by 18 per cent. to £277 million (as compared to £235 million in 2005 and £270 million in 2004 (pro forma)). Underlying non-interest income increased in 2006 to 6 per cent. while underlying operating expenses increased by 2 per cent. (in each case, as compared to 2005).

## Investment Business

### Income Statement

Underlying profit before tax in the Investment Business increased in 2006 by 18 per cent. to £277 million (as compared to £235 million in 2005 and £270 million in 2004 (pro forma)). Underlying non-interest income increased in 2006 by 6 per cent. while underlying operating expenses increased by 2 per cent. (in each case, as compared to 2005).

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	(in £ millions)		
Net interest income .....	(120)	(119)	(35)
Non-interest income .....	9,925	12,153	6,905
Fees and commission income .....	103	123	196
Fees and commission expense .....	(238)	(216)	(398)
Net earned premiums on insurance contracts .....	3,846	3,241	2,581
Change in value of in-force long term assurance business .....	184	283	(4)
Investment and other operating incomes .....	6,030	8,722	4,530
<b>Net operating income</b> .....	<b>9,805</b>	<b>12,034</b>	<b>6,870</b>
<b>Operating expenses</b> .....	<b>(9,528)</b>	<b>(11,799)</b>	<b>(6,602)</b>
Underlying operating expenses .....	(684)	(670)	(684)
Change in investment contract liabilities .....	(2,898)	(5,198)	(1,697)
Net claims incurred on insurance contracts .....	(1,863)	(1,538)	(2,099)
Net change in insurance contract liabilities .....	(3,514)	(4,024)	(2,122)
Change in unallocated surplus .....	(569)	(369)	
Impairment on investment securities .....			1
<b>Operating profit</b> .....	<b>277</b>	<b>235</b>	<b>269</b>
Share of profits of associates and jointly controlled entities .....			1
<b>Underlying profit before tax</b> .....	<b>277</b>	<b>235</b>	<b>270</b>

The above income statement includes a number of items which relate solely to policyholder payments and benefits. When these are netted off against each other, the income statement can be simplified as follows:

## Investment Business

### Simplified Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	(120)	(119)	(35)
Underlying non-interest income .....	1,081	1,024	988
<b>Underlying net operating income</b> .....	<b>961</b>	<b>905</b>	<b>953</b>
Underlying operating expenses.....	(684)	(670)	(684)
Share of profits of associates and jointly controlled entities .....			1
<b>Underlying profit before tax</b> .....	<b>277</b>	<b>235</b>	<b>270</b>

Under IFRS, insurance contracts (i.e., investment business which carries significant insurance risk as well as ‘with-profit’ contracts) are accounted for on an EV basis, whereas investment contracts (i.e., investment business which does not carry significant insurance risk) are accounted for under IAS 39. Consequently, on an IFRS basis the income statement incorporates two very different profit recognition patterns depending on the nature of the contract.

The table below sets out the profit contribution from each type of contract and other items.

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Contribution from insurance contracts* .....	485	491	404
Contribution from investment contracts* .....	50	(2)	(32)
Development expenditure .....	(67)	(80)	(74)
Overheads associated with development activity* .....	(56)	(45)	
Efficiency improvements .....			46
Profit on disposal of Life Assurance Holdings Corporation (“LAHC”) .....			13
Other income and costs.....	(7)	(11)	(13)
Debt financing cost** .....	(128)	(118)	(74)
<b>Underlying profit before tax</b> .....	<b>277</b>	<b>235</b>	<b>270</b>

\* The 2005 figures for contribution from insurance contracts, contribution from investment contracts, overheads associated with development activity and debt financing cost have been re-analysed to reflect changes to the overhead allocation methodology. The figures for 2004 do not reflect this.

\*\* Debt financing cost includes the interest cost of subordinated debt finance previously included within the contribution from insurance contracts.

*Insurance Contracts (accounted for on an EV basis).* The contribution from insurance contracts decreased by 1 per cent. in 2006 to £485 million (as compared to £491 million in 2005 and £404 million in 2004) as a result of lower actual versus expected experience on existing business.

The contribution from new business increased in 2006 by 23 per cent. to £216 million (as compared to £176 million in 2005), reflecting continued growth in sales of insurance contracts (up 18 per cent. over

2005), with bonds sold in the division's bancassurance channel making an important contribution. The expected contribution from existing business increased in 2006 by 5 per cent. to £140 million (as compared to £133 million in 2005) as a result of the growth of the in-force book. Actual vs. expected experience was lower at £16 million (as compared to £77 million in 2005) reflecting a strong 2005 comparative.

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Contribution from existing business:			
Expected contribution .....	140	133	124
Actual vs. expected experience * .....	16	77	60*
	156	210	184
Contribution from new business .....	216	176	128
Investment earnings on net assets using long term assumptions .....	113	105	92
<b>Contribution from insurance contracts*</b> .....	<b>485</b>	<b>491</b>	<b>404*</b>

\* The 2005 actual vs. expected experience and contribution from insurance contracts figures have been re-analyzed to reflect changes to the overhead allocation methodology. The figures for 2004 do not reflect this.

*Investment Contracts (accounted for on an IAS 39 basis).* The profit contribution from investment contracts is analyzed in the table below. Under IAS 39, profit recognition on investment contracts is deferred to later years with a loss typically recorded in the year of sale. Continued growth in investment contract sales (up 25 per cent. over 2005) increased this new business strain in 2006. However, strong growth in the contribution from existing business, which grew 35 per cent. in 2006 to £279 million (as compared to £206 million in 2005), as the division's in-force book increased in size and asset values rose, resulted in investment contracts making an overall net positive contribution of £50 million (as compared to £(2)m in 2005) to underlying profit despite the strong sales growth.

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Contribution from existing business * .....	279	206	160*
Contribution from new business * .....	(229)	(208)	(192)*
<b>Contribution from investment contracts *</b> .....	<b>50</b>	<b>(2)</b>	<b>(32)</b>

\* The 2005 contribution from existing business, contribution from new business and contribution from investment contracts figures have been re-analysed to reflect changes to the overhead allocation methodology. The figures for 2004 do not reflect this.

Total liabilities for investment contracts (which provide an indication of the funds under management) amounted to £37.3 billion at the end of 2006 (as compared to £29.3 billion in 2005).

*Full EV Basis Supplementary Information.* To assist in the understanding of the underlying performance and value generation of the Investment Business, supplementary information is set out on pages 20 to 24 of the HBOS plc Annual Report and Accounts 2006, providing income statement and balance sheet information for the Group's U.K. Investment Business on a consistent EV accounting basis for both insurance and investment contracts. The Group refers to this basis as the 'Full EV' basis.

*New Business Profitability.* With the publication of the Full EV basis supplementary information and with the industry-wide demise of the achieved profits basis previously used to report the new business profitability of the Group's Investment business, the Group henceforth intends to report new business profitability by reference to the Full EV basis.

This results in new business profitability for 2005 which is 2 per cent. of APE lower than the previously-reported level because the Full EV basis allocates a higher proportion of overhead expenses to new business.

New business profitability by channel and product type on the Full EV basis is set out below.

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
	% APE	% APE	% APE
Bancassurance.....	33	29	28
Intermediary – UK .....	10	8	11
Wealth Management .....	36	37	42
<b>Total</b> .....	<b>27</b>	<b>24</b>	<b>25</b>
Life & Pensions* .....	26	26	
Mutual Funds* .....	29	20	
<b>Total</b> .....	<b>27</b>	<b>24</b>	

\* This disclosure commenced in 2006 with 2005 comparables also provided; however, have not been reported.

New business profitability increased strongly in 2006 to 27 per cent. (as compared to 24 per cent. in 2005), reflecting the division's continued focus on value creation. In Wealth Management, profitability remained strong in 2006 at 36 per cent. (as compared to 37 per cent. in 2005), with the decrease in margin being due to higher sales of pensions business post Pensions 'A' Day. The division's bancassurance channel continues to deliver strong margins through the efficiency of its model and the productivity of its sales forces, and margins in this channel increased to 33 per cent. (as compared to 29 per cent. in 2005). There has also been an increase in profitability in 2006 in the intermediary channel to 10 per cent. (as compared to 8 per cent. in 2005), reflecting reducing unit costs and increased average policy sizes.

Overall life and pensions margins remained strong in 2006 at 26 per cent.. The increase in mutual funds profitability largely reflects efficiencies from increased scale, larger case sizes and changes in the mix of funds.

*Operational Performance.* Investment sales increased in 2006 by 23 per cent. to £1,817 million APE (as compared to £1,473 million in 2005) reflecting strong growth across all 3 distribution channels (bancassurance up 12 per cent. over 2005, Intermediary up 28 per cent. over 2005 and Wealth Management up 58 per cent. over 2005).



## Investment Sales\*

	Year ended 31 December,											
	2006 Single £m	2006 Annual £m	2006 Total £m	2006 Total APE £m	2005 Single £m	2005 Annual £m	2005 Total £m	2005 Total APE £m	2004 Single £m	2004 Annual £m	2004 Total £m	2004 Total APE £m
Investment Bonds*** ....	6,645	23	6,668	688	5,767	12	5,779	589				
Individual Pensions***..	2,293	243	2,536	472	1,607	160	1,767	321				
Group Pensions***.....	84	115	199	123	51	70	121	75				
Annuities***.....	292		292	29	242		242	24				
Protection*** .....		40	40			55	55	55				
Mutual funds*** .....	1,790	286	2,076	465	1,665	243	1,908	409				
<b>Total</b> .....	<b>11,104</b>	<b>707</b>	<b>11,811</b>	<b>1,817</b>	<b>9,332</b>	<b>540</b>	<b>9,872</b>	<b>1,473</b>	<b>8,139</b>	<b>430</b>	<b>8,569</b>	<b>1,244</b>
Bancassurance .....	5,482	389	5,871	937	5,130	325	5,455	838	4,651	220	4,871	685
Intermediary .....	3,035	228	3,263	531	2,591	155	2,746	414	2,272	155	2,427	382
Wealth Management .....	2,587	90	2,677	349	1,611	60	1,671	221	1,216	55	1,271	177
<b>Total</b> .....	<b>11,104</b>	<b>707</b>	<b>11,811</b>	<b>1,817</b>	<b>9,332</b>	<b>540</b>	<b>9,872</b>	<b>1,473</b>	<b>8,139</b>	<b>430</b>	<b>8,569</b>	<b>1,244</b>
Insurance Contracts** ..	3,776	85	3,861	462	3,096	81	3,177	390	2,569	81	2,650	338
Investment Contracts ....	7,328	622	7,950	1,355	6,236	459	6,695	1,083	5,570	349	5,919	906
<b>Total</b> .....	<b>11,104</b>	<b>707</b>	<b>11,811</b>	<b>1,817</b>	<b>9,332</b>	<b>540</b>	<b>9,872</b>	<b>1,473</b>	<b>8,139</b>	<b>430</b>	<b>8,569</b>	<b>1,244</b>

\* APE is calculated as annual premiums plus 10 per cent. of single premiums.

\*\* Accounted for on an embedded value basis, under IFRS reporting.

\*\*\* This disclosure commenced in 2006 with 2005 comparables also provided; 2004 comparables, however, have not been reported as only been effective from the HBOS Annual Report and Accounts 2006 which does not report the 2004 comparatives.

*Movement in assets under management.* At a time when there is considerable amount of business replacement activity across the industry, particularly in the intermediary channel following Pensions 'A' Day, the following table is designed to assist in understanding net flows of investment business (i.e. premiums received less the outflow of funds from surrendered or matured policies) in addition to sales growth and investment returns.

	Year ended 31 December 2006	Year ended 31 December 2005
	£bn	£bn
<b>Opening assets under management</b> .....	68.1	57.4
Premiums (new and existing business) .....	12.2	10.9
Maturities and claims .....	(2.4)	(2.7)
Lapses (i.e. surrenders and repurchases) .....	(7.4)	(5.6)
Net inflow of business .....	2.4	2.6
Investment return (net of charges) .....	5.6	8.1
Increase in assets under management .....	8.0	10.7
<b>Closing assets under management</b> .....	<b>76.1</b>	<b>68.1</b>
Lapse rate (i.e. lapses as % of average assets).....	10%	9%

Assets under management increased by £8.0 billion (up 12 per cent. over 2005) to £76.1 billion with premiums from new and existing business increasing by 12 per cent. over 2005. Lapses, however, also increased, primarily in the intermediary channel as a result of replacement activity associated with Pensions 'A' Day and higher lapses on with-profit bonds. Net inflows were £2.4 billion (as compared to £2.6 billion in 2005) and investment returns (net of charges) were £5.6 billion (as compared to £8.1 billion in 2005).

*Bancassurance.* Sales through the division's Bancassurance channel increased in 2006 by 12 per cent. to £937 million APE (as compared to £838 million in 2005 and £685 million in 2004 (pro forma)). Although sales growth was slower than other channels, the Group believes the profitability and persistency of this business is strong. With over one million customers, the Group continues to reinforce its leading bancassurer position in the U.K. with simple value for money 'no load' products provided alongside full financial advice.

The Group believes that its bancassurance sales forces remains the most productive in the market, with approximately £620,000 APE per active adviser in the Group's branches (as compared to £590,000 in 2005) and £850,000 APE (as compared to £700,000 in 2005) per client manager in the Bank of Scotland Investment Service (**BOSIS**) high net worth sales force.

Additional new business growth through the division's branch base Personal Financial Advisers ('PFA's) has come, in part, from the expansion of the Retail division's branch network. The opening of further branches across the South East of England, together with the benefits from branch regeneration activity, will help to drive future growth. BOSIS is becoming an increasingly important source of new business. Sales through this channel increased in 2006 by 26 per cent. to £211 million APE (as compared to £168 million in 2005). In an environment of increasing personal wealth, the division expects this channel to leverage the strengths of the HBOS Group an important driver of future growth.

*Intermediary.* Intermediary sales increased in 2006 by 28 per cent. to £531 million APE (as compared to £414 million in 2005 and £382 million in 2004 (pro forma)). Impressive growth was again seen in the division's offshore proposition (up 104 per cent. over 2005) through the Group's Global Investor Product, and also in its pensions products. The Group's full pension product range has been successfully transitioned to the simplified regime introduced after Pensions 'A' Day and the Group continues to benefit from its well regarded technical support to IFAs and other intermediary partners under the Clerical Medical brand.

Continued strong growth in volumes is helping to drive down unit costs and this, together with changes in business mix, has improved new business margins. The division intends to continue its selective approach to this channel, focusing on individual pensions and investment business, where it is able to leverage the strengths of the HBOS Group to generate stronger returns, in preference to group pensions business where margins are thin and the future of the market is uncertain given the planned introduction of personal pension accounts, as proposed by the Government in its pensions White Paper of December 2006.

In keeping with competitors the Group has also put in place specific initiatives to help reduce the relatively high level of lapses experienced in the intermediary channel in 2006. This will include special reinvestment offers for customers switching out of the with-profit fund.

*Wealth Management.* Sales at St. James's Place increased by 58 per cent. in 2006 to £349 million APE (as compared to £221 million in 2005 and £177 million in 2004 (pro forma)) in yet another year of strong performance. Sales of investment bonds continued to be strong while at the same time significant growth in pensions business was generated from the Pensions 'A' Day changes. Fund performance and business retention have been excellent, with funds under management up 25 per cent. in 2006 to £15.4 billion (as compared to £12.3 billion in 2005 and £9.5 billion in 2004 (pro forma)). Partner numbers now stand at 1,157 (as compared to 1,148 in 2005).

**International**

*Financial Performance*

**International**

**Income Statement**

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	1,239	1,018	728
Non-interest income .....	929	503	428
Fees and commission income .....	237	206	109
Fees and commission expense .....	(191)	(176)	(83)
Net earned premiums on insurance contracts .....	488	187	163
Change in value of in-force long term assurance business .....	104	59	108
Operating lease rental income .....	36	32	20
Investment and other operating income .....	255	195	111
<b>Net operating income</b> .....	<b>2,168</b>	<b>1,521</b>	<b>1,156</b>
<b>Operating expenses</b> .....	<b>(1,128)</b>	<b>(723)</b>	<b>(573)</b>
Staff .....	(350)	(283)	(202)
Accommodation, repairs and maintenance .....	(43)	(39)	(27)
Technology .....	(33)	(19)	(7)
Marketing and communication .....	(45)	(35)	(28)
Depreciation:			
Tangible and intangible fixed assets .....	(33)	(28)	(21)
Other .....	(139)	(124)	(91)
Sub total .....	(643)	(528)	(376)
Recharges:			
Technology .....	(1)	(1)	(1)
Accommodation .....	(1)		
Underlying operating expenses .....	(645)	(529)	(377)
Operating lease depreciation .....	(24)	(25)	(17)
Change in investment contract liabilities .....	(12)	109	(56)
Net claims incurred on insurance contracts .....	(113)	(127)	(55)
Net change in insurance contract liabilities .....	(334)	(151)	(68)
Impairment on investment securities .....	(2)	(6)	(1)
<b>Operating profit before provisions</b> .....	<b>1,038</b>	<b>792</b>	<b>582</b>
Impairment losses on loans and advances .....	(221)	(180)	(186)
<b>Operating profit</b> .....	<b>817</b>	<b>612</b>	<b>396</b>
Share of (losses)/profits of associates and jointly controlled entities .....	3	(2)	12
<b>Underlying profit before tax</b> .....	<b>820</b>	<b>610</b>	<b>408</b>
Net interest margin .....	2.49%	2.65%	2.41%
Impairment losses as a % of average advances .....	0.46%	0.48%	0.62%
Cost:income ratio .....	38.3%	40.0%	39.3%

## Australia

Underlying profit before tax in HBOS Australia ('HBOSA') increased in 2006 by 24 per cent. to £278 million (as compared to £224 million in 2005 and £191 million in 2004), notwithstanding the Group's sizable investment in people, technology and branches in the division in 2006. Profit growth was achieved in all businesses by the delivery of strong growth in income, lending and market shares. Lending increased in 2006 by 24 per cent. to £24.5 billion (as compared to £19.7 billion in 2005) with deposits increasing in 2006 by 28 per cent. to £11.5 billion (as compared to £9.0 billion in 2005).

### Financial Performance

#### International – Australia

#### Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	501	413	338
Non-interest income .....	166	143	89
Fees and commission income .....	113	99	80
Fees and commission expense .....	(12)	(6)	(12)
Net earned premiums on insurance contracts .....	21	16	
Operating lease rental income .....	9	10	7
Other operating income .....	35	24	14
<b>Net operating income</b> .....	<b>667</b>	<b>556</b>	<b>427</b>
<b>Operating expenses</b> .....	<b>(331)</b>	<b>(302)</b>	<b>(219)</b>
Staff .....	(171)	(145)	(106)
Accommodation, repairs and maintenance .....	(21)	(18)	(15)
Technology .....	(24)	(12)	(4)
Marketing and communication .....	(21)	(22)	(17)
Depreciation:			
Tangible and intangible fixed assets .....	(16)	(16)	(12)
Other .....	(53)	(65)	(59)
Underlying operating expenses .....	(306)	(278)	(213)
Operating lease depreciation .....	(6)	(7)	(5)
Change in investment contract liabilities .....	(11)	(11)	
Net claims incurred on insurance contracts .....	(2)	(1)	(1)
Net change in insurance contract liabilities .....	(6)	(5)	
<b>Operating profit before provisions</b> .....	<b>336</b>	<b>254</b>	<b>208</b>
Impairment losses on loans and advances .....	(59)	(33)	(19)
<b>Operating profit</b> .....	<b>277</b>	<b>221</b>	<b>189</b>
Share of profits of associates and jointly controlled entities .....	1	3	2
<b>Underlying profit before tax</b> .....	<b>278</b>	<b>224</b>	<b>191</b>
Net interest margin .....	2.33%	2.39%	2.41%
Impairment losses as a % of average advances .....	0.27%	0.19%	0.14%
Cost:income ratio .....	47.7%	52.3%	50.6%

*Operating Income and Margins.* Underlying net operating income increased in 2006 by 21 per cent. to £642 million (as compared to £532 million in 2005), assisted by a 24 per cent. growth in lending in 2006. Net interest income increased by 21 per cent. in 2006 to £501 million (as compared to £413 million in 2005 and £338 million in 2004). In 2006, increased asset and deposit growth was partially offset by a decline in margin. Since HBOSA launched its aggressively-priced products, competition has intensified, reducing margins. The interest margin declined in 2006 to 2.33 per cent. (as compared to 2.39 per cent. in 2005).

	<u>Basis points</u>
<b>Movement in margin</b>	
Net interest margin for the year ended 31 December 2004 (pro forma).....	241
Lending margins .....	(2)
Net interest margin for the year ended 31 December 2005.....	239
Lending margins .....	(6)
<b>Net interest margin for the year ended 31 December 2006 .....</b>	<u><u>233</u></u>

Underlying non-interest income rose by 18 per cent. in 2006 to £141 million (as compared to £119 million in 2005) benefiting from growth in the retail, commercial and corporate businesses, and the full year contribution of insurance & investment income following the purchase of RACV Financial Services in March 2005. This is reflected in the 14 per cent. increase (as compared to 2005) in fee and commission income and the 31 per cent. increase (as compared to 2005) in net earned premiums on insurance contracts.

*Operating Expenses.* Underlying operating expenses increased in 2006 by 10 per cent. to £306 million (as compared to £278 million in 2005 and £213 million in 2004 (pro forma)). The division's continuing investment in physical distribution (particularly business banking centers), brand recognition, customer facing staff, new products and back office infrastructure is designed to underpin its growth ambitions. Notwithstanding this, the cost:income ratio improved in 2006 to 47.7 per cent. (as compared to 52.3 per cent. in 2005 and 50.6 per cent. in 2004 (pro forma)) as a result of the 20 per cent. growth in net operating income in 2006. As the Group continues to pursue its goal of providing an alternative to the existing established financial service providers, the division will accelerate its investment spend during 2007, expanding its retail and business banking physical presence as well as investing further in its strategic business brands and support functions.

*Credit Quality and Provisions.* Impaired loans as a percentage of closing advances increased to 1.00 per cent. (as compared to 0.66 per cent. in 2005 and 0.76 per cent. in 2004 (pro forma)) primarily as a result of a small number of impaired corporate transactions on which the ultimate recovery rate is expected to be high. Provisions as a percentage of impaired loans fell in 2006 to 46 per cent. (as compared to 62 per cent. in 2005 and 64 per cent. in 2004 (pro forma)). Impairment losses as a percentage of average advances rose in 2006 to 0.27 per cent. (as compared to 0.19 per cent. in 2005 and 0.14 per cent. in 2004 (pro forma)).

## International – Australia

### Balance Sheet and Asset Quality Information

	As at 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
<b>Loans and advances to customers</b> .....	£24.5bn	£19.7bn	£14.6bn
<b>Impairment provisions on advances</b> .....	£113m	£80m	£71m
<b>Impairment provisions as a % of closing advances</b> .....	0.46%	0.41%	0.49%
<b>Classification of advances*:</b>	%	%	%
Agriculture, forestry and fishing.....	3	2	3
Energy .....	3	4	3
Manufacturing industry.....	3	3	3
Construction and property .....	24	23	21
Hotels, restaurants and wholesale and retail trade .....	9	8	8
Transport, storage and communication.....	2	2	2
Financial .....	3	3	7
Other services etc.....	7	8	8
Individuals:			
Home mortgages .....	38	42	37
Other personal lending .....	6	5	7
Overseas residents.....	2		1
	100	100	100
<b>Impaired loans</b> .....	£245m	£130m	£111m
<b>Impaired loans as a % of closing advances</b> .....	1.00%	0.66%	0.76%
<b>Impairment provisions as a % of impaired loans</b> .....	46%	62%	64%
<b>Risk weighted assets</b> .....	£21.0bn	£16.4bn	£12.0bn
<b>Customer deposits</b> .....	£11.5bn	£9.0bn	£6.0bn

\* Before impairment provisions

*Operational Performance.* The significant investment being made in the national expansion of the Group's Australian operations is designed to support future profit growth in each of the division's retail, commercial and insurance & investment businesses. At the same time, it is expected that further investments will support the growth of the division's asset finance and corporate businesses in their specialist markets.

*Lending and Deposit Growth.* Lending grew in 2006 by 24 per cent. to £24.5 billion (as compared to £19.7 billion in 2005 and £14.6 billion in 2004 (pro forma)), with continued growth in the residential and commercial books. Customer deposits grew in 2006 by 28 per cent. to £11.5 billion (as compared to £9.0 billion in 2005 and £6.0 billion in 2004 (pro forma)) as a result of the continued success of retail and commercial deposit initiatives, notwithstanding intense competition.

*Retail Business.* The division's retail business, operating under the BankWest brand, continued its push to build national market share with its 'Betterdeal' strategy and 'hero' product offerings. Lending increased in 2006 by 16 per cent. to £8.6 billion (as compared to £7.4 billion in 2005 and deposits increased in 2006 by 17 per cent. to £4.9 billion (as compared to £4.2 billion in 2005)). The division's share of the mortgage broker new loan market increased in 2006 to 16 per cent. (as compared to 13 per cent. in 2005).

In 2006, BankWest achieved the biggest credit card market share percentage gain of all banks nationally. Growth was driven by the two market-leading products, the updated Lite MasterCard and the Zero MasterCard.

The Group believes that BankWest continues to be a market leader in deposit growth. The TeleNet direct deposit product grew strongly, passing £1 billion in balances in 2006, and during the year a Kid's Bonus Saver, offering interest rates up to 10 per cent., was launched with what the Group believes are encouraging results. Transactional services available to East Coast customers were increased significantly by the rollout of more than 350 BankWest-branded ATMs in the first half of 2006 as the BankWest 7-Eleven partnership was implemented.

*Commercial Business.* The Group's business bank in Australia, operating under the BankWest brand, continued to outgrow the market in 2006. Lending increased in 2006 by 46 per cent. to £7.0 billion (as compared to £4.8 billion in 2005) and deposits increased in 2006 by 38 per cent. to £6.6 billion (as compared to £4.8 billion in 2005).

Deposits grew significantly in 2006, again outperforming the market, driven primarily by the contribution of Specialist Deposit Services and by the launch of Business Bonus and Business TeleNet products. Transactional banking facilities were upgraded as a result of improvements to the division's internet and trading platforms. The division's physical distribution has also continued to expand, particularly on the East Coast, with nine business banking centers opened in 2006.

*Asset Finance Business.* Capital Finance, the division's asset finance business, performed well in 2006, with lending increasing by 9 per cent. to £3.8 billion (as compared to £3.5 billion in 2005). The business continues to grow market share organically and the Group believes future growth is underpinned by a strong pipeline of quality lending approvals and the launch of new products. A motor finance and insurance placement service was launched during 2006 and has received outstanding dealer support demonstrating Capital Finance's commitment to the motor trade.

*Insurance & Investment Business* Sales of insurance products as measured by GWP increased in 2006 by 30 per cent. to £21.7 million (as compared to £16.7 million in 2005), driven by the strong lending growth in the division's retail business and an extension of relationships with corporate distribution partners. This growth includes a solid contribution from the life insurance products launched in 2005.

The division's financial planning business benefited from the full year contribution of RACV Financial Services acquired in 2005 and additional recruitment during 2006 with commission income nearly doubling compared to the previous year. In January 2007, St Andrew's acquired the Queensland based financial planners, Whittaker Macnaught, which will boost funds under management and advice by £0.6 billion.

## **Ireland**

Underlying profit before tax in Ireland increased in 2006 by 43 per cent. to £149 million (as compared to £104 million in 2005 and £97 million in 2004). This strong performance was achieved in a year that saw significant investment in Ireland's retail proposition with the opening of 24 new branches and the re-branding of the retail business to the Halifax brand.

Strong growth was recorded in all businesses in 2006. Ireland's customer focused proposition, building on a healthy Irish economy enabled the division to grow lending in 2006 by 31 per cent. to £15.9 billion (as compared to £12.1 billion in 2005 and 8.9 billion in 2004) and customer deposits by 32 per cent. to £5.8 billion (as compared to £4.4 billion in 2005 and 3.9 billion in 2004). Ireland was successful in increasing its market share in both its core businesses, most notably capturing 8 per cent. (as compared to 7



per cent. in 2005) of net lending in the mortgage market. This was achieved with only a slight reduction in overall margins and with credit quality maintained.

### Financial Performance

#### International – Ireland

#### Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	268	203	160
Non-interest income .....	49	39	28
Fees and commission income .....	14	15	16
Fees and commission expense .....		(3)	(2)
Operating lease rental income .....	12	13	13
Other operating income .....	23	14	1
<b>Net operating income</b> .....	<b>317</b>	<b>242</b>	<b>188</b>
<b>Operating expenses</b> .....	<b>(143)</b>	<b>(108)</b>	<b>(80)</b>
Staff .....	(73)	(55)	(42)
Accommodation, repairs and maintenance .....	(9)	(11)	(5)
Technology .....	(3)	(3)	(2)
Marketing and communication .....	(15)	(6)	(5)
Depreciation:			
Tangible and intangible fixed assets .....	(6)	(5)	(5)
Other .....	(27)	(16)	(9)
Underlying operating expenses .....	(133)	(96)	(68)
Operating lease depreciation .....	(10)	(12)	(12)
Impairment on investment securities .....	(2)	(5)	1
<b>Operating profit before provisions</b> .....	<b>172</b>	<b>129</b>	<b>109</b>
Impairment losses on loans and advances .....	(28)	(21)	(11)
<b>Operating profit</b> .....	<b>144</b>	<b>108</b>	<b>98</b>
Share of profits/losses of associates and jointly controlled entities ..	5	(4)	(1)
<b>Underlying profit before tax</b> .....	<b>149</b>	<b>104</b>	<b>97</b>
Net interest margin .....	1.73%	1.77%	2.01%
Impairment losses as a % of average advances .....	0.20%	0.20%	0.15%
Cost:income ratio .....	43.6%	42.7%	38.4%

*Operating Income and Margins.* Net operating income grew in 2006 by 31 per cent. to £317 million (as compared to £242 million in 2005 and £188 million in 2004). Net interest income grew by 32 per cent. to £268 million (as compared to £203 million in 2005 and £160 million in 2004), reflecting lending growth of 31 per cent. in 2006, with a small contraction in margin due to a change in product mix.

	<u>Basis points</u>
<b>Movement in margin</b>	
Net interest margin for the year ended 31 December 2004 (pro forma).....	201
Changes in product mix .....	(9)
Mortgages.....	(2)
Business banking .....	(7)
Funding and other movements.....	(6)
Net interest margin for the year ended 31 December 2005.....	177
Changes in product mix .....	(2)
Retail .....	(2)
<b>Net interest margin for the year ended 31 December 2006 .....</b>	<b>173</b>

Margins in business banking remained stable in the period, reflecting the quality of the division's customer proposition while mortgage margins were resilient despite Ireland's market leading pricing in this segment.

Non-interest income increased in 2006 by 26 per cent. to £49 million (as compared to £39 million in 2005 and £28 million in 2004 (pro forma)). The increase was largely due to one-off profits realized from Ireland's venture capital portfolio being further augmented by the profit from the disposal of a small number of properties.

*Operating Expenses*, Underlying operating expenses increased by 39 per cent. to £133 million (as compared to £96 million in 2005 and £68 million in 2004) reflecting the division's continuing investment in both infrastructure and people as part of Ireland's retail expansion. Notwithstanding this investment, the cost: income ratio increased only marginally in 2006 to 43.6 per cent. (as compared to 42.7 per cent. in 2005 and 38.4 per cent. in 2004).

*Credit Quality and Provisions*. Credit performance continued to be strong in the period with impaired loans as a percentage of closing advances decreasing to 1.87 per cent. (as compared to 1.98 per cent. in 2005 and 2.07 per cent. in 2004 (pro forma)).

## International – Ireland

### Balance Sheet and Asset Quality Information

	As at 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (pro forma)
<b>Loans and advances to customers</b> .....	£15.9bn	£12.1bn	£8.9bn
<b>Impairment provisions on advances</b> .....	£113m	£91m	£72m
<b>Impairment provisions as a % of closing advances</b> .....	0.71%	0.75%	0.81%
<b>Classification of advances*:</b>	%	%	%
Agriculture, forestry and fishing.....	1		1
Manufacturing industry.....	4	5	7
Construction and property .....	27	25	20
Hotels, restaurants and wholesale and retail trade .....	13	15	19
Transport, storage and communication.....	2	2	2
Financial .....	2	2	2
Other services etc .....	6	8	10
Individuals:			
Home mortgages .....	28	25	24
Other personal lending .....	6	7	6
Overseas residents.....	11	11	9
	100	100	100
<b>Impaired loans</b> .....	£297m	£240m	£184m
<b>Impaired loans as a % of closing advances</b> .....	1.87%	1.98%	2.07%
<b>Impairment provisions as a % of impaired loans</b> .....	38%	38%	39%
<b>Risk weighted assets</b> .....	£14.4bn	£11.2bn	£8.3bn
<b>Customer deposits</b> .....	£5.8bn	£4.4bn	£3.9bn

\* Before impairment provisions

### Operational Performance

*Lending and Deposit Growth.* Overall, lending grew in 2006 by 31 per cent. to £15.9 billion (as compared to £12.1 billion in 2005 and £8.9 billion in 2004). Strong demand for the division's products was experienced across all businesses, with business banking lending up 30 per cent. in 2006 and retail lending up 35 per cent. in 2006. Deposits growth kept pace with lending growth, increasing in 2006 by 32 per cent. to £5.8 billion (as compared to £4.4 billion in 2005 and £3.9 billion in 2004).

*Business Banking.* Ireland's business banking operations had another strong year with solid performance across all divisions (property banking, business banking and regional banking) in terms of both volumes and profit. Above-market lending growth of 30 per cent. in 2006, to £11.3 billion (as compared to £8.7 billion in 2005 and £6.4 billion in 2004 (pro forma)) allowed Ireland to further increase its market share in business banking, and the Group believes the pipeline remains strong at £2 billion for 2006.

Ireland's integrated and acquisition finance business is developing well with a number of deals completed in the second half of the year. The delivery of additional penetration through its branch network offers further opportunity to build on the franchise. Ireland has established a dedicated development team which will leverage its expertise to maximize the growth potential in this new market.

*Retail.* Ireland's retail businesses (Intermediary Homeloans, asset finance and retail branch network) performed well in 2006, with lending growth in 2006 of 35 per cent. to £4.6 billion (as compared to £3.4 billion in 2005). The Group believes that increases in interest rates have not materially affected mortgage volumes, margins or credit quality. Margin performance, in particular, remains strong despite the lead pricing positions the division has taken in a number of market segments.

The roll out of the new retail network in Ireland has progressed through 2006 with approximately 400 new colleagues recruited and trained and with 24 of the planned 46 branches and Ireland's customer service center in Dundalk open for business at the end of 2006. The remaining branch openings are planned to be completed by the end of 2007. The new retail product suite has been well received by customers; the Group expects the offering to be further enhanced through the delivery of a personal current account during 2007. Ireland has made significant progress in terms of customers, with 44,000 new retail customers acquired in 2006.

### **Europe and North America**

Underlying profit before tax in ENA increased 39 per cent. in 2006 to £393 million (as compared to £282 million in 2005 and £120 million in 2004 (pro forma)). The Group's corporate businesses in both North America and Europe, together with its investment business European Financial Services ('EFS'), all delivered strong earnings growth in 2006. ENA's retail business continued to grow its lending, while expanding its branch network in Spain and facing increasing competitive pressures in the mortgage market in the Netherlands.

On 7 December 2006, the Group sold its 64.5 per cent. financial investment in Drive Financial Services ('Drive'), a sub-prime auto finance receivables business based in Texas. Excluding Drive, which was consolidated as a subsidiary up to the date of disposal, underlying profit before tax increased by 41 per cent. in 2006 to £303 million (as compared to £215 million in 2005). The sale of Drive realized a gain on disposal of £180 million, which has been excluded from the Group's underlying results and consequently does not feature in the divisional income statement set out below.

The Group's European corporate business, currently part of ENA, will move into Corporate division reporting, starting with the 2007 half-year results.

Financial Performance

International – Europe and North America

Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	470	402	230
Non-interest income .....	714	321	311
Fees and commission income .....	110	92	13
Fees and commission expense .....	(179)	(167)	(69)
Net earned premiums on insurance contracts .....	467	171	163
Change in value of in-force long term assurance business .....	104	59	108
Operating lease rental income .....	15	9	
Investment and other operating income .....	197	157	96
<b>Net operating income</b> .....	<b>1,184</b>	<b>723</b>	<b>541</b>
<b>Operating expenses</b> .....	<b>(654)</b>	<b>(313)</b>	<b>(274)</b>
Staff .....	(106)	(83)	(54)
Accommodation, repairs and maintenance .....	(13)	(10)	(7)
Technology .....	(6)	(4)	(1)
Marketing and communication .....	(9)	(7)	(6)
Depreciation:			
Tangible and intangible fixed assets .....	(11)	(7)	(4)
Other .....	(59)	(43)	(23)
Sub total .....	(204)	(154)	(95)
Recharges:			
Technology .....	(1)	(1)	(1)
Accommodation .....	(1)		
Underlying operating expenses .....	(206)	(155)	(96)
Operating lease depreciation .....	(8)	(6)	
Change in investment contract liabilities .....	(1)	120	(56)
Net claims incurred on insurance contracts .....	(111)	(126)	(54)
Net change in insurance contract liabilities .....	(328)	(146)	(68)
Impairment on investment securities .....		(1)	(2)
<b>Operating profit before provisions</b> .....	<b>530</b>	<b>409</b>	<b>265</b>
Impairment losses on loans and advances .....	(134)	(126)	(156)
<b>Operating profit</b> .....	<b>396</b>	<b>283</b>	<b>109</b>
Share of (losses)/profits of associates and jointly controlled entities .....	(3)	(1)	11
<b>Underlying profit before tax</b> .....	<b>393</b>	<b>282</b>	<b>120</b>
Net interest margin .....	3.70%	4.09%	2.80%
Impairment losses as a % of average advances .....	1.13%	1.26%	1.81%
Cost:income ratio .....	28.0%	27.5%	26.6%

The income statement includes a number of items which relate solely to policyholder payments and benefits in EFS. The ENA income statement can be simplified on an underlying basis as follows:

## International – Europe and North America

### Simplified Income Statement

	Year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Net interest income .....	470	402	230
Underlying non-interest income .....	266	162	131
<b>Underlying net operating income</b> .....	<b>736</b>	<b>564</b>	<b>361</b>
Underlying operating expenses.....	(206)	(155)	(96)
Impairment losses on loans and advances .....	(134)	(126)	(156)
Share of (losses)/profits of associates and jointly controlled entities .....	(3)	(1)	11
<b>Underlying profit before tax</b> .....	<b>393</b>	<b>282</b>	<b>120</b>

*Operating income and margins.* Net interest income increased in 2006 by 17 per cent. to £470 million (as compared to £402 million in 2005 and £230 million in 2004), driven by a combination of strong asset growth across all of ENA's banking businesses and Drive's expansion into wider non-prime auto finance markets.

The division's reduction in net interest margin to 3.70 per cent. (as compared to 4.09 per cent. in 2005 and 2.80 per cent. in 2004) reflects continued portfolio diversification within ENA's corporate businesses, a competitive Dutch mortgage market and the impact of the expansion of Drive's activities in the wider non-prime auto finance market. In ENA's corporate businesses, the current high level of liquidity and competition created dynamic markets with increasing new business opportunities but with associated margin pressure. Additionally, the division's continued focus on diversifying the division's portfolio risk across a broader mix of sectors is evidenced in its anticipated trend of lower margin. Excluding Drive, the net interest margin reduced to 1.90 per cent. (as compared to 2.27 per cent. in 2005).

	Basis points
<b>Movement in margin</b>	
Net interest margin for the year ended 31 December 2004 (pro forma).....	280
Lending margin Corporate .....	6
Lending margin Retail .....	(6)
Change in product mix.....	(22)
Drive.....	151
Net interest margin for the year ended 31 December 2005.....	409
Lending margin Corporate .....	(27)
Lending margin Retail .....	(6)
Lending margin Drive .....	(6)
<b>Net interest margin for the year ended 31 December 2006</b> .....	<b>370</b>

Underlying non-interest income increased in 2006 by 64 per cent. to £266 million (as compared to £162 million in 2005), which includes a full year's consolidation of Heidelberger Leben ('HLE') within EFS.

On a like-for-like basis, underlying non-interest income increased in 2006 by 53 per cent.. In ENA's corporate businesses, increased activity levels, early redemptions and selective investment realizations have generated strong fee and equity gains.

*Operating Expenses.* Underlying operating expenses increased in 2006 by 33 per cent. to £206 million (as compared to £155 million in 2005 and £96 million in 2004 (pro forma)). This increase is partly due to the full year consolidation of HLE and the acquisition of controlling interests in the Group's premier distributors in Germany and Italy. Excluding these items, underlying operating expenses grew by 23 per cent. in 2006, reflecting continued investment in people and systems, and the impact of ENA's network expansion programme which has seen the number of Banco Halifax Hispania ('BHH') branches increase in 2006 from 14 to 19, and a new corporate office opened in Stockholm in July. However, despite these investments, the cost:income ratio increased only modestly to 28.0 per cent. (as compared to 27.5 per cent. in 2005 and 26.6 per cent. in 2004 (pro forma)).

*Credit Quality and Provisions.* Overall credit quality in ENA improved in 2006, with the level of impaired loans as a percentage of closing advances reducing to 0.62 per cent. (as compared to 1.61 per cent. in 2005 and 2.52 per cent. in 2004 (pro forma)) and impairment losses as a percentage of average advances decreasing in 2006 to 1.13 per cent. (as compared to 1.26 per cent. in 2005 and 1.81 per cent. in 2004 (pro forma)). Impairment provisions as a percentage of impaired loans decreased in 2006 to 59 per cent. (as compared to 78 per cent. in 2005 and 56 per cent. in 2004 (pro forma)).

Excluding Drive, the level of impaired loans as a percentage of closing advances reduced to 0.62 per cent. (as compared to 1.22 per cent. in 2005). Impairment losses in ENA for 2006 were £14 million (as compared to £32 million for 2004) and, as a percentage of average advances, improved to 0.13 per cent. (as compared to 0.35 per cent. in 2005). Impairment provisions as a percentage of impaired loans decreased in 2006 to 59 per cent. (as compared to 68 per cent. in 2005).

In the Corporate businesses, excluding Drive, ENA's diversified portfolio risk approach coupled with what the Group believes are established and proactive risk management techniques across a broader mix of sectors resulted in a significant improvement in credit quality. Impaired loans as a percentage of closing advances improved in 2006 to 0.87 per cent. (as compared to 2.01 per cent. in 2005), while impairment losses as a percentage of average advances improved to 0.14 per cent. (as compared to 0.54 per cent. in 2005). Impairment losses in 2006 benefited from a number of successful recoveries.

In ENA retail business, credit quality also improved in 2006, with impaired loans as a percentage of closing advances reducing to 0.34 per cent. (as compared to 0.40 per cent. for 2005 and 0.44 per cent. in 2004) and impairment losses as a percentage of average advances improved at 0.12 per cent. (as compared to 0.14 per cent. in both 2005 and 2004).



*Drive Financial Services.* The table below shows the impact of Drive and its related earnings included in the overall divisional income statement up to the disposal on 7 December 2006.

	31 December 2006	31 December 2005
	£m	£m
Net interest income.....	254	201
Other income .....	(1)	
Net operating income .....	253	201
Underlying operating expenses .....	(43)	(40)
profit .....	210	161
Impairment losses on loans and advances .....	(120)	(94)
<b>Underlying profit before tax .....</b>	<b>90</b>	<b>67</b>

The sub-prime nature of Drive's lending dominates certain divisional metrics and is also in the context of the Group. The following table sets out the key metrics for ENA and the Group with and without Drive included.

	At 31 December 2006	
	Drive included	Drive excluded
	%	%
<b>ENA</b>		
Net interest margin .....	3.70	1.90
Impairment losses as a % of average advances .....	1.13	0.13
Cost:income ratio .....	28.0	33.8
<b>Group</b>		
Net interest margin .....	1.78	1.72
Impairment losses as a % of average advances .....	0.48	0.45
Cost:income ratio .....	40.9	41.4

## International – Europe and North America

### Balance Sheet and Asset Quality Information

	As at 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
<b>Loans and advances to customers</b> .....	£12.6bn	£11.1bn	£8.9bn
<b>Impairment provisions on advances</b> .....	£46m	£139m	£126m
<b>Impairment provisions as a % of closing advances</b> .....	0.37%	1.25%	1.42%
<b>Classification of advances*</b> : .....	%	%	%
Energy .....	1		
Hotels, restaurants and wholesale and retail trade .....	1	2	3*
Transport, storage and communication.....	2		
Financial .....	1	2	1*
Other services .....	1		
Individuals:			
Home mortgages .....	4	4	42*
Other personal lending .....		8	7*
Overseas residents:			
Energy .....	4	4	5*
Manufacturing industry.....	5	5	8*
Construction and property .....	20	14	9*
Hotels, restaurants and wholesale and retail trade .....	3	2	3*
Transport, storage and communication.....	1	1	2*
Financial .....	4	2	3*
Other services .....	12	15	17*
Individuals:			
Home mortgages .....	41	41	
	100	100	100
<b>Impaired loans</b> .....	£78m	£179m	£224m
<b>Impaired loans as a % of closing advances</b> .....	0.62%	1.61%	2.52%
<b>Impairment provisions as a % of impaired loans</b> .....	59%	78%	56%
<b>Risk weighted assets</b> .....	£11.7bn	£11.1bn	£9.2bn
<b>Customer deposits</b> .....	£1.0bn	£0.5bn	£0.1bn

\* Before impairment provisions. In addition, the *Classification of advances* figures for 2005 have been restated. The 2004 comparatives have not, however, been similarly restated.

#### Operational Performance

*Lending and Deposit Growth.* Overall in 2006, lending in ENA increased by 14 per cent. to £12.6 billion (as compared to £11.1 billion in 2005). Excluding Drive, lending in ENA increased in 2006 by 24 per cent. from a 2005 equivalent of £10.2 billion, with strong growth experienced across all the Group's lending businesses.

The Group believes ENA's portfolio remains well spread both geographically and by business, with 53 per cent. of lending in corporate and 47 per cent. in retail at the end of 2006. In ENA's retail business, its

lending portfolio is almost wholly in the form of residential mortgages, while its corporate business now benefits from a diverse portfolio spread across a range of specialist sectors. The largest overall concentration in ENA's lending book continues to be in property, with residential mortgages accounting for 45 per cent. of the ENA property portfolio and commercial property for 20 per cent. of the ENA property portfolio at the end of 2006.

	31 December, 2006	31 December 2005	31 December 2006	31 December, 2005
	£bn	£bn	%	%
<b>Corporate</b>				
North America.....	2.5	2.2	20	20
Drive .....		0.9		8
Europe .....	4.2	3.0	33	27
<b>Retail</b> .....	5.9	5.0	47	45
	12.6	11.1	100	100

Risk weighted assets increased in 2006 by only 5 per cent. to £11.7 billion (as compared to £11.1 billion in 2005), reflecting the disposal of Drive and an enlargement of BOS Netherlands (**BOSNL**) Candide mortgage securitisation programme. Overall, ENA deposits increased in 2006 to £1.0 billion (as compared to £0.5 billion in 2005).

*Corporate.* Corporate Europe lending increased in 2006 by 40 per cent. to £4.2 billion (as compared to £3.0 billion in 2005 and £2.9 billion in 2004 (pro forma)), with continued focus on effective asset management and credit quality. Continued portfolio diversification towards a broader mix of sectors has resulted in an anticipated reduction in net interest margins, offset by increased new lending opportunities delivering growth in 2006 of 55 per cent. in non-interest income through increased fees and equity gains. Corporate Europe brings together specialist expertise in sectors such as structured finance, commercial real estate and energy and utilities. Corporate Europe's Stockholm office opened in July 2006 in an effort to take advantage of a buoyant economic environment in the Nordic region and expand its network to five Continental European offices.

Corporate North America also delivered strong growth in both the core business and in Drive. In the core business, lending increased in 2006 by 14 per cent. (30 per cent. in local currency terms) to £2.5 billion (as compared to £2.2 billion in 2005). North America has a clear focus on specialist sectors such as oil and gas, gaming and real estate where it benefits from long experience. It has a proven track record in joint venture activity and an expanding regional banking partnership initiative. This initiative identifies U.S. regional banks with which corporate North America can partner in commercial lending opportunities that would otherwise be beyond its lending limits. It now accounts for 17 per cent. of the total portfolio, growing by 97 per cent. from 2005. Corporate North America operates through an office network based in seven major economic centers across the U.S.

*Retail.* BOSNL, ENA's leading Dutch online and intermediary introduced residential mortgage provider, saw lending grow in 2006 by 15 per cent. to £4.7 billion (as compared to £4.1 billion in 2005) despite facing intense price competition in the Dutch market. The Group believes that BOSNL remains a market leader in online mortgage sales, founded upon an innovative and low cost entry model, geared to operate at competitive margins. The Group expects these are key credentials for continued growth in a competitive market.

The BHH roll out programme in Spain continued with a further five branches opened in 2006. ENA's expanded retail branch network is located in areas with the maximum growth opportunities, targeting the

expanding U.K. and Irish expatriate market. Lending in Spain grew by 33 per cent. to £1.2 billion (as compared to £0.9 billion in 2005).

*European Financial Services.* ENA's investment business, EFS, performed well in 2006 given the continuing soft market conditions in the German market, with sales up 30 per cent. (compared to 2005) to £103 million APE (as compared to £79 million in 2005). Funds under management increased by 3 per cent. in 2006 (6 per cent. in local currency terms) to £9.6 billion (as compared to £9.3 billion in 2005).

With underlying profit before tax increasing in 2006 by 57 per cent. to £102 million (as compared to £65 million in 2005), EFS is well positioned to take advantage of improving opportunities in ENA's core markets. In 2006, the Group completed the consolidation of the HLE business and increased distribution through the long-term agreement with MLP AG. In addition, by securing controlling interests in the Group's key Premier Distributors, EFS has been able to restructure and reposition its broker distribution channel, while at the same time, it believes, strengthening its sales and management teams.

The vast majority of investment business in EFS is accounted for on an EV basis. The table below analyses the EV profit contribution of EFS.

	Year ended 31 December,		
	2006	2005	2004 (unaudited)
	(in £ millions)		
Contribution from existing business:			
Expected contribution .....	44	30	12
Actual vs expected experience* .....	19	7	8
	63	37	20
Contribution from new business .....	36	25	52
Investment earnings on net assets using long term assumptions .....	3	3	
<b>Underlying profit before tax *</b> .....	<b>102</b>	<b>65</b>	<b>72</b>

\* The figures for 2005 have been re-analyzed to reflect changes to the overhead allocation methodology. The figures for 2004 do not reflect this.

New business profitability, now measured on the embedded value basis, used for IFRS reporting purposes, was 35 per cent. APE in 2006 (as compared to 32 per cent. in 2005).

## Treasury & Asset Management

Underlying profit before tax increased by 33% to £350 million in 2006 (as compared to £263 million in 2005). Asset quality remained high and no credit provisions were required in the period.

### Income Statement

	Year ended 31 December 2006	Year ended 31 December 2005
	£bn	£bn
Net interest income.....	205	183
Non-interest income .....	414	326
Net trading income .....	249	197
Fees and commission income.....	186	146
Fees and commission expense .....	(43)	(37)
Other operating income .....	22	20
<b>Net operating income</b> .....	<b>619</b>	<b>509</b>
<b>Operating expenses</b> .....	<b>(292)</b>	<b>(247)</b>
Staff .....	(171)	(134)
Accommodation, repairs and maintenance .....	(1)	(1)
Technology .....	(10)	(10)
Marketing and communication.....	(6)	(5)
Depreciation:		
Property and equipment and intangible assets .....	(4)	(4)
Other .....	(78)	(74)
Subtotal.....	(270)	(228)
Recharges:		
Technology .....	(6)	(4)
Accommodation .....	(14)	(13)
Other shared services .....	(2)	(2)
<b>Operating profit</b> .....	<b>327</b>	<b>262</b>
Share of profits of associates and jointly controlled entities .....	1	1
Non-operating income .....	22	
<b>Underlying profit before tax</b> .....	<b>350</b>	<b>263</b>
Net interest margin (bps)* .....	7	8
Cost:income ratio .....	47.2%	48.5%
Insight's funds under management.....	£98.6bn	£81.9bn
of which, overlay funds under management .....	£5.0bn	
Invista's funds under management .....	£9.2bn	£6.8bn
Risk weighted assets.....	£15.0bn	£13.7bn

\* Net interest margin has been calculated as net interest income divided by average interest earning assets excluding securities classified as trading assets but including lending to other members of the group.

### Financial Performance

*Operating income and margins.* Net operating income increased by 22 per cent. in 2006 to £619 million (as compared to £509 million in 2005 and £484 million in 2004). Net interest income increased in

2006 by 12 per cent. to £205 million (as compared to £183 million in 2005 and £168 million in 2004 (pro forma)). Net interest margin decreased in 2006 to 7bps (as compared to 8bps in 2005 and 9bps in 2004) on a larger portfolio.

Non-interest income increased in 2006 by 27 per cent. to £414 million (as compared to £326 million in 2005 and £316 million in 2004 (pro forma)). In Treasury, there was a strong performance from both the U.K. trading and sales businesses, with revenues up 33 per cent. and 19 per cent., respectively, in 2006. In the asset management business, non-interest income benefited from strong sales in the institutional market place of Insight's flagship products of fixed income and LDI. This was combined with growth in performance fees received by Invista, the Group's property fund manager, both before and after its initial public offering ('IPO') on the London Alternative Investment Market in September 2006.

*Operating Expenses.* Underlying operating expenses increased in 2006 by 18 per cent. to £292 million (as compared to £247 million in 2005 and £212 million in 2004 (pro forma)), reflecting an increase in personnel to support improvements to the division's infrastructure, and investment in its overseas Treasury offices and its asset management capabilities. Part of this investment included the successful completion of the project to outsource Insight's back office operations to Northern Trust.

*Asset Quality and Provision:* Within the Group's Treasury operations, the division continues to maintain a cautious policy to avoid sub-investment grade investments, with 99 per cent. of Treasury's bank and structured investment portfolios rated A or above. During the year no credit provisions were required.

*Non-operating Income:* The IPO of Invista in September 2006, which raised almost £100 million of balance sheet co-investment capital for the business to expand its sphere of operations, resulted in a one-off gain of £22 million. HBOS now owns 55 per cent. of the enlarged business.

*Funding.* Treasury continued to be active in supporting the Group's capital and funding requirements in 2006, arranging four capital issues on behalf of HBOS plc during the year; a €500 million floating rate lower Tier 2 subordinated debt issue; a €750 million Tier 1 perpetual preferred security issue; a £350 million Tier 1 perpetual preference share issue and a US\$750 million floating rate lower Tier 2 subordinated debt issue.

Approximately £21 billion of funds were raised from existing programmes in the securitisation and covered bond markets during the year. This comprised approximately £6.5 billion from covered bonds and approximately £14.5 billion from securitisations. These transactions included a securitisation of Australian residential mortgages originated by BankWest and the first U.S. dollar mortgage backed covered bond issued into the United States.

*Sales and Trading.* Sales and trading performance was strong with net trading income increasing in 2006 by 26 per cent. to £249 million (as compared to £197 million in 2005). Sales revenues were up 19 per cent. in 2006, primarily due to increased sales of foreign exchange and interest rate derivatives to Treasury's corporate customers. Trading revenues were up 33 per cent. in 2006, mainly as a result of increased interest rate derivatives flow and credit trading activities.

*Overseas offices.* Overseas Treasury revenues increased in 2006 by 16 per cent. to £29 million (as compared to £25 million in 2005). Sydney is the division's largest overseas office where it is building its capacity to support the Group's expansion in Australia. The New York branch has also continued to broaden its customer base in the United States.

*Asset Management.* Total funds managed by Insight and Invista in 2006 were £107.8 billion (as compared to £88.7 billion in 2005 and £77.7 billion in 2004 (pro forma)). Group assets, managed primarily on behalf of the insurance & investment division and invested in equity, fixed income, cash, property, private equity and absolute return funds, totaled £58.3 billion (as compared to £53.1 billion in 2005).

Insight's investment performance was strong in the year with 12 out of 16 asset classes performing ahead of benchmark. Insight's has over 95 per cent. of institutional fixed income and cash mandates by value ahead of benchmarks over 1 and 3 years. In equities, Global, North American, European and Japanese products were all ahead of benchmark for the year. U.K. equity performance in the first half of the year was, however, below benchmark, leading to a restructuring of the U.K. equity platform in the second half of the year designed to improve performance. Following on from its successful first year, the Insight Absolute Return Fund performed ahead of its benchmark in 2006.

On the back of this strong investment performance, Insight in 2006 delivered its best ever year for new business with gross inflows of £23.7 billion (as compared to £9.7 billion in 2005). Included within gross sales were LDI sales of £10.6 billion (as compared to £0.6 billion in 2005) including overlay mandates, an LDI product where Insight manage some of the risks of a pension scheme's liabilities rather than the underlying portfolio of assets. Net inflows in 2006 were £13.4 billion (as compared to £2.6 billion in 2006).

Invista, formed following the de-merger and subsequent IPO of the real estate division of Insight in September 2006, is now the largest U.K.-listed real estate fund manager with assets under management of £9.2 billion. Invista manages 16 real estate funds spread across the U.K. and Continental Europe. This includes five funds managed on behalf of the HBOS Group. During 2006, four real estate funds were launched, including the Invista European Real Estate Trust, which was listed on the Official List of the London Stock Exchange on 20 December 2006.



## SELECTED STATISTICAL AND OTHER INFORMATION

Set forth in the following section is certain additional statistical and other information relating to the Group for 2006, 2005 and 2004. The 2006, 2005 and 2004 comparisons are (unless otherwise specifically indicated) made on the basis of the audited statutory financial information for 31 December 2006, 31 December, 2005 and 31 December 2004. As previously indicated, such information may not be fully comparable (see “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Accounting Policies”). However, it generally has not been practicable to prepare pro forma information for 2004 in this case.

### *Loan portfolio*

Gross loans and advances to customers are classified as advances to customers (including banking advances, installment credit and other financial agreements and assets leased to customers), advances to joint ventures and advances to associated undertakings. Cumulative provisions for impairment are deducted from gross loans and advances to determine net loans and advances to customers.

### **Loans and advances to customers**

	As at 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(statutory)
	(in £ millions)		
<i>Loans and advances to customers</i>			
Gross loans and advances to customers .....	379,897	346,706	318,190
Non-refundable finance .....	—	—	(28,890)
Impairment losses on loans and advances .....	(3,089)	(2,938)	(2,494)
Interest in suspense .....	—	—	(138)
Net loans and advances to customers .....	376,808	343,768	286,668

The Group’s loans and advances to customers (after taking into account provisions for impairment) totaled £376,808 million as at 31 December 2006 (as compared to £343,768 million as at 31 December 2005 and £286,668 million as at 31 December 2004 (statutory)). This amount represents an increase of £33,040 million (or 10 per cent.) over the 2005 levels and an increase of £90,140 (or 31 per cent.) over the 2004 (statutory) level.

### *Lending concentrations*

The following table analyzes the Group’s classification of loans and advances to customers before impairment provisions and after taking account of collateral. For 2004, the Group’s lending exposure is after the deduction of non-returnable finance and before the deduction of impairment provisions and interest in suspense).

## Loans and advances to customers by classification

	As at 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(statutory)
	(in £ millions)		
Agriculture, forestry and fishing.....	1,402	1,316	1,327
Energy.....	2,275	1,800	1,347
Manufacturing industry.....	5,797	6,351	6,206
Construction and property.....	40,537	36,913	32,895
Hotels, restaurants and wholesale and retail trade.....	12,951	12,601	10,299
Transport, storage and communication.....	7,412	4,873	4,817
Financial.....	6,555	10,815	10,829
Other services.....	19,747	19,369	17,958
Individuals:			
Home mortgages.....	234,582	213,842	170,098
Other personal lending.....	22,732	23,463	22,316
Overseas residents.....	25,907	15,363	11,208
	379,897	346,706	289,300

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

## Analysis of net loans and advances to customers by maturity

	As at 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(statutory)
	(in £ millions)		
Up to 1 month.....	45,169	27,566	31,968
Other loans and advances repayable:			
1 to 3 months.....	54,797	50,604	34,752
between 3 months and 1 year.....	13,123	14,885	14,871
between 1 year and 5 years.....	39,827	47,363	48,729
after 5 years.....	223,892	203,350	156,348
Net loans and advances to customers.....	376,808	343,768	286,668

## Loans and advances to banks

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

## Analysis of loans and advances to banks by maturity

	As at 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(statutory)
	(in £ millions)		
Up to 1 month.....	1,218	8,161	9,753
Other loans and advances repayable:			
1 to 3 months .....	6,640	5,225	6,817
3 months and 1 year .....	1,037	1,868	1,709
1 year and 5 years .....	528	272	77
over 5 years.....	2	380	–
Policyholder funds .....	2,168	1,450	1,645
Loans and advances to banks .....	11,593	17,356	20,001

### *Country exposure*

Country risk can arise from transfer risk, political and economic risk. It is accepted practice to control country risk through the setting of country limits i.e. monetary caps on the total value of all sanctioned exposures across each country of risk.

The Board has delegated the authority to set country limits for credit exposure throughout the Group to the Group Credit Risk Committee, which meets monthly or more regularly if required.

It is the policy of the Group for all countries to be rated independently by Group Risk and to have a country limit (excluding the United Kingdom), even if they carry the highest credit ratings. The Group Credit Risk Committee reviews individual country ratings and limits at least annually and country exposures at least quarterly. Group country limits are sub-allocated to each operating division according to levels of business and approved strategies.

The following table sets forth the Group's country exposure as at 28 February 2007.

### Country exposure<sup>(3)</sup>

	<b>Risk Exposure</b>
	<b>(in £ millions)</b>
<b>As at 28 February 2007</b>	
<i>Geographic area<sup>(1)</sup></i>	
Europe (other than United Kingdom) .....	59,879
North America .....	40,794
Oceania (New Zealand, Australia, Papua New Guinea) .....	34,134
Asia (including Hong Kong and Singapore) .....	770
Middle East .....	225
Central America & the Caribbean .....	1,291
Africa .....	135
South/Latin America .....	138
Other <sup>(2)</sup> .....	829

(1) Excludes UK exposure

(2) Based on the location of the customer.

(3) Supranational exposure

This table corresponds to the extent to which the Group is exposed in certain geographical areas, but does not represent the profit before tax or any other measure of the Group relating to such geographical areas.

### Securities portfolio

The Group's investment securities portfolio consists of debt securities and equity shares. Investment securities consist of both listed and unlisted securities. The following table shows the value of the Group's investment securities portfolio as at the dates indicated.

### Securities portfolio

	<b>As at 31 December,</b>		
	<b>2006 (statutory)</b>	<b>2005 (statutory)</b>	<b>2004</b>
	<b>(in £ millions)</b>		
<b>Listed</b>			
Debt Securities .....	50,812	47,729	54,145
Equity Shares .....	43,624	34,180	25,472
	<u>94,436</u>	<u>81,909</u>	<u>79,617</u>
<b>Unlisted</b>			
Debt Securities .....	18,014	21,399	28,756
Equity Shares .....	4,581	1,026	195
	<u>22,595</u>	<u>22,425</u>	<u>28,951</u>
<b>Total .....</b>	<u><u>117,031</u></u>	<u><u>104,334</u></u>	<u><u>108,568</u></u>

## *Assets and Liabilities*

As at 31 December, 2006, the Group's total assets were £591,029 million, an increase of £50,156 million, or 9 per cent., from £540,873 million as at 31 December 2005 and an increase of £142,864 million, or 32 per cent., from £448,165 million as at 31 December 2004 (statutory). Advances to customers increased in 2006 to £376,808 million from £343,768 million as at 31 December 2005 (an increase of 10 per cent. from such date), and from £286,668 million as at 31 December 2004 (statutory) (an increase of 31 per cent. from such date).

## *Deposits*

The Group's assets are funded by the taking of both retail and wholesale deposits.

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

### **Maturity analysis of deposits**

	As at 31 December,		
	2006 (statutory)	2005 (statutory)	2004
(in £ millions except ratios)			
<i>Customer accounts</i>			
Repayable on demand .....	177,826	174,659	165,789
Repayable:			
in 3 months or less .....	16,979	11,037	17,446
between 3 months and 1 year .....	10,067	9,052	8,257
between 1 year and 5 years.....	5,361	3,198	2,940
after 5 years .....	1,624	3,002	1,062
Total customer accounts .....	211,857	200,948	195,494
<i>Deposits by banks</i>			
Repayable on demand .....	11,866	16,904	29,715
Repayable:			
in 3 months or less .....	11,817	11,072	4,054
between 3 months and 1 year .....	3,145	3,810	3,290
between 1 year and 5 years.....	1,215	187	176
after 5 years .....	2,513	66	63
policyholder funds .....	1	2	97
Total deposits by banks .....	30,557	32,041	37,395
Total .....	242,414	232,989	232,889

### *Capital resources*

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

#### **Capital resources**

	As at 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(statutory)
	(in £ millions)		
Ordinary shares .....	941	959	981
Preference shares .....	198	198	400
Reserves .....	19,546	17,108	15,881
Minority interests (equity) .....	486	191	295
Minority interests (non-equity).....	-	-	2,617
Total shareholders' equity .....	21,171	18,456	20,174

### *Capital adequacy*

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

#### **Capital adequacy**

	As at 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	(pro forma)
	(in £ millions)		
Tier 1 capital .....	22,429	20,667	18,550
Total capital.....	33,154	31,726	28,987
Risk-weighted assets.....	276,012	255,065	234,873
Tier 1 capital ratio.....	8.1%	8.1%	7.9%
Total capital ratio .....	12.0%	12.4%	12.3%

The minimum total capital ratio of 8 per cent., established by the Basel Committee, serves as the base standard from which the Financial Services Authority sets individual banks' ratios, reflecting each institution's particular circumstances. As shown, the Group's capital ratios exceed the minimum requirements of the Basel Committee. Tier 1 capital increases year to year through retained profits and both Tier 1 and Tier 2 capital are periodically supplemented by new capital being raised. Tier 2 capital increased by £103 million in the year ended 31 December 2006 in comparison to 2005. Supervisory deductions increased to £5,666 million from £5,229 million.

### *Contingent liabilities and commitments*

The Group's contingent liabilities consist of acceptances and endorsements and guarantees and assets pledged as collateral security. The Group's commitments consist of short-term trade related transactions, undrawn formal standby facilities, credit lines and other irrevocable commitments to lend (classified as up

to and including one year and over one year). The following table sets out the Group's contingent liabilities and commitments for the dates indicated.

### Contingent liabilities and commitments

	As at 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (statutory)
	Contract Amount	Contract Amount	Contract Amount
	(in £ millions)		
<i>Contingent Liabilities</i>			
Acceptances and endorsements .....	62	23	75
Guarantees and assets pledged as collateral security:			
Guarantees and irrevocable letters of credit .....	5,068	5,093	4,233
	<u>5,130</u>	<u>5,116</u>	<u>4,308</u>
<i>Commitments</i>			
Short-terms trade related transactions .....	120	117	129
Undrawn formal standby facilities, credit lines and other irrevocable commitments to lend:			
up to and including 1 year .....	61,645	59,315	53,796
over 1 year .....	24,049	20,381	17,473
	<u>85,814</u>	<u>79,813</u>	<u>71,398</u>

### Geographical regions

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



## Geographic segment analysis

	As at or for the year ended 31 December,		
	2006	2005	2004
	(statutory)	(statutory)	
	(in £ millions)		
<i>Net Interest income</i> .....	7,400	6,829	5,885
U.K. ....	6,097	5,793	5,284
Non-U.K. ....	1,303	1,036	601
<i>Net Fees and commissions income</i> .....	1,163	1,034	1,468
U.K. ....	937	977	1,202
Non U.K. ....	226	57	266
<i>Non-trading income</i> .....	279	218	208
U.K. ....	278	211	189
Non U.K. ....	1	7	19
<i>Other Operating income</i> .....	13,872	15,536	14,934
U.K. ....	12,661	15,078	14,827
Non U.K. ....	1,211	458	107
<i>Non-operating income</i> .....	22,714	23,617	22,495
U.K. ....	19,973	22,059	21,502
Non-U.K. ....	2,741	1,558	993
<i>Operating profit</i> .....	5,330	4,723	4,462
U.K. ....	4,306	3,981	3,862
Non U.K. ....	1,024	742	600
<i>Total assets</i> .....	591,029	540,873	448,165
U.K. ....	499,767	468,529	403,784
Non U.K. ....	91,262	72,344	44,381
<i>Total liabilities</i> .....	569,858	522,417	427,991
U.K. ....	484,284	460,183	380,757
Non U.K. ....	85,574	62,234	47,234

## *Income taxes*

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

### **Income taxes**

	Year ended 31 December,		
	2006 (statutory)	2005 (statutory)	2004 (statutory)
	(in £ millions)		
U.K. corporation tax <sup>(1)</sup> .....	978	876	1,061
Relief for overseas taxation .....	(73)	(36)	(29)
Overseas taxation .....	206	161	148
	1,111	1,001	1,180
Deferred taxation .....	661	545	92
Total income tax on profit .....	1,772	1,546	1,272

(1) at 30 per cent. (2005 and 2004 30 per cent.)

The Group charge for tax increased 15 per cent. in 2006 (as compared to 2005) to £1,772 million (as compared to £1,546 million in 2005 and £1,272 million in 2004). The taxation charge in 2006 represented 31.1 per cent. of profit before taxation (as compared to 32.2 per cent. for 2005 and 27.6 per cent. for 2004).

## RISK MANAGEMENT

### Risk Management

#### *Introduction*

Identification, measurement and management of risk is a strategic priority for HBOS. The provision of financial services carries a number of diverse risks which may have a material impact on financial performance. Consequently, the Board has established a comprehensive framework covering accountability, oversight, measurement and reporting to maintain high standards of risk management throughout the Group.

The principal risks faced by HBOS are:

- Credit Risk – the risk of financial loss from a customer’s failure to meet obligations as they fall due.
- Liquidity or Funding Risk – 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.
- Market Risk – defined as the potential loss in value or earnings arising from changes in external market factors such as interest rates, foreign exchange rates, commodities and equities, and the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions.
- Operational Risk – arising from internal processes, people and systems or from external events.
- Regulatory change – the risk to HBOS strategy, reputation and financial position arising from failure to respond to changes in laws, regulations or business standards in the jurisdictions and businesses in which we operate.
- Insurance and Investment Risk – the potential for loss through adverse claims, expense and persistency experience, from both life and general insurance contracts.

#### *Overview: Management and Controls*

##### *Principles*

Within the Group, risk is managed in accordance with the following principles:

- Key risks are identified, measured where appropriate, and managed to achieve a balance between risk and reward which is acceptable to the Board. Each year the Board carries out a formal strategic review of risk management, and also reassesses its appetite for risk in light of 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 and can provide only reasonable – and not absolute – assurance against material misstatement or loss. The Board also reviews risk management performance through regular management information reporting.
- Responsibility for risk is a key element of managers’ competencies at all levels. For each major risk type, specialist teams have been established where appropriate, both in the Divisions and at Group level, to ensure that guidance is available for managers within the Group. Specialist risk managers are tasked with researching industry best practice, and with ensuring that

standards and policies within the Group are progressively developed to improve risk management practice.

- Staff and systems resources are dedicated to ensuring that risk management information is accurate, timely and relevant to the business, reflecting the true position at any given time.

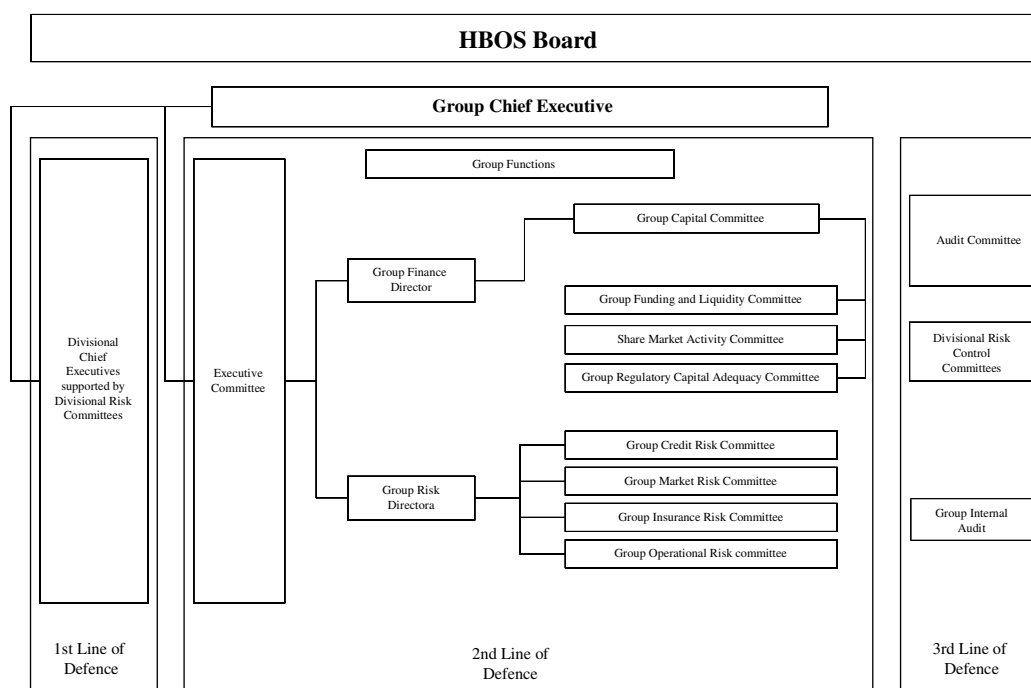
The Board has overall responsibility for the Group's system of control and approval of principal risk policies and standards, which are continually evolving. The Board is also responsible for reviewing the effectiveness of the systems and controls. The system of control described in this section has been in place throughout the period to the date of approval of the HBOS plc Annual Report and Accounts. It accords with the Turnbull guidance on internal control and has also been reviewed by the Board specifically for the purposes of this statement.

#### *The Risk Management Framework*

HBOS 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':

- Within Operating Divisions, primary management responsibility for strategy, performance management and risk control lies with the Divisional Chief Executives (*first line of defence*). They have responsibility for managing strategic, market, credit, liquidity, regulatory and operational issues and risks affecting their own operations within the parameters of Group policies. Each Operating Division also has its own risk management committee or committees;
- Centralised policies and standards are developed and objective oversight of risk management is exercised by specialist risk functions, supporting the Group's Executive Committee and Executive Risk Committees (*second line of defence*); and
- Independent and objective assurance on the effectiveness of control systems is provided by Group Internal Audit with oversight by the Audit Committee (*third line of defence*).

This model operates through a formal governance structure, comprising committees with specified areas of responsibility, supported by management functions with a similar remit.



### *The Committee Framework*

The Group Executive Risk Committees develop the policies and parameters within which Operating Divisions are required to manage risk. The Committees provide central oversight by reviewing and challenging the work of the Operating Divisions' own risk committees and considering the application of appropriate risk management techniques.

The four specific Executive Risk Committees are:

- Group Credit Risk Committee, which covers all credit risk matters;
- Group Market Risk Committee, which is responsible for all trading and market risk matters;
- Group Insurance Risk Committee, which is responsible for insurance risks within the insurance and investment businesses; and
- Group Operational Risk Committee, responsible for operational and regulatory risks.

The Group has an established specialist Group Risk function, reporting to the Group Risk Director, in support of these Committees. Its accountabilities 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 Operating 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 through:
  - Establishing and monitoring compliance with the Group's Capital Plan in line with the Board approved Group Capital Policy.
  - Establishing and monitoring compliance with the Group Funding Plan.
  - Establishing policies and minimum standards to measure and monitor the financial resource requirements of the Group in accordance with regulatory requirements, including:
    - Establishing and monitoring execution of strategies for the management of non-trading related balance sheet risks within approved risk appetite, policy and minimum standards (as monitored by the Group Market Risk Committee),
    - Establishing and reviewing stress, scenario and contingency planning and management strategies in that regard (in co-operation with the Executive Risk Committees)
- Establish and recommend for approval to the Board, the Group's appetite for Liquidity Risk, including relevant policy (Group Liquidity Policy Statement) and minimum standards, and monitoring the implementation of those policies and standards within the HBOS Group.

#### *Strategy, Risk Control and Oversight*

The Group's risk appetite is established by the Board. The strategy for managing risk is formulated by the Executive Committee and recommended to the Board for approval. The Executive Committee also reviews the effectiveness of risk management systems through reports from management and the Group Executive Risk Committees.

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 assessment process is designed to be consistent across the Divisions and Group Functions and uses an iterative challenge process to provide successive assurances to ascending levels of management up to the Board.

In judging the effectiveness of the Group's controls, the Board reviews the reports of the Audit Committee and management. It also considers key performance indicators and reviews monthly financial and business performance showing variances against budget.

Certain responsibilities are delegated to the Audit Committee, including ensuring that there is regular review of the adequacy and efficiency of internal control procedures. This role provides independent and objective assurance that there is an appropriate control structure throughout the Group.

The Audit Committee, which is supported by Divisional Risk Control Committees, obtains assurance about the internal control and risk management environment through regular reports from Group Risk and Group Internal Audit. It also considers external auditors' reports and reviews the minutes and work of the Divisional Risk Control Committees.

### *The Basel II Accord*

HBOS continues to make good progress with Basel II preparations. The primary goal of our programme has always been to optimise the way we do business through an improved risk management capability. The overarching objective of all HBOS activity is to deliver sustainable income streams and generate added shareholder value and the Basel II programme is integral to our strategy of targeted growth. During 2006 the UK legislative process gathered significant momentum with the publication of several consultative papers and feedback statements that culminated on the 25 October 2006 with the Financial Services Authority (FSA) Board approving final GENPRU and BIPRU rules for adoption into the Prudential Sourcebook for Banks, Building Societies and Investment Firms. This legislative process enacts the European Capital Requirements Directive and, therefore, the Basel II Capital Accord, in the UK with effect from 1 January 2007.

HBOS 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. HBOS has elected to adopt transitional arrangements in 2007 and remain on the current Basel I rules to determine minimum regulatory capital requirements. HBOS has submitted Advanced Internal Ratings Based Approach and Advanced Measurement Approach waiver applications to the FSA and is seeking approval to adopt the more sophisticated approaches to capital determination from 1 January 2008. We continue to maintain a close dialogue with the FSA to work through the accreditation process.

### *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.

### *Credit Risk*

Credit Risk is the risk of financial loss from a counterparty's failure to settle financial obligations as they fall due. The Group Credit Risk Committee, one of the Executive Risk Committees, is chaired by the Group Risk Director and comprises senior executives from across the Operating Divisions and Group Functions. It meets monthly and reviews the Group's lending portfolio. It also assists the Board in formulating the Group's credit risk appetite. The Group Credit Risk Policy Statement, to be applied across all businesses subject to credit risk, is approved by the Board on an annual basis.

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 agreed 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. Typical functions undertaken by these teams include credit sanctioning, portfolio management and the management and collection of high risk and defaulted accounts.

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

- For Retail portfolios, use is made of software technology in credit scoring new applications. In addition, where practical, 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 an increasingly important measure and is reviewed in combination with either application and/or behavioural scores. Collections activity for credit cards, current accounts and personal loans is centralised for the various products and software systems are used to prioritise action. Mortgage collection is conducted through a number of payment collection departments. 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 credit risk rating. Internal ratings are reviewed regularly. The same approach is also used for larger SME (small to medium enterprise) customers.
- Within HBOSTS, largely incorporating the Group's wholesale, sovereign and banking related exposures, focused credit risk policies are established and reviewed by the Group Wholesale Credit Committee, a subcommittee of the Group Credit Risk Committee.

An additional measure within the credit risk framework is the establishment of product, industrial sector and country limits to avoid excessive concentrations of risk particularly within volatile economic sectors or individual countries. Material portfolio areas, such as the mortgages portfolios, have approved sub-sector limits to ensure that they remain within our plans and tolerance for risk. All such limits are set and monitored by the Group Credit Risk Committee. The controls applied to lending assessment processes consider environmental risk and the potential impact this may have on the value of the underlying security.

Target and benchmark standards have been established across the Group for the management of credit risk. All Divisions are committed to continuously improving credit risk management and there have been significant levels of investment in the development of credit risk rating tools, including scorecards better able to discriminate and price for risk across the portfolio.

Within the insurance and investment businesses, formal policies and an overall risk appetite, approved by the Board of the relevant insurance subsidiary, are in use together with a regular monitoring process to help ensure compliance. Additionally, oversight in this area is undertaken by the Group Insurance Risk Committee.

### *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;
- the quality of the Group's profits is appropriately managed and its reputation safeguarded; and

- those making decisions have appropriate information on market risk, such that the taking of market risk enhances shareholder value.

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

The Group devotes considerable 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 HBOS 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, as well as external disclosure requirements.

Market risk is controlled across the Group by setting limits using a range of measurement methodologies. The principal methodologies are Value-at-Risk (**VaR**), Net Interest Income (**NII**) at Risk and scenario analysis. NII at Risk is a technique that provides estimates of the potential negative change in the forecast NII of a portfolio over a specified time horizon for a specific interest rate environment. VaR is a technique that produces estimates of the potential negative change in the market value of a portfolio over a specified time horizon at given confidence levels. Scenario analysis is performed in order to estimate the potential economic loss that could arise from extreme, but plausible stress events. In 2006 the Group introduced market value methodology for its banking businesses to expand on the Group's capabilities in capturing market risk.

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 Operating 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 company. In the case of the risk borne by the customer, this is controlled by adherence to, and regular monitoring of, investment mandates and, if appropriate, unit pricing systems and controls. In the case of the company, the overall risk appetites and policies are approved by the company's Board and monitored thereafter.

Market risk – principally interest rate 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.

Group items (centrally managed net free reserves, subordinated debt and structural foreign exchange) are managed within separate policies and limits/mandates, as set by the Group Capital Committee.

#### *Interest Rate Risk*

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

The Board limit for structural interest rate risk is expressed in terms of potential volatility of net interest income in adverse market conditions. Risk exposures will be monitored using one or a combination of the following measures:

- Net Interest Income at Risk – This methodology combines an analysis of the Group’s 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 different interest rates scenarios. These scenarios range from next most likely rate move, to a significant parallel shock.
- Present Value of a Basis Point (‘PVBP’) – PVBP is a measure of market value sensitivity and quantifies the change in present value of cash flows for a one basis point change in interest rates.
- Market Value Measures (Banking Book) – A dynamic balance sheet mark to market is a risk measurement that considers future business and customer behaviour implications to capture the optionality embedded within the banking books.
- Duration – Duration provides a single measure of a portfolio’s ‘average maturity’ as calculated when considering all future cash flows of that portfolio, discounted at current market rates.

The Board has delegated authority to the Group Market Risk Committee to allocate limits to business areas as appropriate within the overall risk appetite, as approved by the Board each year. In turn, the Group Market Risk Committee has granted limits, which represent the risk tolerance for each Division. Interest rate risk arising in the course of business is required to be transferred to Treasury from the banking Divisions. The residual risk in the banking Divisions is primarily that related either to behavioural characteristics or to basis risk arising from imperfect correlations in the adjustment of rates earned and paid on different instruments with otherwise similar characteristics.

#### *Foreign Exchange Risk*

The Group Funding & Liquidity Committee is responsible for oversight and management of structural foreign currency risk. The Group Funding & Liquidity Committee manages foreign currency exposures based on forecast currency information provided by the Operating Divisions, and mandates Treasury to execute transactions and undertake currency programmes to manage structural currency risk. The 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.

#### *Trading*

The Group’s market risk trading activities are principally 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. 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 forecasts the Group’s exposure to market risk within an estimated level of confidence over a defined time period.

The average VaR value in 2006 was £4.2m. The calculation is based upon a confidence level of 99 per cent. with a one-day holding period. The principal areas of market risk taken are interest rate (outright positioning, basis, credit spread and volatility risk), and foreign exchange risk. There is no material commodity exposure, and limited equity exposure.

The current methodology for providing an aggregated VaR for the business uses conservative assumptions. In order to assess the effectiveness of VaR the Group uses a technique known as 'back testing', which compares the daily profit and loss from trading activities to the VaR estimate for that day. Daily standard deviation of trading profit and loss was £0.6m.

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

The regulatory capital charge for market risk trading exposures represents only 1.3 per cent. of the Group's capital base.

### *Derivatives*

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

Examples of how derivatives are used in managing and mitigating market risk exposures arising from banking services and activities are:

- Fixed interest rate swaps are used to manage the interest rate risk of fixed rate mortgages; and
- Basis swaps are used to manage exposure between 1 month LIBOR and base rates.

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

### *Liquidity Risk (Funding)*

Liquidity risk is the risk that the Group does not have sufficient financial resources to meet its obligations when they come 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.

The Group Liquidity Policy Statement 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 in the UK and Australia, where liquidity is managed on a group basis, and for overseas banking units subject to specific regulatory requirements. The responsibility to direct the management of liquidity and to report against policy is delegated to the Group Capital Committee.

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 Group Funding & Liquidity Committee (a sub-Committee of the Group Capital Committee) oversees the controls exercised by Treasury.

The Board requires that prudential liquidity limits should be set by the Group Funding & Liquidity Committee, both at aggregate levels and for individual currencies in which the Group has significant wholesale funding. These limits are established by way of cashflow mismatch and are quantified over two time horizons – from sight to eight days and from sight to one month.

For the purpose of calculation, marketable assets are subject to both instrument concentration limits and prudential discount factors. An assessment is also made for the possible outflow from customer deposits and committed facilities, determined by prudential behavioural modelling.

The Group's approach to the management of liquidity goes beyond the Sterling Stock Liquidity approach used by the FSA, in that it includes measures of liquidity cover out to one month, and measures for currencies other than sterling. Whilst following this approach, the Group also adheres to the FSA's Sterling Stock Liquidity policy, of which a key element is that a bank should hold a stock of high quality liquid assets that can be sold quickly and discreetly 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, whilst providing an opportunity to arrange more permanent funding solutions.

The FSA has a prescriptive regime for retail banks that specifies the formula for determining both the quantum and type of assets qualifying for Sterling Stock Liquidity. Sterling Stock Liquidity is regarded as a cost of doing business. It is not regarded as an operational liquidity pool as it will always be required in case of emergency. From an operational perspective, the Group will place greater reliance on market access to funding sources and the retention of a pool of diversified assets that can be sold in an efficient and discreet manner.

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 funding capacity of the Group is dependent upon factors such as the strength of the balance sheet, earnings, asset quality, ratings and market position. The Group Funding & Liquidity Committee 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 of Treasury represents a significant component of its overall funding, and the Group Funding & Liquidity Committee directs and co-ordinates the activities of the Operating Divisions in raising liabilities from a range of sources. Within Treasury, the Group avoids undue concentration by maintaining both a widespread mix of counterparties and inward credit lines and a core set of bank and non-bank depositor relationships, providing a stable source of funding. The Group Funding & Liquidity Committee approves the appropriate balance of short to medium term funding.

The Group has established a Liquidity Contingency Planning Framework to identify liquidity stress situations at an early stage.

#### *General Insurance & Long Term Assurance Business Risks*

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

Insurance risk is the potential for loss, arising out of adverse claims, expense and persistency experience, 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 considers regular reports on specified aggregate insurance risks across all of the Group's insurance and investment businesses. The Committee takes a technical and expert perspective on insurance risks within these 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 per cent. of the life businesses operated outside the UK. Day to day management of insurance and investment risk is undertaken both by Divisional and business 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 standards in respect of the operation of comprehensive Insurance and Investment Risk Management frameworks.

#### *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 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 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 our infrastructure has been to focus on the explicit risk management of specialist areas that underpin the HBOS Operational Risk Framework. 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.



## FORM OF THE COVERED BONDS

The Covered Bonds of each Series will be in either bearer form, with or without interest coupons attached, or registered form, without interest coupons attached. Bearer Covered Bonds will be issued outside the United States in reliance on Regulation S under the Securities Act (**Regulation S**) and Registered Covered Bonds will be issued both outside the United States in reliance on the exemption from registration provided by Regulation S and within the United States or to, or for the benefit of U.S. persons as described herein, in reliance on Rule 144A.

### **Bearer Covered Bonds**

Each Tranche of Bearer Covered Bonds will be initially issued in the form of a temporary bearer global covered bond without interest coupons attached (a **Temporary Bearer Global Covered Bond**) or, if so specified in the applicable Final Terms (the **applicable Final Terms**), a permanent bearer global covered bond without interest coupons attached (a **Permanent Bearer Global Covered Bond** and, together with the Temporary Bearer Global Covered Bonds, the **Bearer Global Covered Bonds** and each a **Bearer Global Covered Bond**) which, in either case, will:

- (i) if the Bearer Global Covered Bonds are intended to be issued in new global covered bond (**NGCB**) form, as stated in the applicable Final Terms, be delivered on or prior to the original issue date of the Tranche to a common safekeeper (the **Common Safekeeper**) for Euroclear Bank S.A./N.V. (**Euroclear**) and Clearstream Banking, *société anonyme* (**Clearstream, Luxembourg**); and
- (ii) if the Bearer Global Covered Bonds are not intended to be issued in NGCB form, be delivered on or prior to the original issue date of the Tranche to a common depository (the **Common Depository**) for Euroclear and Clearstream, Luxembourg.

Whilst any Bearer Covered Bond is represented by a Temporary Bearer Global Covered Bond, payments of principal, interest (if any) and any other amount payable in respect of the Covered Bonds due prior to the Exchange Date (as defined below) will be made (against presentation of the Temporary Bearer Global Covered Bond if the Temporary Bearer Global Covered Bond is not intended to be issued in NGCB form) only to the extent that certification (in a form to be provided) to the effect that the beneficial owners of interests in such Bearer Covered Bond are not United States persons for US federal income tax purposes (**United States person**) or persons who have purchased for resale to any United States person, as required by U.S. Treasury regulations, has been received by Euroclear and/or Clearstream, Luxembourg and Euroclear and/or Clearstream, Luxembourg, as applicable, has given a like certification (based on the certifications it has received) to the Agent.

On and after the date (the **Exchange Date**) which is 40 days after a Temporary Bearer Global Covered Bond is issued, interests in such Temporary Bearer Global Covered Bond will be exchangeable (free of charge) upon a request as described therein either for (i) interests in a Permanent Bearer Global Covered Bond of the same Series or (ii) for definitive Bearer Covered Bonds of the same Series with, where applicable, receipts, interest coupons and talons attached (as indicated in the applicable Final Terms and subject, in the case of definitive Covered Bonds, to such notice period as is specified in the applicable Final Terms), in each case against certification of non-U.S. beneficial ownership as described above unless such certification has already been given. The holder of a Temporary Bearer Global Covered Bond will not be entitled to collect any payment of interest, principal or other amount due on or after the Exchange Date unless, upon due certification, exchange of the Temporary Bearer Global Covered Bond for an interest in a Permanent Bearer Global Covered Bond or for definitive Bearer Covered Bonds is improperly withheld or refused.



Payments of principal, interest (if any) or any other amounts on a Permanent Bearer Global Covered Bond will be made through Euroclear and/or Clearstream, Luxembourg (against presentation or surrender (as the case may be) of the Permanent Bearer Global Covered Bond if the Permanent Bearer Global Covered Bond is not intended to be issued in NGCB form) without any requirement for certification.

The applicable Final Terms will specify that a Permanent Bearer Global Covered Bond will be exchangeable (free of charge), in whole but not in part, for definitive Bearer Covered Bonds with, where applicable, receipts, interest coupons and talons attached upon either (i) when the Covered Bonds have a Minimum Specified Denomination or integral multiples thereof, not less than 60 days' written notice from Euroclear and/or Clearstream, Luxembourg (acting on the instructions of any holder of an interest in such Permanent Bearer Global Covered Bond) to the Agent as described therein or (ii) only upon the occurrence of an **Exchange Event**. For these purposes, Exchange Event means that (i) the Issuer has been notified that both Euroclear and Clearstream, Luxembourg have been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or have announced an intention permanently to cease business or have in fact done so and no successor clearing system is available or (ii) the Issuer has or will become subject to adverse tax consequences as a result of legislative changes in the domicile of the Issuer which would not be suffered were the Covered Bonds represented by the Permanent Bearer Global Covered Bond in definitive form. The Issuer will promptly give notice to Covered Bondholders of each Series in accordance with Condition 13 if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or Clearstream, Luxembourg (acting on the instructions of any holder of an interest in such Permanent Bearer Global Covered Bond) or the Bond Trustee may give notice to the Agent requesting exchange and, in the event of the occurrence of an Exchange Event as described in (ii) above, the Issuer may also give notice to the Agent requesting exchange. Any such exchange shall occur not later than 45 days after the date of receipt of the first relevant notice by the Agent.

Global Covered Bonds and Bearer Covered Bonds in definitive form will be issued pursuant to the Agency Agreement.

The following legend will appear on all Bearer Covered Bonds which have an original maturity of more than 365 days and on all receipts and interest coupons relating to such Covered Bonds:

“ANY UNITED STATES PERSON WHO HOLDS THIS OBLIGATION WILL BE SUBJECT TO LIMITATIONS UNDER THE UNITED STATES INCOME TAX LAWS, INCLUDING THE LIMITATIONS PROVIDED IN SECTIONS 165(j) AND 1287(a) OF THE INTERNAL REVENUE CODE.”

The sections referred to provide that United States holders, with certain exceptions, will not be entitled to deduct any loss on Bearer Covered Bonds, receipts or interest coupons and will not be entitled to capital gains treatment of any gain on any sale, disposition, redemption or payment of principal in respect of such Covered Bonds, receipts or interest coupons.

Covered Bonds which are represented by a Global Bearer Covered Bond will only be transferable in accordance with the rules and procedures for the time being of Euroclear or Clearstream, Luxembourg, as the case may be.

### **Registered Covered Bonds**

The Registered Covered Bonds of each Tranche offered and sold in reliance on Regulation S, which will be sold to non-U.S. persons outside the United States, will initially be represented by a global covered bond in registered form (a *Regulation S Global Covered Bond*). Prior to expiry of the distribution compliance period (as defined in Regulation S) applicable to each Tranche of Covered Bonds, beneficial interests in a Regulation S Global Covered Bond may not be offered or sold to, or for the account or benefit

of, a U.S. person save as otherwise provided in Condition 2 and may not be held otherwise than through Euroclear or Clearstream, Luxembourg and such Regulation S Global Covered Bond will bear a legend regarding such restrictions on transfer.

The Registered Covered Bonds of each Tranche may only be offered and sold in the United States or to U.S. persons in private transactions exempt from registration under the Securities Act (i) to QIBs or (ii) to IAI's who agree to purchase the Covered Bonds for their own account and not with a view to the distribution thereof in accordance with the Securities Act. The Registered Covered Bonds of each Tranche sold to QIBs will be represented by a global covered bond in registered form (a **Rule 144A Global Covered Bond** and, together with a Regulation S Global Covered Bond, the **Registered Global Covered Bonds**).

Registered Global Covered Bonds will either (i) be deposited with a custodian for, and registered in the name of a nominee of, DTC or (ii) be deposited with a common depository for, and registered in the name of a common nominee of, Euroclear and Clearstream, Luxembourg, as specified in the applicable Final Terms. Persons holding beneficial interests in Registered Global Covered Bonds will be entitled or required, as the case may be, under the circumstances described below, to receive physical delivery of definitive Covered Bonds in fully registered form.

The Registered Covered Bonds of each Tranche sold to Institutional Accredited Investors will be in definitive form, registered in the name of the holder thereof (**Definitive IAI Registered Covered Bonds**). Unless otherwise set forth in the applicable Final Terms, Definitive IAI Registered Covered Bonds will be issued only in minimum denominations of U.S.\$500,000 and integral multiples of U.S.\$1,000 in excess thereof (or the approximate equivalents in the applicable Specified Currency). Definitive IAI Registered Covered Bonds will be subject to the restrictions on transfer set forth therein and will bear the restrictive legend described under *Subscription and Sale and Transfer and Selling Restrictions*. Institutional Accredited Investors that hold Definitive IAI Registered Covered Bonds may elect to hold such Covered Bonds through DTC, but transferees acquiring the Covered Bonds in transactions exempt from Securities Act registration pursuant to Regulation S or Rule 144A under the Securities Act (if available) may do so upon satisfaction of the requirements applicable to such transfer as described under *Subscription and Sale and Transfer and Selling Restrictions*. The Rule 144A Global Covered Bond and the Definitive IAI Registered Covered Bonds will be subject to certain restrictions on transfer set forth therein and will bear a legend regarding such restrictions.

Payments of principal, interest and any other amount in respect of the Registered Global Covered Bonds will, in the absence of provision to the contrary, be made to the person shown on the Register (as defined in Condition 6(d)) as the registered holder of the Registered Global Covered Bonds. None of the Issuer, the Guarantors, any Paying Agent or the Bond Registrar will have any responsibility or liability for any aspect of the records relating to or payments or deliveries made on account of beneficial ownership interests in the Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

Payments of principal, interest or any other amount in respect of the Registered Covered Bonds in definitive form will, in the absence of provision to the contrary, be made to the persons shown on the Register on the relevant Record Date (as defined in Condition 6(d)) immediately preceding the due date for payment in the manner provided in that Condition.

Interests in a Registered Global Covered Bond will be exchangeable (free of charge), in whole but not in part, for definitive Registered Covered Bonds without receipts, interest coupons or talons attached only upon the occurrence of an Exchange Event. For these purposes, **Exchange Event** means (i) in the case of Covered Bonds registered in the name of a nominee for DTC, either DTC has notified the Issuer that it is unwilling or unable to continue to act as depository for the Covered Bonds and no alternative clearing system is available or DTC has ceased to constitute a clearing agency registered under the Exchange Act, (ii) in the

case of Covered Bonds registered in the name of a nominee for a common depository for Euroclear and Clearstream, Luxembourg, the Issuer has been notified that both Euroclear and Clearstream, Luxembourg have been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or have announced an intention permanently to cease business or have in fact done so and, in any such case, no successor clearing system is available or (iii) the Issuer has or will become subject to adverse tax consequences as a result of legislative changes in the domicile of the Issuer which would not be suffered were the Covered Bonds represented by the Registered Global Covered Bond in definitive form. The Issuer will promptly give notice to Covered Bondholders in accordance with Condition 14 if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, DTC, Euroclear and/or Clearstream, Luxembourg (acting on the instructions of any holder of an interest in such Registered Global Covered Bond) may give notice to the Bond Registrar requesting exchange and, in the event of the occurrence of an Exchange Event as described in (iv) above, the Issuer may also give notice to the Bond Registrar requesting exchange. Any such exchange shall occur not later than 10 days after the date of receipt of the first relevant notice by the Bond Registrar.

### **Transfer of Interests**

Interests in a Registered Global Covered Bond may, subject to compliance with all applicable restrictions, be transferred to a person who wishes to hold such interest in another Registered Global Covered Bond or in the form of a Definitive IAI Registered Covered Bond and Definitive IAI Registered Covered Bonds may, subject to compliance with all applicable restrictions, be transferred to a person who wishes to hold such Covered Bonds in the form of an interest in a Registered Global Covered Bonds. No beneficial owner of an interest in a Registered Global Covered Bond will be able to transfer such interest, except in accordance with the applicable procedures of DTC, Euroclear and Clearstream, Luxembourg, in each case to the extent applicable. **Registered Covered Bonds are also subject to the restrictions on transfer set forth therein and will bear a legend regarding such restrictions, see *Subscription and Sale and Transfer and Selling Restrictions*.**

Pursuant to the Agency Agreement (as defined under *Terms and Conditions of the Covered Bonds*), the Agent shall arrange that, where a further Tranche of Covered Bonds is issued which is intended to form a single Series with an existing Tranche of Covered Bonds, the Covered Bonds of such further Tranche shall be assigned a common code and ISIN and, where applicable, a CUSIP and CINS number which are different from the common code, ISIN, CUSIP and CINS assigned to Covered Bonds of any other Tranche of the same Series until at least the expiry of the distribution compliance period (as defined in Regulation S under the United States Securities Act of 1933, as amended (the **Securities Act**)) applicable to the Covered Bonds of such Tranche.

Any reference herein to Euroclear and/or Clearstream, Luxembourg and/or DTC shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system specified in the applicable Final Terms or as may otherwise be approved by the Issuer, the Agent and the Bond Trustee.

No Covered Bondholder, Receiptholder or Couponholder shall be entitled to proceed directly against the Issuer or any Guarantor unless the Bond Trustee or, as the case may be, the Security Trustee, having become bound so to proceed, fails so to do within a reasonable period and the failure shall be continuing.

## FORM OF FINAL TERMS

Set out below is the form of Final Terms which, subject to any necessary amendment, will be completed for each Tranche of Covered Bonds issued under the Programme.

[Date]

### HBOS Treasury Services plc

**Issue of [Aggregate Nominal Amount of Tranche] [Title of Covered Bonds]**

**Unconditionally guaranteed by HBOS plc and The Governor and  
Company of the Bank of Scotland  
and**

**Irrevocably and unconditionally guaranteed as to payment of principal and interest by  
HBOS Covered Bonds LLP  
under the €60 billion  
Covered Bond Programme**

### PART A – CONTRACTUAL TERMS

Terms used herein shall be deemed to be defined as such for the purposes of the Conditions set forth in the Offering Circular dated 9 May 2007 which constitutes a base prospectus for the purposes of the Prospectus Directive (Directive 2003/71/EC) (the **Prospectus Directive**). This document constitutes the Final Terms of the Covered Bonds described herein for the purposes of Article 5.4 of the Prospectus Directive and must be read in conjunction with the Offering Circular. Full information on the Issuer and the offer of the Covered Bonds is only available on the basis of the combination of these Final Terms and the Offering Circular. The Offering Circular is available for viewing at the registered office of the Issuer and the specified office of the Agent.

*[The following alternative language applies if the first Tranche of an issue which is being increased was issued under an Offering Circular with an earlier date.]*

Terms used herein shall be deemed to be defined as such for the purposes of the Conditions (the **Conditions**) set forth in the Offering Circular dated [original date]. This document constitutes the Final Terms of the Covered Bonds described herein for the purposes of Article 5.4 of the Prospectus Directive (Directive 2003/71/EC) (the **Prospectus Directive**) and must be read in conjunction with the Offering Circular dated 9 May 2007, save in respect of the Conditions which are extracted from the Offering Circular dated [original date] and are attached hereto. Full information on the Issuer and the offer of the Covered Bonds is only available on the basis of a combination of these Final Terms and the Offering Circulars dated 9 May 2007. Copies of such Offering Circulars are available for viewing at the registered office of the Issuer and the specified office of the Agent.]

*[Include whichever of the following apply or specify as “Not Applicable” (N/A). Note that the numbering should remain as set out below, even if “Not Applicable” is indicated for individual paragraphs or sub-paragraphs. Italics denote directions for completing the Final Terms.]*

*[When adding any other final terms or information consideration should be given as to whether such terms or information constitute “significant new factors” and consequently trigger the need for a supplement to the Offering Circular under Article 16 of the Prospectus Directive.]*

1. (i) Issuer: HBOS Treasury Services plc

- (ii) Guarantors: HBOS plc, The Governor and Company of the Bank of Scotland and HBOS Covered Bonds LLP
2. (i) Series Number: [ ]  
(ii) Tranche Number: [ ]  
*(If fungible with an existing Series, details of that Series, including the date on which the Covered Bonds become fungible)*
3. Specified Currency or Currencies: [ ]
4. Aggregate Nominal Amount:  
[(i) Series: [ ]  
(ii) Tranche: [ ]]
5. Issue Price: [ ] per cent. of the Aggregate Nominal Amount  
[plus accrued interest from *[insert date]* (*in the case of fungible issues only, if applicable*)]
6. Specified Denominations: [ ]  
*(in the case of Registered Covered Bonds, this means the minimum integral amount in which transfers can be made)*  
*(N.B. Where multiple denominations above €50,000 or equivalent are being used the following sample wording should be followed: €50,000 and integral multiples of [€1,000] in excess thereof up to and including [€99,000]. No Covered Bonds in definitive form will be issued with a denomination above [€99,000].)*  
*(N.B. if an issue of Covered Bonds is (i) NOT admitted to trading on a regulated market within the European Economic Area; and (ii) only offered to the public in a Member State of the European Economic Area in circumstances where a prospectus is not required to be published under the Prospectus Directive the €50,000 minimum denomination is not required)*
7. (i) Issue Date: [ ]  
(ii) Interest Commencement Date: [ ]
8. Final Maturity Date: *[Fixed rate - specify date]*  
*Floating rate — Interest Payment Date falling in or nearest to [specify month and year]]*
9. Interest Basis: [[ ] per cent. Fixed Rate]  
[[LIBOR/EURIBOR] +/- [ ] per cent. Floating Rate]  
[Zero Coupon]  
[Index Linked Interest]  
[Dual Currency Interest]  
[specify other]  
(further particulars specified below)

10. Redemption/Payment Basis: [Redemption at par]  
[Index Linked Redemption]  
[Dual Currency Redemption]  
[Instalment]  
[Hard Bullet Covered Bond]  
[specify other]  
*(N.B. If the Final Redemption Amount is other than 100 per cent. of the nominal value the Covered Bonds will be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply)*
11. Change of Interest Basis or Redemption/Payment Basis: [Specify details of any provision for change of Covered Bonds into another Interest Basis or Redemption/Payment Basis]
12. Call Option: [Issuer Call]  
[(further particulars specified below)]
13. (i) Status of the Covered Bonds: Senior  
(ii) Status of the Guarantees: Senior  
(iii) [Date [Board] approval for issuance of Covered Bonds [and Guarantee] obtained: [ ] [and [ ], respectively]] *(N.B. Only relevant where Board (or similar) authorisation is required for the particular tranche of Covered Bonds or related Guarantee)*
14. Method of distribution: [Syndicated/Non-syndicated]

#### PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE

15. **Fixed Rate Covered Bond Provisions** [Applicable/Not Applicable]  
*(If not applicable, delete the remaining subparagraphs of this paragraph)*
- (i) Rate(s) of Interest: [ ] per cent. per annum [payable [annually/semi-annually/quarterly] in arrear]  
*(If payable other than annually, consider amending Condition 5)*
- (ii) Interest Payment Date(s): [ ] in each year up to and including the Final Maturity Date]/[specify other]  
*(NB: This will need to be amended in the case of long or short Coupons)*
- (iii) Fixed Coupon Amount(s): [ ] per [ ] in nominal amount
- (iv) Broken Amount(s): [Insert particulars of any initial or final broken interest amounts which do not correspond with the Fixed Coupon Amount]
- (v) Day Count Fraction: [30/360 or Actual/Actual (ICMA) or specify other]



- (vi) Determination Date(s):  in each year  
*[Insert regular Interest Payment Dates, ignoring Issue Date or Final Maturity Date in the case of a long or short first or last Coupon  
 NB: This will need to be amended in the case of regular Interest Payment Dates which are not of equal duration  
 NB: Only relevant where Day Count Fraction is Actual/Actual (ICMA)]*
- (vii) Other terms relating to the method of calculating interest for Fixed Rate Covered Bonds:  [None/Give details]
- 16. Floating Rate Covered Bond Provisions**  [Applicable/Not Applicable]  
*(If not applicable, delete the remaining subparagraphs of this paragraph)*
- (i) Specified Period(s)/Specified Interest Payment Dates:  [ ]
- (ii) Business Day Convention:  [Floating Rate Convention / Following Business Day Convention / Modified Following Business Day Convention / Preceding Business Day Convention / [specify other]]
- (iii) Additional Business Centre(s):  [ ]
- (iv) Manner in which the Rate of Interest and Interest Amount is to be determined:  [Screen Rate Determination/ISDA Determination/ specify other]
- (v) Party responsible for calculating the Rate of Interest and Interest Amount (if not the Agent):  [ ]
- (vi) Screen Rate Determination:
- Reference Rate:  [ ]  
*(Either LIBOR, EURIBOR or other, although additional information is required if other - including fallback provisions in the Agency Agreement)*
- Interest Determination Date(s):  [ ]  
*(Second London Business Day prior to the start of each Interest Period if LIBOR (other than Sterling or euro LIBOR), first day of each Interest Period if Sterling LIBOR and the second day on which the TARGET System is open prior to the start of each Interest Period if EURIBOR or euro LIBOR)*
- Relevant Screen Page:  [ ]



*(In the case of EURIBOR, if not Reuters EURIBOR01 ensure it is a page which shows a composite rate or amend the fallback provisions appropriately)*

- (vii) ISDA Determination:
- Floating Rate Option: [ ]
  - Designated Maturity: [ ]
  - Reset Date: [ ]
- (viii) Margin(s): [+/-] [ ] per cent. per annum
- (ix) Minimum Rate of Interest: [ ] per cent. per annum
- (x) Maximum Rate of Interest: [ ] per cent. per annum
- (xi) Day Count Fraction: [Actual/365  
Actual/365 (Fixed)  
Actual/365 (Sterling)  
Actual/360  
30/360  
30E/360  
Other]  
*(See Condition 5 for alternatives)*
- (xii) Fall back provisions, rounding provisions and any other terms relating to the method of calculating interest on Floating Rate Covered Bonds, if different from those set out in the Conditions: [ ]
- 17. Zero Coupon Covered Bond Provisions** [Applicable/Not Applicable]  
*(If not applicable, delete the remaining subparagraphs of this paragraph)*
- (i) Accrual Yield: [ ] per cent. per annum
  - (ii) Reference Price: [ ]
  - (iii) Any other formula/basis of determining amount payable: [ ]
  - (iv) Day Count Fraction in relation to Early Redemption Amounts and late payment: [Conditions 7(d)(iii) and (h) apply/specify other]  
*(Consider applicable day count fraction if not U.S. dollar denominated)*
- 18. Index Linked Interest Covered Bond Provisions** [Applicable/Not Applicable]  
*(If not applicable, delete the remaining subparagraphs of this paragraph)*
- (i) Index/Formula: [give or annex details]

- (ii) Calculation Agent responsible for calculating the interest due: [Name and address of Calculation Agent]
- (iii) Provisions for determining Coupon where calculation by reference to Index and/or Formula is impossible or impracticable: [[need to include a description of market disruption or settlement disruption events and adjustment provisions]]
- (iv) Specified Period(s)/Specified Interest Payment Dates: [ ]
- (v) Business Day Convention: [Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/specify other]
- (vi) Additional Business Centre(s): [ ]
- (vii) Minimum Rate of Interest: [ ] per cent. per annum
- (viii) Maximum Rate of Interest: [ ] per cent. per annum
- (ix) Day Count Fraction: [ ]
19. **Dual Currency Interest Covered Bond Provisions** [Applicable/Not Applicable]  
(If not applicable, delete the remaining sub-paragraphs of this paragraph)
- (i) Rate of Exchange/method of calculating Rate of Exchange: [give or annex details]
- (ii) Calculation Agent, if any, responsible for calculating interest payable: [ ]
- (iii) Provisions applicable where calculation by reference to Rate of Exchange impossible or impracticable: [need to include a description of market disruption or settlement disruption events and adjustment provisions]
- (iv) Person at whose option Specified Currency(ies) is/are payable: [ ]

**PROVISIONS RELATING TO REDEMPTION**

20. Issuer Call: [Applicable/Not Applicable]  
(If not applicable, delete the remaining sub-paragraphs of this paragraph)
- (i) Optional Redemption Date(s): [ ]
- (ii) Optional Redemption Amount of each Covered Bond and method, if any, of calculation of such amount(s): [ ] per Covered Bond of [ ] Specified Denomination
- (iii) If redeemable in part:

- (a) Minimum Redemption Amount: [ ]
- (b) Maximum Redemption Amount: [ ]
- (iv) Notice period (if other than as set out in the Conditions): [ ]  
*(N.B. If setting notice periods which are different to those provided in the Conditions, the Issuer is advised to consider the practicalities of distribution of information through intermediaries, for example, clearing systems and custodians, as well as any other notice requirements which may apply, for example, as between the Issuer and the Agent or Trustee)*

21. Final Redemption Amount of each Covered Bond: [Nominal Amount/specify other/see Appendix]  
*(N.B. In relation to any issue of Covered Bonds which are expressed at paragraph 6 above to have a minimum denomination and tradeable amounts above such minimum denomination which are smaller than it, the following wording should be added: “For the avoidance of doubt, in the case of a holding of Covered Bonds in an integral multiple of [ ] in excess of [ ] as envisaged in paragraph 6 above, such holding will be redeemed at its nominal amount”.)*  
*(N.B. If the Final Redemption Amount is other than 100 per cent. of the nominal value the Covered Bonds will be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply)*

22. Early Redemption Amount of each Covered Bond payable on redemption for taxation reasons, on acceleration following an HBOS Event of Default as against the Issuer and the Group Guarantors or an LLP Event of Default and/or the method of calculating the same (if required or if different from that set out in Condition 7(d)): [ ]

**GENERAL PROVISIONS APPLICABLE TO THE COVERED BONDS**

23. Form of Covered Bonds:  
 [(a) Form:] Bearer Covered Bonds  
 [Temporary Bearer Global Covered Bond exchangeable for a Permanent Bearer Global Covered Bond which is exchangeable for Covered Bonds in definitive form [on 60 days’ notice given at any time/only upon an Exchange Event]]

[Temporary Bearer Global Covered Bond exchangeable for Bearer Covered Bonds in definitive form on and after the Exchange Date]

[Permanent Bearer Global Covered Bond exchangeable for Covered Bonds in definitive form [on 60 days' notice given at any time/only upon an Exchange Event]]

Registered Covered Bonds

Regulation S Global Covered Bond (U.S.\$[ ] nominal amount) registered in the name of a nominee for [DTC/a common depository for Euroclear and Clearstream, Luxembourg]/Rule 144A

Global Covered Bond (U.S.\$[ ] nominal amount registered in the name of a nominee for [DTC/a common depository for Euroclear and Clearstream, Luxembourg/Definitive IAI Registered Covered Bond (*specify nominal amount*)

*(Ensure that this is consistent with the wording in the "Form of the Covered Bonds" section in the Offering Circular and the Covered Bonds themselves. [N.B. Need to amend exchange provisions to disapply Covered Bondholder optional exchange where Covered Bonds are expressed to have a minimum denomination of €50,000 and are tradeable in integral multiples of €1,000 thereafter in order for Covered Bonds to be accepted by the clearing systems]).*

[(b) New Global Covered Bond

[Yes][No]]

24. Additional Financial Centre(s) or other special provisions relating to Payment Dates:

[Not Applicable/*give details*]

(Note that this item relates to the place of payment and not Interest Period end dates to which items 16(iii) and 18(vi) relate)

25. Talons for future Coupons or Receipts to be attached to Definitive Bearer Covered Bonds (and dates on which such Talons mature):

[Yes/No. *If yes, give details*]

26. Details relating to Instalment Covered Bonds:

(i) [Instalment Amount(s):

[Not Applicable/*give details*]

(ii) [Instalment Date(s):

[Not Applicable/*give details*]

27. Redenomination applicable:

Redenomination [not] applicable

*(If Redenomination is applicable, specify the applicable Day Count Fraction and any provisions necessary to deal with floating rate interest calculation (including alternative reference rates))*

28. Additional U.S. Federal Income Tax Considerations [Not Applicable/give details]
29. Other Final Terms: [Not Applicable/give details]  
*(When adding any other final terms consideration should be given as to whether such terms constitute “significant new factors” and consequently trigger the need for a supplement to the Offering Circular under Article 16 of the Prospectus Directive).*

## DISTRIBUTION

30. (i) If syndicated, names of Managers [Not Applicable/give names]  
*[and address where issue of Covered Bonds to which Annex XII applies]:*
- (ii) Date of Subscription Agreement: [ ]  
*(Only relevant where issue of Covered Bonds to which Annex XII applies)*
- (iii) Stabilising Manager (if any): [Not Applicable/give name]
31. If non-syndicated, name of relevant Dealer(s): [ ]  
*[and address where issue of Covered Bonds to which Annex XII applies]:*
32. Whether TEFRA D rules applicable or TEFRA rules not applicable: [TEFRA D/TEFRA not applicable]
33. Additional selling restrictions: [Not Applicable/give details]

## [LISTING AND ADMISSION TO TRADING

These Final Terms comprise the final terms required to list and have admitted to trading the issue of Covered Bonds described herein pursuant to the €60,000,000,000 Covered Bond Programme of HBOS Treasury Services plc.]

## RESPONSIBILITY

Each of the Issuer, the Group Guarantors and the LLP accepts responsibility for the information contained in these Final Terms. [[ ] has been extracted from [ ]. The Issuer confirms that such information has been accurately reproduced and that, so far as it is aware and able to ascertain from information published by [ ], no facts have been omitted which would render the reproduced information inaccurate or misleading.

Signed on behalf of the Issuer:

Signed on behalf of HBOS plc:

By:

By:

*Duly authorised*

*Duly authorised*

Signed on behalf of The Governor and  
Company of the Bank of Scotland:

By:

*Duly authorised*

Signed on behalf of HBOS Covered Bonds LLP:

By:

*Duly authorised*

## PART B – OTHER INFORMATION

### 1. LISTING AND ADMISSION TO TRADING

- (i) Listing: [Luxembourg/other (*specify*)/None]
- (ii) Admission to trading: [Application has been made for the Covered Bonds to be admitted to trading on [ ] with effect from [ ].] [Not Applicable.]
- (iii) Estimate of total expenses related to admission to trading: [ ]

### 2. RATINGS

- Ratings: The Covered Bonds to be issued have been rated:
- [S & P: [ ]]
- [Moody's: [ ]]
- [[Other]: [ ]]

*(The above disclosure should reflect the rating allocated to Covered Bonds of the type being issued under the Programme generally or, where the issue has been specifically rated, that rating.)*

### 3. NOTIFICATION

The Commission de Surveillance du Secteur Financier [has been requested to provide/has provided - *include first alternative for an issue which is contemporaneous with the establishment or update of the Programme and the second alternative for subsequent issues*] the [names of competent authorities of host Member States] with a certificate of approval attesting that the Prospectus has been drawn up in accordance with the Prospectus Directive.]

### 4. INTERESTS OF NATURAL AND LEGAL PERSONS INVOLVED IN THE ISSUE

[Save for any fees payable to the Dealers, so far as the Issuer is aware, no person involved in the issue of the Covered Bonds has an interest material to the offer. - *Amend as appropriate if there are other interests*]

### 5. REASONS FOR THE OFFER, ESTIMATED NET PROCEEDS AND TOTAL EXPENSES

- [(i) Reasons for the offer [ ]]
- [(ii) Estimated net proceeds: [ ]]
- [(iii) Estimated total expenses: [ ]]

*(N.B.: If the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies (i) above is required where the reasons for the offer are different from making profit*



*and/or hedging certain risks and, where such reasons are inserted in (i), disclosure of net proceeds and total expenses at (ii) and (iii) above are also required.)*

**6. YIELD** (*Fixed Rate Covered Bonds only*)

Indication of yield: [ ]

The yield is calculated at the Issue Date on the basis of the Issue Price. It is not an indication of future yield.

**7. PERFORMANCE OF INDEX/FORMULA, EXPLANATION OF EFFECT ON VALUE OF INVESTMENT AND ASSOCIATED RISKS AND OTHER INFORMATION CONCERNING THE UNDERLYING** (*Index-Linked Covered Bonds only*)

*[Need to include details of where information about the past and future performance and volatility of the index/formula can be obtained.]*

*[Need to include a description of any market disruption or settlement disruption events that affect the underlying.]*

*[Need to include adjustment rules in relation to events covering the underlying.]*

*[Where the underlying is a security the name of the issuer of the security and its ISIN or other such security identification code.]*

*[Where the underlying is an index need to include the name of the index and a description if composed by the Issuer and if the index is not composed by the Issuer need to include details of where the information about the index can be obtained. Where the underlying is not an index need to include equivalent information.]*

*[Where the underlying is an interest rate a description of the interest rate.]*

*[Where the underlying is a basket of underlyings disclosure of the relevant weightings of each underlying in the basket.]*

**8. PERFORMANCE OF RATE[S] OF EXCHANGE AND EXPLANATION OF EFFECT ON VALUE OF INVESTMENT** (*Dual Currency Covered Bonds only*)

*[Need to include details of where information about the past and future performance and volatility of the relevant rates can be obtained.]*

**9. OPERATIONAL INFORMATION**

(i) ISIN Code: [ ]

(ii) Common Code: [ ]

(insert here any other relevant codes such CUSIP and CINS codes)

- (iii) Any clearing system(s) other than Euroclear Bank S.A./N.V., and Clearstream Banking, société anonyme and DTC and the relevant identification number(s): [Not Applicable/give name(s) and number(s)]
- (iv) Delivery: Delivery [against/free of] payment
- (v) Names and addresses of additional Paying Agent(s) (if any): [ ]
- [(vi) Intended to be held in a manner which would allow Eurosystem eligibility: [Yes][No]
- [Note that the designation “yes” simply means that the Covered Bonds are intended upon issue to be deposited with one of Euroclear or Clearstream, Luxembourg as common safekeeper and does not necessarily mean that the Covered Bonds will be recognised as eligible collateral for Eurosystem monetary policy and intra-day credit operations by the Eurosystem either upon issue or at any or all times during their life. Such recognition will depend upon satisfaction of the Eurosystem eligibility criteria.][include this text if “yes” selected in which case the Covered Bonds must be issued in NGCB form]]

## TERMS AND CONDITIONS OF THE COVERED BONDS

*The following are the Terms and Conditions of the Covered Bonds which will be incorporated by reference into each Global Covered Bond (as defined below) and each definitive Covered Bond, in the latter case only if permitted by the relevant stock exchange or other relevant authority (if any) and agreed by the Issuer and the relevant Dealer(s) at the time of issue but, if not so permitted and agreed, such definitive Covered Bond will have endorsed thereon or attached thereto such Terms and Conditions. The applicable Final Terms in relation to any Tranche of Covered Bonds may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the following Terms and Conditions, replace or modify the following Terms and Conditions for the purpose of such Covered Bonds. The applicable Final Terms (or the relevant provisions thereof) will be endorsed upon, or attached to, each Global Covered Bond and definitive Covered Bond. Reference should be made to "Form of the Notes" for a description of the content of Final Terms which will specify which of such terms are to apply in relation to the relevant Covered Bonds.*

This Covered Bond is one of a Series (as defined below) of Covered Bonds issued by HBOS Treasury Services plc (the **Issuer**) constituted by a trust deed (such trust deed as modified and/or supplemented and/or restated from time to time, the **Trust Deed**) dated 18 July 2003 (the **Programme Date**) made between the Issuer, HBOS plc as guarantor (**HBOS**) and The Governor and Company of the Bank of Scotland as guarantor (**Bank of Scotland** and, together with HBOS in its capacity as guarantor, the **Group Guarantors** and each a **Group Guarantor**), HBOS Covered Bonds LLP as guarantor (the **LLP** and, together with the Group Guarantors, the **Guarantors** and each a **Guarantor**, which expression shall include any additional or successor guarantor) and Citicorp Trustee Company Limited as bond trustee (in such capacity, the **Bond Trustee**, which expression shall include any successor as Bond Trustee) and as security trustee (in such capacity, the **Security Trustee**, which expression shall include any successor as Security Trustee).

Save as provided for in Conditions 10 and 15 references herein to the Covered Bonds shall be references to the Covered Bonds of this Series and shall mean:

- (i) in relation to any Covered Bonds represented by a global bond (a **Global Covered Bond**), units of the lowest Specified Denomination in the Specified Currency;
- (ii) any Global Covered Bond;
- (iii) any definitive Covered Bonds in bearer form (**Bearer Covered Bonds**) issued in exchange for a Global Covered Bond; and
- (iv) any definitive Covered Bonds in registered form (**Registered Covered Bonds**) (whether or not issued in exchange for a Global Covered Bond in registered form).

The Covered Bonds, the Receipts (as defined below) and the Coupons (as defined below) have the benefit of an agency agreement (such agency agreement as amended and/or supplemented and/or restated from time to time, the **Agency Agreement**) dated the Programme Date and made between the Issuer, the Group Guarantors, the LLP, the Bond Trustee, Citibank, N.A., London Branch, as issuing and principal paying agent and agent bank (the **Agent**, which expression shall include any successor agent) and the other paying agents named therein (together with the Agent, the **Paying Agents**, which expression shall include any additional or successor paying agents), Citibank, N.A., London Branch as exchange agent (the **Exchange Agent**, which expression shall include any successor exchange agent) and as bond registrar (the **Bond Registrar**, which expression shall include any successor registrar) and a transfer agent and the other transfer agents named therein (together with the Bond Registrar, the **Transfer Agents**, which expression shall include any additional or successor transfer agents).

Interest bearing definitive Bearer Covered Bonds have (unless otherwise indicated in the applicable Final Terms) interest coupons (**Coupons**) and, if indicated in the applicable Final Terms, talons for further Coupons (**Talons**) attached on issue. Any reference herein to Coupons or coupons shall, unless the context otherwise requires, be deemed to include a reference to Talons or talons. Definitive Bearer Covered Bonds repayable in instalments have receipts (**Receipts**) for the payment of the instalments of principal (other than the final instalment) attached on issue. Registered Covered Bonds and Global Covered Bonds do not have Receipts, Coupons or Talons attached on issue.

The **Final Terms** for this Covered Bond (or the relevant provisions thereof) are set out in Part A of the Final Terms attached to or endorsed on this Covered Bond and supplement these Terms and Conditions (the **Conditions**) and may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the Conditions, replace or modify the Conditions for the purposes of this Covered Bond. References to the applicable Final Terms are to Part A of the Final Terms (or the relevant provisions thereof) attached to or endorsed on this Covered Bond.

The Bond Trustee acts for the benefit of the holders for the time being of the Covered Bonds (the **Covered Bondholders**, which expression shall, in relation to any Covered Bonds represented by a Global Covered Bond, be construed as provided below), the holders of the Receipts (the **Receiptholders**) and the holders of the Coupons (the **Couponholders**, which expression shall, unless the context otherwise requires, include the holders of the Talons), and for holders of each other Series of Covered Bonds in accordance with the provisions of the Trust Deed.

As used herein, **Tranche** means Covered Bonds which are identical in all respects (including as to listing and admission to trading) and **Series** means a Tranche of Covered Bonds together with any further Tranche or Tranches of Covered Bonds which are (i) expressed to be consolidated and form a single series and (ii) identical in all respects (including as to listing and admission to trading) except for their respective Issue Dates, Interest Commencement Dates and/or Issue Prices.

The Group Guarantors have, in the Trust Deed, unconditionally guaranteed (on a joint and several basis as between themselves) the due and punctual payment of principal and interest and other amounts due by the Issuer under or in respect of the Covered Bonds and the Trust Deed as and when the same shall become due and payable (including accelerated amounts).

The LLP has, in the Trust Deed, irrevocably and unconditionally guaranteed (on a several basis as between the Group Guarantors and itself) the due and punctual payment of Guaranteed Amounts in respect of the Covered Bonds when the same shall become Due for Payment, but only after service of a Notice to Pay on the LLP following an HBOS Event of Default and service by the Bond Trustee of an HBOS Acceleration Notice on the Issuer and Group Guarantors.

The security for the obligations of the LLP under the Covered Bond Guarantee and the other Transaction Documents to which it is a party, has been created in and pursuant to, and on the terms set out in, a deed of charge (such deed of charge as amended and/or supplemented and/or restated from time to time, the **Deed of Charge**) dated the Programme Date and made between the LLP, Citicorp Trustee Company Limited as Bond Trustee and Security Trustee and certain other Secured Creditors.

These Conditions include summaries of, and are subject to, the provisions of the Trust Deed, the Deed of Charge and the Agency Agreement.

Copies of the Trust Deed, the Deed of Charge, the Master Definitions and Construction Agreement (as defined below), the Agency Agreement, the Deed Poll and each of the other Transaction Documents are available for inspection during normal business hours at the registered office for the time being of the Bond Trustee being at Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB and at the specified

office of each of the Paying Agents. Copies of the applicable Final Terms for all Covered Bonds of each Series (including in relation to Covered Bonds of any Series which are unlisted or not admitted to trading) are obtainable during normal business hours at the specified office of each of the Paying Agents and any Covered Bondholder must produce evidence satisfactory to the Issuer and the Bond Trustee or, as the case may be, the relevant Paying Agent as to its holding of Covered Bonds and identity. The Covered Bondholders, the Receiptholders and the Couponholders are deemed to have notice of, are bound by, and are entitled to the benefit of, all the provisions of, and definitions contained in, the Trust Deed, the Deed of Charge, the Master Definitions and Construction Agreement, the Agency Agreement, the Deed Poll, each of the other Transaction Documents and the applicable Final Terms which are applicable to them and to have notice of each Final Terms relating to each other Series.

Except where the context otherwise requires, capitalised terms used and not otherwise defined in these Conditions shall bear the meanings given to them in the applicable Final Terms and/or the master definitions and construction agreement made between the parties to the Transaction Documents on or about the Programme Date (such master definitions and construction agreement as amended and/or supplemented and/or restated from time to time, the **Master Definitions and Construction Agreement**), a copy of each of which may be obtained as described above.

## 1. FORM, DENOMINATION AND TITLE

The Covered Bonds are in bearer form or in registered form as specified in the applicable Final Terms and, in the case of definitive Covered Bonds, serially numbered, in the Specified Currency and the Specified Denomination(s). Covered Bonds of one Specified Denomination may not be exchanged for Covered Bonds of another Specified Denomination and Bearer Covered Bonds may not be exchanged for Registered Covered Bonds and vice versa.

This Covered Bond may be a Fixed Rate Covered Bond, a Floating Rate Covered Bond, a Zero Coupon Covered Bond, an Index Linked Interest Covered Bond, a Dual Currency Interest Covered Bond or a combination of any of the foregoing, depending upon the Interest Basis shown in the applicable Final Terms.

This Covered Bond may be an Index Linked Redemption Covered Bond, an Instalment Covered Bond, a Dual Currency Redemption Covered Bond or a combination of any of the foregoing, depending upon the Redemption/Payment Basis shown in the applicable Final Terms.

Definitive Bearer Covered Bonds are issued with Coupons attached, unless they are Zero Coupon Covered Bonds in which case references to Coupons and Couponholders in these Conditions are not applicable.

Subject as set out below, title to the Bearer Covered Bonds, Receipts and Coupons will pass by delivery and title to the Registered Covered Bonds will pass upon registration of transfers in accordance with the provisions of the Agency Agreement. The Issuer, the Group Guarantors, the LLP, the Paying Agents, the Security Trustee and the Bond Trustee may (except as otherwise required by law) deem and treat the bearer of any Bearer Covered Bond, Receipt or Coupon and the registered holder of any Registered Covered Bond as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes but, in the case of any Global Covered Bond, without prejudice to the provisions set out in the next succeeding paragraph.

For so long as any of the Covered Bonds are represented by a Global Covered Bond held on behalf of Euroclear Bank S.A./N.V. (**Euroclear**) and/or Clearstream Banking, société anonyme (**Clearstream, Luxembourg**), each person (other than Euroclear or Clearstream, Luxembourg) who is for the time being shown in the records of Euroclear or of Clearstream, Luxembourg as the holder of a particular nominal amount of such Covered Bonds (in which regard any certificate or other document issued by Euroclear or

Clearstream, Luxembourg as to the nominal amount of such Covered Bonds standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error) shall be treated by the Issuer, the Group Guarantors, the LLP, the Paying Agents, the Security Trustee and the Bond Trustee as the holder of such nominal amount of such Covered Bonds for all purposes other than with respect to the payment of principal or interest or other amounts on such nominal amount of such Covered Bonds, for which purpose the bearer of the relevant Bearer Global Covered Bond or the registered holder of the relevant Registered Global Covered Bond shall be treated by the Issuer, the Group Guarantors, the LLP, any Paying Agent, the Security Trustee and the Bond Trustee as the holder of such nominal amount of such Covered Bonds in accordance with and subject to the terms of the relevant Global Covered Bond and the expressions **Covered Bondholder** and **holder of Covered Bonds** and related expressions shall be construed accordingly. In determining whether a particular person is entitled to a particular nominal amount of Covered Bonds as aforesaid, the Bond Trustee may rely on such evidence and/or information and/or certification as it shall, in its absolute discretion, think fit and, if it does so rely, such evidence and/or information and/or certification shall, in the absence of manifest error or an error established as such to the satisfaction of the Bond Trustee, be conclusive and binding on all concerned.

For so long as the Depository Trust Company (**DTC**) or its nominee is the registered owner or holder of a Registered Global Covered Bond, DTC or such nominee, as the case may be, will be considered the sole owner or holder of the Covered Bonds represented by such Registered Global Covered Bond for all purposes under the Agency Agreement and the Covered Bonds except to the extent that in accordance with DTC's published rules and procedures any ownership rights may be exercised by its participants or beneficial owners through participants.

Covered Bonds which are represented by a Global Covered Bond will be transferable only in accordance with the rules and procedures for the time being of DTC, Euroclear and Clearstream, Luxembourg, as the case may be.

References to DTC, Euroclear and/or Clearstream, Luxembourg shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system specified in the applicable Final Terms or as may otherwise be approved by the Issuer, the Agent and the Bond Trustee.

## **2. TRANSFERS OF REGISTERED COVERED BONDS**

### *(a) Transfers of interests in Registered Global Covered Bonds*

Transfers of beneficial interests in Registered Global Covered Bonds will be effected by DTC, Euroclear or Clearstream, Luxembourg, as the case may be, and, in turn, by other participants and, if appropriate, indirect participants in such clearing systems acting on behalf of beneficial transferors and transferees of such interests. A beneficial interest in a Registered Global Covered Bond will, subject to compliance with all applicable legal and regulatory restrictions, be transferable for Registered Covered Bonds in definitive form or for a beneficial interest in another Registered Global Covered Bond only in the authorised denominations set out in the applicable Final Terms and only in accordance with the rules and operating procedures for the time being of DTC, Euroclear or Clearstream, Luxembourg, as the case may be, and in accordance with the terms and conditions specified in the Agency Agreement. Transfers of a Registered Global Covered Bond registered in the name of a nominee for DTC shall be limited to transfers of such Registered Global Covered Bond, in whole but not in part, to another nominee of DTC or to a successor of DTC or such successor's nominee.



(b) *Transfers of Registered Covered Bonds in definitive form*

Subject as provided in paragraphs (e), (f) and (g) below, upon the terms and subject to the conditions set forth in the Agency Agreement, a Registered Covered Bond in definitive form may be transferred in whole or in part (in the authorised denominations set out in the applicable Final Terms). In order to effect any such transfer (i) the holder or holders must (A) surrender the Registered Covered Bond for registration of the transfer of the Registered Covered Bond (or the relevant part of the Registered Covered Bond) at the specified office of the Bond Registrar or any Transfer Agent, with the form of transfer thereon duly executed by the holder or holders thereof or his or their attorney or attorneys duly authorised in writing and (B) complete and deposit such other certifications as may be required by the Bond Registrar or, as the case may be, the relevant Transfer Agent and (ii) the Bond Registrar or, as the case may be, the relevant Transfer Agent must, after due and careful enquiry, be satisfied with the documents of title and the identity of the person making the request. Any such transfer will be subject to such reasonable regulations as the Issuer and the Bond Registrar may from time to time prescribe (the initial such regulations being set out in Schedule 6 to the Agency Agreement). Subject as provided above, the Bond Registrar or, as the case may be, the relevant Transfer Agent will, within three business days (being for this purpose a day on which banks are open for business in the city where the specified office of the Bond Registrar or, as the case may be, the relevant Transfer Agent is located) of the request (or such longer period as may be required to comply with any applicable fiscal or other laws or regulations), authenticate and deliver, or procure the authentication and delivery of, at its specified office to the transferee or (at the risk of the transferee) send by uninsured mail, to such address as the transferee may request, a new Registered Covered Bond in definitive form of a like aggregate nominal amount to the Registered Covered Bond (or the relevant part of the Registered Covered Bond) transferred. In the case of the transfer of part only of a Registered Covered Bond in definitive form, a new Registered Covered Bond in definitive form in respect of the balance of the Registered Covered Bond not transferred will be so authenticated and delivered or (at the risk of the transferor) sent to the transferor.

(c) *Registration of transfer upon partial redemption*

In the event of a partial redemption of Covered Bonds under Condition 7, the Issuer shall not be required to register the transfer of any Registered Covered Bond, or part of a Registered Covered Bond, called for partial redemption.

(d) *Costs of registration*

Covered Bondholders will not be required to bear the costs and expenses of effecting any registration of transfer as provided above, except for any costs or expenses of delivery other than by regular uninsured mail and except that the Issuer may require the payment of a sum sufficient to cover any stamp duty, tax or other governmental charge that may be imposed in relation to the registration.

(e) *Transfers of interests in Regulation S Global Covered Bonds*

Prior to expiry of the applicable Distribution Compliance Period, transfers by the holder of, or of a beneficial interest in, a Regulation S Global Covered Bond to a transferee in the United States or who is a U.S. person will only be made:

- (i) upon receipt by the Bond Registrar of a written certification substantially in the form set out in the Agency Agreement, amended as appropriate (a **Transfer Certificate**), copies of which are available from the specified office of the Bond Registrar or any Transfer Agent, from the



transferor of the Covered Bond or beneficial interest therein to the effect that such transfer is being made

- (A) to a person whom the transferor reasonably believes is a QIB in a transaction meeting the requirements of Rule 144A; or
  - (B) to a person who is an Institutional Accredited Investor, together with, in the case of (B), a duly executed investment letter from the relevant transferee substantially in the form set out in the Agency Agreement (an **IAI Investment Letter**); or
- (ii) otherwise pursuant to the Securities Act or an exemption therefrom, subject to receipt by the Issuer of such satisfactory evidence as the Issuer may reasonably require, which may include an opinion of U.S. counsel, that such transfer is in compliance with any applicable securities laws of any State of the United States,

and, in each case, in accordance with any applicable securities laws of any State of the United States or any other jurisdiction.

In the case of (A) above, such transferee may take delivery through a Legended Covered Bond in global or definitive form and, in the case of (B) above, such transferee may take delivery only through a Legended Covered Bond in definitive form. After expiry of the applicable Distribution Compliance Period (i) beneficial interests in Regulation S Global Covered Bonds registered in the name of a nominee for DTC may be held through DTC directly, by a participant in DTC, or indirectly through a participant in DTC and (ii) such certification requirements will no longer apply to such transfers.

(f) *Transfers of interests in Legended Covered Bonds*

Transfers of Legended Covered Bonds or beneficial interests therein may be made:

- (i) to a transferee who takes delivery of such interest through a Regulation S Global Covered Bond, upon receipt by the Bond Registrar of a duly completed Transfer Certificate from the transferor to the effect that such transfer is being made in accordance with Regulation S and that in the case of a Regulation S Global Covered Bond registered in the name of a nominee for DTC, if such transfer is being made prior to expiry of the applicable Distribution Compliance Period, the interests in the Covered Bonds being transferred will be held immediately thereafter through Euroclear and/or Clearstream, Luxembourg; or
- (ii) to a transferee who takes delivery of such interest through a Legended Covered Bond
  - (A) where the transferee is a person whom the transferor reasonably believes is a QIB in a transaction meeting the requirements of Rule 144A, without certification; or
  - (B) where the transferee is an Institutional Accredited Investor, subject to delivery to the Bond Registrar of a Transfer Certificate from the transferor to the effect that such transfer is being made to an Institutional Accredited Investor, together with a duly executed IAI Investment Letter from the relevant transferee; or
- (iii) otherwise pursuant to the Securities Act or an exemption therefrom, subject to receipt by the Issuer of such satisfactory evidence as the Issuer may reasonably require, which may include an opinion of U.S. counsel, that such transfer is in compliance with any applicable securities laws of any State of the United States,

and, in each case, in accordance with any applicable securities laws of any State of the United States or any other jurisdiction.

Covered Bonds transferred by Institutional Accredited Investors to QIBs pursuant to Rule 144A or outside the United States pursuant to Regulation S will be eligible to be held by such QIBs or non-U.S. investors through DTC, Euroclear or Clearstream, Luxembourg, as appropriate, and the Bond Registrar will arrange for any Covered Bonds which are the subject of such a transfer to be represented by the appropriate Registered Global Covered Bond, where applicable.

Upon the transfer, exchange or replacement of Legended Covered Bonds, or upon specific request for removal of the Legend, the Bond Registrar shall deliver only Legended Covered Bonds or refuse to remove the Legend, as the case may be, unless there is delivered to the Issuer such satisfactory evidence as may reasonably be required by the Issuer, which may include an opinion of U.S. counsel, that neither the Legend nor the restrictions on transfer set forth therein are required to ensure compliance with the provisions of the Securities Act.

(g) *Definitions*

In this Condition, the following expressions shall have the following meanings:

**Distribution Compliance Period** has the meaning given to it in Regulation S;

**Institutional Accredited Investor** means **accredited investors** (as defined in Rule 501(a)(1), (2), (3) or (7) under the Securities Act) that are institutions;

**Legended Covered Bond** means Registered Covered Bonds in definitive form that are issued to Institutional Accredited Investors and Registered Covered Bonds (whether in definitive form or represented by a Registered Global Covered Bond) sold in private transactions to QIBs in accordance with the requirements of Rule 144A;

**QIB** means a qualified institutional buyer within the meaning of Rule 144A;

**Regulation S** means Regulation S under the Securities Act;

**Regulation S Global Covered Bond** means a Registered Global Covered Bond representing Covered Bonds sold outside the United States in reliance on Regulation S;

**Rule 144A** means Rule 144A under the Securities Act;

**Rule 144A Global Covered Bond** means a Registered Global Covered Bond representing Covered Bonds sold in the United States or to QIBs; and

**Securities Act** means the United States Securities Act of 1933, as amended.

**3. STATUS OF THE COVERED BONDS AND THE GUARANTEES**

(a) Status of the Covered Bonds

The Covered Bonds and any relative Receipts and Coupons constitute direct, unconditional, unsubordinated and unsecured obligations of the Issuer and rank *pari passu* without any preference among themselves and at least *pari passu* with all other unsecured and unsubordinated obligations of the Issuer, present and future, other than any obligations preferred by mandatory provisions of applicable law.

(b) Status of the Group Guarantee

The payment of principal and interest in respect of the Covered Bonds and all other moneys (including default interest) payable by the Issuer under or pursuant to the Trust Deed has been unconditionally guaranteed (on a joint and several basis as between themselves) by the Group Guarantors (the **Group Guarantee**) in the Trust Deed. The obligations of the Group Guarantors under the Group Guarantee are direct, unconditional (subject to a written demand by the Bond Trustee on the Group Guarantors for payment under the Group Guarantee), unsubordinated and unsecured obligations of each Group Guarantor and claims under the Group Guarantee rank at least pari passu with all other unsecured and unsubordinated obligations of the Group Guarantor, present and future, other than any obligations preferred by mandatory provisions of applicable law.

(c) Status of the Covered Bond Guarantee

The payment of Guaranteed Amounts in respect of the Covered Bonds when the same shall become Due for Payment has been unconditionally and irrevocably guaranteed (on a several basis as between the Group Guarantors on the one hand and the LLP on the other) by the LLP (the **Covered Bond Guarantee**) in the Trust Deed. However, the LLP shall have no obligation under the Covered Bond Guarantee to pay any Guaranteed Amount when the same shall become Due for Payment under the Covered Bonds or the Trust Deed until the occurrence of an HBOS Event of Default, service by the Bond Trustee on the Issuer and Group Guarantors of an HBOS Acceleration Notice and service by the Bond Trustee on the LLP of a Notice to Pay. The obligations of the LLP under the Covered Bond Guarantee are direct, (following an HBOS Event of Default, service of an HBOS Acceleration Notice and service of a Notice to Pay) unconditional and unsubordinated obligations of the LLP, which are secured as provided in the Deed of Charge.

As security for the LLP's obligations under the Covered Bond Guarantee and the other Transaction Documents (as defined in the Master Definitions and Construction Agreement) to which it is a party, the LLP has granted fixed and floating security over all of its assets under the Deed of Charge in favour of the Security Trustee (for itself and on behalf of the other Secured Creditors).

#### 4. REDENOMINATION

(a) Redenomination

Where redenomination is specified in the applicable Final Terms as being applicable, the Issuer may, without the consent of the Covered Bondholders, the Receiptholders and the Couponholders, on giving prior written notice to the Bond Trustee, the Security Trustee, the Agent, (in the case of Registered Covered Bonds) the Bond Registrar Euroclear and Clearstream, Luxembourg and at least 30 days' prior notice to the Covered Bondholders in accordance with Condition 14, elect that, with effect from the Redenomination Date specified in the notice, the Covered Bonds shall be redenominated in euro. In relation to any Covered Bonds where the applicable Final Terms provide for a minimum Specified Denomination in the Specified Currency which is equivalent to at least euro 50,000 and which are admitted to trading on a regulated market in the European Economic Area, it shall be a term of any such article that the holder of any Covered Bonds held through Euroclear and/or Clearstream, Luxembourg and/or DTC must have credited to its securities account with the relevant clearing system a minimum balance of Covered Bonds of at least euro 50,000.

The election will have effect as follows:

- (i) the Covered Bonds and the Receipts shall be deemed to be redenominated in euro in the denomination of euro 0.01 with a nominal amount for each Covered Bond and Receipt equal to

- the nominal amount of that Covered Bond or Receipt in the Specified Currency, converted into euro at the Established Rate, provided that, if the Issuer determines, in consultation with the Agent and the Bond Trustee, that the then market practice in respect of the redenomination in euro of internationally offered securities is different from the provisions specified above, such provisions shall be deemed to be amended so as to comply with such market practice and the Issuer shall promptly notify the Covered Bondholders, the competent listing authority, stock exchange, and/or market (if any) on or by which the Covered Bonds may be listed and/or admitted to trading and the Paying Agents of such deemed amendments;
- (ii) save to the extent that an Exchange Notice has been given in accordance with paragraph (iv) below, the amount of interest due in respect of the Covered Bonds will be calculated by reference to the aggregate nominal amount of Covered Bonds presented (or, as the case may be, in respect of which Coupons are presented) for payment by the relevant holder and the amount of such payment shall be rounded down to the nearest euro 0.01;
  - (iii) if definitive Covered Bonds are required to be issued after the Redenomination Date, they shall be issued at the expense of the Issuer in the denominations of euro 50,000 and/or such higher amounts as the Agent may determine and notify to the Covered Bondholders and any remaining amounts less than euro 50,000 shall be redeemed by the Issuer and paid to the Covered Bondholders in euro in accordance with Condition 6;
  - (iv) if issued prior to the Redenomination Date, all unmatured Coupons denominated in the Specified Currency (whether or not attached to the Covered Bonds) will become void with effect from the date on which the Issuer gives notice (the **Exchange Notice**) that replacement euro-denominated Covered Bonds, Receipts and Coupons are available for exchange (provided that such securities are so available) and no payments will be made in respect of them. The payment obligations contained in any Covered Bonds, Receipts and Coupons so issued will also become void on that date although those Covered Bonds, Receipts and Coupons will continue to constitute valid exchange obligations of the Issuer. New euro-denominated Covered Bonds, Receipts and Coupons will be issued in exchange for Covered Bonds, Receipts and Coupons denominated in the Specified Currency in such manner as the Agent may specify and as shall be notified to the Covered Bondholders in the Exchange Notice. No Exchange Notice may be given less than 15 days prior to any date for payment of principal or interest on the Covered Bonds;
  - (v) after the Redenomination Date, all payments in respect of the Covered Bonds, the Receipts and the Coupons, other than payments of interest in respect of periods commencing before the Redenomination Date, will be made solely in euro as though references in the Covered Bonds to the Specified Currency were to euro. Payments will be made in euro by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee or, at the option of the payee, by a euro cheque;
  - (vi) if the Covered Bonds are Fixed Rate Covered Bonds and interest for any period ending on or after the Redenomination Date is required to be calculated for a period ending other than on an Interest Payment Date, it will be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention;
  - (vii) if the Covered Bonds are Floating Rate Covered Bonds, the applicable Final Terms will specify any relevant changes to the provisions relating to interest; and

(viii) such other changes shall be made to this Condition (and the Transaction Documents) as the Issuer may decide, after consultation with the Agent and the Bond Trustee, and as may be specified in the notice, to conform it to conventions then applicable to instruments denominated in euro.

(b) *Definitions*

In these Conditions, the following expressions have the following meanings:

**Established Rate** means the rate for the conversion of the relevant Specified Currency (including compliance with rules relating to roundings in accordance with applicable European Community regulations) into euro established by the Council of the European Union pursuant to Article 123 of the Treaty.

**euro** means the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty.

**Redenomination Date** means (in the case of interest bearing Covered Bonds) any date for payment of interest under the Covered Bonds or (in the case of Zero Coupon Covered Bonds) any date, in each case specified by the Issuer in the notice given to the Covered Bondholders pursuant to paragraph (a) above and which falls on or after the date on which the country of the relevant Specified Currency first participates in the third stage of European economic and monetary union.

**Treaty** means the Treaty establishing the European Community, as amended.

## 5. INTEREST

(a) *Interest on Fixed Rate Covered Bonds*

Each Fixed Rate Covered Bond bears interest on its Principal Amount Outstanding from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest. Interest will be payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Final Maturity Date.

Except as provided in the applicable Final Terms, the amount of interest payable on each Interest Payment Date in respect of the Fixed Interest Period ending on (but excluding) such date will amount to the Fixed Coupon Amount. Payments of interest on any Interest Payment Date will, if so specified in the applicable Final Terms, amount to the Broken Amount so specified.

As used in the Conditions, **Fixed Interest Period** means the period from (and including) an Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

If interest is required to be calculated for a period other than a Fixed Interest Period or if no Fixed Coupon Amount is specified in the Final Terms, such interest shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

**Day Count Fraction** means, in respect of the calculation of an amount of interest in accordance with this Condition 4(a):

(i) if “Actual/Actual (ICMA)” is specified in the applicable Final Terms:

- (A) in the case of Covered Bonds where the number of days in the relevant period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (the **Accrual Period**) is equal to or shorter than the Determination Period during which the Accrual Period ends, the number of days in such Accrual Period divided by the product of (1) the number of days in such Determination Period and (2) the number of Determination Dates (as specified in the applicable Final Terms) that would occur in one calendar year; or
- (B) in the case of Covered Bonds where the Accrual Period is longer than the Determination Period during which the Accrual Period ends, the sum of:
  - (1) the number of days in such Accrual Period falling in the Determination Period in which the Accrual Period begins divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year; and
  - (2) the number of days in such Accrual Period falling in the next Determination Period divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year; and
- (ii) if “30/360” is specified in the applicable Final Terms, the number of days in the period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (such number of days being calculated on the basis of a year of 360 days with 12 30-day months) divided by 360.

In these Conditions:

**Determination Period** means each period from (and including) a Determination Date to (but excluding) the next Determination Date (including, where either the Interest Commencement Date or the final Interest Payment Date is not a Determination Date, the period commencing on the first Determination Date prior to, and ending on the first Determination Date falling after, such date); and

**Principal Amount Outstanding** means in respect of a Covered Bond the principal amount of that Covered Bond on the relevant Issue Date thereof less principal amounts received by the relevant Covered Bondholder in respect thereof.

**sub-unit** means, with respect to any currency other than euro, the lowest amount of such currency that is available as legal tender in the country of such currency and, with respect to euro, one cent.

(b) *Interest on Floating Rate Covered Bonds and Index Linked Interest Covered Bonds*

(i) *Interest Payment Dates*

Each Floating Rate Covered Bond and Index Linked Interest Covered Bond bears interest on its Principal Amount Outstanding from (and including) the Interest Commencement Date and such interest will be payable in arrear on either:

- (A) the Specified Interest Payment Date(s) in each year specified in the applicable Final Terms; or
- (B) if no Specified Interest Payment Date(s) is/are specified in the applicable Final Terms, each date (each such date, together with each Specified Interest Payment Date, an **Interest Payment Date**) which falls the number of months or other period specified as the Specified



Period in the applicable Final Terms after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after the Interest Commencement Date.

Such interest will be payable in respect of each Interest Period. In these Conditions, the expression **Interest Period** shall mean the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

If a Business Day Convention is specified in the applicable Final Terms and (x) if there is no numerically corresponding day in the calendar month in which an Interest Payment Date should occur or (y) if any Interest Payment Date would otherwise fall on a day which is not a Business Day, then, if the Business Day Convention specified is:

- (1) in any case where Specified Periods are specified in accordance with Condition 5(b)(i)(B) above, the **Floating Rate Convention**, such Interest Payment Date (i) in the case of (x) above, shall be the last day that is a Business Day in the relevant month and the provisions of (B) below shall apply *mutatis mutandis* or (ii) in the case of (y) above, shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event (A) such Interest Payment Date shall be brought forward to the immediately preceding Business Day and (B) each subsequent Interest Payment Date shall be the last Business Day in the month which falls the Specified Period after the preceding applicable Interest Payment Date occurred; or
- (2) the **Following Business Day Convention**, such Interest Payment Date shall be postponed to the next day which is a Business Day; or
- (3) the **Modified Following Business Day Convention**, such Interest Payment Date shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event such Interest Payment Date shall be brought forward to the immediately preceding Business Day; or
- (4) the **Preceding Business Day Convention**, such Interest Payment Date shall be brought forward to the immediately preceding Business Day.

In the Conditions, **Business Day** means a day which is both:

- (A) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in London and each Additional Business Centre specified in the applicable Final Terms; and
- (B) either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (if other than London and any Additional Business Centre and which if the Specified Currency is Australian dollars or New Zealand dollars shall be Sydney and Auckland, respectively) or (2) in relation to any sum payable in euro, a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) System (the **TARGET System**) is open.



(ii) *Rate of Interest*

The Rate of Interest payable from time to time in respect of Floating Rate Covered Bonds and Index Linked Interest Covered Bonds will be determined in the manner specified in the applicable Final Terms.

(A) *ISDA Determination for Floating Rate Covered Bonds*

Where ISDA Determination is specified in the applicable Final Terms as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will be the relevant ISDA Rate plus or minus (as indicated in the applicable Final Terms) the Margin (if any). For the purposes of this sub-paragraph (A), **ISDA Rate** for an Interest Period means a rate equal to the Floating Rate that would be determined by the Agent under an interest rate swap transaction if the Agent were acting as Calculation Agent for that swap transaction under the terms of an agreement incorporating the 2000 ISDA Definitions, as published by the International Swaps and Derivatives Association, Inc. and as amended and updated as at the Issue Date of the first Tranche of the Covered Bonds (the **ISDA Definitions**) and under which:

- (1) the Floating Rate Option is as specified in the applicable Final Terms;
- (2) the Designated Maturity is a period as specified in the applicable Final Terms; and
- (3) the relevant Reset Date is either (i) if the applicable Floating Rate Option is based on the London inter-bank offered rate (**LIBOR**) or on the Euro-zone inter-bank offered rate (**EURIBOR**), the first day of that Interest Period or (ii) in any other case, as specified in the applicable Final Terms.

For the purposes of this sub-paragraph (A), **Floating Rate**, **Calculation Agent**, **Floating Rate Option**, **Designated Maturity** and **Reset Date** have the meanings given to those terms in the ISDA Definitions.

(B) *Screen Rate Determination for Floating Rate Covered Bonds*

Where Screen Rate Determination is specified in the applicable Final Terms as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will, subject as provided below, be either:

- (1) the offered quotation; or
- (2) the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards) of the offered quotations,

(expressed as a percentage rate per annum) for the Reference Rate which appears or appear, as the case may be, on the Relevant Screen Page as at 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the Interest Determination Date in question plus or minus (as indicated in the applicable Final Terms) the Margin (if any), all as determined by the Agent. If five or more of such offered quotations are available on the Relevant Screen Page, the highest (or, if there is more than one such highest quotation, one only of such quotations) and the lowest (or, if there is more than one such lowest quotation, one only of such quotations) shall be disregarded by the Agent for the purpose of determining the arithmetic mean (rounded as provided above) of such offered quotations.

The Agency Agreement contains provisions for determining the Rate of Interest in the event that the Relevant Screen Page is not available or if, in the case of (1) above, no such offered quotation appears or, in the case of (2) above, fewer than three such offered quotations appear, in each case as at the time specified in the preceding paragraph.

If the Reference Rate from time to time in respect of Floating Rate Covered Bonds is specified in the applicable Final Terms as being other than LIBOR or EURIBOR, the Rate of Interest in respect of such Covered Bonds will be determined as provided in the applicable Final Terms.

(iii) *Minimum Rate of Interest and/or Maximum Rate of Interest*

If the applicable Final Terms specifies a Minimum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is less than such Minimum Rate of Interest, the Rate of Interest for such Interest Period shall be such Minimum Rate of Interest.

If the applicable Final Terms specifies a Maximum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is greater than such Maximum Rate of Interest, the Rate of Interest for such Interest Period shall be such Maximum Rate of Interest.

(iv) *Determination of Rate of Interest and calculation of Interest Amounts*

The Agent, in the case of Floating Rate Covered Bonds, and the Calculation Agent, in the case of Index Linked Interest Covered Bonds, will at or as soon as practicable after each time at which the Rate of Interest is to be determined, determine the Rate of Interest for the relevant Interest Period. In the case of Index Linked Interest Covered Bonds, the Calculation Agent will notify the Agent of the Rate of Interest for the relevant Interest Period as soon as practicable after calculating the same.

The Agent will calculate the amount of interest (the **Interest Amount**) payable on the Floating Rate Covered Bonds or Index Linked Interest Covered Bonds in respect of each Specified Denomination for the relevant Interest Period. Each Interest Amount shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

**Day Count Fraction** means, in respect of the calculation of an amount of interest in accordance with this Condition 5(b):

- (i) if “Actual/365” or “Actual/Actual” is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365 (or, if any portion of that Interest Period falls in a leap year, the sum of (A) the actual number of days in that portion of the Interest Period falling in a leap year divided by 366 and (B) the actual number of days in that portion of the Interest Period falling in a non-leap year divided by 365);
- (ii) if “Actual/365 (Fixed)” is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365;

- (iii) if “Actual/365 (Sterling)” is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365 or, in the case of an Interest Payment Date falling in a leap year, 366;
  - (iv) if “Actual/360” is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 360;
  - (v) if “30/360”, “360/360” or “Bond Basis” is specified in the applicable Final Terms, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months (unless (a) the last day of the Interest Period is the 31st day of a month but the first day of the Interest Period is a day other than the 30th or 31st day of a month, in which case the month that includes that last day shall not be considered to be shortened to a 30-day month, or (b) the last day of the Interest Period is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month)); and
  - (vi) if “30E/360” or “Eurobond Basis” is specified in the applicable Final Terms, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months, without regard to the date of the first day or last day of the Interest Period unless, in the case of the final Interest Period, the Final Maturity Date is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month).
- (v) *Notification of Rate of Interest and Interest Amounts*

The Agent will cause the Rate of Interest and each Interest Amount for each Interest Period and the relevant Interest Payment Date to be notified to the Issuer, the Bond Trustee and any competent listing authority, stock exchange and/or market on or by which the relevant Floating Rate Covered Bonds or Index Linked Interest Covered Bonds are for the time being listed (by no later than the first day of each Interest Period) and notice thereof to be published in accordance with Condition 14 as soon as possible after their determination but in no event later than the fourth London Business Day thereafter. Each Interest Amount and Interest Payment Date so notified may subsequently be amended (or appropriate alternative arrangements made by way of adjustment) without prior notice in the event of an extension or shortening of the Interest Period. Any such amendment will be promptly notified to each competent listing authority, stock exchange and/or market on or by which the relevant Floating Rate Covered Bonds or Index Linked Interest Covered Bonds are for the time being listed, and/or admitted to trading and to the Covered Bondholders in accordance with Condition 14. For the purposes of this paragraph, the expression **London Business Day** means a day (other than a Saturday or a Sunday) on which banks and foreign exchange markets are open for general business in London.

- (vi) *Determination or Calculation by Bond Trustee*

If for any reason at any relevant time the Agent or, as the case may be, the Calculation Agent defaults in its obligation to determine the Rate of Interest or the Agent defaults in its obligation to calculate any Interest Amount in accordance with sub-paragraph (ii)(A) or (B) above or as otherwise specified in the applicable Final Terms, as the case may be, and in each case in accordance with paragraph (iv) above, the Bond Trustee shall determine the Rate of Interest at such rate as, in its absolute discretion (having such regard as it shall think fit to the foregoing provisions of this Condition, but subject always to any Minimum Rate of Interest or Maximum Rate of Interest specified in the applicable Final Terms), it shall deem fair and reasonable in all the circumstances or, as the case may be, the Bond Trustee shall calculate the Interest Amount(s)

in such manner as it shall deem fair and reasonable in all the circumstances and each such determination or calculation shall be deemed to have been made by the Agent or the Calculation Agent, as applicable.

(vii) *Certificates to be final*

All certificates, communications, opinions, determinations, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions of this Condition 5(b), whether by the Agent or, if applicable, the Calculation Agent, or the Bond Trustee shall (in the absence of wilful default, bad faith or manifest error or an error established as such to the satisfaction of the Bond Trustee) be binding on the Issuer, the Group Guarantors, the LLP, the Agent, the Calculation Agent (if applicable), the other Paying Agents, the Bond Trustee and all Covered Bondholders, Receiptholders and Couponholders and (in the absence of wilful default or bad faith) no liability to the Issuer, the Group Guarantors, the LLP, the Covered Bondholders, the Receiptholders or the Couponholders shall attach to the Agent or, (if applicable), the Calculation Agent or the Bond Trustee in connection with the exercise or non-exercise by it of its powers, duties and discretions pursuant to such provisions.

(c) *Interest on Dual Currency Interest Covered Bonds*

The rate or amount of interest payable in respect of Dual Currency Interest Covered Bonds shall be determined in the manner specified in the applicable Final Terms.

(d) *Accrual of interest*

Each Covered Bond (or in the case of the redemption of part only of a Covered Bond, that part only of such Covered Bond) will cease to bear interest (if any) from the date for its redemption unless, upon due presentation thereof, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue as provided in the Trust Deed.

## **6. PAYMENTS**

(a) *Method of payment*

Subject as provided below:

- (i) payments in a Specified Currency other than euro will be made by credit or transfer to an account in the relevant Specified Currency (which, in the case of a payment in Japanese Yen to a non-resident of Japan, shall be a non-resident account) maintained by the payee with, or, at the option of the payee, by a cheque in such Specified Currency drawn on, a bank in the principal financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney and Auckland, respectively) and;
- (ii) payments in euro will be made by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee or, at the option of the payee, by a euro cheque.

In the case of Bearer Covered Bonds, payments in U.S. Dollars will be made by transfer to a U.S. Dollar account maintained by the payee with a bank outside of the United States (which expression, as used in this Condition 5, means the United States of America including the State and the District of Columbia, its territories, its possessions and other areas subject to its jurisdiction), or by cheque drawn on a United States bank. In no event will payment in respect of

Bearer Covered Bonds be made by a cheque mailed to an address in the United States. All payments of interest in respect of Bearer Covered Bonds will be made to accounts located outside the United States except as may be permitted by United States tax law in effect at the time of such payment without detriment to the Issuer.

Payments will be subject in all cases to any fiscal or other laws and regulations applicable thereto in the place of payment in these Conditions, the Trust Deed, the Agency Agreement and the Final Terms, but without prejudice to the provisions of Condition 8. References to Specified Currency will include any successor currency under applicable law.

(b) *Presentation of definitive Bearer Covered Bonds, Receipts and Coupons*

Payments of principal in respect of definitive Bearer Covered Bonds will (subject as provided below) be made in the manner provided in paragraph (a) above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of definitive Bearer Covered Bonds, and payments of interest in respect of definitive Bearer Covered Bonds will (subject as provided below) be made as aforesaid only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of Coupons, in each case at the specified office of any Paying Agent outside the United States and its possessions.

Payments of instalments of principal (if any) in respect of definitive Bearer Covered Bonds, other than the final instalment, will (subject as provided below) be made in the manner provided in paragraph (a) above against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Receipt in accordance with the preceding paragraph. Payment of the final instalment will be made in the manner provided in paragraph (a) above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Bearer Covered Bond in accordance with the preceding paragraph. Each Receipt must be presented for payment of the relevant instalment together with the definitive Bearer Covered Bond to which it appertains. Receipts presented without the definitive Bearer Covered Bond to which they appertain do not constitute valid obligations of the Issuer or any Guarantor. Upon the date on which any definitive Bearer Covered Bond becomes due and repayable, unmatured Receipts (if any) relating thereto (whether or not attached) shall become void and no payment shall be made in respect thereof.

Fixed Rate Covered Bonds in definitive bearer form (other than Dual Currency Interest Covered Bonds, Index Linked Covered Bonds or Long Maturity Covered Bonds (as defined below)) should be presented for payment together with all unmatured Coupons appertaining thereto (which expression shall for this purpose include Coupons falling to be issued on exchange of matured Talons), failing which the amount of any missing unmatured Coupon (or, in the case of payment not being made in full, the same proportion of the amount of such missing unmatured Coupon as the sum so paid bears to the sum due) will be deducted from the sum due for payment. Each amount of principal so deducted will be paid in the manner mentioned above against surrender of the relative missing Coupon at any time before the expiry of 10 years after the Relevant Date (as defined in Condition 8) in respect of such principal (whether or not such Coupon would otherwise have become void under Condition 9) or, if later, five years from the date on which such Coupon would otherwise have become due, but in no event thereafter.

Upon any Fixed Rate Covered Bond in definitive bearer form becoming due and repayable prior to its Final Maturity Date, all unmatured Talons (if any) appertaining thereto will become void and no further Coupons will be issued in respect thereof.

Upon the date on which any Floating Rate Covered Bond, Dual Currency Interest Covered Bond, Index Linked Covered Bond or Long Maturity Covered Bond in definitive bearer form becomes due and repayable, unmatured Coupons and Talons (if any) relating thereto (whether or not attached) shall become void and no payment or, as the case may be, exchange for further Coupons shall be made in respect thereof. A **Long Maturity Covered Bond** is a Fixed Rate Covered Bond (other than a Fixed Rate Covered Bond which on issue had a Talon attached) whose nominal amount on issue is less than the aggregate interest payable thereon provided that such Covered Bond shall cease to be a Long Maturity Covered Bond on the Interest Payment Date on which the aggregate amount of interest remaining to be paid after that date is less than the Principal Amount Outstanding of such Covered Bond.

If the due date for redemption of any definitive Bearer Covered Bond is not an Interest Payment Date, interest (if any) accrued in respect of such Covered Bond from (and including) the preceding Interest Payment Date or, as the case may be, the Interest Commencement Date shall be payable only against surrender of the relevant definitive Bearer Covered Bond.

(c) *Payments in respect of Bearer Global Covered Bonds*

Payments of principal and interest (if any) in respect of Covered Bonds represented by any Global Covered Bond in bearer form will (subject as provided below) be made in the manner specified above in relation to definitive Bearer Covered Bonds and otherwise in the manner specified in the relevant Global Covered Bond against presentation or surrender, as the case may be, of such Global Covered Bond if the Global Covered Bond is not intended to be issued in new global covered bond (**NGCB**) form at the specified office of any Paying Agent outside the United States and its possessions. On the occasion of each payment, (i) in the case of any Global Covered Bond which is not issued in NGCB form, a record of such payment made on such Global Covered Bond, distinguishing between any payment of principal and any payment of interest, will be made on such Global Covered Bond by the Paying Agent, and such record shall be prima facie evidence that the payment in question has been made and (ii) in the case of any Global Covered Bond which is an NGCB, the Paying Agent shall instruct Euroclear and Clearstream, Luxembourg to make appropriate entries in their records to reflect such payment.

(d) *Payments in respect of Registered Covered Bonds*

Payments of principal (other than instalments of principal prior to the final instalment) in respect of each Registered Covered Bond (whether or not in global form) will be made against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the Registered Covered Bond at the specified office of the Bond Registrar or any of the Paying Agents. Such payments will be made by transfer to the Designated Account (as defined below) of the holder (or the first named of joint holders) of the Registered Covered Bond appearing in the register of holders of the Registered Covered Bonds maintained by the Bond Registrar (the **Register**) at the close of business on the third business day (being for this purpose a day on which banks are open for business in the city where the specified office of the Bond Registrar is located) before the relevant due date. Notwithstanding the previous sentence, if (i) a holder does not have a Designated Account or (ii) the principal amount of the Covered Bonds held by a holder is less than U.S.\$250,000 (or its approximate equivalent in any other Specified Currency), payment will instead be made by a cheque in the Specified Currency drawn on a Designated Bank (as defined below). For these purposes, **Designated Account** means the account (which, in the case of a payment in Japanese yen to a non resident of Japan, shall be a non resident account) maintained by a holder with a Designated Bank and identified as such in the Register and **Designated Bank** means (in the case of payment in a Specified Currency other than euro) a bank in the principal



financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney or Auckland, respectively) and (in the case of a payment in euro) any bank which processes payments in euro.

Payments of interest and payments of instalments of principal (other than the final instalment) in respect of each Registered Covered Bond (whether or not in global form) will be made by a cheque in the Specified Currency drawn on a Designated Bank and mailed by uninsured mail on the relevant due date in the city where the specified office of the Bond Registrar is located to the holder (or the first named of joint holders) of the Registered Covered Bond appearing in the Register at the close of business on the fifteenth day (whether or not such fifteenth day is a business day) before the relevant due date (the **Record Date**) at his address shown in the Register on the Record Date and at his risk. Upon application of the holder to the specified office of the Bond Registrar not less than three business days in the city where the specified office of the Bond Registrar is located before the due date for any payment of interest in respect of a Registered Covered Bond, the payment may be made by transfer on the due date in the manner provided in the preceding paragraph. Any such application for transfer shall be deemed to relate to all future payments of interest (other than interest due on redemption) and instalments of principal (other than the final instalment) in respect of the Registered Covered Bonds which become payable to the holder who has made the initial application until such time as the Bond Registrar is notified in writing to the contrary by such holder. Payment of the interest due in respect of each Registered Covered Bond on redemption and the final instalment of principal will be made in the same manner as payment of the principal amount of such Registered Covered Bond.

Holders of Registered Covered Bonds will not be entitled to any interest or other payment for any delay in receiving any amount due in respect of any Registered Covered Bond as a result of a cheque posted in accordance with this Condition arriving after the due date for payment or being lost in the post. No commissions or expenses shall be charged to such holders by the Bond Registrar in respect of any payments of principal or interest in respect of the Registered Covered Bonds.

All amounts payable to DTC or its nominee as registered holder of a Registered Global Covered Bond in respect of Covered Bonds denominated in a Specified Currency other than U.S. dollars shall be paid by transfer by the Bond Registrar to an account in the relevant Specified Currency of the Exchange Agent on behalf of DTC or its nominee for conversion into and payment in U.S. dollars in accordance with the provisions of the Agency Agreement.

None of the Issuer, the Guarantors or the Agents will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

(e) *General provisions applicable to payments*

The holder of a Global Covered Bond shall be the only person entitled to receive payments in respect of Covered Bonds represented by such Global Covered Bond and the Issuer or, as the case may be, either of the Group Guarantors or the LLP and the Bond Trustee will be discharged by payment to, or to the order of, the holder of such Global Covered Bond in respect of each amount so paid. Each of the persons shown in the records of Euroclear or Clearstream, Luxembourg or DTC as the beneficial holder of a particular nominal amount of Covered Bonds represented by such Global Covered Bond must look solely to Euroclear or Clearstream, Luxembourg or DTC, as the case may be, for his share of each payment so made by the Issuer or, as the case may be, the Group Guarantors or the LLP or the Bond Trustee to, or to the order of, the holder of such Global Covered Bond.



Notwithstanding the foregoing provisions of this Condition, if any amount of principal and/or interest in respect of Bearer Covered Bonds is payable in U.S. Dollars, such U.S. Dollar payments of principal and/or interest in respect of such Covered Bonds will be made at the specified office of a Paying Agent in the United States if:

- (i) the Issuer has appointed Paying Agents with specified offices outside the United States with the reasonable expectation that such Paying Agents would be able to make payment in U.S. Dollars at such specified offices outside the United States of the full amount of principal and interest on the Bearer Covered Bonds in the manner provided above when due;
- (ii) payment of the full amount of such principal and interest at all such specified offices outside the United States is illegal or effectively precluded by exchange controls or other similar restrictions on the full payment or receipt of principal and interest in U.S. Dollars; and
- (iii) such payment is then permitted under United States law without involving, in the opinion of the Issuer, the Group Guarantors and the LLP, adverse tax consequences to the Issuer, the Group Guarantors or the LLP.

(f) *Payment Day*

If the date for payment of any amount in respect of any Covered Bond, Receipt or Coupon is not a Payment Day, the holder thereof shall not be entitled to payment until the next following Payment Day in the relevant place and shall not be entitled to further interest or other payment in respect of such delay. For these purposes, **Payment Day** means any day which (subject to Condition 9) is:

- (i) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in:
  - (A) the relevant place of presentation;
  - (B) London;
  - (C) each Additional Financial Centre specified in the applicable Final Terms; and
- (ii) either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (if other than the place of presentation, London and any Additional Financial Centre and which if the Specified Currency is Australian dollars or New Zealand dollars shall be Sydney and Auckland, respectively) or (2) in relation to any sum payable in euro, a day on which the TARGET System is open; and
- (iii) in the case of any payment in respect of a Registered Global Covered Bond denominated in a Specified Currency other than U.S. dollars and registered in the name of DTC or its nominee and in respect of which an accountholder of DTC (with an interest in such Registered Global Covered Bond) has elected to receive any part of such payment in U.S. dollars, a day on which commercial banks are not authorised or required by law or regulation to be closed in New York City.

(g) *Interpretation of principal and interest*

Any reference in these Conditions to principal in respect of the Covered Bonds shall be deemed to include, as applicable:

- (i) any additional amounts which may be payable with respect to principal under Condition 8 or under any undertaking or covenant given in addition thereto, or in substitution therefor, pursuant to the Trust Deed;
- (ii) the Final Redemption Amount of the Covered Bonds;
- (iii) the Early Redemption Amount of the Covered Bonds;
- (iv) the Optional Redemption Amount(s) (if any) of the Covered Bonds;
- (v) in relation to Covered Bonds redeemable in instalments, the Instalment Amounts;
- (vi) in relation to Zero Coupon Covered Bonds, the Amortised Face Amount (as defined in Condition 7(d));
- (vii) any premium and any other amounts (other than interest) which may be payable by the Issuer under or in respect of the Covered Bonds; and
- (viii) any Excess Proceeds which may be payable by the Bond Trustee under or in respect of the Covered Bonds.

Any reference in these Conditions to interest in respect of the Covered Bonds shall be deemed to include, as applicable, any additional amounts which may be payable with respect to interest under Condition 8 or under any undertaking or covenant given in addition thereto, or in substitution therefor, pursuant to the Trust Deed.

## **7. REDEMPTION AND PURCHASE**

### **(a) *Redemption at maturity***

Unless previously redeemed or purchased and cancelled as specified below, each Covered Bond will be redeemed by the Issuer at its Final Redemption Amount specified in, or determined in the manner specified in, the applicable Final Terms in the relevant Specified Currency on the Final Maturity Date.

### **(b) *Redemption for tax reasons***

The Covered Bonds may be redeemed at the option of the Issuer in whole, but not in part, at any time (if this Covered Bond is neither a Floating Rate Covered Bond, an Index Linked Interest Covered Bond nor a Dual Currency Interest Covered Bond) or on any Interest Payment Date (if this Covered Bond is either a Floating Rate Covered Bond, an Index Linked Interest Covered Bond or a Dual Currency Interest Covered Bond), on giving not less than 30 nor more than 60 days' notice to the Bond Trustee and the Agent and, in accordance with Condition 14, the Covered Bondholders (which notice shall be irrevocable), if the Issuer satisfies the Bond Trustee immediately before the giving of such notice that:

- (i) on the occasion of the next payment due under the Covered Bonds, the Issuer has or will become obliged to pay additional amounts as provided or referred to in Condition 8 or either of the Group Guarantors would be unable for reasons outside its control to procure payment by the Issuer and in making payment itself would be required to pay such additional amounts, in each case as a result of any change in, or amendment to, the laws or regulations of a Tax Jurisdiction (as defined in Condition 8) or any change in the application or official interpretation of such laws or regulations, which change or amendment becomes effective on or after the date on which agreement is reached to issue the first Tranche of the Covered Bonds; and

- (ii) such obligation cannot be avoided by the Issuer or, as the case may be, either of the Group Guarantors taking reasonable measures available to it,

provided that no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which the Issuer or, as the case may be, either of the Group Guarantors would be obliged to pay such additional amounts were a payment in respect of the Covered Bonds then due.

Prior to the publication of any notice of redemption pursuant to this Condition, the Issuer shall deliver to the Bond Trustee a certificate signed by two directors of the Issuer or, as the case may be, two directors of the relevant Group Guarantor stating that the Issuer is entitled to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred and the Bond Trustee shall be entitled to accept the certificate as sufficient evidence of the satisfaction of the conditions precedent set out above, in which event it shall be conclusive and binding on the Covered Bondholders, the Receiptholders and the Couponholders.

Covered Bonds redeemed pursuant to this Condition 7(b) will be redeemed at their Early Redemption Amount referred to in paragraph (d) below together (if appropriate) with interest accrued to (but excluding) the date of redemption.

(c) *Redemption at the option of the Issuer (Issuer Call)*

If Issuer Call is specified in the applicable Final Terms, the Issuer may, having given:

- (i) not less than 15 nor more than 30 days' notice to the Covered Bondholders in accordance with Condition 14; and
- (ii) not less than 15 days before the giving of the notice referred to in (i), notice to the Bond Trustee, (in the case of Registered Covered Bonds) the Bond Registrar and to the Agent;

(which notices shall be irrevocable and shall specify the date fixed for redemption), redeem all or some only of the Covered Bonds then outstanding on any Optional Redemption Date and at the Optional Redemption Amount(s) specified in, or determined in the manner specified in, the applicable Final Terms together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such partial redemption must be of a nominal amount not less than the Minimum Redemption Amount and not more than the Maximum Redemption Amount, in each case as may be specified in the applicable Final Terms. In the case of a partial redemption of Covered Bonds, the Covered Bonds to be redeemed (the **Redeemed Covered Bonds**) will be selected individually by lot, in the case of Redeemed Covered Bonds represented by definitive Covered Bonds, and in accordance with the rules of Euroclear and/or Clearstream, Luxembourg (to be reflected in the records of Euroclear and Clearstream, Luxembourg as either a pool factor or a reduction in nominal amount, at their discretion) and/or DTC, in the case of Redeemed Covered Bonds represented by a Global Covered Bond, in each case, not more than 30 days prior to the date fixed for redemption (such date of selection being hereinafter called the **Selection Date**). In the case of Redeemed Covered Bonds represented by definitive Covered Bonds, a list of the serial numbers of such Redeemed Covered Bonds will be published in accordance with Condition 14 not less than 15 days prior to the date fixed for redemption. The aggregate nominal amount of Redeemed Covered Bonds represented by definitive Covered Bonds shall bear the same proportion to the aggregate nominal amount of all Redeemed Covered Bonds as the aggregate nominal amount of definitive Covered Bonds outstanding bears to the aggregate nominal amount of the Covered Bonds outstanding, in each case on the Selection Date, provided that such first mentioned nominal amount shall, if necessary, be rounded downwards to the nearest integral multiple of the Specified Denomination, and the aggregate nominal amount of Redeemed Covered Bonds represented by a Global Covered Bond shall be equal to the balance of the Redeemed Covered Bonds.

No exchange of the relevant Global Covered Bond will be permitted during the period from (and including) the Selection Date to (and including) the date fixed for redemption pursuant to this paragraph (c) and notice to that effect shall be given by the Issuer to the Covered Bondholders in accordance with Condition 14 at least five days prior to the Selection Date.

(d) *Early Redemption Amounts*

For the purpose of paragraph (b) above and Condition 10, each Covered Bond will be redeemed at its Early Redemption Amount calculated as follows:

- (i) in the case of a Covered Bond with a Final Redemption Amount equal to the Issue Price, at the Final Redemption Amount thereof;
- (ii) in the case of a Covered Bond (other than a Zero Coupon Covered Bond but including an Instalment Covered Bond) with a Final Redemption Amount which is or may be less or greater than the Issue Price or which is payable in a Specified Currency other than that in which the Covered Bond is denominated, at the amount specified in, or determined in the manner specified in, the applicable Final Terms or, if no such amount or manner is so specified in the applicable Final Terms, at its nominal amount; or
- (iii) in the case of a Zero Coupon Covered Bond, at an amount (the **Amortised Face Amount**) calculated in accordance with the following formula:

$$\text{Early Redemption Amount} = \text{RP} \times (1 + \text{AY})^y$$

where:

**RP** means the Reference Price;

**AY** means the Accrual Yield expressed as a decimal; and

**y** is a fraction the numerator of which is equal to the number of days (calculated on the basis of a 360-day year consisting of 12 months of 30 days each) from (and including) the Issue Date of the first Tranche of the Covered Bonds to (but excluding) the date fixed for redemption or (as the case may be) the date upon which such Covered Bond becomes due and repayable and the denominator of which is 360,

or on such other calculation basis as may be specified in the applicable Final Terms.

(e) *Instalments*

Instalment Covered Bonds will be redeemed in the Instalment Amounts and on the Instalment Dates. In the case of early redemption, the Early Redemption Amount will be determined pursuant to paragraph (d) above.

(f) *Purchases*

The Issuer, either Group Guarantor, the LLP or any of the Group Guarantors' Subsidiaries may at any time purchase Covered Bonds (provided that, in the case of definitive Covered Bonds, all unmatured Receipts, Coupons and Talons appertaining thereto are purchased therewith) at any price in the open market or otherwise. If purchases are made by tender, tenders must be available to all Covered Bondholders alike. Such Covered Bonds may be held, reissued, resold or, at the option of the Issuer,

either Group Guarantor or the LLP, surrendered to any Paying Agent and/or the Bond Registrar for cancellation.

(g) *Cancellation*

All Covered Bonds which are redeemed will forthwith be cancelled (together with, in the case of Bearer Definitive Covered Bonds, all unmatured Receipts, Coupons and Talons attached thereto or surrendered therewith at the time of redemption). All Covered Bonds so cancelled and any Covered Bonds purchased and cancelled pursuant to paragraph (f) above (together with, in the case of Bearer Definitive Covered Bonds, all unmatured Receipts, Coupons and Talons cancelled therewith) shall be forwarded to the Agent and cannot be reissued or resold.

(h) *Late payment on Zero Coupon Covered Bonds*

If the amount payable in respect of any Zero Coupon Covered Bond upon redemption of such Zero Coupon Covered Bond pursuant to paragraph (a), (b) or (c) above or upon its becoming due and repayable as provided in Condition 10 is improperly withheld or refused, the amount due and repayable in respect of such Zero Coupon Covered Bond shall be the amount calculated as provided in paragraph (d)(iii) above as though the references therein to the date fixed for the redemption or the date upon which such Zero Coupon Covered Bond becomes due and payable were replaced by references to the date which is the earlier of:

- (i) the date on which all amounts due in respect of such Zero Coupon Covered Bond have been paid; and
- (ii) five days after the date on which the full amount of the moneys payable in respect of such Zero Coupon Covered Bonds has been received by the Agent or the Bond Trustee or the Bond Registrar and notice to that effect has been given to the Covered Bondholders in accordance with Condition 14.

(i) *Legislative Exchange*

Following the coming into force in the United Kingdom, at any time after the Programme Date, of (i) any legislation similar to covered bond legislation in force in any other European Union country or (ii) any rules, regulations or guidelines published by any governmental authority that provides for bonds issued by United Kingdom issuers to qualify for the same benefits available to covered bonds issued under covered bond legislation in force in any other European Union country, the Issuer may, at its option and without the consent of the Bond Trustee, the Security Trustee or the Covered Bondholders, exchange all (but not some only) of the Covered Bonds of all Series then outstanding (the **Existing Covered Bonds**) for new Covered Bonds which qualify as covered bonds under such new legislation, rules, regulations or guidelines (the **New Covered Bonds**) in identical form, amounts and denominations as the Existing Covered Bonds and on the same economic terms and conditions as the Existing Covered Bonds (the **Legislative Exchange**) if not more than 60 nor less than 30 days' notice to the Covered Bondholders (in accordance with Condition 14) and the Bond Trustee is given and provided that:

- (i) on the date on which such notice expires the Issuer delivers to the Bond Trustee a certificate signed by two directors of each of the Issuer and the Group Guarantors and a certificate signed by a Designated Member of the LLP confirming that, in the case of the Issuer and the Group Guarantors, no HBOS Event of Default or Potential HBOS Event of Default and, in the case of

the LLP, no LLP Event of Default or Potential LLP Event of Default, shall have occurred and be continuing;

- (ii) each of the Rating Agencies then rating the Existing Covered Bonds has confirmed in writing that the New Covered Bonds will be assigned the same ratings as are then applicable to the Existing Covered Bonds; and
- (iii) if the Existing Covered Bonds are listed, quoted and/or traded on or by a competent and/or relevant listing authority, stock exchange and/or quotation system on or before the date on which such notice expires the Issuer delivers to the Bond Trustee a certificate signed by two directors of the Issuer confirming that all applicable rules of such competent and/or relevant listing authority, stock exchange and/or quotation system have been or will be complied with.

The Existing Covered Bonds will be cancelled concurrently with the issue of the New Covered Bonds and with effect on and from the date of issue thereof all references herein to Covered Bonds shall be deemed to be references to the New Covered Bonds.

(j) *Redemption due to illegality*

The Covered Bonds of all Series may be redeemed at the option of the Issuer in whole, but not in part, at any time, on giving not less than 30 nor more than 60 days' notice to the Bond Trustee, the Agent, the Bond Registrar and, in accordance with Condition 14, all Covered Bondholders (which notice shall be irrevocable), if the Issuer satisfies the Bond Trustee immediately before the giving of such notice that it has, or will, before the next Interest Payment Date of any Covered Bond of any Series, become unlawful for the Issuer to make, fund or allow to remain outstanding any Term Advance made by it to the LLP under the Intercompany Loan Agreement, as a result of any change in, or amendment to, the applicable laws or regulations or any change in the application or official interpretation of such laws or regulations, which change or amendment has become or will become effective before the next such Interest Payment Date.

Prior to the publication of any notice of redemption pursuant to this Condition, the Issuer shall deliver to the Bond Trustee a certificate signed by two directors of the Issuer stating that the Issuer is entitled to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred and the Bond Trustee shall be entitled to accept the certificate as sufficient evidence of the satisfaction of the conditions precedent set out above, in which event it shall be conclusive and binding on all Covered Bondholders, Receiptholders and Couponholders.

Covered Bonds redeemed pursuant to this Condition 7(j) will be redeemed at their Early Redemption Amount referred to in paragraph 7(d) above together (if appropriate) with interest accrued to (but excluding) the date of redemption.

## **8. TAXATION**

All payments of principal and interest in respect of the Covered Bonds, Receipts and Coupons by the Issuer, the LLP or the Group Guarantors, as the case may be, will be made without withholding or deduction for or on account of any present or future taxes or duties of whatever nature imposed or levied by or on behalf of any Tax Jurisdiction unless such withholding or deduction is required by law. In the event of a withholding or deduction being made by either the Issuer or the Group Guarantors in respect of a payment made by any of them, the Issuer or, as the case may be, either Group Guarantor will pay such additional amounts as shall be necessary in order that the net amounts received by the holders of the Covered Bonds, Receipts or Coupons after such withholding or deduction shall equal the respective amounts of principal and interest



which would otherwise have been receivable in respect of the Covered Bonds, Receipts or Coupons, as the case may be, in the absence of such withholding or deduction; except that no such additional amounts shall be payable with respect to any Covered Bond, Receipt or Coupon:

- (a) presented for payment in the United Kingdom; or
- (b) presented for payment by or on behalf of a holder who is liable for such taxes or duties in respect of such Covered Bond, Receipt or Coupon by reason of his having some connection with a Tax Jurisdiction other than the mere holding of such Covered Bond, Receipt or Coupon; or
- (c) presented for payment more than 30 days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on presenting the same for payment on such thirtieth day assuming that day to have been a Payment Day (as defined in Condition 6(e)); or
- (d) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Union Council Directive 2003/48/EC on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive; or
- (e) presented for payment by or on behalf of a holder who would be able to avoid such withholding or deduction by presenting the relevant Covered Bond, Receipt or Coupon to another Paying Agent in a Member State of the European Union.

As used herein:

- (i) **Tax Jurisdiction** means the United Kingdom or any political subdivision or any authority thereof or therein having power to tax; and
- (ii) the **Relevant Date** means the date on which such payment first becomes due, except that, if the full amount of the moneys payable has not been duly received by the Bond Trustee or the Agent on or prior to such due date, it means the date on which, the full amount of such moneys having been so received, notice to that effect is duly given to the Covered Bondholders in accordance with Condition 14.

Should any payments made by the LLP under the Covered Bond Guarantee be made subject to any withholding or deduction on account of taxes or duties of whatever nature imposed or levied by or on account of any Tax Jurisdiction the LLP will not be obliged to pay any additional amounts as a consequence.

## 9. PRESCRIPTION

The Covered Bonds (whether in bearer or registered form), Receipts and Coupons will become void unless presented for payment within a period of ten years (in the case of principal) and five years (in the case of interest) after the Relevant Date (as defined in Condition 8) therefor, subject in each case to the provisions of Conditions 4 and 6(b).

There shall not be included in any Coupon sheet issued on exchange of a Talon any Coupon the claim for payment in respect of which would be void pursuant to this Condition or Condition 6(b) or any Talon which would be void pursuant to Condition 6(b).



## 10. EVENTS OF DEFAULT AND ENFORCEMENT

### (a) *HBOS Events of Default*

The Bond Trustee at its discretion may (except in relation to the default set out in sub-paragraphs (i) and (viii) below in which case the Bond Trustee shall) and if so requested in writing by the holders of not less than twenty-five per cent. of the Principal Amount Outstanding of the Covered Bonds (which for this purpose and the purpose of any Extraordinary Resolution referred to in this Condition 10(a) means the Covered Bonds of all Series together as if they were a Single Series (with the nominal amount of Covered Bonds not denominated in sterling converted into sterling at the relevant Covered Bond Swap Rate) then outstanding or if so directed by an Extraordinary Resolution shall (subject in each case to being indemnified and/or secured to its satisfaction), but in the case of the happening of any of the events described in paragraph (ii) below or, in relation to the Group Guarantors only, paragraphs (iii) to (vi) (inclusive) only if the Bond Trustee shall have certified in writing to the Issuer and the Group Guarantors that such event is, in its opinion, materially prejudicial to the interests of the Covered Bondholders of any Series, give notice (an **HBOS Acceleration Notice**) in writing to the Issuer and the Group Guarantors that as against the Issuer and the Group Guarantors (but not against the LLP) each Covered Bond of each Series is, and each such Covered Bond shall thereupon immediately become, due and repayable at its Early Redemption Amount together with accrued interest as provided in the Trust Deed if any of the following events (each an **HBOS Event of Default**) shall occur and be continuing:

- (i) default is made by the Issuer and (following the delivery of a written demand on the Group Guarantors by the Bond Trustee for payment under the terms of the Group Guarantee) the Group Guarantors in the payment of any principal, or redemption amount or interest on the Covered Bonds of any Series when due (unless the Bond Trustee is satisfied that the default has arisen by reason of technical default or error and the Issuer and the Group Guarantors have the moneys available to make payment and payment is made within three London Business Days of the due date thereof); or
- (ii) a default is made in the performance by the Issuer or any Group Guarantor of any obligation (other than any obligation for the payment of principal, redemption amount or interest in respect of the Covered Bonds of any Series) under the provisions of the Covered Bonds of any Series or the Trust Deed or any other Transaction Document to which the Issuer or any Group Guarantor is a party which (unless certified by the Bond Trustee, in its opinion, to be incapable of remedy) shall continue for more than thirty days after written notification requiring such default to be remedied and indicating that this provision may be invoked if it is not so remedied shall have been given to the Issuer and the Group Guarantors by the Bond Trustee in accordance with the Trust Deed; or
- (iii) an order is made or an effective resolution passed for the bankruptcy or liquidation or winding up or sequestration of the Issuer or either Group Guarantor (except a bankruptcy, liquidation, winding up or sequestration for the purpose of a reconstruction, amalgamation, merger or following the transfer of all or substantially all of the assets of the Issuer or either Group Guarantor, the terms of which have previously been approved by an Extraordinary Resolution (as defined in the Trust Deed) of the holders of the Covered Bonds or which has been effected in compliance with the terms of Condition 15); or
- (iv) the Issuer or either Group Guarantor ceases to carry on its business or substantially all its business (except a cessation for the purpose of a reconstruction, amalgamation, merger or following the transfer of all or substantially all of the assets of the Issuer or either Group Guarantor, the terms

of which have previously been approved by an Extraordinary Resolution of the holders of the Covered Bonds or which has been effected in compliance with the terms of Condition 15); or

- (v) proceedings shall be initiated against the Issuer or either Group Guarantor under any applicable liquidation, winding-up, sequestration, insolvency, bankruptcy, composition, reorganisation or other similar laws (except in connection with a reconstruction, amalgamation, merger or following the transfer of all or substantially all of the assets of the Issuer or either Group Guarantor, the terms of which have previously been approved by an Extraordinary Resolution of the holders of the Covered Bonds or which has been effected in compliance with the terms of Condition 15); or a receiver, administrator, trustee or other similar official shall be appointed in relation to the Issuer or either Group Guarantor or in relation to the whole or a substantial part (having an aggregate book value in excess of £50,000,000) of its assets or a distress, diligence or execution or other process shall be levied or enforced upon or sued out against the whole or a substantial part (having an aggregate book value in excess of £50,000,000) of its assets and, in any of the foregoing cases, it shall not be discharged within thirty days; or if the Issuer or either Group Guarantor shall initiate or consent to judicial proceedings relating to itself under any applicable liquidation, winding up, sequestration, insolvency, bankruptcy, composition, reorganisation or other similar laws (except in connection with a reconstruction, amalgamation, merger or following the transfer of all or substantially all of the assets of the Issuer or either Group Guarantor, the terms of which have previously been approved by an Extraordinary Resolution of the holders of the Covered Bonds or which has been effected in compliance with the terms of Condition 15) or shall make a conveyance, assignment or assignation for the benefit of, or shall enter into any composition with, its creditors generally; or
- (vi) the Issuer or either Group Guarantor shall be unable to pay its debts as they fall due (within the meaning of section 123(1)(b) to (e) and section 123(2) of the Insolvency Act 1986 (as that section may be amended)) or shall admit inability to pay its debts as they fall due or shall stop payment in respect of any debts that are due (save, in the case of stopping payments, in each case in respect of any obligation for the payment of principal, redemption amount or interest in respect of the Covered Bonds of any Series) or shall be adjudged or found bankrupt or insolvent; or
- (vii) except as provided by the terms of the Group Guarantee, the Group Guarantee is not, or is claimed by the relevant Group Guarantor not to be, in full force and effect; or
- (viii) a failure to satisfy the Asset Coverage Test (as set out in the LLP Deed) on any Calculation Date which has not been cured by the LLP by the next following Calculation Date; or
- (ix) if the Pre-Maturity Test in respect of any Series of Hard Bullet Covered Bonds is breached less than six months prior to the Final Maturity Date of that Series of Hard Bullet Covered Bonds, and the LLP has not cured the breach as described in the LLP Deed before the earlier to occur of (i) ten London Business Days from the date that the Sellers are notified of the breach of the Pre-Maturity Test and (ii) the Final Maturity Date of that Series of Hard Bullet Covered Bonds.

Upon the Covered Bonds becoming immediately due and repayable against the Issuer and Group Guarantors pursuant to this Condition 10(a), the Bond Trustee shall forthwith serve a notice to pay (the **Notice to Pay**) on the LLP pursuant to the Covered Bond Guarantee and the LLP shall be required to make payments of Guaranteed Amounts when the same shall become Due for Payment in accordance with the terms of the Covered Bond Guarantee.

Following the occurrence of an HBOS Event of Default and service of an HBOS Acceleration Notice, the Bond Trustee may or shall take such proceedings against the Issuer and/or Group Guarantors in accordance with the first paragraph of Condition 10(c).

The Trust Deed provides that all moneys received by the Bond Trustee from the Issuer, either of the Group Guarantors or any administrator, administrative receiver, receiver, liquidator, trustee in sequestration or other similar official appointed in relation to the Issuer or the Group Guarantors following the occurrence of an HBOS Event of Default and service of an HBOS Acceleration Notice and a Notice to Pay (the **Excess Proceeds**), shall be paid by the Bond Trustee on behalf of the Covered Bondholders of the relevant Series to the LLP for its own account, as soon as practicable, and shall be held by the LLP in the GIC Account and the Excess Proceeds shall thereafter form part of the Security and shall be used by the LLP in the same manner as all other moneys from time to time standing to the credit of the GIC Account. Any Excess Proceeds received by the Bond Trustee shall discharge the obligations of the Issuer in respect of the Covered Bonds, Receipts and Coupons and the obligations of the Group Guarantors under the Group Guarantee. However, the obligations of the LLP under the Covered Bond Guarantee are unconditional and irrevocable and the receipt by the Bond Trustee of any Excess Proceeds shall not reduce or discharge any of such obligations.

By subscribing for Covered Bond(s), each Covered Bondholder shall be deemed to have irrevocably directed the Bond Trustee to pay the Excess Proceeds to the LLP in the manner as described above.

(b) *LLP Events of Default*

The Bond Trustee at its discretion may, and if so requested in writing by the holders of not less than twenty-five per cent. of the Principal Amount Outstanding of the Covered Bonds (which for this purpose and the purpose of any Extraordinary Resolution referred to in this Condition 10(b) means the Covered Bonds of this Series together with the Covered Bonds of any other Series constituted by the Trust Deed) then outstanding as if they were a Single Series (with the nominal amount of Covered Bonds not denominated in sterling converted into sterling at the relevant Covered Bond Swap Rate) or if so directed by an Extraordinary Resolution shall (subject in each case to being indemnified and/or secured to its satisfaction), but in the case of the happening of any of the events described in paragraph (ii) below, only if the Bond Trustee shall have certified in writing to the Issuer and the LLP that such event is, in its opinion, materially prejudicial to the interests of the Covered Bondholders of any Series, give notice (the **LLP Acceleration Notice**) in writing to the Issuer, copied to the LLP, that each Covered Bond of each Series is, and each Covered Bond of each Series shall as against the Issuer and each Group Guarantor (if not already due and repayable against them following an HBOS Event of Default) and as against the LLP, thereupon immediately become, due and repayable at its Early Redemption Amount together with accrued interest as provided in the Trust Deed and thereafter the Security shall become enforceable if any of the following events (each an **LLP Event of Default**) shall occur and be continuing:

- (i) default is made by the LLP in the payment of any Guaranteed Amount when Due for Payment in respect of the Covered Bonds of any Series unless the Bond Trustee is satisfied that the default has arisen by reason of technical default or error and the LLP has the moneys available to make payment and payment is made within three London Business Days of the due date; or
- (ii) a default is made in the performance or observance by the LLP of any obligation binding upon it (other than any obligation for the payment of Guaranteed Amounts in respect of the Covered Bonds of any Series) under the Trust Deed, the Deed of Charge or any other Transaction Document to which the LLP is a party which (unless certified by the Bond Trustee, in its opinion, to be incapable of remedy) shall continue for more than thirty days after written notification requiring such default to be remedied and indicating that this provision may be invoked if it is not

- so remedied shall have been given to the LLP by the Bond Trustee in accordance with the Trust Deed; or
- (iii) an order is made or an effective resolution passed for the liquidation or winding up of the LLP; or
  - (iv) the LLP ceases to carry on its business or substantially all its business; or
  - (v) proceedings shall be initiated against the LLP under any applicable liquidation, winding up, insolvency, bankruptcy, composition, reorganisation or other similar laws (including, but not limited to, presentation of a petition for an administration order); or a receiver, administrator, trustee or other similar official shall be appointed in relation to the LLP or in relation to the whole or any part of its assets, or a distress, diligence or execution or other process shall be levied or enforced upon or sued out against the whole or any part of its assets, or if the LLP shall initiate or consent to judicial proceedings relating to itself under any applicable liquidation, winding up, insolvency, bankruptcy, composition, reorganisation or other similar laws or shall make a conveyance, assignment or assignation for the benefit of, or shall enter into any composition with, its creditors generally; or
  - (vi) the LLP shall stop payment or shall be unable, or shall admit inability, to pay its debts generally as they fall due or shall be adjudicated or found bankrupt or insolvent; or
  - (vii) the Covered Bond Guarantee is not, or is claimed by the LLP not to be, in full force and effect; or
  - (viii) a failure to satisfy the Amortisation Test (as set out in the LLP Deed) on any Calculation Date following an HBOS Event of Default.

For the purposes hereof:

**Amortisation Test** means the Amortisation Test Aggregate Loan Amount (as defined in the Master Definitions and Construction Agreement) which shall be an amount at least equal to the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on each Calculation Date following an HBOS Event of Default.

Following the occurrence of an LLP Event of Default and service of an LLP Acceleration Notice, each of the Bond Trustee and the Security Trustee may or shall take such proceedings or steps in accordance with the first and second paragraphs, respectively, of Condition 10(c) and the Covered Bondholders shall have a claim against the LLP, under the Covered Bond Guarantee, for the Early Redemption Amount together with accrued interest as provided in the Trust Deed in respect of each Covered Bond.

(c) *Enforcement*

The Bond Trustee may at any time after service of an HBOS Acceleration Notice (in the case of the Issuer and Group Guarantors) or an LLP Acceleration Notice (in the case of the LLP), at its discretion and without further notice, take such proceedings against the Issuer and/or either Group Guarantor or the LLP, as the case maybe, and/or any other person as it may think fit to enforce the provisions of the Trust Deed, the Covered Bonds, the Receipts, and the Coupons, but it shall not be bound to take any such enforcement proceedings in relation to the Trust Deed, the Covered Bonds, the Receipts or the Coupons or any other Transaction Document unless (i) it shall have been so directed by an Extraordinary Resolution (with the Covered Bonds of all Series taken together as a single Series as aforesaid) or so requested in writing by the holders of not less than twenty-five per cent. of the Principal Amount Outstanding of the Covered Bonds of all Series then outstanding (taken together and converted

into sterling at the relevant Covered Bond Swap Rate as aforesaid) and (ii) it shall have been indemnified and/or secured to its satisfaction.

The Security Trustee may at any time, at its discretion and without further notice, take such proceedings against the LLP and/or any other person as it may think fit to enforce the provisions of the Deed of Charge and may, at any time after the Security has become enforceable, take such steps as it may think fit to enforce the Security, but it shall not be bound to take any such steps unless (i) it shall have been so directed by an Extraordinary Resolution (with the Covered Bonds of all Series taken together as a single Series as aforesaid) or a request in writing by the holders of not less than twenty-five per cent. of the Principal Amount Outstanding of the Covered Bonds of all Series then outstanding (taken together converted into sterling at the relevant Covered Bond Swap Rate as aforesaid); and (ii) it shall have been directed in writing to do so by each of the other Secured Creditors (other than the Issuer, the Group Guarantors or the Sellers); and (iii) it shall have been indemnified and/or secured to its satisfaction.

No Covered Bondholder, Receiptholder or Couponholder shall be entitled to proceed directly against the Issuer, either Group Guarantor or the LLP or to take any action with respect to the Trust Deed, the Receipts, the Coupons, or the Security unless the Bond Trustee or the Security Trustee, as applicable, having become bound so to proceed, fails so to do for a period of 30 days and the failure shall be continuing.

## **11. REPLACEMENT OF COVERED BONDS, RECEIPTS, COUPONS AND TALONS**

Should any Covered Bond, Receipt, Coupon or Talon be lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Agent (in the case of Bearer Covered Bonds, Receipts or Coupons) or the Bond Registrar (in the case of Registered Covered Bonds) upon payment by the claimant of such costs and expenses as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Covered Bonds, Receipts, Coupons or Talons must be surrendered before replacements will be issued.

## **12. PAYING AGENTS**

The names of the initial Paying Agents, the initial Bond Registrar, the Initial Transfer Agent, the initial Exchange Agent and their initial specified offices are set out below.

The Issuer is entitled, with the prior written approval of the Bond Trustee (such approval not to be unreasonably withheld or delayed), to vary or terminate the appointment of any Paying Agent and/or appoint additional or other Paying Agents and/ or approve any change in the specified office through which any Paying Agent acts, provided that:

- (a) there will at all times be a Principal Paying Agent and a Bond Registrar (in the case of Bearer Covered Bonds), which may be the Principal Paying Agent, and a Transfer Agent (in the case of Registered Covered Bonds) which may be the Bond Registrar;
- (b) so long as the Covered Bonds are listed and/or admitted to trading on or by any competent listing authority, on any stock exchange or market, there will at all times be a Paying Agent with a specified office in such place as may be required by the rules and regulations of the relevant competent listing authority, stock exchange or market; and
- (c) so long as any of the Registered Global Covered Bonds payable in a Specified Currency other than U.S.\$ are held through DTC or its nominee, there will at all times be an Exchange Agent; and

- (d) it will ensure that it maintains a Paying Agent in a Member State of the European Union that is not obliged to withhold or deduct tax pursuant to the European Union Council Directive 2003/48/EC on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive.

In addition, the Issuer shall forthwith appoint a Paying Agent having a specified office in New York City in the circumstances described in Condition 6(d). Any variation, termination, appointment or change shall only take effect (other than in the case of insolvency, when it shall be of immediate effect) after not less than 30 nor more than 45 days' prior notice thereof shall have been given to the Covered Bondholders in accordance with Condition 14.

In acting under the Agency Agreement, the Paying Agents act solely as agents of the Issuer, the Group Guarantors and the LLP and, in certain circumstances specified therein, of the Bond Trustee and do not assume any obligation to, or relationship of agency or trust with, any Covered Bondholders, Receiptholders or Couponholders. The Agency Agreement contains provisions permitting any entity into which any Paying Agent is merged or converted or with which it is consolidated or to which it transfers all or substantially all of its assets to become the successor paying agent.

### **13. EXCHANGE OF TALONS**

On and after the Interest Payment Date on which the final Coupon comprised in any Coupon sheet matures, the Talon (if any) forming part of such Coupon sheet may be surrendered at the specified office of the Agent or any other Paying Agent in exchange for a further Coupon sheet including (if such further Coupon sheet does not include Coupons to (and including) the final date for the payment of interest due in respect of the Bearer Covered Bond to which it appertains) a further Talon, subject to the provisions of Condition 9.

### **14. NOTICES**

All notices regarding the Bearer Covered Bonds will be deemed to be validly given if published in a leading English language daily newspaper of general circulation in London and, (for so long as any Bearer Covered Bonds are listed on the Official List of the Luxembourg Stock Exchange and traded on (the regulated market of the Luxembourg Stock Exchange) if published in a daily newspaper of general circulation in Luxembourg and/or on the website of the Luxembourg Stock Exchange, [www.bourse.lu](http://www.bourse.lu). It is expected that such publication in a newspaper will be made in the *Financial Times* in London and (in relation to Covered Bonds listed on the Luxembourg Stock Exchange) in the *d'Wort* and/or the *Tageblatt* in Luxembourg. The Issuer shall also ensure that notices are duly published in a manner which complies with the rules of any competent listing authority, stock exchange or market on or by which the Bearer Covered Bonds are for the time being listed, and/or admitted to trading or by which they have been admitted to listing and/or trading. Any such notice will be deemed to have been given on the date of the first publication or, where required to be published in more than one newspaper, on the date of the first publication in all required newspapers. If publication as provided above is not practicable, a notice will be given in such other manner, and will be deemed to have been given on such date, as the Bond Trustee shall approve.

All notices regarding the Registered Covered Bonds will be deemed to be validly given if sent by first class mail or (if posted to an address overseas) by airmail to the holders (or the first named of joint holders) at their respective addresses recorded in the Register and will be deemed to have been given on the fourth day after mailing and, in addition, for so long as any Registered Covered Bonds are listed on a stock exchange and the rules of that stock exchange (or any other relevant authority) so require, such notice will be published in a daily newspaper of general circulation in the place or places required by those rules.



So long as the Covered Bonds are represented in their entirety by any Global Covered Bonds held on behalf of Euroclear and/or Clearstream, Luxembourg and/or DTC, there may be substituted for such publication in such newspaper(s) the delivery of the relevant notice to Euroclear and/or Clearstream, Luxembourg and/or DTC for communication by them to the holders of the Covered Bonds and, in addition, for so long as any Covered Bonds are listed and/or admitted to trading on or by any competent listing authority, stock exchange or market and the rules of that competent listing authority, stock exchange or market so require, such notice will be published in a daily newspaper of general circulation in the place or places required by those rules. Any such notice shall be deemed to have been given to the holders of the Covered Bonds on the day on which the said notice was given to Euroclear and/or Clearstream, Luxembourg and/or DTC.

Notices to be given by any Covered Bondholder shall be in writing and given by lodging the same, together (in the case of any Covered Bond in definitive form) with the relative Covered Bond or Covered Bonds, with the Agent (in the case of Bearer Covered Bonds) or the Bond Registrar (in the case of Registered Covered Bonds). Whilst any of the Covered Bonds are represented by a Global Covered Bond, such notice may be given by any holder of a Covered Bond to the Agent or the Bond Registrar through Euroclear and/or Clearstream, Luxembourg and/or DTC, as the case may be, in such manner as the Agent, the Bond Registrar and Euroclear and/or Clearstream, Luxembourg and/or DTC, as the case may be, may approve for this purpose.

#### **15. MEETINGS OF COVERED BONDHOLDERS, MODIFICATION, WAIVER AND SUBSTITUTION**

The Trust Deed contains provisions for convening meetings of the Covered Bondholders of any Series to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution of a modification of the Covered Bonds of such Series or the related Receipts and/or Coupons or of any of the Transaction Documents (subject as provided below and in the Trust Deed). Such a meeting may be convened by the Issuer, either Group Guarantor, the LLP or the Bond Trustee and shall be convened by the Issuer if required in writing by Covered Bondholders of a Series of Covered Bonds holding not less than five per cent. of the Principal Amount Outstanding of the Covered Bonds of such Series for the time being remaining outstanding. The quorum at any such meeting in respect of any Series of Covered Bonds for passing an Extraordinary Resolution is one or more persons holding or representing not less than 50 per cent. of the Principal Amount Outstanding of the Covered Bonds of such Series for the time being outstanding, or at any adjourned meeting one or more persons being or representing Covered Bondholders of such Series whatever the nominal amount of the Covered Bonds of such Series so held or represented, except that at any meeting the business of which includes the modification of certain provisions of the Covered Bonds of a Series, the related Receipts or the Coupons or the Trust Deed (including a reduction or cancellation of the amount payable in respect of such Covered Bonds, the alteration of the currency in which payments under such Covered Bonds are to be made, the alteration of the majority required to pass an Extraordinary Resolution, any amendment to any of the Guarantees or the Deed of Charge (except in a manner determined by the Bond Trustee not to be materially prejudicial to the interests of the Covered Bondholders of any Series) or the sanction of any scheme or proposal for the exchange of such Covered Bonds in respect of such Series of Covered Bonds (each, a **Series Reserved Matter** all as more particularly set out in the Trust Deed)), the quorum shall be one or more persons holding or representing not less than two-thirds of the Principal Amount Outstanding of the Covered Bonds of such Series for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing not less than one-third of the Principal Amount Outstanding of the Covered Bonds of such Series for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Covered Bondholders of a Series shall, subject as provided below, be binding on all the Covered Bondholders of such Series, whether or not they are present at the meeting, and on all Receiptholders and Couponholders in respect of such Series of Covered Bonds. Pursuant to the



Trust Deed, the Bond Trustee may convene a single meeting of the holders of Covered Bonds of more than one Series if in the opinion of the Bond Trustee there is no conflict between the holders of the such Covered Bonds, in which event the provisions of this paragraph shall apply thereto mutatis mutandis.

Notwithstanding the provisions of the immediately preceding paragraph, any Extraordinary Resolution to direct the Bond Trustee to accelerate the Covered Bonds pursuant to Condition 10 or to direct the Bond Trustee or the Security Trustee to take any enforcement action (each a **Programme Resolution**) shall only be capable of being passed at a single meeting of the holders of the Covered Bonds of all Series then outstanding. Any such meeting to consider a Programme Resolution may be convened by the Issuer, either Group Guarantor, the LLP or the Bond Trustee or by Covered Bondholders of any Series. The quorum at any such meeting for passing a Programme Resolution is one or more persons holding or representing not less than fifty per cent. in aggregate of the Principal Amount Outstanding of the Covered Bonds of all Series for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing Covered Bonds whatever the nominal amount of the Covered Bonds of any Series so held or represented. A Programme Resolution passed at any meeting of the Covered Bondholders of all Series shall be binding on all Covered Bondholders of all Series, whether or not they are present at the meeting, and on all related Receiptholders and Couponholders in respect of such Series of Covered Bonds.

In connection with any meeting of the holders of Covered Bonds of more than one Series where such Covered Bonds are not denominated in sterling, the nominal amount of the Covered Bonds of any Series not denominated in sterling shall be converted into sterling at the relevant Covered Bond Swap Rate.

The Bond Trustee, the Security Trustee and the Issuer may also agree, without the consent of the Covered Bondholders, Receiptholders or Couponholders of any Series and without the consent of the other Secured Creditors (and for this purpose the Bond Trustee and the Security Trustee may disregard whether any such modification relates to a Series Reserved Matter), to:

- (a) any modification of the Covered Bonds of one or more Series, the related Receipts and/or Coupons or any Transaction Document provided that (i) in the opinion of the Bond Trustee and the Security Trustee such modification is not materially prejudicial to the interests of any of the Covered Bondholders of any Series or any of the other Secured Creditors (other than the LLP and the Sellers) (in which respect the Bond Trustee and the Security Trustee may rely upon the consent in writing of any other Secured Creditor as to the absence of material prejudice to the interests of such Secured Creditor) and (ii) it has not been informed in writing by any Secured Creditor (other than any Covered Bondholder(s)) that such Secured Creditor will be materially prejudiced thereby (other than a Secured Creditor who has given his/her written consent as aforesaid); or
- (b) any modification of the Covered Bonds of any one or more Series, the related Receipts and/or Coupons or any Transaction Document which is of a formal, minor or technical nature or is made to correct a manifest error or an error established as such to the satisfaction of the Bond Trustee or to comply with mandatory provisions of law.

The Bond Trustee may also agree, without the consent of the Covered Bondholders of any Series, the related Receiptholders and/or Couponholders or any other Secured Creditor, to the waiver or authorisation of any breach or proposed breach of any of the provisions of the Covered Bonds of any Series, or determine, without any such consent as aforesaid, that any HBOS Event of Default or LLP Event of Default or Potential HBOS Event of Default or Potential LLP Event of Default shall not be treated as such, where, in any such case, it is not, in the opinion of the Bond Trustee, materially prejudicial to the interests of any of the Secured Creditors (in which respect the Bond Trustee may (without further enquiry) rely upon the consent in writing of any other Secured Creditor as to the absence of material prejudice to the interests of such Secured Creditor) provided that the Bond Trustee has not been informed by any Secured Creditor (other than any

Covered Bondholder(s)) that such Secured Creditor will be materially prejudiced thereby (other than a Secured Creditor who has given its written consent as aforesaid).

Any such modification, waiver, authorisation or determination shall be binding on all Covered Bondholders of all Series of Covered Bonds for the time being outstanding, the related Receiptholders and the Couponholders and the other Secured Creditors, and unless the Security Trustee and the Bond Trustee otherwise agree, any such modification shall be notified by the Issuer to the Covered Bondholders of all Series of Covered Bonds for the time being outstanding and the other Secured Creditors in accordance with the relevant terms and conditions as soon as practicable thereafter.

In connection with the exercise by it of any of its trusts, powers, authorities and discretions (including, without limitation, any modification, waiver, authorisation, determination or substitution), the Bond Trustee and the Security Trustee shall have regard to the general interests of the Covered Bondholders of each Series as a class (but shall not have regard to any interests arising from circumstances particular to individual Covered Bondholders, Receiptholders or Couponholders whatever their number) and, in particular but without limitation, shall not have regard to the consequences of any such exercise for individual Covered Bondholders, the related Receiptholders, Couponholders (whatever their number) resulting from their being for any purpose domiciled or resident in, or otherwise connected with, or subject to the jurisdiction of, any particular territory or any political sub-division thereof and the Bond Trustee and the Security Trustee shall not be entitled to require, nor shall any Covered Bondholder, Receiptholder or Couponholder be entitled to claim, from the Issuer, either of the Group Guarantors, the LLP, the Bond Trustee, the Security Trustee or any other person any indemnification or payment in respect of any tax consequences of any such exercise upon individual Covered Bondholders, Receiptholders and/or Couponholders, except to the extent already provided for in Condition 8 and/or in any undertaking or covenant given in addition to, or in substitution for, Condition 8 pursuant to the Trust Deed.

Provided that the Bond Trustee and the Security Trustee shall have received a certificate of two directors of the Issuer and the relevant Group Guarantor and a certificate of a Designated Member of the LLP stating that immediately after giving effect to such transaction no HBOS Event of Default (in respect of the Issuer or the relevant Group Guarantor) or LLP Event of Default, respectively and no Potential HBOS Event of Default (in respect of the Issuer or the relevant Group Guarantor) or Potential LLP Event of Default, respectively, shall have happened and be continuing and certain other conditions as are specified in the Trust Deed are satisfied, but without the consent of the Covered Bondholders of any Series of Covered Bonds for the time being outstanding or of the holders of the Coupons and Receipts appertaining thereto, or of any other Secured Creditor: (a) either Group Guarantor may assume the obligations of the Issuer as principal obligor under the Trust Deed and all other Transaction Documents in respect of all Series of Covered Bonds subject to the Covered Bonds of all Series being or remaining unconditionally guaranteed by the Group Guarantors on the same basis (save for such Group Guarantor to become the principal obligor) or (b) another Subsidiary (as defined in the Trust Deed) of either Group Guarantor may assume the obligations of the Issuer as principal obligor under the Trust Deed and the other Transaction Documents in respect of all Series of Covered Bonds subject to the Covered Bonds of all Series being or remaining unconditionally guaranteed by the Group Guarantors on the same basis. The Trust Deed provides that any such assumption shall be notified to the holders of all Series of Covered Bonds (in accordance with the relevant terms and conditions of such Covered Bonds).

Provided that the Bond Trustee and the Security Trustee shall have received a certificate of two directors of the Issuer and the relevant Group Guarantor and a certificate of a Designated Member of the LLP stating that immediately after giving effect to such resignation or assumption no HBOS Event of Default (in respect of the Issuer or the relevant Guarantor) and no LLP Event of Default, respectively, and no Potential HBOS Event of Default (in respect of the Issuer or the relevant Guarantor) and no Potential LLP Event of Default, respectively, shall have happened and be continuing and certain other conditions as are specified in

the Trust Deed are satisfied, but without the consent of the Covered Bondholders of any Series of Covered Bonds for the time being outstanding or of the holders of the Coupons and the Receipts appertaining thereto or any other Secured Creditor, HBOS and/or Bank of Scotland (each in their capacity as Group Guarantor) may resign as a Group Guarantor (or Group Guarantors) provided that the long-term unsecured, unsubordinated and unguaranteed debt ratings of the Issuer (if independently rated) or any remaining Group Guarantor or any Replacement Guarantor are at least equal to the ratings (at the time of the resignation) of the highest rated Group Guarantor and for such purpose **Replacement Guarantor** means any other member of the HBOS Group (as defined in the Trust Deed) who assumes the obligations of the resigning Guarantor (or Guarantors) under the Trust Deed in respect of such Covered Bonds. The Trust Deed provides that any such resignation or assumption shall be notified to the holders of such Covered Bonds (in accordance with the relevant terms and conditions of such Covered Bonds).

The Issuer and the Group Guarantors may each, without the consent of the holders of the Covered Bonds of any Series or any Receipts or Coupons relating thereto, or any other Secured Creditor consolidate with, merge or amalgamate into or transfer their respective assets substantially as an entirety to, any corporation organised under the laws of the United Kingdom, or any political subdivision thereof, provided that (i) a certificate of two Directors of the Issuer and the Group Guarantors and a certificate of a Designated Member of the LLP is delivered to the Bond Trustee and the Security Trustee to the effect that immediately after giving effect to such transaction no HBOS Event of Default in respect of the Issuer or the relevant Group Guarantor and no LLP Event of Default, respectively, and no Potential HBOS Event of Default in respect of the Issuer or the relevant Group Guarantor and no Potential LLP Event of Default, respectively, will have happened and be continuing and (ii) unless the Issuer or either Group Guarantor, as the case may be, is the surviving entity, the Issuer or, as the case may be, either Group Guarantor shall procure that the surviving or transferee company assumes its obligations as Issuer or, as the case may be, Group Guarantor under the Trust Deed, each other relevant Transaction Document and all of the outstanding Covered Bonds of all Series, in place of the Issuer or, as the case may be, either Group Guarantor and (iii) in the case of an assumption of the obligations of the Issuer by a successor or transferee company, the guarantee of both Group Guarantors and the guarantee of the LLP are fully effective on the same basis in relation to the obligations of such successor or transferee company and (iv) certain other conditions set out in the Trust Deed are met. Upon the assumption of the obligations of the Issuer or either Group Guarantor by such surviving or transferee company, the predecessor Issuer or Group Guarantor, as the case may be, shall (subject to the provisions of the Trust Deed) have no further liabilities under or in respect of the Trust Deed or the outstanding Covered Bonds of each Series then outstanding or any Coupons or Receipts appertaining thereto and the other Transaction Documents. Any such assumption shall be subject to the relevant provisions of the Trust Deed. The Trust Deed provides that any such assumption shall be notified to the holders of all Series of Covered Bonds in accordance with the relevant terms and conditions of such Covered Bonds and the other Secured Creditors.

For the purposes hereof:

**Potential HBOS Event of Default** means any condition, event or act which, with the lapse of time and/or the issue, making or giving of any notice, certification, declaration, demand, determination and/or request and/or the taking of any similar action and/or the fulfilment of any similar condition, would constitute an HBOS Event of Default.

**Potential LLP Event of Default** means any condition, event or act which, with the lapse of time and/or the issue, making or giving of any notice, certification, declaration, demand, determination and/or request and/or the taking of any similar action and/or the fulfilment of any similar condition, would constitute an LLP Event of Default.

**Rating Agency Confirmation** means a confirmation in writing by the Rating Agencies that the then current ratings of the Covered Bonds will not be adversely affected by or withdrawn as a result of the relevant event or matter.

#### **16. INDEMNIFICATION OF THE BOND TRUSTEE AND/OR SECURITY TRUSTEE AND BOND TRUSTEE AND/OR SECURITY TRUSTEE CONTRACTING WITH THE ISSUER AND/OR BANK OF SCOTLAND AND/OR HBOS AND/OR THE LLP**

If, in connection with the exercise of its powers, trusts, authorities or discretions, the Bond Trustee or the Security Trustee is of the opinion that the interests of the holders of the Covered Bonds of any one or more Series would be materially prejudiced thereby, the Bond Trustee or the Security Trustee shall not exercise such power, trust, authority or discretion without the approval of such Covered Bondholders by Extraordinary Resolution or by a written resolution of such Covered Bondholders of not less than fifty per cent. of the Principal Amount Outstanding of Covered Bonds of the relevant Series then outstanding.

The Trust Deed and the Deed of Charge contain provisions for the indemnification of the Bond Trustee and the Security Trustee and for their relief from responsibility, including provisions relieving them from taking any action unless indemnified and/or secured to their satisfaction.

The Trust Deed and the Deed of Charge also contain provisions pursuant to which each of the Bond Trustee and Security Trustee, respectively, is entitled, *inter alia*, (i) to enter into business transactions with the Issuer, either of the Group Guarantors, the LLP and/or any of their respective Subsidiaries and affiliates and to act as trustee for the holders of any other securities issued or guaranteed by, or relating to, the Issuer, either of the Group Guarantors, the LLP and/or any of their respective Subsidiaries and affiliates, (ii) to exercise and enforce its rights, comply with its obligations and perform its duties under or in relation to any such transactions or, as the case may be, any such trusteeship without regard to the interests of, or consequences for, the Covered Bondholders, Receiptholders or Couponholders or the other Secured Creditors and (iii) to retain and not be liable to account for any profit made or any other amount or benefit received thereby or in connection therewith.

Neither the Bond Trustee nor the Security Trustee will be responsible for any loss, expense or liability, which may be suffered as a result of any Loans or Related Security, or any deeds or documents of title thereto, being uninsured or inadequately insured or being held by clearing organisations or their operators or by intermediaries such as banks, brokers or other similar persons on behalf of the Bond Trustee and/or the Security Trustee. Neither the Bond Trustee nor the Security Trustee will be responsible for (i) supervising the performance by the Issuer or any other party to the Transaction Documents of their respective obligations under the Transaction Documents and the Bond Trustee and the Security Trustee will be entitled to assume, until they each have written notice to the contrary, that all such persons are properly performing their duties; (ii) considering the basis on which approvals or consents are granted by the Issuer or any other party to the Transaction Documents under the Transaction Documents; (iii) monitoring the Portfolio, including, without limitation, whether the Portfolio is in compliance with the Asset Coverage Test, the Pre-Maturity Liquidity Test or the Amortisation Test; or (iv) monitoring whether Loans and Related Security satisfy the Eligibility Criteria. Neither the Bond Trustee nor the Security Trustee will be liable to any Covered Bondholder or other Secured Creditor for any failure to make or to cause to be made on their behalf the searches, investigations and enquiries which would normally be made by a prudent chargee in relation to the Security and have no responsibility in relation to the legality, validity, sufficiency and enforceability of the Security and the Transaction Documents.

## 17. FURTHER ISSUES

The Issuer shall be at liberty from time to time without the consent of the Covered Bondholders, the Receiptholders or the Couponholders to create and issue further bonds having terms and conditions the same as the Covered Bonds of any Series or the same in all respects save for the amount and date of the first payment of interest thereon, issue date and/or purchase price and so that the same shall be consolidated and form a single Series with the outstanding Covered Bonds of such Series.

## 18. CONTRACTS (RIGHTS OF THIRD PARTIES) ACT 1999

No person shall have any right to enforce any term or condition of this Covered Bond under the Contracts (Rights of Third Parties) Act 1999, but this does not affect any right or remedy of any person which exists or is available apart from that Act.

## 19. GOVERNING LAW AND SUBMISSION TO JURISDICTION

### (a) *Governing law*

The Trust Deed, the Agency Agreement, the Deed Poll, the Covered Bonds, the Receipts, the Coupons and the other Transaction Documents (other than each Scottish Declaration of Trust, certain documents to be granted pursuant to the Deed of Charge and the Corporate Services Agreement) are governed by, and shall be construed in accordance with, English law unless specifically stated to the contrary. Each Scottish Declaration of Trust is governed by, and shall be construed in accordance with, Scots law. Certain documents to be granted pursuant to the Deed of Charge will be governed by, and construed in accordance with, Scots law. The Corporate Services Agreement is governed by, and shall be construed in accordance with, Jersey law.

### (b) *Submission to jurisdiction*

Each of the Group Guarantors agrees, for the exclusive benefit of the Bond Trustee, the Covered Bondholders, the Receiptholders, the Couponholders and the other Secured Creditors, that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Trust Deed, the Covered Bonds, the Receipts, the Coupons and/or the other Transaction Documents and that accordingly any suit, action or proceedings (together referred to as **Proceedings**) arising out of or in connection with the Trust Deed, the Covered Bonds, the Receipts, the Coupons and the other Transaction Documents (other than each Scottish Declaration of Trust, certain documents to be granted pursuant to the Deed of Charge and the Corporate Services Agreement) may be brought in such courts.

Each of the Group Guarantors hereby irrevocably waives any objection which it may have now or hereafter to the laying of the venue of any such Proceedings in any such court and any claim that any such Proceedings have been brought in an inconvenient forum and hereby further irrevocably agrees that a judgment in any such Proceedings brought in the English courts shall be conclusive and binding upon it and may be enforced in the courts of any other jurisdiction.

Nothing contained in this Condition shall limit any right to take Proceedings against either of the Group Guarantors in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings in any other jurisdiction, whether concurrently or not.

(c) *Appointment of Process Agent*

Each of the Group Guarantors appoints the Issuer at its registered office at 33 Old Broad Street, London EC2N 1HZ for the attention of the Head of Legal and Regulatory Risk as its agent for service of process, and undertakes that, in the event of the Issuer ceasing so to act or ceasing to be registered in England, it will appoint another person approved by the Trustee as its agent for service of process in England in respect of any Proceedings. Nothing herein shall affect the right to serve proceedings in any other manner permitted by law.

## USE OF PROCEEDS

The Sterling Equivalent of the gross proceeds from each issue of Covered Bonds will be used by the Issuer to make available Term Advances to the LLP pursuant to the terms of the Intercompany Loan Agreement, which in turn shall be used by the LLP either:

- (i) to acquire Loans and their Related Security or to invest the same in Substitution Assets up to the prescribed limit; and/or
- (ii) if an existing Series, or part of an existing Series, of Covered Bonds is being refinanced by such issue of Covered Bonds, to repay the Term Advance(s) corresponding to the Covered Bonds being so refinanced; and/or
- (iii) to deposit all or part of the proceeds into the GIC Account and/or subject to written confirmation from the LLP that the Asset Coverage Test is met on the relevant Issue Date (both before and immediately following the making of the relevant Term Advance), to make a Capital Distribution to any Seller (in its capacity as a Member) by way of distribution of that Member's equity in the LLP in an amount equal to the Term Advance or any part thereof, which is to be paid to the Member on the relevant Issue Date by telegraphic transfer or as otherwise directed by the Member.



## THE ISSUER

### Introduction

The Issuer, a direct, wholly owned subsidiary of Bank of Scotland, was registered in England and Wales in the register of companies on 26 February 1992, as Bank of Scotland Treasury Services PLC (registered number 2692890), a public limited company under the Companies Act 1985, for the purpose of taking over and developing Bank of Scotland's treasury operations. Following the merger of Halifax Group plc and Bank of Scotland in 2001, substantially all of the treasury business of Halifax Group plc was transferred to the Issuer with effect from 1 June 2002. On 14 June 2002, the Issuer changed its name from Bank of Scotland Treasury Services PLC to HBOS Treasury Services plc. The Issuer is an "authorised person" under the FSMA. The Issuer's registered office is located at 33 Old Broad Street, London EC2N 1HZ, England, with telephone no. 00 44 20 7574 8000.

### HBOS Group Reorganisation Act

On the Effective Date, the business conducted by the Issuer will be consolidated into Bank of Scotland plc. At that date, Bank of Scotland plc will also assume all outstanding obligations of the Issuer, including its obligations in respect of the Covered Bonds previously issued under this Programme.

### Business

The Issuer provides centralised wholesale multi-currency funding, liquidity management and treasury services to HBOS and its subsidiary undertakings in the United Kingdom, Ireland, Australia and to Bank of Scotland's New York branch in the United States.

The Issuer manages the market risk arising from the HBOS Group's Retail and Corporate Divisions. It operates in the world's foreign exchange and money markets and also provides a range of treasury services to certain of the HBOS Group's customers from its office in London and its branches in Glasgow, Grand Cayman, New York and Sydney. The Issuer's branch in Grand Cayman operates under license from the Cayman Islands Monetary Authority. The Issuer's New York branch operates under the supervision of the Office of the Comptroller of the Currency and oversight of the Board of Governors of the Federal Reserve System.

The Issuer is registered as a foreign company in Australia and operates its branch in Sydney under authority from the Australian Prudential Regulation Authority to carry on banking business in Australia. An Australian Financial Services license from the Australian Securities and Investments Commission is held by the Issuer to enable it to provide financial product advice, dealing services and market making services in connection with foreign exchange, derivatives, securities and certain other financial products.

Trading transactions are undertaken to accommodate customer and HBOS Group requirements, whilst proprietary activity is maintained within approved limits. The Issuer manages the treasury investment portfolio for the HBOS Group. The Issuer leads the debt capital issuance and asset securitisation activities of the HBOS Group.

From and after the Effective Date, these business activities will be performed directly by Bank of Scotland plc.

## **Major Shareholders**

The Issuer is (and until the Effective Date will continue to be) a wholly owned subsidiary of Bank of Scotland.

## **HBOS Treasury Services plc, Sydney Branch**

The Issuer was registered as a foreign company in Australia on 23 September 2004 and on 6 July 2005 received authority from the Australian Prudential Regulation Authority to carry on banking business in Australia.

On 4 August 2005, the Issuer was issued its Australian Finance Services License by the Australian Securities and Investments Commission permitting the Issuer to provide financial product advice, dealing services and market services in connection with foreign exchange, derivatives, securities and certain other financial products.

The registered office of the branch of the Issuer in Sydney is located at Level 25, 45 Clarence Street, Sydney NSW 2000 Australia.

## **Subsidiaries of the Issuer**

The Issuer has eleven subsidiaries, all investment companies, eight of which are incorporated in the Cayman Islands, two of which are incorporated in England and Wales, with the remaining subsidiary being incorporated in Scotland.

## MANAGEMENT

### Board of Directors of the Issuer

Name	Position in the Issuer	Principal outside activities (if any) of significance to the Issuer
*Colin Matthew	Chairman	Chief Executive, Strategy, International, Treasury & Asset Management, HBOS plc
Lindsay Mackay	Executive Director and Chief Executive	—
John Anderson	Executive Director and Head of Operations	—
Peter Harlow	Executive Director and Head of Risk	—
Stephen Krag	Executive Director and Chief Operating Officer	—
Clifford Pattenden	Executive Director and Head of Treasury	—
David Smith	Executive Director and Head of Sydney Branch	—
Mike Wooderson	Non-executive Director	Divisional Chief Executive, Europe and North America, HBOS plc

*The business address for the Board is 33 Old Broad Street, London EC2N 1HZ.*

### Conflicts of Interest

No potential conflicts of interest exist at the date of this Offering Circular between the duties of the directors to the Issuer and their private interests or other duties.

\* Phil Hodkinson resigned as Chairman on 9th May 2007. Colin Matthew was appointed to the Board on 9th May 2007.

1 Based on a comparison of HBOS Group's UK residential mortgage book as against market size information taken from Bank of England statistics.

## HBOS

### Introduction

HBOS plc is the holding company of the HBOS Group. HBOS currently has four principal subsidiaries: Halifax, Bank of Scotland, HBOS Insurance & Investment Group Limited and Halifax Share Dealing Limited. Halifax and Bank of Scotland are among the largest commercial banks in the United Kingdom. HBOS together with its subsidiaries and subsidiary undertakings (as defined in the Companies Act) are collectively referred to as the **HBOS Group**.

HBOS was incorporated and registered in Scotland in the register of companies on 3 May 2001, with registered number SC 218813 as a public limited company under the Companies Act 1985 (the **Companies Act**). As a consequence of the approval of schemes of arrangement for Bank of Scotland and Halifax, which became effective in 2001, HBOS became the holding company of the HBOS Group. The principal legislation under which HBOS operates is the Companies Act. The registered office and head office of HBOS in the United Kingdom is at The Mound, Edinburgh EH1 1YZ, telephone no. 0870 600 500. The HBOS Group is a diversified financial services group engaged in a range of banking, insurance broking, financial services and finance-related activities throughout the United Kingdom and internationally.

### HBOS Group Reorganisation Act

On 21 June 2006, the HBOS Group Reorganisation Act of 2006 (the **HBOS Group Reorganisation Act**) received Royal Assent. Pursuant to the provisions of the HBOS Group Reorganisation Act, on a date to be determined by HBOS (the **Effective Date**), which is currently expected to be on or around 17 September 2007, Bank of Scotland will become registered as a public limited company under the Companies Act and will change its name to Bank of Scotland plc. On the same day, under the HBOS Group Reorganisation Act, Bank of Scotland plc will, as universal successor, succeed to and assume all of the business, assets and liabilities of Halifax, Capital Bank plc and HBOSTS (the **Transferor Entities**). Bank of Scotland plc shall as of the Effective Date assume any existing obligations (including any Covered Bonds which are issued and outstanding) relating to the Transferor Entities. This series of transactions is referred to as the **HBOS Group Reorganisation**.

The largest impact on the balance sheet of Bank of Scotland plc relating to the HBOS Group Reorganisation will be the assumption of the assets and liabilities of Halifax. For the year ended 31 December 2006, Halifax profit before taxation was £1,913 million (as compared to the profit before taxation of £5,706 million for HBOS Group) and as at 31 December 2006 Halifax's total assets were £363,772 million (as compared with total assets of £591,029 million for HBOS). Prospective investors who wish to more fully appreciate the implications of the consolidation of Halifax into Bank of Scotland plc are referred to the Halifax Financial Statements, which are incorporated by reference in this Offering Circular.

Unlike Halifax, both Capital Bank plc (total assets of £21,370 million as at 31 December 2006) and the Issuer (total assets of £374.5 billion as at 31 December 2006) are Bank of Scotland subsidiaries and the consolidation of their respective businesses into Bank of Scotland plc will not significantly affect Bank of Scotland plc's consolidation balance sheet on a pro-forma basis. Furthermore, since all such businesses will continue to be wholly-owned (directly or indirectly) by HBOS, there will be no significant impact on the consolidated balance sheet of the HBOS Group.

### Strategy

HBOS has emerged as one of the leading financial services groups in the United Kingdom. Its overall strategy focuses on five key elements: growing its franchise in the United Kingdom; targeting specific

international growth segments; achieving cost leadership; developing the capability, motivation and performance of its employees; and maintaining capital discipline. While management is determined to implement this strategy in the year ahead, there can be no assurance that it will achieve its stated objectives, which will be affected by a range of competitive, market, regulatory and other factors described elsewhere in this Offering Circular. This overall strategy may also need to be adjusted from time to time as circumstances warrant.

### ***Growth in United Kingdom Franchise***

HBOS's number one priority is to grow its businesses in the United Kingdom. Its Retail division currently serves approximately 23 million customers through a variety of different brands. Given its customer base and distribution strength, however, HBOS's aim is to achieve a market share of between 15 per cent. and 20 per cent. in all the markets in which it operates. Currently, only two products, mortgages and savings, fall within or ahead of that range. Accordingly, HBOS intends to focus on improving its United Kingdom current market share in banking, credit cards, personal loans, household insurance, business banking, investment and motor insurance.

In the Corporate division, HBOS's activities concentrate on markets where it has real expertise and can generate superior returns. Thus, HBOS generally covers corporate customers from FTSE 250 companies to small- and medium-sized companies with a turnover in excess of £1 million. Additionally, HBOS has growing businesses in asset finance, motor asset finance sold at point of sale and real estate. HBOS's Integrated Finance business provides an array of funding solutions (from senior debt through mezzanine financing to equity) with a view to creating long term, value-creating partnerships with its customers.

With respect to the Insurance & Investment division, HBOS believes it is well-placed to benefit from the opportunities that being the largest liquid saver in the United Kingdom provides. HBOS expects that this, together with what it considers increasingly supportive demographics and the recognition by individuals that they will require to self-provide for retirement, will drive growth in investment sales in the United Kingdom. In general insurance, HBOS intends to benefit from the opportunities that being the number one mortgage lender in the United Kingdom affords in increasing household insurance sales.

### ***Targeted International Growth***

HBOS's international strategy is to grow its business by adopting in other areas that fit its growth model the same formula that has been successful in the United Kingdom. In Australia, where HBOS has been operating for over ten years, it is expanding on its strong presence in Western Australia and taking its commercial and retail banking capability to the eastern states of Australia.

In Ireland, where HBOS has been active in the economy for well over a decade, it is now expanding into retail banking. In 2005, HBOS bought approximately fifty shops from the Irish Electricity Board and will open the majority as new-style branches by the end of 2007. In Europe & North America, in corporate and retail banking and in European financial services, HBOS is expanding its interest and seeking to capture the synergies open to it by closer cooperation across geographical boundaries.

### ***Cost Leadership***

A third element of HBOS's overall strategy is to ensure that it is being low-cost in such a way that more of revenue growth is converted to profit. Cost leadership provides the strategic flexibility to deliver further revenue growth. Cost leadership at HBOS is not about avoiding or reducing the investment spend but rather ensuring an ability to invest by taking out unproductive cost from operations. HBOS believes that there are a number of opportunities to take out further costs across its businesses. In 2006, HBOS announced a

programme that it intends to deliver at least £300 million of annual savings, around 12 per cent. of its U.K. processing and support costs, by the end of 2009. Allowing for these savings, the costs of achieving them and planned revenue growth, HBOS is targeting its cost:income ratio to fall to the mid-30s by 2010. In 2006 the cost income ratio for HBOS was 40.9 per cent. and in 2005 it was 42.2 per cent..

### ***Colleague Development***

HBOS's ability to execute its strategy and to deliver consistently high-quality products and services to customers relies on the capability, motivation and performance of its employees. HBOS's colleague strategy is very clear. It aims to have the best leadership teams in the industry, and have clear and increasingly high expectations of both what its leaders deliver and how they do this. HBOS believes it offers all of its colleagues the necessary training and personal development they need to do their job well and it aims to create a positive working environment that reflects colleague diversity. HBOS reward systems are strongly geared to both individual and team performance, and the widest possible share ownership by HBOS colleagues. Through its internal surveys, HBOS tracks its leadership and capability indices as well as employer and product advocacy. In addition, HBOS monitors colleague turnover at all levels of the organization.

### ***Capital Discipline***

HBOS's approach is to treat capital as a scarce resource. It takes the view that capital is owned by the shareholders and it accepts its task is to deploy it to achieve sustainable returns. With a return on equity just above 20 per cent. in 2006, HBOS expects it can fund approximately 13 per cent. annual asset growth from internal capital generation. Organic growth is HBOS's first priority, but if it is not growing to its full capital capacity, HBOS intends to hand surplus capital back through its share buy back programme.

HBOS believes in strong capital ratios and manages to a target 8 per cent. Tier 1 capital level and a Tier 1 leverage of 25 per cent. plus/minus 2 per cent. Likewise, HBOS has a strong dividend cover and targets a cover level of around 2.5 times with dividends growing in line with earnings. In 2006, as in 2005, HBOS judged that the right level of asset growth relative to return prospects favored another £1 billion buyback programme. HBOS has achieved its plans to buyback £1 billion of shares in each year and have, as a consequence, cancelled 210 million shares, resulting in a corresponding uplift in earnings per share.

HBOS's logic on buybacks remains consistent. If HBOS sees opportunities for more profitable growth, then it will deploy more of the capital it generates in growing the business. For 2007, HBOS does not see an opportunity to deploy more capital in support of growth than it did in 2006 and will therefore target an initial buyback programme of up to £500 million. As in previous years, HBOS will review the growth, buyback balance at the half year stage.

### **Business**

The HBOS Group's products and services can be categorized into the following business divisions:

- Retail;
- Corporate;
- Insurance & Investment;
- Strategy & International; and
- Treasury & Asset Management.

## ***Retail***

The Retail division provides financial services to over 23 million customers through a broad distribution base (ranging from branches to direct mail, telephone and internet services). Its range of multi-branded products includes personal and business banking services providing mortgages, savings, bank accounts, personal loans and credit cards.

As at 31 December 2006, the HBOS Group was the largest retail mortgage provider in the U.K.,<sup>1</sup> with a market share of residential mortgages of 21 per cent, with balances of approximately £220 billion and customer deposits of more than £144 billion. Mortgages in the United Kingdom are currently provided by the Retail division under five mortgage brands: Halifax, Bank of Scotland, Intelligent Finance, Birmingham Midshires and The Mortgage Business. It is anticipated that, as of the Effective Date, the mortgages currently provided under the Halifax, Intelligent Finance, Birmingham Midshires and Bank of Scotland brands will continue to be provided under those brands by Bank of Scotland plc. It is further expected that mortgages provided under The Mortgage Business brand name will be provided by The Mortgage Business plc, a subsidiary of Bank of Scotland plc.

Savings products are offered through four brands: Halifax, Bank of Scotland, Birmingham Midshires and Intelligent Finance, catering for all segments of the savings market, including children's accounts, tax-free, fixed rate and regular savings accounts. HBOS is the current market leader for savings with a 16 per cent. market share. Bank accounts range from full facilities current accounts to basic social banking facilities. It is anticipated that, as of the Effective Date, the savings products currently provided under the Halifax, Intelligent Finance, Birmingham Midshires and Bank of Scotland brands will continue to be provided under those brands by Bank of Scotland plc (albeit still under their respective brands).

Personal loans and credit cards are offered through the Halifax, Bank of Scotland and Intelligent Finance brands. Credit cards are also provided through a host of affinity-branded credit cards such as charity cards, where a proportion of income earned is donated to the charity. The Retail division also distributes the Group's insurance and investment products on behalf of the Group's Insurance & Investment division and participates in a number of joint ventures, such as Sainsbury's Bank. It is anticipated that, as of the Effective Date, the personal loans and credit cards currently provided under the Halifax and Bank of Scotland brands will continue to be provided under those brands by Bank of Scotland plc.

The Retail division's strategy is to continue to grow its market share of major retail products such that each falls within the 15 per cent.-20 per cent. range. The division intends to implement this strategy through offering products that not only attract new customers but also drive cross-sales to existing customers. Specifically, the Retail division wants to increase the number of customers holding two or more products by one million over the next five years. In addition to growing its market share, the Retail division aims to continue to target growth that achieves the right balance between risk and reward, provides consistently good customer service and keeps tight control of costs.

## ***Corporate***

The Corporate division provides a range of banking services to the corporate business sector. Its principal market is medium-to-large-sized UK-based businesses with an annual turnover in excess of £1 million. The division comprises a number of relationship banking and specialist lending teams. Their responsibilities include the provision of term loans, asset finance, motor finance, multi-currency loans and deposits, mezzanine funding, equity investment, fund investment, joint venture partnerships, working capital finance, project and specialist finance, acquisition finance and syndicated lending. The key objective of these

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<sup>1</sup> Based on a comparison of HBOS Group's U.K. residential Mortgage book as against market size information taken from Bank of England statistics.



teams is to expand and strengthen the HBOS Group's corporate market share by pursuing a relationship-and partnership-driven asset class approach and delivering specialist services to existing and new customers. The European Corporate business, currently part of ENA in the Strategy & International division, will move into Corporate division reporting starting with the 2007 half-year results.

The Corporate division's real estate teams have experience in commercial property finance and offer a range of funding options. The Corporate division's commercial bank is a diverse business focusing on the needs of medium and large businesses. The integrated, structured and acquisition finance teams operate in the leveraged buy-out market, providing a range of financing vehicles to their customers. The private equity business has a reputation for innovative deal making and additionally invests in a number of private equity funds. The asset finance team is charged with coverage of a diverse market sector and is engaged in financing or owning tangible assets (ranging from oil tankers, trains and airplanes to photocopiers, IT and vending machines). The motor business finances single vehicles to fleets of cars, vans and buses. The Oil and Gas team delivers bespoke products to the UK sector. The infrastructure and housing finance teams provide debt funding solutions and risk capital investments in economic and social infrastructure projects via government PFI and PPP projects.

Corporate division's strategy is asset class management, which is applied to establish selective asset growth while preserving strong margins and exercising vigilant credit risk management. To this end, the Corporate division continues to seek quality opportunities at the right price and with the right partners, concentrating on returns rather than volumes and an increasing focus on sell downs. In addition, recognizing that its success is dependent upon the success and prosperity of the communities and the society in which it operates, the Corporate division aims to maintain a leading role in the corporate and social responsibility area. Finally, the Corporate division aims to exercise cost discipline by driving value for money from all expenditures. The Corporate division thus continues to challenge how it can deliver a superior service, from innovation and delivery of differentiating strategic projects, while driving value for money from all expenditure and minimizing costs.

### ***Insurance & Investment***

The Insurance & Investment division is one of the United Kingdom's largest providers of general insurance and investment products, offering multi-brand life, pensions, mutual funds and general insurance products. The division uses a multi-channel, multi-brand operating model which it believes allows it to maximize both distribution reach and product and pricing flexibility. While low-cost access to the large Retail division customer base is a core strength, the division also benefits from solid third party distribution relationships with partners and intermediaries. Products offered by the Insurance & Investment division include savings, investments and pensions, life, household, repayment, travel and motor insurance. Products are distributed through a number of different channels, including branches, independent financial advisers, a dedicated high net worth salesforce and telephone and internet sales.

The Investment businesses focus on structuring and distributing investment funds, bond and pension products. This business mix covers over 80 per cent. of the United Kingdom life, pensions and investment market. The Insurance & Investment division has chosen not to actively market annuities given the longevity risk and capital requirements of such products, and instead offers its customers access to products from other providers via an in-house independent annuity service. The Investment businesses have three distinct distribution channels: Bancassurance, Intermediary and Wealth Management. In Bancassurance, Halifax-branded business is distributed principally through branch-based personal finance advisers with mass affluent and high net worth business sold under the Bank of Scotland Investment Service brand. Clerical Medical branded products are distributed through the Intermediary channel and, in Wealth Management, HBOS owns a 60 per cent. stake in St. James's Place, a leader in the wealth management market.

The General Insurance business focuses on household, repayment and motor insurance. The Retail division's distribution network serves as the Insurance & Investment division's core distribution channel for household insurance. However, increasingly sales of household insurance are being made through partners and intermediaries and direct to customers via e-commerce and telephone channels. Repayment insurance products are also distributed through the Retail division's network as well as a number of large third party relationships.

The esure joint venture underwrites all of the motor insurance under the esure, Sheilas' Wheels, First Alternative, Halifax and Sainsbury's Bank brands. Distribution takes place largely through esure's direct channels as well as in Sainsbury's supermarkets and the Retail branch network.

The goal of the Insurance & Investment division is to be the United Kingdom's leading insurance and investment group, acting through its multi-channel, multi-brand operating model and accessing the significant HBOS customer base to grow profitable market share. Specifically, to implement this strategy, the Insurance & Investment division seeks to grow the market share of personal lines insurance, recognizing that there are significant opportunities through the Retail division's network, intermediaries and joint ventures to grow market share, with a particular focus on using HBOS's leading position in mortgages to grow market share in household insurance. Moreover, the Insurance & Investment division aims to grow its market share of investment products, using its place as part of the United Kingdom's largest liquid savings provider to benefit from higher savings ratios, supporting demographics and what the Insurance & Investment division believes is the increasing recognition by individuals that they will need to save for their retirement themselves. Finally, the Insurance & Investment division intends to place an emphasis on increasing customer satisfaction and maintaining cost leadership through maximum efficiency.

### ***Strategy & International***

The Strategy & International division is responsible for the development of the HBOS Group's strategic direction (including mergers and acquisitions (**M&A**) activity) and has divisional responsibility for the HBOS Group's main overseas interests in Australia, Ireland, Europe & North America (**ENA**). It consists of the following teams: (i) Group Strategy, which assists the HBOS Group's executive in the development of HBOS Group strategy in the United Kingdom and overseas, and oversees the implementation of strategic initiatives, that are controlled at Group level; (ii) International Operations, which oversees credit risk across Strategy & International; (iii) Bank of Scotland (Ireland) which focuses on providing banking solutions to small and medium-sized enterprises in Ireland and has recently moved into full service retail banking; (iv) HBOS Australia, a full service offering in Australia; (v) ENA, which encompasses the Group's businesses in Europe and North America; and (vi) Public Policy, which manages the Group's interface with external policy and regulatory bodies.

The Strategy & International division consists of three distinct businesses in Australia, Ireland and ENA. In Australia, the division's retail and commercial businesses operate under the BankWest brand with a strong presence in Western Australia and what HBOS believes to be a growing presence nationally. The division's insurance & investment businesses in Australia operate under the St. Andrew's brand and the division's Australian corporate banking businesses, based in Sydney, operate under the BOS International brand. These provide, principally, mergers and acquisition finance, real estate lending and infrastructure/project finance. In Australia, the division's asset finance business operates under the Capital Finance brand.

In Ireland, the division has become established in the business banking and intermediary markets, operating under Bank of Scotland (Ireland's) brand. The division has targeted establishing a full-service bank in Ireland during 2007 and, to that end, it is in the process of developing a nationwide branch network that will support the delivery of a more complete range of retail banking products, including current accounts.

Using the Halifax name, HBOS expects the bank will offer simple, value-for-money retail products aimed at overcoming customer inertia and creating clear differentiation from competitor offerings.

In ENA, Corporate North America focuses on sectors in which HBOS has experience, including oil and gas, gaming and real estate. The retail activities consist of Banco Halifax Hispania, an expanding branch network in Spain and an online and intermediary mortgage business, BOS Netherlands. The investment business provides life insurance and pensions, predominantly to the German investment market through the Clerical Medical Europe and Heidelberger Leben brands. The European corporate business, currently part of ENA, will move into Corporate division reporting in the 2007 half-year results.

Public Policy seeks to identify the agenda of public policy decision makers whenever in the world HBOS Group has business interests and develop an internal understanding of these agendas; facilitate HBOS Group's positioning on policy developments; and engage and support senior executives in public policy formation and influencing.

Seeking to apply to certain targeted areas the same approach that HBOS considers to have been successful in the United Kingdom, the Strategy & International division's ongoing strategies include growing nationally across Australia, creating a full service bank in Ireland as discussed above, growing products and sector specialisms in ENA and maintaining overall cost leadership.

### ***Treasury & Asset Management***

Treasury is the centralized treasury for the HBOS Group. The Treasury team provides and manages prudential and regulatory liquidity and wholesale multi-currency funding for the HBOS Group. It arranges the HBOS Group's debt capital issuance and asset securitisation programmes and offers a range of treasury services to HBOS Group customers. Treasury has branches in London, Sydney, New York and Glasgow and has management responsibility for the treasury activities of Bank of Scotland (Ireland) limited.

Asset Management, comprised of Insight Investment Management Limited (**Insight**) and Invista Real Estate Management plc (**Invista**) and their respective subsidiary companies, comprises the investment management business within the HBOS Group. It provides investment management services, investment advisory services and is also a retailer of open-ended investment companies and other investment vehicles.

Insight is one of the largest United Kingdom fund managers, with funds under management of £98.6 billion. It operates a multi-channel business, managing money for the Group, retail investors, pension funds, insurance groups and other institutions. Insight's strategic product lines are Fixed Income, Cash, Liability Driven Investment, Equities and Absolute Return.

Invista was formed following the initial public offering of the real estate division of Insight and is the largest U.K.-listed real estate fund manager with funds under management of £9.2 billion. Invista currently manages sixteen real estate funds spread across the United Kingdom and continental Europe. This includes five funds managed on behalf of the Group as well as other funds managed on behalf of third party clients.

The Treasury & Asset Management strategy involves the provision and management of the Group's funding and liquidity requirements to ensure it has sufficient financial resources to deliver its strategy, including maintaining a balance of short- and medium-term funding. In addition, the division seeks to deliver top quality service to the Group and its customers supported by the appropriate level of investment in systems and infrastructure. The division intends to maximize cross-selling opportunities with Group customers, leveraging its product innovation and capability in the market to drive sales levels. With respect to Asset Management, HBOS is of the view that investment performance is at the heart of asset management, and accordingly the division will focus on the delivery of superior investment returns by focusing on those products that have a proven track record of exceptional performance.

## *Recent Developments*

The HBOS Group has announced plans for a reorganisation of its European Corporate business pursuant to which that business, currently part of ENA in the Strategy & International division, will move into Corporate division reporting starting with the 2007 half-year results.

## *Principal HBOS Group Subsidiaries*

HBOS is the holding company of the HBOS Group. The following table shows the principal direct and indirect subsidiary undertakings of HBOS which HBOS believes are likely to have a significant effect on the assessment of the assets and liabilities, the financial position and/or the profits and losses of the HBOS Group and HBOS's percentage interest in those companies. Under the HBOS Group Reorganisation Act, Bank of Scotland will change its name to Bank of Scotland plc and succeed to the business, assets and liabilities of certain HBOS subsidiaries as of the Effective Date. We have footnoted below those companies affected by the change.

<b>Company</b>	<b>Activity</b>	<b>Total % of ordinary share capital held (directly or indirectly) by HBOS</b>	<b>Country of incorporation or registration</b>	<b>Registered office/head office</b>
The Governor and Company of Bank of Scotland <sup>1</sup>	Banking, financial and related services	100	Scotland	The Mound Edinburgh EH1 1YZ
HBOS Treasury Services plc <sup>2</sup>	Banking	100	England and Wales	33 Old Broad Street London EC2N 1HZ
Bank of Scotland (Ireland) Limited	Banking	100	Ireland	Bank of Scotland House 124-127 St. Stephen's Green, Dublin 2 Ireland
Capital Bank plc <sup>2</sup>	Banking and personal finance	100	England and Wales	Capital House Queens Park Road Handbridge Chester CH88 3AN
HBOS Australia Pty Limited	Banking	100	Australia	Bankwest Tower 108 St Georges Terrace Perth Australia WA 6000
Bank of Western Australia Limited	Banking	100	Australia	Bankwest Tower 108 St Georges Terrace Perth Australia WA 6000
Halifax plc <sup>2</sup>	Banking	100	England and Wales	Trinity Road Halifax West Yorkshire HX1 2RG
Halifax Share Dealing Limited	Execution only stockbroking	100	England and Wales	Trinity Road Halifax West Yorkshire HX1 2RG
HBOS Insurance & Investment Group Limited	Investment holding	100	England and Wales	Trinity Road Halifax West Yorkshire HX1 2RG
Halifax General Insurance Services Limited	General insurance brokerage	100	England and Wales	Trinity Road Halifax West Yorkshire HX1 2RG
St Andrews Insurance plc	General insurance	100	England and Wales	St Andrews House Portsmouth Road Esher Surrey KT10 9SA

<b>Company</b>	<b>Activity</b>	<b>Total % of ordinary share capital held (directly or indirectly) by HBOS</b>	<b>Country of incorporation or registration</b>	<b>Registered office/head office</b>
Clerical Medical Investment Group Limited	Life assurance	100	England and Wales	33 Old Broad Street London EC2N 1HZ
Halifax Life Limited	Life assurance	100	England and Wales	Trinity Road Halifax West Yorkshire HX1 2RG
Halifax Investment Fund Managers Limited	OEIC management	100	England and Wales	Trinity Road Halifax West Yorkshire HX1 2RG
Insight Investment Management Limited	Investment management	100	England and Wales	33 Old Broad Street London EC2N 1HZ
Invista Real Estate Investment Management Holdings plc	Real Estate Fund Management	55	England and Wales	33 Old Broad Street London EC2N 1HZ
St James's Place Capital plc	Financial services	60	England and Wales	St James's Place House Dollar Street Cirencester GL7 2AQ

1 As of the Effective Date, The Governor & Company of the Bank of Scotland will become a public limited company registered under the Companies Act 1985 and will change its corporate name to Bank of Scotland plc.

2 As of the Effective Date, all assets and liabilities will be transferred to Bank of Scotland plc.

## **Employees**

The HBOS Group employed on average 57,884 people on a full-time basis and 16,368 people on a part-time basis during the year ended 31 December 2006. Certain of the HBOS Group's employees in the United Kingdom are members of the unions AMICUS and ACCORD, both of which are recognized by the HBOS Group as representing the interests of such employees. The HBOS Group considers its relations with its employees to be satisfactory.

## **Properties**

As at 31 December 2006, HBOS Group operated throughout the world, principally in the United Kingdom, from both freehold and leasehold properties.

## **Competition**

### ***United Kingdom***

The banking market in the United Kingdom is characterized by continuing structural change which has increased competition in recent years from a variety of sources, including merged banks, demutualized life insurers and building societies and diversified consumer services companies. Increased regulatory intervention has also influenced the U.K. banking market.

As at 31 December 2006, HBOS had over 984 branches in the United Kingdom of which 834 were full branches and 150 were sub-branches through which banking services are offered. HBOS competes with U.K. clearing banks, through which other major international banks are also represented, with U.K. building societies and with other financial services providers.

The U.K. markets for HBOS's activities are characterized by competition with putting pressure on new business lending margins. HBOS has pursued a strategy based on delivering value and simplicity to customers combined with a disciplined approach to cost management, which, together with distribution power and efficiency gains, has achieved asset growth and increased net income.

### *Australia*

The Australian market is dominated by four major trading banks, who also hold significant positions in the wealth management and insurance markets. Competition in the market continues to increase as international banks increasingly take a more significant interest in the market, and a number of smaller regional banks seek to expand outside their traditional geographies.

HBOS's Retail and Business Divisions, trading under the Bank West brand have over 110 branches mostly in the state of Western Australia, although approximately 20 Business branches have opened in metropolitan and regional areas of the eastern states (which represents roughly 10 per cent. of the national market), where the Business Division continues to expand its operations.

HBOS continues its strategy to grow its Retail, Corporate and Insurance and Investment businesses in the more populous eastern states via cost effective distribution, both direct-to-customer and via third party channels such as finance brokers.

### *Ireland*

The Irish market is dominated by two major trading banks. However, regulatory initiatives are opening up the market, and several international players have recently entered or extended their position in the market. For example, HBOS, under the Bank of Scotland (Ireland) brand, is developing a more complete range of retail banking products, and will continue the process of developing a full branch network during 2007.

### *Other International*

HBOS has other less significant overseas operations conducted through branches and subsidiaries in the United States, Canada and various European jurisdictions. In these locations, the HBOS Group competes with a wide variety of large domestic and international financial services companies.

## **Regulation and Supervision**

### *Regulation and Supervision in the U.K.*

The HBOS Group is subject to the banking regulation and supervisory regime in the United Kingdom. Responsibility for banking supervision rests with the FSA. The FSA's powers and responsibilities are derived from the U.K.'s Financial Services and Markets Act 2000 (**FSMA**). The FSA has responsibility for: (i) regulating and authorizing all businesses carrying on regulated activities in the U.K. (which currently includes all forms of deposit taking, investment activity, certain residential mortgages and general insurance business); (ii) regulating and authorising unit trusts and open-ended investment companies; and (iii) recognizing and supervising markets and investment exchanges.

The FSA is required to observe and pursue four statutory objectives: (i) to maintain confidence in the U.K. financial system; (ii) to promote public understanding of the financial system; (iii) to secure the right degree of protection for consumers; and (iv) to reduce financial crime.



### *Banking supervision*

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

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

### *Financial services supervision*

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

Accordingly, HBOS Group companies carrying on these businesses are subject to the regulation of the FSA. The regulation of certain residential mortgages was introduced on 31 October 2004 for mortgages and mortgage advice, with general insurance coming under FSA regulation on 14 January 2005.

With the advent of on-line banking facilities, the rules on financial promotion (that is, the communication in the course of business of an invitation or inducement to engage in investment activity) made under the FSMA, which are media neutral, apply to the internet as they would to other media such as letter, fax or phone call.

### *Financial Services Compensation Scheme*

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

### *Capital adequacy*

As at 31 December 2006, the banks within the HBOS Group met and exceeded the current minimum capital requirements of the guidelines established by the 1988 Basel Capital Accord (the **Basel Accord**) and the FSA relating to capital adequacy. It is anticipated that continued compliance with the Basel Accord and the FSA minimum capital requirements, pending Basel II, and the implementation of Basel II, will not impede the development of the HBOS Group's activities.

The revised requirements pursuant to the implementation of Basel II consist of three "pillars": (i) minimum capital requirements; (ii) supervisory review of an institution's internal assessment process and capital adequacy; and (iii) effective use of disclosure to strengthen market discipline. The FSA believes that Basel II will help produce more efficient use of capital, better risk management by financial institutions and improved disclosure which should lead to a safer, more efficient financial system.



Due to the growing complexity of the financial markets since 1988, the banking industry has responded by developing a suite of sophisticated risk management techniques. Basel II was conceived against this background and is intended to encourage improvements in banks' ability to measure risk and to align capital requirements closely with risk management practices.

The HBOS approach to Basel II has consistently focused on improving how the HBOS Group does business as opposed to regulatory compliance per se. Our Basel II programme is aligned with internal plans to deliver improved risk management capability at both a divisional and HBOS Group level. These activities will enhance our ability to measure and monitor the risks facing the HBOS Group and provide a clear focus on delivering sustainable income streams to generate added shareholder value.

We continue to play an active role in discussions within the industry and the FSA to shape the regulatory approach. Based on our current understanding of the requirements, we intend to apply for the "Advanced" approach to regulatory capital calculations.

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

#### *The Bank of England*

The Bank of England has the task of ensuring financial stability in the banking market which it undertakes in co-operation with the FSA. The agreed framework for co-operation in the field of financial stability is set out in detail in the Memorandum of Undertaking published jointly by H.M. Treasury, the FSA and the Bank of England at the end of October 1997 and updated in March 2006. The Bank of England is responsible for the overall stability of the financial system as a whole, including (i) ensuring the stability of the monetary system; (ii) oversight of the financial system infrastructure, in particular payments systems at home and abroad; and (iii) maintaining a broad overview of the financial system through its monetary stability role and the deputy governor's membership of the FSA's Board.

#### *H.M. Treasury*

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

#### *European Commission proposals on Consumer Credit*

In September 2002, the European Commission published a proposal for a directive of the European Parliament and of the Council on consumer credit. If the proposed directive is finalised, member states will have two years in which to bring national implementing legislation into force. The proposal includes (among other things) specific documentation and procedural requirements in respect of loan origination and administration. Penalties for non-compliance with these requirements will be determined by the member states, and may provide that credit agreements that do not comply will be unenforceable against the borrower.

In July 2005, the European Commission published a Green Paper on mortgage credit. In October 2005, the European Commission published a revised proposal for a consumer credit directive, which provides that loans secured by a mortgage on land will be excluded from the consumer credit directive. The

European Commission is expected to publish a White Paper on mortgage credit in mid-2007 with a view to a possible mortgage directive.

Until the final text of the directive and any initiatives resulting from the Green Paper process are decided and the details of United Kingdom implementing legislation are published, it is not certain what effect the adoption and implementation of the directive or initiatives would have on the respective businesses and operations of entities in the HBOS Group.

#### *Data protection*

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

#### ***Regulation and Supervision in the United States***

HBOS owns two principal bank subsidiaries: Bank of Scotland and Halifax. Because Bank of Scotland and its direct, wholly owned subsidiary, HBOSTS, maintain federally-licensed branches located in New York City (the **New York Branches**), HBOS, Bank of Scotland and HBOSTS are subject to the International Banking Act of 1978, as amended (the **IBA**), and thus to various federal statutes, including the Bank Holding Company Act of 1956, as amended (the **BHCA**), and certain provisions of the Federal Reserve Act, as amended. As a general rule, the IBA regulates the U.S. banking activities, and the BHCA regulates the U.S. non-banking activities, of HBOS, Bank of Scotland, HBOSTS and their affiliates. On the Effective Date, Bank of Scotland plc will maintain the New York Branches (including the existing branch of HBOSTS) and HBOS and Bank of Scotland plc will continue to be subject to the IBA and the various federal statutes referred to above, including the BHCA.

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

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

#### *Regulation of Banking Activities*

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

Scotland in Boston, Massachusetts that performs a representative office function, are subject to regulations issued under the IBA by the FRB. It is expected that, after the Effective Date, Bank of Scotland plc's New York Branch will continue to be subject to the regulation described in this paragraph.

HBOS, Bank of Scotland and HBOSTS may not open any branch, agency or representative office in the United States, or acquire more than 5 per cent. of any class of the voting stock of a U.S. bank or bank holding company, without the prior notice to approval of the FRB. Furthermore, the IBA and related interstate banking and branching laws impose restrictions on the establishment by Bank of Scotland and HBOSTS of banking operations outside their home state (which is New York). In particular, there may be some states in which Bank of Scotland and HBOSTS may not be able to establish a full service branch if they should decide to do so. Bank of Scotland and HBOSTS generally may acquire a U.S. bank or establish an agency or representative office in any state.

The Gramm-Leach-Bliley Act of 1999 (the **GLBA**), an act which amended various bank and securities laws, includes so-called broker-dealer "push-out" provisions that eliminated the exclusion of banks (including U.S. branches of foreign banks) from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 while providing limited exemptions to facilitate certain activities in which banks have traditionally engaged. This change effectively requires most securities activities in which the New York Branches have been authorised to engage to be conducted, if they are to be conducted, in a U.S.-registered broker-dealer affiliate of Bank of Scotland or HBOSTS. The final rules relating to the "push-out" provisions covering dealers were adopted by the Commission with an effective date of 26 March 2003. Banks had until 30 September 2003 to comply with those rules. Interim final rules relating to the "push-out" provisions covering brokers were adopted by the Commission with an effective date of 12 May 2001. Compliance by banks with these rules has been delayed several times as the Commission has revised the broker "push-out" rules in response to comments from banks. On 13 October 2006, President Bush signed into law the "Financial Services Regulatory Relief Act of 2006 (**Regulatory Relief Act**). Among other things, the Regulatory Relief Act requires that the Commission and the FRB jointly adopt a single set of rules to implement the bank broker exceptions under the Securities Exchange Act of 1934. On 26 December 2006, the Commission and the FRB proposed for comment rules governing the bank broker exceptions. The period for submitting comments on the proposed rules expired 26 March 2007. On 18 December 2006, the Commission and the Federal Reserve Board proposed new Regulation R to implement the GLBA statutory exceptions for bank brokerage activities. Under proposed Regulation R, a bank would remain exempt from the definition of "broker" until the first day of its fiscal year commencing after 30 June 2008. At that time, subject to certain exceptions permitting banks to continue to act as "broker" in a *de minimis* number of transactions (500 per year) and certain other exemptions relating to trust and fiduciary activities, safekeeping and custody activities, and securities lending activities, among others, banks would be required to conduct all securities brokerage activities through a registered broker-dealer.

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

#### *Regulation of Non-Banking Activities*

Each of HBOS, Bank of Scotland and HBOSTS has elected to become a financial holding company. As financial holding companies, HBOS, Bank of Scotland and HBOSTS may engage in the United States in a wider range of financial activities than those in which they had previously been authorised to engage. In particular, HBOS, Bank of Scotland and HBOSTS may now engage in a full range of securities, insurance

and merchant banking activities, all of which to varying degrees had been restricted or prohibited under prior law. Moreover, they generally may do so without the prior approval of the FRB which in most cases would have been required under prior law.

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

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

Bank of Scotland owns BoS (USA) Inc. and BoS (USA) AL Inc., both non-banking financial lending companies, and BoS (USA) Fund Investments Inc. which invests in various private investment funds. Bank of Scotland also indirectly owns 60 percent of another non-banking subsidiary, Resort Finance LLC, a company that is currently inactive. These lending companies are subject to various federal and state laws regarding lending and consumer protection, as well as the federal laws described above that govern non-banking activities of financial holding companies.

### ***Regulation and Supervision in Australia***

HBOSTS was registered as a foreign company in Australia on 23 September 2004 (the **Branch**). On 6 July 2005, the Branch received authority (**Authority**) from Australian Prudential Regulation Authority (**APRA**) to carry on banking business in Australia (subject to certain conditions set out in the APRA Authority, a copy of which is available free of charge from the APRA internet website at <http://www.apra.gov.au>), and commenced operations on 7 September 2005.

On 4 August 2005, the Australian Securities and Investments Commission issued to the Branch an Australian Financial Services license which enables the Branch to provide financial product advice, dealing services and market making services in connection with foreign exchange, derivatives, securities and certain other financial products.

HBOSTS is a foreign Authorised Deposit-Taking Institution (**ADI**) for the purposes of the Banking Act 1959 of Australia (**Australian Banking Act**). ADIs are corporations which are authorised under the Australian Banking Act to carry on banking business in Australia.

ADIs (including foreign ADIs such as HBOSTS) operate under the prudential guidelines of the Australian Prudential guidelines of the APRA.

## MANAGEMENT OF HBOS

### Board of Directors of HBOS

Name	Position in HBOS	Principal outside activity (if any) of significance to HBOS
Lord Stevenson of Coddenham.....	Chairman Non-executive Director	
Sir Ronald Garrick .....	Deputy Chairman Non-executive Director	—
Andy Hornby .....	Chief Executive	
Phil Hodgkinson .....	Group Finance Director	—
Peter Cummings .....	Chief Executive – Corporate Division	—
Jo Dawson .....	Chief Executive – Insurance & Investment Division	—
Benny Higgins.....	Chief Executive – Retail Division	—
Colin Matthew.....	Chief Executive, Strategy, International, Treasury & Asset Management	—
Richard Cousins .....	Non-executive Director	Compass Group plc
Charles Dunstone .....	Non-executive Director	Carphone Warehouse Group plc
Anthony Hobson .....	Non-executive Director	—
Karen Jones.....	Non-executive Director	Food & Fuel Limited
John E. Mack .....	Non-executive Director	—
Coline McConville .....	Non-executive Director	Clear Channel International Limited
Kate Nealon .....	Non-executive Director	—

The business address for the Board is The Mound, Edinburgh EH1 1YZ.

### Conflicts of Interest

No potential conflicts of interest exist at the date of this Offering Circular between the duties of the directors to HBOS and their private interests or other duties.

### Audit Committee

The members of the audit committee of HBOS are Anthony Hobson (Chairman), Coline McConville, Kate Nealon and John Ormerod. This committee also acts as the audit committee for the HBOS Group, and as the audit committee for regulated entities that are not wholly within a single division of the HBOS Group, such as Bank of Scotland, and is supported by five Risk Control Committees.

Without diminishing its own accountability, the Board of directors of HBOS has delegated certain responsibilities to the Audit Committee, including ensuring that there is regular review of the adequacy and effectiveness of the internal control procedures. This role provides independent and objective assurance that there is an appropriate control structure throughout the HBOS Group.

The Audit Committee, which meets at least quarterly, *inter alia* reviews management's procedures for:

- identifying business risks and controlling their financial impact;
- preventing or detecting fraud;
- ensuring compliance with regulatory and legal requirements; and
- monitoring the operational effectiveness of policies and systems.

The Audit Committee, which summarises its findings to the Board of directors of HBOS, obtains assurance about the internal control and risk management environment through regular reports from Group Risk, Group Internal Audit and Group Money Laundering Reporting Officer. The Group Risk Director, and the Head of Group Internal Audit (and each of their direct reports) all have right of direct access to the Chairman of the Audit Committee and the Chief Executive.

The Audit Committee also considers external auditors' reports and reviews the minutes and work of divisional Risk Control Committees.

All business divisions have divisional Risk Control Committees which generally comprise at least two independent Non-executive Directors and an Executive Director, independent of that division. They review, on behalf of the Audit Committee, the adequacy of the business divisions' systems of internal control (including financial, regulatory and operational risk management). These committees meet regularly to review the significant risks facing their division's business and the techniques used to identify, assess and manage them.

The divisional Risk Control Committees and, where appropriate, subsidiary companies' Audit Committees operate under delegated authority from the Audit Committee and the planning and co-ordination of their activities is reviewed by the Audit Committee.

Group Internal Audit supports the Audit Committee, Divisional Risk Control Committees and senior management by reviewing independently and objectively the effectiveness of the control and risk environment.

During 2006 the Committee met eight times. In those meetings, as well as in separate meetings with Executive Directors and management, and privately with both the external and internal auditors, the Committee:

- reviewed and advised the Board of directors of HBOS on the HBOS Group's interim and annual financial statements, its accounting policies and practices, and on the control of its financial and business risks, the nature and scope of the work to be performed by the external and internal auditors, and the results of this audit work and of the response of management;
- considered the activities, resources, organisational structure and operational effectiveness of the internal audit function;
- reviewed the effectiveness of the HBOS Group's system of internal control (including financial, operational, compliance and risk management), as well as the appropriateness and effectiveness of "whistleblowing" procedures;
- made recommendations on the appointment and remuneration of the external auditors and monitored the performance of the auditors; and
- reviewed the non-audit services provided to the HBOS Group by the external auditors and monitored the independence of the auditors.



HBOS complies with all of the provisions of the Combined Code Principles of Good Governance and Code of Best Practice (the **Combined Code**), save for the requirement in Combined Code Provision D.1.1 that the Senior Independent Director should attend meetings with a range of shareholders. The Senior Independent Director attended briefings and other meetings with analysts and other representatives of institutional investors during 2006.

#### *Meetings of the Board of Directors*

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

#### *Terms of Office of Directors*

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

#### *Remuneration of Directors*

The aggregate remuneration paid to the Directors by members of the HBOS Group for the year ended 31 December 2006 was £16.66 million, including bonuses, taxable benefits in kind, total potential pre tax gains on share options exercised and the total value of shares vested under the long-term incentive scheme.

#### *Advances to Key Management Personnel*

As at 31 December 2006, there were loans (including credit card accounts) by the Group outstanding to 10 Directors, and other key management personnel in the aggregate principal amount of £5.049 million.

## **BANK OF SCOTLAND**

### **Introduction**

Bank of Scotland, which was established by an Act of the Parliament of Scotland on 17 July 1695, is a U.K. clearing bank with its headquarters in Edinburgh. Bank of Scotland is an “authorised person” under the FSMA. As at 31 December 2006, Bank of Scotland operated from branch outlets in Scotland and England, overseas branches in New York City, Paris, Amsterdam, Frankfurt, Madrid and Stockholm and representative offices in Boston, Chicago, Dallas, Houston, Los Angeles, Seattle and Minneapolis. It is a member of the British Bankers’ Association and the Committee of Scottish Clearing Bankers. The Bank Notes (Scotland) Act 1845 confirmed Bank of Scotland’s right to issue bank notes in Scotland. At 31 December 2006, circulation of such notes was approximately £857 million. The issuance and circulation of these covered bonds will remain unchanged following the HBOS Group reorganisation. Bank of Scotland together with its subsidiaries and subsidiary undertakings (as defined in the Companies Act 1985) are collectively referred to as the **Bank of Scotland Group**. The head office of Bank of Scotland is located at The Mound, Edinburgh EH1 1YZ, Scotland, with telephone no. 0870 600 500. Bank of Scotland operates under the laws of Scotland.

### **HBOS Group Reorganisation Act**

On the Effective Date, Bank of Scotland plc will, as universal successor, succeed and assume all of the business, assets and liabilities of the Transferor Entities, as more fully described above under “Description of HBOS – HBOS Group Reorganisation Act”. From and after that date, the assets and liabilities of Halifax will be consolidated into Bank of Scotland plc and there will be a corresponding significant impact on the balance sheet of Bank of Scotland on a pro-forma basis. Prospective investors who wish to more fully appreciate the implications of the this consolidation are referred to the Halifax Financial Statements, which are incorporated by reference in this Offering Circular.

On the Effective Date, the business, assets and liabilities of Capital Bank plc and HBOSTS will also be consolidated into Bank of Scotland plc, but these consolidations will not have significant impact as both are currently subsidiaries of Bank of Scotland. However, as of the Effective Date, Bank of Scotland plc will assume all outstanding liabilities of these entities, including the obligations of the Issuer in respect of Covered Bonds previously issued under the Programme.

### **Strategy**

Bank of Scotland pursues a strategy that is an integral part of the overall HBOS Group Strategy described elsewhere in this Offering Circular. See “HBOS – Strategy”.

### **Business**

The Bank of Scotland Group is engaged in a range of banking, insurance broking, financial services and finance-related activities throughout the UK and internationally.

The Bank of Scotland Group’s products and services can be categorised into the following business divisions:

- Retail;
- Corporate;
- Strategy & International; and

- Treasury.

### ***Retail***

The Bank of Scotland Group offers an extensive range of products which include personal and small business banking, savings, mortgages, personal loans and credit cards. As at 31 December 2006, Bank of Scotland Group had a market share of residential mortgages of 4 per cent., with balances of £39.5 billion and held savings and banking balances of £17.4 billion.

In addition products offered by HBOS Financial Services Limited and its subsidiaries such as investments, pensions and protection are distributed through branches of the Bank of Scotland and via Wealth Management Client managers under the Bank of Scotland brand. Products offered by HBOS General Insurance such as household, creditor and travel are also distributed through branches of the Bank of Scotland.

From and after the Effective Date, the Retail division of the Bank of Scotland Group will include the Retail division of Halifax, which will significantly impact the size and scope of its Retail franchise.

### ***Corporate***

The Bank of Scotland Group provides a range of banking services to the corporate and business sector. Its principal market is medium-sized and large-sized UK based businesses with an annual turnover in excess of £1 million. The division comprises a number of relationship banking and specialist lending teams with responsibilities include the provision of term loans, asset finance, motor finance, multi-currency loans and deposits, mezzanine funding, equity investment, fund investment, joint venture partnerships, working capital finance, project and specialist finance, acquisition finance and syndicated lending. The key objective of these teams is to expand and strengthen the HBOS Group's corporate market share by pursuing a relationship and partnership driven approach and delivering specialist services to existing and new customers.

The European corporate business, currently part of the ENA in the Strategy & International division, will move into Corporate division reporting with the 2007 half-year results.

Halifax has a modest Corporate division, which will also become part of the Bank of Scotland Group as of the Effective Date.

### ***Strategy & International***

Strategy & International Operations consists of three operating divisions in Ireland, Australia and Europe/North America. Bank of Scotland (Ireland) Limited focuses on providing banking solutions to small and medium-sized enterprises in Ireland and has recently begun to roll out its full service retail offering. HBOS Australia Pty Limited operates under the four separate brands of BankWest, Capital Finance, St Andrews and BOSIAL, to offer a full range of financial solutions to retail and corporate customers.

HBOS Europe and North America (**ENA**) encompasses the group's interests in Europe and North America and covers a range of financial services. The division operates through a range of businesses including EUBOS (Netherlands). As noted above, the European corporate business is scheduled to move into Corporate division reporting starting with the 2007 half-year results. The Bank of Scotland brand is used for the Group's European corporate business.

The Bank of Scotland operates principally within the United Kingdom, Ireland and Australia.

Halifax does not have an international business and is not expected to impact Strategy & International when it becomes part of the Bank of Scotland Group.

## Treasury

The Issuer, a direct wholly-owned subsidiary of the Bank of Scotland, is the centralised treasury for the HBOS Group. It provides and manages prudential and regulatory liquidity and wholesale multi-currency funding for the HBOS Group. It arranges the HBOS Group's debt capital issuance and asset securitisation programmes and offers a range of treasury services to HBOS Group customers. As described above, the business of the Issuer will be consolidated into Bank of Scotland plc as of the Effective Date.

## Major Shareholders

Bank of Scotland is a wholly owned subsidiary of HBOS.

## Principal Bank of Scotland Subsidiaries

Bank of Scotland is the holding company of the Bank of Scotland Group. The following table shows the principal direct and indirect subsidiary undertakings of Bank of Scotland which Bank of Scotland believes are likely to have a significant effect on the assessment of the assets and liabilities, the financial position and/or the profits and losses of the Bank of Scotland Group and Bank of Scotland's percentage interest in those companies:

Company	Activity	Total % of ordinary share capital held (directly or indirectly) by Bank of Scotland	Country of incorporation or registration	Registered office/head office
HBOS Treasury Services plc <sup>1</sup>	Banking	100	England and Wales	33 Old Broad Street London EC2N 1HZ
Bank of Scotland (Ireland) Limited	Banking	100	Ireland	Bank of Scotland House 124-127 St. Stephen's Green, Dublin 2 Ireland
Capital Bank plc <sup>2</sup>	Banking and personal finance	100	England and Wales	Capital House Queens Park Road Handbridge Chester CH88 3AN
HBOS Australia Pty Limited	Retail and Commercial banking	100	Australia	Bankwest Tower 108 St Georges Terrace Perth Australia WA 6000
Bank of Western Australia Limited	Retail and Commercial banking	100	Australia	Bankwest Tower 108 St Georges Terrace Perth Australia WA 6000

1 Based on comparisons of The Bank of Scotland Group's U.K. residential mortgage book as against market size information taken from Bank of England statistics.

2 Under the HBOS Group Reorganisation Act, Bank of Scotland will become registered as a public company under the Companies Act change its name to Bank of Scotland plc and succeed to the business, assets and liabilities of HBOSTS, Capital Bank plc and Halifax (Halifax is currently a subsidiary of HBOS) as of the Effective Date.

## MANAGEMENT OF BANK OF SCOTLAND

### Board of Directors of Bank of Scotland

<u>Name</u>	<u>Position in Bank of Scotland</u>	<u>Principal outside activities (if any) of significance to the Bank of Scotland</u>
Lord Stevenson of Coddenham	Governor	Chairman of HBOS plc
Colin Matthew	Treasurer	Chief Executive, Strategy, International, Treasury & Asset Management, HBOS plc
Sir Ronald Garrick	Deputy Governor	Non-executive Director of HBOS plc
Andy Hornby	Executive Director	Chief Executive, of HBOS plc
Phil Hodgkinson	Executive Director	Group Finance Director, HBOS plc
Peter Cummings	Executive Director	Chief Executive Corporate Division, HBOS plc
Jo Dawson	Executive Director	Chief Executive Insurance & Investment Division, HBOS plc
Benny Higgins	Executive Director	Chief Executive Retail Division, HBOS
Richard Cousins	Non-executive Director	Non-executive Director, HBOS plc
Charles Dunstone	Non-executive Director	Non-executive Director, HBOS plc
Anthony Hobson	Non-executive Director	Non-executive Director, HBOS plc
Karen Jones	Non-executive Director	Non-executive Director, HBOS plc
John E. Mack	Non-executive Director	Non-executive Director, HBOS plc
Coline McConville	Non-executive Director	Non-executive Director, HBOS plc
Kate Nealon	Non-executive Director	Non-executive Director, HBOS plc

*The business address for the Board is The Mound, Edinburgh EH1 1YZ.*

#### **Conflicts of Interest**

No potential conflicts of interest exist at the date of this Offering Circular between the duties of the directors to Bank of Scotland and their private interests or other duties.

## THE LLP

### Introduction

The LLP was incorporated in England and Wales on 15 May 2003 as a limited liability partnership (registered number OC304674) with limited liability under the LLPA 2000 by the Original Seller and the Issuer as its Members. The Liquidation Member was admitted as a Member of the LLP pursuant to a deed of admission entered into on or before the Programme Date between the Original Seller, the Issuer, the LLP and the Liquidation Member (the **Deed of Admission**). The principal place of business of the LLP is at LP/3/3/SEC Trinity Road, Halifax, West Yorkshire HX1 2RG and its telephone number is 01132 352 176. The LLP has no subsidiaries.

The LLP is a subsidiary of the Original Seller, which itself is a subsidiary of HBOS plc. For a description of the HBOS group please see pages 62-63 under “HBOS”, above. The Original Seller, the Issuer and the Liquidation Member are the members of the LLP.

### Principal Activities

The principal objects of the LLP are set out in the LLP Deed and include, *inter alia*, the ability to carry on the business of acquiring the Loans and their Related Security pursuant to the terms of the Mortgage Sale Agreement with a view to profit and to do all such things as are incidental or conducive to the carrying on of that business and to borrow money.

The LLP has not engaged since its incorporation, and will not engage whilst the Covered Bonds or any Term Advance remains outstanding, in any material activities other than activities incidental to its incorporation under the LLPA 2000, activities contemplated under the Transaction Documents to which it is or will be a party, applying for a standard licence under the CCA, filing a notification under the Data Protection Act 1998 and other matters which are incidental or ancillary to the foregoing.

### Members

The members of the LLP as at the date hereof are and their registered offices are:

<u>Name</u>	<u>Registered Office</u>
Halifax plc	LP/3/3/SEC Trinity Road Halifax West Yorkshire HX1 2RG
HBOS Treasury Services plc	33 Old Broad Street London EC2N 1HZ
Connery Limited	47 Esplanade St. Helier Jersey JE1 0BD

The LLP has no employees.

## Members of the Management Board of the LLP

<u>Name</u>	<u>Responsibility within LLP</u>	<u>Principal activities outside the LLP</u>
Ian Stewart	Management Board Chairman	Head of Mortgage Securitisation and Structured Analysis, Halifax plc
Joe Higgins*	Management Board Member	Head of Mortgages, Halifax plc
Phil Jenks	Management Board Member	Head of Specialist Lending, HBOS plc
David Balai	Management Board Member	Senior Director Securitisation, HBOS Treasury Services plc

The business address of Ian Stewart, Joe Higgins and Phil Jenks is LP/3/3/SEC, Trinity Road, Halifax HX1 2RG and for David Balai is 33, Old Broad Street, London EC2N 1HZ.

There are no potential conflicts of interest between any duties of the above Members of the Management Board and their private interests or other duties.

## Directors of the Members

The following table sets out the directors of Connery Limited and their respective business addresses and occupations.

<u>Name</u>	<u>Business Address</u>	<u>Business Occupation</u>
Elizabeth Ann Mills	47 Esplanade St. Helier Jersey JE1 0BD	Director of special purpose companies
Peter John Richardson	47 Esplanade St Helier Jersey JE1 0BD	Director of special purpose companies
David Balai	33 Old Broad Street London EC2N 1HZ	Senior Director Securitisation, HBOS Treasury Services plc

The directors of Halifax plc and of HBOS Treasury Services plc are set out under The Original Seller and the Issuer.

\* David Nicholson resigned on 10 October 2006.  
Peter Jackson was appointed to the Management Board on 10 October 2006.  
Peter Jackson resigned on 2 April 2007.  
Joe Higgins was appointed to the Management Board on 2 April 2007.



## THE ORIGINAL SELLER

### The Original Seller

Halifax Building Society was founded in 1853 as the Halifax Permanent Benefit Building and Investment Society. In 1928, it merged with Halifax Equitable Building Society to form Halifax Building Society. The Original Seller was incorporated in England and Wales with registered number 02367076 on 31 March 1989. On 2 June 1997 Halifax Building Society, at the time the United Kingdom's largest building society, transferred its business to the Original Seller, which on that date became authorised under the UK Banking Act 1987. Upon completion of the transfer, Halifax Building Society ceased to exist. On 4 December 1996 the Original Seller changed its name to Halifax plc (**Halifax**) and re-registered as a public limited company. The UK Banking Act 1987 was repealed when section 19 of FSMA was brought into force on 30 November 2001. The Original Seller is now authorised as required under FSMA. On 1 June 1999, through a scheme of arrangement, Halifax Group plc acquired and became the holding company of the Original Seller. On 10 September 2001 Halifax Group plc and The Governor and Company of the Bank of Scotland were acquired by a new holding company, HBOS plc as more fully described in *The Group Guarantors - HBOS*. On 1 July 2002 Halifax became a directly held undertaking of HBOS plc having formerly been a subsidiary undertaking of Halifax Group plc.

The Original Seller had total consolidated assets at 31 December 2006 of £363,772 million (at 31 December 2005 this figure was £254,918 million). In the year to 31 December 2006, the Original Seller's consolidated profit on ordinary activities before tax was £1,913 million (for the year to 31 December 2005 this figure was £1,188 million).

### Mortgage Business

The total consolidated value of the Original Seller's mortgage loans and advances secured on residential properties as at 31 December 2006 was approximately £181,569 billion (for 2005 this figure was £167 billion).

### HBOS Group Reorganisation Act

On the Effective Date, the Original Sellers' business will be transferred to Bank of Scotland plc as more fully described above under "Description of HBOS – HBOS Group Reorganisation Act". From and after that date, the Original Seller will become a wholly-owned subsidiary of Bank of Scotland plc and there will be a corresponding significant impact on the balance sheet of Bank of Scotland on a pro-forma basis. Prospective investors who wish to more fully appreciate the implications of this transfer are referred to the Halifax Financial Statements, which are incorporated by reference in this Offering Circular.

## SUMMARY OF THE PRINCIPAL DOCUMENTS

### Trust Deed

The Trust Deed (as modified and/or supplemented and/or restated from time to time) made between the Issuer, the Guarantors and the Bond Trustee and the Security Trustee on the Programme Date, is the principal agreement governing the Covered Bonds. The Trust Deed contains provisions relating to, *inter alia*:

- the constitution of the Covered Bonds and the terms and conditions of the Covered Bonds (as more fully set out under *Terms and Conditions of the Covered Bonds* above);
- the covenants of the Issuer and the Guarantors;
- the terms of the Group Guarantee and the Covered Bond Guarantee (as described below);
- the enforcement procedures relating to the Covered Bonds and the Guarantees; and
- the appointment, powers and responsibilities of the Bond Trustee and the circumstances in which the Bond Trustee may resign or retire or be removed.

### Group Guarantee

Under the terms of the Group Guarantee, if the Issuer defaults in the payment on the due date of any moneys due and payable under or pursuant to the Trust Deed or the Covered Bonds or any Receipts or Coupons, the Group Guarantors have agreed, on a joint and several basis, to pay or procure to be paid upon demand the amount in respect of which such default has been made.

Each of the Group Guarantors agrees that its obligations under the Group Guarantee shall be as principal debtor and not merely as surety and shall be absolute and unconditional, irrespective of, and unaffected by, any invalidity, irregularity or unenforceability of, or defect in, any provisions of the Trust Deed or the Covered Bonds or Receipts or Coupons or the absence of any action to enforce the same or the waiver, modification or consent by the Bond Trustee or any of the Covered Bondholders, Receiptholders or Couponholders in respect of any provisions of the same or the obtaining of any judgment or decree against the Issuer or any action to enforce the same or any other circumstances which might otherwise constitute a legal or equitable discharge or defence of a guarantor.

Under the Trust Deed, the Group Guarantee may be withdrawn if the Issuer becomes a rated entity and the long-term unsecured, unguaranteed and unsubordinated debt obligations of the Issuer are rated by the Rating Agencies at least equal to the then highest ratings of the Group Guarantors (such ratings, the **Requisite Ratings**) or a further guarantee is provided by another member of the HBOS Group which is on terms substantially similar to the Group Guarantee and the long term unsecured, unguaranteed and unsubordinated debt obligations of such member providing such further guarantee are rated by the Rating Agencies at least equal to the Requisite Ratings.

In addition, one Group Guarantor may withdraw its Group Guarantee if the remaining Group Guarantor or the Issuer or any member of the HBOS Group who provides a replacement Group Guarantee as described in the previous paragraph has the Requisite Ratings.

Subject as provided above or in the Transaction Documents, the Group Guarantee will remain in force in relation to each Series of Covered Bonds until all moneys payable by the Issuer under or pursuant to the Trust Deed and the Covered Bonds of the relevant Series have been paid.

The Trust Deed also provides that all moneys received by the Bond Trustee from the Issuer or either of the Group Guarantors following the occurrence of an HBOS Event of Default and service of an HBOS Acceleration Notice and Notice to Pay, including any moneys recovered in the liquidation, administration, winding-up or sequestration of the Issuer or either Group Guarantor (the **Excess Proceeds**), shall be paid by the Bond Trustee on behalf of the Covered Bondholders of the relevant Series to the LLP for its own account, as soon as practicable, and shall be held by the LLP in the GIC Account and the Excess Proceeds shall thereafter form part of the Security and shall be used by the LLP in the same manner as all other money from time to time standing to the credit of the GIC Account in accordance with the Guarantee Priority of Payments. Any Excess Proceeds received by the Bond Trustee shall discharge the obligations of the Issuer in respect of the Covered Bonds, Receipts and Coupons and the obligations of the Group Guarantors under the Group Guarantee. However, the obligations of the LLP under the Covered Bond Guarantee are unconditional and irrevocable and the receipt by the Bond Trustee of any Excess Proceeds shall not reduce or discharge any of such obligations.

By subscribing for Covered Bond(s), each Covered Bondholder shall be deemed to have directed the Bond Trustee to pay the Excess Proceeds to the LLP in the manner as described above.

### ***Covered Bond Guarantee***

Under the terms of the Covered Bond Guarantee, if the Issuer and Group Guarantors default in the payment on the due date subject to any grace periods of any moneys due and payable under or pursuant to the Trust Deed or the Covered Bonds or any Receipts or Coupons or if any other HBOS Event of Default occurs (other than by reason of non-payment), or if an LLP Event of Default occurs the LLP has agreed (subject as described below) on a several basis (as between the Group Guarantors on the one hand and the LLP on the other) to pay or procure to be paid (following the service of an HBOS Acceleration Notice and a Notice to Pay on the LLP, or, if earlier, the service on the Issuer and the LLP of an LLP Acceleration Notice) unconditionally and irrevocably to or to the order of the Bond Trustee (for the benefit of the Covered Bondholders), an amount equal to that portion of the Guaranteed Amounts which shall become Due for Payment but would otherwise be unpaid, as of any Scheduled Payment Date, by the Issuer or the Group Guarantors.

Following the occurrence of an HBOS Event of Default and after the Covered Bonds have been declared due and payable by the Bond Trustee as against the Issuer and the Group Guarantors and following service of an HBOS Acceleration Notice on the Issuer and the Group Guarantors, the Bond Trustee will serve a notice to pay (the **Notice to Pay**) on the LLP. Payment by the LLP of the Guaranteed Amounts pursuant to the Covered Bond Guarantee will be made on the later of (a) the day which is two London Business Days following service of a Notice to Pay on the LLP or (b) the day on which the Guaranteed Amounts are otherwise Due for Payment.

All payments of Guaranteed Amounts by or on behalf of the LLP will be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or other governmental charges of whatever nature, unless the withholding or deduction of such taxes, assessments or other governmental charges are required by law or regulation or administrative practice of any jurisdiction. If any such withholding or deduction is required, the LLP will pay the Guaranteed Amounts net of such withholding or deduction and shall account to the appropriate tax authority for the amount required to be withheld or deducted. **The LLP will not be obliged to pay any amount to the Bond Trustee or any holder of Covered Bonds in respect of the amount of such withholding or deduction.**

Under the terms of the Covered Bond Guarantee, the LLP agrees that its obligations under the Covered Bond Guarantee shall be as principal debtor and not merely as surety and shall be absolute and (following the occurrence of an HBOS Event of Default, service of an HBOS Acceleration Notice on the Issuer and the

Group Guarantors and service of a Notice to Pay on the LLP or, if earlier, service on the Issuer and the LLP of an LLP Acceleration Notice) unconditional, irrespective of, and unaffected by, any invalidity, irregularity or unenforceability of, or defect in, any provisions of the Trust Deed or the Covered Bonds or Receipts or Coupons or the absence of any action to enforce the same or the waiver, modification or consent by the Bond Trustee or any of the Covered Bondholders, Receiptholders or Couponholders in respect of any provisions of the same or the obtaining of any judgment or decree against the Issuer or any action to enforce the same or any other circumstances which might otherwise constitute a legal or equitable discharge or defence of a guarantor.

Failure by the LLP to pay the Guaranteed Amounts when Due for Payment will result in an LLP Event of Default save where such failure arises as a result of a technical default or error and the Bond Trustee is satisfied that the LLP has moneys available to make payment and payment is made within three London Business Days of the Scheduled Payment Date.

For the purposes hereof:

**Due for Payment** means, in relation to any Guaranteed Amount payable by the LLP, the date on which the Scheduled Payment Date in respect of such Guaranteed Amount is reached, or, if later, the day which is two London Business Days following service of a Notice to Pay on the LLP (or, if, in either case, such day is not a London Business Day, the next following London Business Day). For the avoidance of doubt, **Due for Payment** does not refer to any earlier date upon which payment of any Guaranteed Amount may become due under the guaranteed obligations, by reason of prepayment, acceleration of maturity, mandatory or optional redemption or otherwise.

**Guaranteed Amounts** means, with respect to any Scheduled Payment Date, the sum of Scheduled Interest and Scheduled Principal, in each case, payable on each Scheduled Payment Date.

**London Business Day** means a day (other than a Saturday or a Sunday) on which banks and foreign exchange markets are open for general business in London.

**Scheduled Interest** means any amount in respect of scheduled interest payable under the Covered Bonds on each Interest Payment Date as specified in Condition 4 (*Interest*) falling on or after service of a Notice to Pay on the LLP (excluding any additional amounts relating to premiums, default interest or interest upon interest payable by the Issuer and/or the Group Guarantors following an HBOS Event of Default but including such amounts following an LLP Event of Default) less any additional amounts the Issuer or a Group Guarantor would be obliged to pay as a result of any gross-up in respect of any withholding or deduction made under the circumstances set out in Condition 7 (*Taxation*).

**Scheduled Payment Date** means each Interest Payment Date or Final Maturity Date (as applicable) on which Scheduled Interest or Scheduled Principal is due and payable.

**Scheduled Principal** means any amount in respect of scheduled principal payable under the Covered Bonds on each Final Maturity Date or Interest Payment Date (as the case may be) as specified in Condition 6(a) (*Redemption at Maturity*) and Condition 6(e) (*Instalments*) falling on or after service of a Notice to Pay on the LLP (but excluding any additional amounts relating to prepayments, early redemption, broken funding indemnities, penalties, premiums or default interest payable by the Issuer and/or the Group Guarantors following an HBOS Event of Default but including such amounts (if any) together with the Early Redemption Amount and any interest accrued on the Guaranteed Amounts in accordance with Clause 2.2 of the Trust Deed following an LLP Event of Default).

The Trust Deed is governed by English law.

## **Intercompany Loan Agreement**

On each Issue Date, the Issuer will use the proceeds of the Covered Bonds issued under the Programme to lend an amount equal to the Sterling Equivalent of the gross proceeds of the issue of the Covered Bonds to the LLP by way of a term advance (each such term advance, a **Term Advance**) pursuant to a term loan agreement dated the Programme Date between the Issuer, the LLP and the Security Trustee (as amended and/or restated from time to time the **Intercompany Loan Agreement**). Each Term Advance will be used by the LLP (i) as consideration in part for the acquisition of Loans and their Related Security from a Seller or Sellers pursuant to the terms of the Mortgage Sale Agreement, as described under – *Mortgage Sale Agreement – Sale by Sellers of Loans and their Related Security* and/or (ii) to invest in Substitution Assets in an amount not exceeding the prescribed limit and/or (iii) if an existing Series, or part of an existing Series, of Covered Bonds is being refinanced by such issue of Covered Bonds, to repay the Term Advance(s) corresponding to the Covered Bonds being so refinanced and/or (iv) to make a deposit in the GIC Account and/or subject to written confirmation from the LLP that the Asset Coverage Test is met on the relevant Issue Date (both before and immediately following the making of the relevant Term Advance), to make a Capital Distribution to any Seller (in its capacity as a Member) by way of distribution of that Member's equity in the LLP in an amount equal to the Term Advance or any part thereof, which is to be paid to the Member on the relevant Issue Date by telegraphic transfer or as otherwise directed by the Member. Each Term Advance will bear interest at a rate of interest equal to LIBOR for one-month sterling deposits.

The Issuer will not be relying on repayment of any Term Advance in order to meet its repayment obligations under the Covered Bonds. Following payment in full of all amounts outstanding under a Series of Covered Bonds, the LLP will repay the corresponding Term Advances(s) in accordance with the relevant Priorities of Payments. Interest on each Term Advance will be paid by the LLP over the term of that Term Advance. However, the Issuer will not be relying on payment of such interest in order to meet its interest obligations under the Covered Bonds.

The amounts owed by the LLP to the Issuer under the Intercompany Loan Agreement will be reduced by the Sterling Equivalent of any amounts paid by the LLP under the terms of the Covered Bond Guarantee.

The Intercompany Loan Agreement is governed by English law.

## **Mortgage Sale Agreement**

### ***Original Seller and New Sellers***

Loans and their Related Security will be sold to the LLP from time to time pursuant to the terms of a mortgage sale agreement entered into on the Programme Date between Halifax (in its capacity as seller, the **Original Seller**), the LLP and the Security Trustee (as amended and/or restated from time to time, the **Mortgage Sale Agreement**). In addition, any other member of the HBOS Group that wishes to sell Loans and their Related Security (each a **New Seller** and, together with the Original Seller, the **Sellers**) to the LLP will accede to, *inter alia*, the Mortgage Sale Agreement. The sale of New Loans and their Related Security by New Sellers to the LLP will be subject to certain conditions, including the following:

- each New Seller accedes to the terms of the LLP Deed as Member (with such subsequent amendments as may be agreed by the parties thereto) so that it has, in relation to those New Loans and their Related Security to be sold by the relevant New Seller, substantially the same rights and obligations as the Original Seller had in relation to those Loans and their Related Security comprised in the Initial Portfolio under the LLP Deed;
- each New Seller accedes to the terms of the Mortgage Sale Agreement (with such subsequent amendments as may be agreed by the parties thereto) so that it has, in relation to those New Loans and

their Related Security to be sold by the relevant New Seller, substantially the same rights and obligations as the Original Seller had in relation to those Loans and their Related Security comprised in the Initial Portfolio under the Mortgage Sale Agreement;

- each New Seller accedes to the Programme Agreement and enters into such other documents as may be required by the Security Trustee and/or the LLP (acting reasonably) to give effect to the addition of a New Seller to the transactions contemplated under the Programme;
- any Loans and their Related Security sold by a New Seller to the LLP comply with the Eligibility Criteria set out in the Mortgage Sale Agreement;
- the Security Trustee is satisfied that any accession of a New Seller to the Programme will not prejudice the Asset Coverage Test; and
- the Security Trustee is satisfied that the accession of a New Seller to the Programme is not materially prejudicial to Covered Bondholders.

If the above conditions are met, the consent of Covered Bondholders will not be obtained to the accession of a New Seller to the Programme.

For the purposes hereof:

**Arrears of Interest** means, in respect of a Loan on a given date, interest and expenses which are due and payable and unpaid on that date and which are not Capitalised Arrears or Capitalised Expenses.

**Borrower** means, in relation to a Loan, the individual or individuals specified as such in the relevant mortgage together with the individual or individuals (if any) from time to time assuming an obligation to repay such Loan or any part of it.

**Capitalised Arrears** means, in relation to a Loan at any date (the **determination date**), the amount (if any) at such date of any interest and expenses which are due and payable and unpaid on or before that date in respect of which, at the determination date, each of the following conditions have been satisfied:

- (a) a Seller has, by arrangement with the relevant Borrower, agreed to capitalise such amounts; and
- (b) such amounts have been capitalised and added, in the accounts of a Seller (or, if the determination date occurs after the First Transfer Date, the LLP), to the aggregate Principal Amount Outstanding in respect of such Loan.

**Capitalised Expenses** means, in relation to a Loan, the amount of any expense, charge, fee, premium or payment (excluding, however, any Arrears of Interest) capitalised and added to the aggregate Outstanding Principal Balance in respect of such Loan in accordance with the relevant Mortgage Terms (including, for the avoidance of doubt, any High Loan-to-Value Fee (as defined in the Master Definitions and Construction Agreement)).

**Current Balance** means in relation to a Loan at any given date, the aggregate (without double counting) of the Outstanding Principal Balance, Accrued Interest and Arrears of Interest relating to that Loan as at that date.

**Deferred Consideration** means the consideration payable to the Sellers in respect of the Loans sold to the LLP from time to time, which is payable after making payments of a higher order of priority as set out in the relevant Priorities of Payments.

**English Loans** means Loans secured by a mortgage over a property located in England and Wales.



**First Transfer Date** means the date on which the Initial Portfolio is transferred to the LLP pursuant to the Mortgage Sale Agreement.

**Loan** means each loan referenced by its loan identifier number and comprising the aggregate of all principal sums, interest, costs, charges, expenses and other moneys (including all Additional Loan Advances) due or owing with respect to that loan under the relevant Mortgage Terms by a Borrower on the security of a Mortgage from time to time outstanding or, as the context may require, the Borrower's obligations in respect of the same.

**Mortgages** means a first fixed charge by way of legal mortgage (in relation to English Loans) and first ranking standard securities (in relation to Scottish Loans), sold by the relevant Seller to the LLP pursuant to the Mortgage Sale Agreement, which secure the repayment of the relevant Loan.

**Mortgage Conditions** means the terms and conditions applicable to a Loan as contained in the relevant Seller's mortgage Standard Documentation provided to Borrowers from time to time.

**Related Security** means, in relation to a Loan, the security for the repayment of that Loan including the relevant Mortgage and all other matters applicable thereto acquired as part of the Portfolio.

**Scottish Loans** means Loans secured by a standard security over a property located in Scotland.

**Transfer Date** means the First Transfer Date and the date of transfer of any New Portfolio to the LLP in accordance with the Mortgage Sale Agreement.

#### ***Sale by Sellers of Loans and Related Security***

The Portfolio will consist of Loans and their Related Security sold from time to time by Sellers to the LLP in accordance with the terms of the Mortgage Sale Agreement. The types of Loans forming part of the Portfolio will vary over time provided that, at the time the relevant Loans are sold to the LLP, the Eligibility Criteria (as described below) in respect of such Loans are met on the relevant Transfer Date. Accordingly, the Portfolio may, at any time, include Loans originated or purchased by different Sellers, Loans with characteristics that were not being offered to borrowers on previous Transfer Dates or Loans that have not yet been developed, such as Flexible Loans.

Prior to the occurrence of an HBOS Event of Default, the LLP will acquire Loans and their Related Security from the Sellers in the three circumstances described below.

- (a) First, in relation to the issue of Covered Bonds from time to time in accordance with the Programme, the Issuer will make Term Advances to the LLP, the proceeds of which may be applied in whole or in part by the LLP to acquire Loans and their Related Security from the Sellers. In exchange for the sale of the Loans and their Related Security to the LLP, the relevant Seller will receive an amount equal to the Current Balance of those Loans sold by it as at the Transfer Date, which will be satisfied by a combination of:
  - (i) a cash payment to be made by the LLP from the proceeds of the relevant Term Advance and/or from Available Principal Receipts; and/or
  - (ii) the Seller being treated as having made a Capital Contribution in an amount equal to the difference between the Current Balance of the Loans sold by the relevant Seller as at the relevant Transfer Date and the cash payment (if any) made by the LLP; and
  - (iii) Deferred Consideration.



- (b) Secondly, the LLP will use the Available Principal Receipts that are specifically attributable to Loans and their Related Security sold by a specific Seller to acquire New Loans and their Related Security from that Seller or any other Seller nominated by that Seller and/or Substitution Assets (in respect of any Substitution Assets up to the prescribed limit) on each LLP Payment Date.
- (c) Thirdly, the LLP and the Sellers are required to ensure that the Portfolio is maintained at all times in compliance with the Asset Coverage Test (as determined by the Cash Manager on each Calculation Date). If on any Calculation Date there is a breach of the Asset Coverage Test the Sellers will use all reasonable efforts to offer to sell sufficient New Loans and their Related Security to the LLP on or before the next Calculation Date in consideration of the relevant Sellers being treated as having made a Capital Contribution (in an amount equal to the Current Balance of the New Loans) sold by the relevant Seller as at the relevant Transfer Date and in consideration of the right to receive the Deferred Consideration.

If Selected Loans and their Related Security are sold by or on behalf of the LLP as described below under *LLP Deed – Requirement to sell Selected Loans following service of a Notice to Pay*, the obligations of the Sellers insofar as they relate to those Selected Loans and their Related Security will cease to apply.

Sellers will also be required to repurchase Loans and their Related Security sold to the LLP in the circumstances described below under – *Repurchase of Loans*.

**Initial Advance** means, in respect of any Loan, the original principal amount advanced by the relevant Seller to the relevant Borrower.

**New Loans** means Loans, other than the Loans comprised in the Initial Portfolio, which a Seller may assign or transfer to the LLP after the First Transfer Date pursuant to the Mortgage Sale Agreement.

**New Portfolio Notice** means a notice in the form set out in the Mortgage Sale Agreement served in accordance with the terms of the Mortgage Sale Agreement.

**Outstanding Principal Balance** in relation to a Loan at any date (the **determination date**), means the aggregate principal balance of the Loan at such date (but avoiding double counting) including:

- (a) the Initial Advance;
  - (b) Capitalised Expenses;
  - (c) Capitalised Arrears; and
  - (d) any increase in the principal amount due under that Loan due to any form of Additional Loan Advance,
- in each case relating to such Loan less any prepayment, repayment or payment of the foregoing made on or prior to the determination date.

***Eligibility Criteria***

The sale of Loans and their Related Security to the LLP will be subject to various conditions (the **Eligibility Criteria**) being satisfied on the relevant Transfer Date or in respect of Additional Loan Advances, on the next Calculation Date, including:

- (a) no HBOS Event of Default or LLP Event of Default under the Transaction Documents shall have occurred which is continuing;

- (b) the LLP, acting on the advice of the Cash Manager, is not aware, and could not reasonably be expected to be aware, that the purchase of the Loans and their Related Security, would adversely affect the then current ratings by Moody's, S&P or Fitch of the Covered Bonds;
- (c) the yield on the Loans in the Portfolio (including the New Loans) is at least 0.15 per cent. greater than LIBOR for one month sterling deposits after taking into account (i) the average yield on the Loans which are Variable Rate Loans, Tracker Rate Loans and Fixed Rate Loans and other Loans for which hedging is required under the Interest Rate Swaps and (ii) the margins on the Interest Rate Swaps and (iii) the average yield on any Substitution Assets held by the LLP;
- (d) no Loan has a Current Balance of more than £1,000,000; and
- (e) no Loan constitutes a New Loan Type, in respect of which no confirmation has been received, in accordance with the terms of the Mortgage Sale Agreement, that such Loan may be sold to the LLP.

On the relevant Transfer Date, the Representations and Warranties (described below in – *Representations and Warranties*) will be given by the relevant Seller in respect of the Loans and their Related Security sold by that Seller to the LLP.

If a Seller accepts an application from or makes an offer (which is accepted) to a Borrower for a Product Switch or any Additional Loan Advance, then if the Eligibility Criteria referred to in paragraphs (c), (d) and (e) above relating to the Loan subject to that Product Switch or Additional Loan Advance is not satisfied on the next following Calculation Date, the LLP will be entitled to rectify the relevant breach of those Eligibility Criteria by (in the event of a breach of the Eligibility Criteria in paragraphs (c), (d) and (e) above) requiring the relevant Seller to repurchase the Loans subject to any Product Switch or Additional Loan Advance or (in the event of a breach of the Eligibility Criteria in paragraph (c) above) by requiring the relevant Seller to transfer further Loans to the LLP in an amount sufficient to ensure that the Eligibility Criteria in paragraph (c) above is met.

For the purposes hereof:

**Product Switch** means a variation to the financial terms or conditions included in the Mortgage Terms applicable to a Loan other than:

- (a) any variation agreed with a Borrower to control or manage arrears on a Loan;
- (b) any variation in the maturity date of a Loan;
- (c) any variation imposed by statute; or
- (d) any variation in the frequency with which the interest payable in respect of the Loan is charged.

***Transfer of Title to the Loans to the LLP***

English Loans will be sold by Sellers to the LLP by way of equitable assignment. Scottish Loans were sold by the Original Seller on the First Transfer Date by way of a declaration of trust and, in relation to Scottish Loans sold by the Sellers to the LLP after the First Transfer Date, will be sold by way of further declarations of trust (each such declaration of trust, a **Scottish Declaration of Trust** and, together, the **Scottish Declarations of Trust**) under which the beneficial interest in such Scottish Loans will be transferred to the LLP. In relation to Scottish Loans, references in this document to sale of Loans are to be read as references to the making of such Scottish Declarations of Trust. Such beneficial interest (as opposed to the legal title) cannot be registered in the Land Register of Scotland or the General Register of Sasines (the two Scottish property registers). As a result, legal title to both English Loans and Scottish Loans and their Related Security will remain with the Sellers until legal assignments or assignations (as appropriate)

are delivered by the Sellers to the LLP and notice of the sale is given by the Sellers to the Borrowers. Legal assignment or assignation (as appropriate) of the Loans and their Related Security (including, where appropriate, their registration or recording in the relevant property register) to the LLP will be deferred and will only take place in the limited circumstances described below.

Legal assignment or assignation (as appropriate) of the Loans and their Related Security (or, where specified, the Selected Loans and their Related Security) to the LLP will be completed on or before the 20th London Business Day after the earliest of the following:

- (a) the occurrence of an HBOS Event of Default and service on the LLP of a Notice to Pay (unless the relevant Seller or Sellers has or have notified the LLP that it will accept the offer set out in the Selected Loans Offer Notice within the prescribed time);
- (b) in respect of Selected Loans only, at the request of the LLP following the acceptance of any offer to sell the Selected Loans and their Related Security to any person who is not a Seller;
- (c) a Seller and/or the LLP being required, by an order of a court of competent jurisdiction, or by a regulatory authority of which the Seller is a member or any organisation whose members comprise, but are not necessarily limited to, mortgage lenders with whose instructions it is customary for the Seller to comply, to perfect legal title to the Mortgages;
- (d) it being rendered necessary by law to take such actions;
- (e) the Security under the Deed of Charge or any material part of that Security being in jeopardy and the Security Trustee determining or being required by the Bond Trustee (on behalf of the Covered Bondholders) or the other Secured Creditors to take that action to reduce that jeopardy;
- (f) unless otherwise agreed by the Rating Agencies and the Security Trustee, the termination of a Seller's role as Servicer under the relevant Servicing Agreement unless the replacement servicer, if any, is a member of the HBOS Group;
- (g) a Seller requesting a transfer by way of assignment or assignation (as appropriate) by giving notice to the LLP and the Security Trustee;
- (h) the date on which any Seller ceases to be assigned a long-term unsecured, unsubordinated unguaranteed debt obligation rating by Moody's of at least Baa3 or by S&P of at least BBB- or by Fitch of at least BBB-; and
- (i) the occurrence of an Insolvency Event in relation to a Seller.

Pending completion of the transfer, the right of the LLP to exercise the powers of the legal owner of, or (in Scotland) the heritable creditor under, the Mortgages will be secured by, or (in Scotland) supported by, an irrevocable power of attorney granted by each Seller in favour of the LLP and the Security Trustee.

The Title Deeds and Customer Files relating to the Loans in the Portfolio will be held by or to the order of the relevant Seller or relevant Servicer, as the case may be, or by solicitors, licensed conveyancers or (in Scotland) qualified conveyancers acting for the relevant Seller in connection with the creation of the Loans and their Related Security. The Sellers or relevant Servicer, as the case may be, will undertake that all the Title Deeds and Customer Files relating to the Loans in the Portfolio which are at any time in their possession or under their control or held to their order will be held to the order of the Security Trustee or as the Security Trustee may direct.

For the purposes hereof:

**Customer Files** means the file or files relating to each Loan containing, inter alia:

- (a) all material correspondence relating to that Loan; and
- (b) the completed mortgage documentation applicable to the Loan (other than the Title Deeds) including the Valuation Report (if applicable) and, to the extent available, the solicitor's or licensed conveyancer's, or (in Scotland) qualified conveyancer's, Certificate of Title, whether original documentation, electronic form or otherwise or information provided by such documentation stored on an electronic data base.

**Insolvency Event** means, in respect of a Seller, a Servicer or a Cash Manager (each a **relevant entity**):

- (i) an order is made or an effective resolution passed for the bankruptcy or liquidation or winding up or sequestration of the relevant entity; or
- (ii) the relevant entity ceases to carry on its business or substantially all its business; or
- (iii) proceedings shall be initiated against the relevant entity under any applicable liquidation, winding up, sequestration, insolvency, bankruptcy, composition, reorganisation or other similar laws; or a receiver, administrator, trustee or other similar official shall be appointed in relation to the relevant entity or in relation to the whole or a substantial part (having an aggregate book value in excess of £50,000,000) of its assets or a distress, diligence or execution or other process shall be levied or enforced upon or sued out against the whole or a substantial part (having an aggregate book value in excess of £50,000,000) of its assets and, in any of the foregoing cases, it shall not be discharged within thirty days; or if the relevant entity shall initiate or consent to judicial proceedings relating to itself under any applicable liquidation, winding up, sequestration, insolvency, bankruptcy, composition, reorganisation or other similar laws or shall make a conveyance, assignment or assignation for the benefit of, or shall enter into any composition with, its creditors generally; or
- (iv) the relevant entity shall be unable to pay its debts as they fall due (within the meaning of section 123(1)(b) to (e) and section 123(2) of the Insolvency Act 1986 (as those sections may be amended)) or shall admit inability to pay its debts as they fall due or shall stop payment or shall be adjudged or found bankrupt or insolvent.

**Lending Criteria** means the criteria applicable to the granting of an offer of a Loan to a Borrower from time to time, or such other criteria as would be acceptable to a Reasonable, Prudent Mortgage Lender.

**Property** means a freehold, feudal or leasehold property (or in Scotland a heritable property or a property held under a long lease) which is subject to a Mortgage.

**Reasonable, Prudent Mortgage Lender** means the Sellers and/or the Servicers, as applicable, acting in accordance with the standards of a reasonably prudent residential mortgage lender lending to borrowers in England, Wales and/or Scotland who generally satisfy the lending criteria of traditional sources of residential mortgage capital.

**Standard Documentation** means the standard documentation, annexed to the relevant exhibit of the Mortgage Sale Agreement or any update or replacement therefor as each Seller may from time to time introduce acting in accordance with the standards of a Reasonable, Prudent Mortgage Lender.

**Title Deeds** means, in relation to each Loan and its Related Security and the Property relating thereto, all conveyancing deeds and documents which make up the title to the Property and the security for the Loan and all searches and enquiries undertaken in connection with the grant by the Borrower of the related Mortgage.

**Valuation Report** means the valuation report or reports for mortgage purposes, in the form of one of the pro-forma contained in the Standard Documentation, obtained by a Seller from a Valuer in respect of each Property or a valuation report in respect of a valuation made using a methodology which would be acceptable to a Reasonable, Prudent Mortgage Lender and which has been approved by the relevant officers of the relevant Seller.

**Valuer** means an Associate or Fellow of the Royal Institute of Chartered Surveyors or the Incorporated Society of Valuers and Auctioneers who was at the relevant time either a member of a firm which was on the list of Valuers approved by or on behalf of the relevant Seller from time to time or an Associate or Fellow of the Royal Institute of Chartered Surveyors or the Incorporated Society of Valuers and Auctioneers employed in-house by the relevant Seller acting for the relevant Seller in respect of the valuation of a Property.

### ***Representations and warranties***

Neither the Group Guarantors, the LLP, the Security Trustee, the Bond Trustee nor the Issuer has made or has caused to be made on its behalf any enquiries, searches or investigations in respect of the Loans and their Related Security to be sold to the LLP. Instead, each is relying entirely on the Representations and Warranties by the relevant Seller contained in the Mortgage Sale Agreement. The parties to the Mortgage Sale Agreement may, with the prior written consent of the Security Trustee and if agreed with the Rating Agencies, amend the Representations and Warranties in the Mortgage Sale Agreement. The material Representations and Warranties are as follows and are given on the relevant Transfer Date in respect of the Loans and Related Security to be sold to the LLP only on that date and on the Calculation Date following the making of any Further Advance or Product Switch in respect of the Loan to which the Further Advance or Product Switch relates only:

- each Loan was originated by a Seller or purchased by a Seller in the ordinary course of business (and kept on that entity's books for a minimum of 3 months);
- each Loan was originated in pounds sterling and is denominated in pounds sterling (or was originated and is denominated in euro if the euro has been adopted as the lawful currency of the United Kingdom);
- no Loan has a Current Balance of more than £1,000,000;
- each Loan has a remaining term of less than 50 years as at the relevant Transfer Date;
- prior to the making of each advance under a Loan, the Lending Criteria and all preconditions to the making of any Loan were satisfied in all material respects subject only to exceptions as would be acceptable to a Reasonable, Prudent Mortgage Lender;
- all of the Borrowers are individuals;
- at least two monthly payments have been made in respect of each Loan;
- the whole of the Current Balance on each Loan is secured by a Mortgage over residential property;
- subject only in certain appropriate cases to the completion of applications for registrations at the Land Registry or the Registers of Scotland each Mortgage constitutes a valid and subsisting first charge by way of legal mortgage or (in Scotland) first ranking standard security over the relevant property;
- each Loan and its Related Security is, save in relation to any Loan and Related Security which is not binding by virtue of the UTCCR, valid, binding and enforceable in accordance with its terms. To the best of the relevant Seller's knowledge, none of the Loans or their Related Security, save for any term which relates to the recovery of interest under the Standard Documentation applicable to that Loan, is not binding by virtue of its being unfair pursuant to the UTCCR;

- all of the properties are in England or Wales or Scotland;
- not more than twelve months (or a longer period as may be acceptable to a Reasonable, Prudent Mortgage Lender) prior to the granting of each Mortgage, the relevant Seller received a Valuation Report on the relevant Property (or another form of report concerning the valuation of the relevant Property as would be acceptable to a Reasonable, Prudent Mortgage Lender), the contents of which were such as would be acceptable to a Reasonable, Prudent Mortgage Lender or such other form of valuation of the relevant Property as may be confirmed as acceptable by the Rating Agencies from time to time;
- the benefit of all Valuation Reports and Certificates of Title (if available) which were provided to the relevant Seller not more than two years prior to the date of the Mortgage Sale Agreement can be validly assigned to the LLP without obtaining the consent of the relevant Valuer, solicitor, licensed conveyancer or (in Scotland) qualified conveyancers;
- prior to the taking of each Mortgage (other than a remortgage), the relevant Seller instructed its solicitor, licensed conveyancer or (in Scotland) qualified conveyancers to carry out an investigation of title to the relevant property and to undertake other searches, investigations, enquiries and other actions on behalf of the relevant Seller in accordance with the instructions which the Seller issued to the relevant solicitor, licensed conveyancer or (in Scotland) qualified conveyancers as are set out in the case of English Loans in the CML's Lenders' Handbook for England & Wales (or, for Mortgages taken before the CML's Lenders' Handbook for England and Wales was adopted in 1999, the Seller's Mortgage Practice Notes) and, in the case of Scottish Loans, the CML Lenders' Handbook for Scotland (or, for Mortgages taken before the CML Lenders' Handbook for Scotland was adopted in 2000, the Seller's Mortgage Practice Notes) or other comparable or successor instructions and/or guidelines as may for the time being be in place, subject only to those variations as would be acceptable to a Reasonable, Prudent Mortgage Lender;
- buildings insurance cover for each property is available under either a policy arranged by the Borrower or a policy issued to Borrowers by or on behalf of the relevant Seller on behalf of an insurer who agrees with the relevant Seller to issue buildings insurance policies to Borrowers from time to time or a policy arranged by the relevant landlord or the properties in possession cover;
- the relevant Seller has good title to, and is the absolute unencumbered legal and beneficial owner of, all property, interests, rights and benefits agreed to be sold by the relevant Seller to the LLP under the Mortgage Sale Agreement;
- the relevant Seller has, since the making of each Loan, kept or procured the keeping of full and proper accounts, books and records showing clearly all transactions, payments, receipts, proceedings and notices relating to such Loan;
- there are no governmental authorisations, approvals, licences or consents required as appropriate for the relevant Seller to enter into or to perform its obligations under the Mortgage Sale Agreement or to make the Mortgage Sale Agreement legal, valid, binding and enforceable; and
- interest under each Loan can at all times be set in the manner disclosed in the Mortgage Sale Agreement.

If New Loan Types are to be sold to the LLP, then the Representations and Warranties in the Mortgage Sale Agreement will be modified as required to accommodate these New Loan Types. The prior consent of the Covered Bondholders to the requisite amendments will not be required to be obtained.

For the purposes hereof:



**Accrued Interest** means in relation to any Loan and as at any date (the **determination date**) on or after the relevant Transfer Date, interest on such Loan (not being interest which is currently payable on the determination date) which has accrued from and including the Monthly Payment Date immediately prior to the determination date and including the determination date.

**Certificate of Title** means a solicitor's, licensed conveyancer's or (in Scotland) qualified conveyancer's report or certificate of title obtained by or on behalf of the Seller in respect of each Property substantially in the form of the pro-forma set out in the Standard Documentation.

**Flexible Loan** means a type of Loan product that typically incorporates features that give the Borrower options to, among other things, make further drawings on the Loan account and/or to overpay or underpay interest and principal in a given month.

**Further Advance** means, in relation to a Loan, any advance of further money to the relevant Borrower following the making of the Initial Advance, which is secured by the same Mortgage as the Initial Advance, but which is an amount in excess of the principal amount of the Loan approved by the Seller, at the time of origination of the Loan.

**Monthly Payment Date** means the date on which interest (and principal in relation to a repayment mortgage) is due to be paid by a Borrower on a Loan or, if any such day is not a business day, the next following business day.

**New Loan Type** means on any date a type of Loan which is of a type that has not previously been comprised in the Portfolio.

**Representations and Warranties** means the representations and warranties set out in the Mortgage Sale Agreement.

### ***Repurchase of Loans***

If a Seller receives a notice from the Cash Manager (the **Defaulted Loans Notice**) identifying Loans in the Portfolio which are more than 3 months in arrears (the **Defaulted Loans**) or if a Loan in the Portfolio does not, as at the relevant Transfer Date or relevant Calculation Date (in the case of a Further Advance), materially comply with the Representations and Warranties set out in the Mortgage Sale Agreement, then the relevant Seller will immediately notify the LLP and the LLP may, if so directed by the Cash Manager and, subject to the prior Written Consent of the Security Trustee, serve on the Seller a notice substantially in the form set out in the Mortgage Sale Agreement (the **Loan Repurchase Notice**) whereupon the Seller will be required (but only prior to the occurrence of an HBOS Event of Default) to repurchase any such Loans under the relevant Mortgage Account and their Related Security sold by it in an amount equal to the Current Balance thereof and expenses as at the relevant repurchase date. The repurchase proceeds received by the LLP will be applied (other than Accrued Interest) in accordance with the Pre-Acceleration Principal Priority of Payments (see *Cashflows* below).

In addition to the foregoing circumstances, the Sellers will also be required to repurchase a Loan or Loans and its or their Related Security sold by them to the LLP where an Additional Loan Advance made in respect of a Loan results in certain Eligibility Criteria being breached or if a court or other competent authority or any ombudsman makes any determination in respect of that Loan and its Related Security that any term which relates to the recovery of interest under the Standard Documentation applicable to that Loan and its Related Security is not binding on the relevant Borrower because it is unfair.



### ***Right of Pre-emption***

Under the terms of the Mortgage Sale Agreement, each Seller has a right of pre-emption in respect of any sale, in whole or in part, of Selected Loans and their Related Security.

The LLP will serve on the Sellers a notice offering to sell those Selected Loans and their Related Security which each Seller has previously sold to the LLP (or, to such other Seller nominated by the relevant Seller) for an offer price equal to the greater of the then Current Balance of the Selected Loans and the Adjusted Required Redemption Amount, subject to the offer being accepted by the Sellers within ten London Business Days (a **Selected Offer Notice**). If all of the Sellers reject or fail to accept the LLP's offer, the LLP will offer to sell the Selected Loans and their Related Security to Purchasers (as described under – *LLP Deed – Sale of Selected Loans in the Portfolio following the occurrence of an HBOS Event of Default*, below).

If any of the Sellers validly accepts the LLP's offer to sell the Selected Loans and their Related Security, the LLP will, within three London Business Days of such acceptance, serve a further notice on the relevant Seller or Sellers (a **Selected Loan Repurchase Notice**). The relevant Seller or Sellers will sign and return a duplicate copy of the Selected Loan Repurchase Notice and will repurchase from the LLP free from the Security created by and pursuant to the Deed of Charge the relevant Selected Loans and their Related Security (and any other Loan secured or intended to be secured by that Related Security or any part of it) referred to in the relevant Selected Loan Repurchase Notice. Completion of the purchase of the Selected Loans and their Related Security by a Seller will take place on the LLP Payment Date after receipt of the Selected Loans Repurchase Notice(s) or such date as the LLP may direct in the Selected Loans Repurchase Notice (provided that such date is not later than the earlier to occur of the date which is (a) 10 London Business Days after returning the Selected Loan Repurchase Notice to the LLP and (b) the Final Maturity Date of as applicable, the Hard Bullet Covered Bonds or the Earliest Maturing Covered Bonds).

**Purchaser** means any third party or any Seller to whom the LLP offers to sell Selected Loans.

**Required Redemption Amount** means in respect of any relevant Series of Covered Bonds, the amount calculated as follows:

$$\text{the Principal Amount Outstanding of the relevant Series of Covered Bonds} \quad \times \quad (1 + 0.65\% \times (\text{days to maturity of the relevant Series of Covered Bonds} / 365))$$

**Selected Loans** means Loans and their Related Security to be sold by the LLP pursuant to the terms of the LLP Deed having in aggregate the Required Outstanding Principal Balance Amount.

### ***Further Drawings under Loans***

Each Seller is solely responsible for funding all future drawings in respect of any additional advance (including, but not limited to, Further Advances) other than the Initial Advance (each, an **Additional Loan Advance**) in respect of Loans sold by that Seller to the LLP, if any. The amount of the relevant Seller's Capital Contribution will increase by the amount of the funded Additional Loan Advance as set out in the LLP Deed.

### ***Governing law***

The Mortgage Sale Agreement is governed by English law (other than certain aspects relating to the Scottish Loans and their Related Security which are governed by Scots law).

## **Servicing Agreements**

Pursuant to the terms of a servicing agreement entered into on the Programme Date between the LLP, Halifax (in its capacity as servicer, the **Original Servicer**) and the Security Trustee (the **Original Servicing Agreement**), the Original Servicer has agreed to service on behalf of the LLP the Loans and their Related Security sold by the Original Seller to the LLP and the New Loans and their Related Security sold by New Sellers to the LLP, unless any New Seller and the Original Servicer agree that such New Seller shall act as servicer in relation to Loans and their Related Security sold by such New Seller to the LLP (as described below).

If it is agreed that the New Seller will service, on behalf of the LLP, the New Loans and their Related Security sold by such New Seller to the LLP then a servicing agreement will be entered into between such New Seller (in its capacity as servicer, the **New Servicer** and, together with the Original Servicer and any other New Servicer, a **Servicer**), the LLP and the Security Trustee on substantially the same terms as the Original Servicing Agreement so that each New Servicer has substantially the same rights and obligations as the Original Servicer (each a **New Servicing Agreement** and, together with the Original Servicing Agreement, a **Servicing Agreement**).

Each Servicer will be required to administer the Loans in accordance with the relevant Servicing Agreement and:

- (i) in the case of the Original Servicer, as if the Loans and their Related Security sold by the Original Seller to the LLP had not been sold to the LLP but remained with the Original Seller or, in relation to New Loans and their Related Security sold by New Sellers (where the Original Servicer has agreed to service such New Loans and their Related Security), as if such New Loans and their Related Security had been Loans and their Related Security of the Original Seller which had remained with the Original Servicer;
- (ii) in the case of any New Servicer, as if the New Loans and their Related Security sold by the relevant New Seller to the LLP (where the New Servicer has agreed to service such New Loans and their Related Security) had not been sold to the LLP but remained with the relevant New Seller; and
- (iii) in the case of each Servicer, in accordance with the relevant Seller's procedures and administration and enforcement policies as they apply to those Loans.

Each Servicer's actions in servicing the Loans in accordance with its procedures will be binding on the LLP and the Secured Creditors.

Each Servicer will have the power to exercise the rights, powers and discretions and to perform the duties of the LLP in relation to the Loans and their Related Security that it is servicing pursuant to the terms of the relevant Servicing Agreement, and to do anything which it reasonably considers necessary or convenient or incidental to the administration of those Loans and their Related Security.

### ***Undertakings of the Servicer***

Pursuant to the terms of the relevant Servicing Agreement, the relevant Servicer will undertake in relation to those Loans and their Related Security that it is servicing, *inter alia*, to:

- keep records and accounts on behalf of the LLP in relation to the Loans;
- keep the Customer Files and Title Deeds in its possession in safe custody and maintain records necessary to enforce each Mortgage and to provide the LLP and the Security Trustee with access to the Title Deeds and other records relating to the administration of the Loans and their Related Security;

- maintain a register in respect of the Portfolio;
- make available to the LLP and the Security Trustee a report on a monthly basis containing information about the Loans and their Related Security comprised in the Portfolio;
- assist the Cash Manager in the preparation of a monthly asset coverage report in accordance with the Cash Management Agreement;
- take all reasonable steps, in accordance with the usual procedures undertaken by a Reasonable, Prudent Mortgage Lender, to recover all sums due to the LLP, including instituting proceedings and enforcing any relevant Loan or Mortgage; and
- to enforce any Loan which is in default in accordance with the relevant Seller's enforcement procedures or, to the extent that such enforcement procedures are not applicable having regard to the nature of the default in question, with the usual procedures undertaken by a Reasonable, Prudent Mortgage Lender on behalf of the LLP.

The Servicer also undertakes that, on the Servicer ceasing to be assigned a long-term unsecured, unguaranteed and unsubordinated debt obligation rating by Moody's of at least Baa3 or by S&P of at least BBB- or by Fitch of at least BBB-, it will use reasonable efforts to enter into a master servicing agreement with a third party within 60 days.

***Setting of Variable Base Rates and any variable margins***

In addition to the undertakings described above, the Original Servicer has also undertaken in the Original Servicing Agreement to determine and set in relation to all the Original Seller's Loans in the Portfolio the LLP Variable Base Rate and any variable margin applicable in relation to any Tracker Rate Loan in relation to the Loans in the Portfolio except in the limited circumstances described in this sub-section headed – *Setting of Variable Base Rates and any variable margins* when the LLP will be entitled to do so. The Original Servicer will not at any time prior to service of a Notice to Pay on the LLP and/or transfer of legal title of the Portfolio (or any part thereof) to the LLP, without the prior consent of the LLP, set or maintain:

- (i) the LLP Variable Base Rate applicable to the Loans sold by the Original Seller and in the Portfolio at a rate which is higher than (although it may be lower than or equal to) the then prevailing Variable Base Rate of the Original Seller which applies to Loans beneficially owned by the Original Seller outside the Portfolio;
- (ii) a margin in respect of any Tracker Rate Loan sold by the Original Seller and in the Portfolio which, where the Offer Conditions for that Loan provide that the margin shall be the same as the margin applicable to all other Loans having the same Offer Conditions in relation to interest rate setting, is higher or lower than the margin then applying to those Loans beneficially owned by the Original Seller outside the Portfolio; and
- (iii) a margin in respect of any other Tracker Rate Loan sold by the Original Seller and in the Portfolio which is higher than the margin which would then be set in accordance with the relevant Seller's policy from time to time in relation to that type of Loan.

In particular, the Original Servicer shall determine on each Calculation Date, having regard to the aggregate of:

- (a) the income which the LLP would expect to receive during the next succeeding Interest Period (the **relevant Interest Period**);

- (b) the LLP Variable Base Rate, any variable margins applicable in relation to any Tracker Rate Loans and the Variable Mortgage Rates in respect of the Loans which the Original Servicer proposes to set under the Original Servicing Agreement for the relevant Interest Period; and
- (c) the other resources available to the LLP including the relevant Interest Rate Swap Agreements, the relevant Covered Bond Swap Agreements and the Reserve Fund,

whether the LLP would receive an amount of income during the relevant Interest Period which when aggregated with funds otherwise available to it is less than the amount which is the aggregate of (1) the amount of interest which would be payable under the Covered Bond Guarantee and amounts payable to the Covered Bond Swap Providers under the Covered Bond Swap Agreements in respect of all Covered Bonds on each LLP Payment Date of each Series of Covered Bonds falling at the end of each relevant Interest Period and (2) the other senior expenses payable by the LLP ranking in priority thereto in accordance with the relevant Priorities of Payments applicable prior to an LLP Event of Default (the **Interest Shortfall Test**).

If the Original Servicer determines that there will be a shortfall in the foregoing amounts, it will give written notice to the LLP and the Security Trustee, within one London Business Day, of the amount of the shortfall and the LLP Variable Base Rate and any variable margins applicable in relation to any Tracker Rate Loans which would, in the Original Servicer's opinion, need to be set in order for no shortfall to arise, having regard to the date(s) on which the change to the LLP Variable Base Rate and any variable margins would take effect and at all times acting in accordance with the standards of a Reasonable, Prudent Mortgage Lender as regards the competing interests of Borrowers with Variable Base Rate Loans and Borrowers with Tracker Rate Loans. If the LLP or the Security Trustee notify the Original Servicer that, having regard to the obligations of the LLP, the LLP Variable Base Rate and/or any variable margins should be increased, the Original Servicer will take all steps which are necessary to increase the LLP Variable Base Rate and/or any variable margins including publishing any notice which is required in accordance with the mortgage terms. In these circumstances, the Original Servicer will have the right to set the Original Seller's Variable Base Rates.

In addition, the Original Servicer shall determine on each Calculation Date following an HBOS Event of Default, having regard to the aggregate of:

- (a) the LLP Variable Base Rate, any variable margins applicable in relation to any Tracker Rate Loans and the Variable Mortgage Rates in respect of the Loans which the Original Servicer proposes to set under the Original Servicing Agreement for the relevant Interest Period; and
- (b) the other resources available to the LLP under the relevant Interest Rate Swap Agreements,

whether the LLP would receive an aggregate amount of interest on the Loans and amounts under the relevant Interest Rate Swap Agreements during the relevant Interest Period which would give a yield on the Loans of at least LIBOR plus 0.5 per cent. (the **Yield Shortfall Test**).

If the Original Servicer determines that the Yield Shortfall Test will not be met, it will give written notice to the LLP and the Security Trustee, within one London Business Day, of the amount of the shortfall and the LLP Variable Base Rate and any variable margins applicable in relation to any Tracker Rate Loans which would, in the Original Servicer's opinion, need to be set in order for no shortfall to arise, and the Yield Shortfall Test to be met, having regard to the date(s) on which the change to the LLP Variable Base Rate and any variable margins would take effect and at all times acting in accordance with the standards of a Reasonable, Prudent Mortgage Lender as regards the competing interests of Borrowers with Variable Base Rate Loans and Borrowers with Tracker Rate Loans. If the LLP or the Security Trustee notify the Original Servicer that, having regard to the obligations of the LLP, the LLP Variable Base Rate and/or any variable

margins should be increased, the Original Servicer will take all steps which are necessary to increase the LLP Variable Base Rate and/or any variable margins including publishing any notice which is required in accordance with the mortgage terms. In these circumstances, the Original Servicer will have the right to set the Original Seller's Variable Base Rates.

The LLP and the Security Trustee may terminate the authority of the Original Servicer to determine and set the LLP Variable Base Rate and any variable margins on the occurrence of a Servicer Event of Default as defined under – *Removal or resignation of the Servicer*, in which case the LLP will set the LLP Variable Base Rate and any variable margins itself in accordance with this sub-section.

Each New Seller and its relevant servicer will be bound by similar terms to those set out above in relation to Loans sold by that New Seller to the LLP. In these circumstances, the Original Servicing Agreement will be amended (including changes to the Interest Shortfall Test and/or the Yield Shortfall Test).

For the purposes hereof:

**Capped Rate Loans** means those Loans to the extent that and for such period that their Mortgage Terms provide that they are subject to a rate of interest which may at any time be varied in accordance with the relevant Mortgage Terms up to an agreed maximum level;

**Fixed Rate Loans** means those Loans to the extent that and for such time that the interest rate payable by the Borrower on all or part of the Outstanding Principal Balance does not vary and is fixed for a certain period of time by a Seller.

**HVR 1** means the Variable Mortgage Rate known as HVR 1 set by the Original Seller which applies to certain Loans beneficially owned by the Original Seller on the Original Seller's residential mortgage book.

**HVR 2** means the Variable Mortgage Rate known as HVR 2 which applies to certain Loans beneficially owned by the Original Seller on the Original Seller's residential mortgage book.

**LLP Variable Base Rate** means the variable base rates that apply to the Variable Rate Loans in the Portfolio as set, other than in limited circumstances, by the Original Servicer, in accordance with the Original Servicing Agreement.

**Mortgage Terms** means all the terms and conditions applicable to a Loan, including without limitation the applicable Mortgage Conditions and Offer Conditions included in the Standard Documentation from time to time.

**Offer Conditions** means the terms and conditions applicable to a specified Loan as set out in the relevant offer letter to the Borrower.

**Tracker Rate Loan** means those Loans to the extent that and for such period that their Mortgage Terms provide that they are subject to an interest rate which is linked to a variable interest rate other than the Variable Base Rates. For example, the rate on a Tracker Rate Loan may be set at a margin above Sterling LIBOR or above rates set by the Bank of England.

**Variable Base Rates** means HVR 1, HVR 2 or the LLP Variable Base Rate, as applicable.

**Variable Mortgage Rate** means the rate of interest that determines the amount of interest payable each month on a Variable Rate Loan.

**Variable Rate Loans** means those Loans to the extent that and for such period that their Mortgage Terms provide that they are subject to a rate of interest which may at any time be varied in accordance with

the relevant Mortgage Terms (and shall, for the avoidance of doubt, exclude Loans during the period that they are Fixed Rate Loans or Tracker Rate Loans).

### ***Compensation***

The LLP will pay to the Original Servicer a servicing fee of 0.05 per cent. per annum (inclusive of VAT) of the aggregate outstanding amount of the Loans serviced by the Original Servicer in accordance with the Original Servicing Agreement comprised in the Portfolio as of the beginning of the relevant Calculation Period. Fees payable to New Servicers and/or the Original Servicer acting as Servicer in respect of Loans sold by New Sellers to the LLP will be determined on the date that they accede to the Programme.

### ***Removal or resignation of the Servicer***

The LLP and the Security Trustee may, upon written notice to the relevant Servicer, terminate the relevant Servicer's rights and obligations immediately if any of the following events (each a **Servicer Termination Event** and, in relation to the first three events set out below, a **Servicer Event of Default**) occurs:

- the relevant Servicer defaults in the payment of any amount due to the LLP under the relevant Servicing Agreement and fails to remedy that default for a period of three London Business Days after becoming aware of the default;
- the relevant Servicer fails to comply with any of its other obligations under the Servicing Agreement which failure in the opinion of the Security Trustee is materially prejudicial to Covered Bondholders and does not remedy that failure within 20 London Business Days after becoming aware of the failure;
- an Insolvency Event occurs in relation to the relevant Servicer;
- the LLP resolves that the appointment of the relevant Servicer should be terminated.

Subject to the fulfilment of a number of conditions, a Servicer may voluntarily resign by giving not less than 12 months' notice to the Security Trustee and the LLP provided that a substitute servicer qualified to act as such under FSMA and with a management team with experience of administering mortgages in the United Kingdom has been appointed and enters into a servicing agreement with the LLP substantially on the same terms as the Original Servicing Agreement. The resignation of a Servicer is conditional on the resignation having no adverse effect on the then current ratings of the Covered Bonds unless the Covered Bondholders agree otherwise by extraordinary resolution.

If the appointment of a Servicer is terminated, the relevant Servicer must deliver the Title Deeds and Customer Files relating to the Loans administered by it to, or at the direction of, the LLP. The relevant Servicing Agreement will terminate at such time as the LLP has no further interest in any of the Loans or their Related Security sold to the LLP and serviced under the relevant Servicing Agreement that have been comprised in the Portfolio.

A Servicer may sub-contract or delegate the performance of its duties under the Servicing Agreement provided that it meets conditions as set out in the relevant Servicing Agreement.

Neither the Bond Trustee nor the Security Trustee are obliged to act as Servicer in any circumstances.

### ***Governing Law***

The Servicing Agreement is governed by English law.



## Asset Monitor Agreement

Under the terms of an asset monitor agreement entered into on the Programme Date between KPMG Audit Plc (the **Asset Monitor**), the LLP, the Cash Manager and the Security Trustee (the **Asset Monitor Agreement**), the Asset Monitor has agreed, subject to due receipt of the information to be provided by the Cash Manager to the Asset Monitor, to conduct tests in respect of the calculations performed by the Cash Manager on the Calculation Date immediately preceding each anniversary of the Programme Date with a view to confirmation of compliance by the LLP with the Asset Coverage Test or the Amortisation Test, as applicable, on that Calculation Date.

If the long-term ratings of the Cash Manager or the Issuer (or for such time as the Issuer is not, as of the date thereof, independently rated, the higher of the ratings of each Group Guarantor (such higher ratings, the **Deemed Ratings**)) fall below BBB-/Baa3/BBB- (by S&P, Moody's and Fitch, respectively) the Asset Monitor will be required to conduct such tests following each Calculation Date and, following a determination by the Asset Monitor of any errors in the calculations performed by the Cash Manager such that the Asset Coverage Test has been failed on the applicable Calculation Date (where the Cash Manager had recorded it as being satisfied) or the Adjusted Aggregate Loan Amount or the Amortisation Test Aggregate Loan Amount is misstated by an amount exceeding 1 per cent. of the Adjusted Aggregate Loan Amount or the Amortisation Test Aggregate Loan Amount, as applicable, (as at the date of the relevant Asset Coverage Test or the relevant Amortisation Test), the Asset Monitor will be required to conduct such tests following each Calculation Date for a period of six months thereafter.

The Asset Monitor is entitled, in the absence of manifest error, to assume that all information provided to it by the Cash Manager for the purpose of conducting such tests is true and correct and not misleading, and is not required to conduct a test or otherwise take steps to verify the accuracy of any such information. The results of the tests conducted by the Asset Monitor will be delivered to the Cash Manager, the LLP, the Issuer, the Bond Trustee, the Security Trustee and the Rating Agencies (the **Asset Monitor Report**).

Under the terms of the Asset Monitor Agreement the LLP will pay to the Asset Monitor a maximum annual fee of £2,600 per test (exclusive of VAT) for the tests to be performed by the Asset Monitor.

The LLP may, at any time, but subject to the prior written consent of the Security Trustee, terminate the appointment of the Asset Monitor by providing at least 30 days' prior written notice to the Asset Monitor, provided that such termination may not be effected unless and until a replacement asset monitor has been found by the LLP (such replacement to be approved by the Security Trustee if the replacement is an accountancy firm of national standing) which agrees to perform the duties (or substantially similar duties) of the Asset Monitor set out in the Asset Monitor Agreement.

The Asset Monitor may, at any time, resign by giving at least 60 days' prior written notice to the LLP and the Security Trustee (with a copy to the Rating Agencies), provided that such resignation will not take effect unless and until a replacement has been found by the LLP (such replacement to be approved by the Security Trustee if the replacement is an accountancy firm of national standing) which agrees to perform the duties (or substantially similar duties) of the Asset Monitor set out in the Asset Monitor Agreement.

If a replacement asset monitor has not been found by the LLP within 60 days of notice of termination by the LLP or notice of resignation by the Asset Monitor, the Asset Monitor may identify a replacement (such replacement to be approved by the Security Trustee, if the replacement is an accountancy firm of national standing) which agrees to perform the duties of the Asset Monitor set out in the Asset Monitor Agreement.

Neither the Bond Trustee nor the Security Trustee will be obliged to act as Asset Monitor in any circumstances.



The Asset Monitor Agreement is governed by English law.

### **LLP Deed**

The Members of the limited liability partnership incorporated under the name HBOS Covered Bonds LLP (the **LLP**) have agreed to operate the business of the LLP in accordance with the terms of a limited liability partnership deed entered into on the Programme Date between the LLP, the Original Seller, the Issuer, the Liquidation Member, the Bond Trustee and the Security Trustee (as amended and/or restated from time to time, the **LLP Deed**).

### **Members**

As at the date hereof, each of the Original Seller, the Issuer and the Liquidation Member is a member (each a **Member**, and together with any other members from time to time, the **Members**) of the LLP. The Original Seller and the Issuer are the designated members (each a **Designated Member**, and together with any other designated members from time to time, the **Designated Members**) of the LLP. The Designated Members have such duties as are specified in the LLPA 2000 or otherwise at law and in the LLP Deed. The LLP Deed requires there will at all times be at least two Designated Members of the LLP.

Save as set out below, any Member admitted to the LLP after the Programme Date (a **New Member**) must be a Seller and accede to the terms of the Mortgage Sale Agreement. In the event that an administrator or a liquidator is appointed in respect of either the Original Seller or the Issuer, the Liquidation Member has agreed to become a Designated Member of the LLP and will be registered as such. Furthermore, for so long as Covered Bonds are outstanding, if an administrator or a liquidator is appointed to either the Original Seller or the Issuer, the Liquidation Member may, by written notice to the LLP, appoint another Member as a Designated Member or may, at its sole discretion (acting on behalf of itself and the other Members), admit a New Member to the LLP (in each case with the prior written consent of the Security Trustee). A New Member admitted in these circumstances will not be required to be a Seller or to accede to the terms of the Mortgage Sale Agreement.

### **Capital Contributions**

Each sale of Loans and their Related Security by a Seller to the LLP will constitute a Capital Contribution in Kind by the relevant Seller of those Loans in an amount equal to (a) the Current Balance of those Loans as at the relevant Transfer Date minus (b) any cash payment paid by the LLP for the Loans and their Related Security on that Transfer Date.

Any increase in the Outstanding Principal Balance of a Loan due to either Capitalised Interest accruing on that Loan or due to a Seller making an Additional Loan Advance to a Borrower, will be deemed to constitute a Capital Contribution in Kind by the relevant Seller (in its capacity as a Member) in respect of that Loan in an amount equal to the relevant increase.

If so requested by the Management Board, the Members may from time to time make cash contributions to the LLP which will constitute Cash Capital Contributions.

The Liquidation Member will not make any Capital Contributions to the LLP.

### **Calculation of Capital Contributions**

The Capital Contributions made or deemed to be made by each Member (the **relevant Member**) from time to time will be credited to that Member's Capital Account Ledger and Capital Distributions will be debited to the relevant Member's Capital Account Ledger. The Capital Contribution Balance of each Member

shall represent that Member's interest in the capital of the LLP. Any increase or decrease in the Capital Contribution Balance of a Member shall be recorded to that Member's Capital Account Ledger on each Calculation Date. Any such Capital Contribution in Kind will be reduced in an amount equal to the Capital Distribution made to the relevant Seller on any Issue Date where the proceeds of a Term Advance are applied by the LLP to make a Capital Distribution to a Seller (in its capacity as Member) pursuant to the terms of the Intercompany Loan Agreement.

On each Calculation Date (the **relevant Calculation Date**) or the date that the LLP is wound up, the Capital Contribution Balance of the Original Seller in respect of the immediately preceding Calculation Period will be recalculated. The Capital Contribution Balance of the Original Seller will be an amount calculated in sterling (and to the extent that any amount is denominated in a currency other than sterling, converted into sterling at the relevant Covered Bond Swap Rate) as follows:

$$A + B - C$$

where,

A = the Current Balance of the Portfolio as of the last day of the preceding Calculation Period on the immediately preceding Calculation Date;

B = the Principal Receipts standing to the credit of the GIC Account, Substitution Assets and Authorised Investments as of the last day of the preceding Calculation Period;

C = the Principal Amount Outstanding under the Covered Bonds as of the last day of the preceding Calculation Period.

For the purposes hereof:

**Calculation Date** means the twelfth day of each month (or, if such day is not a London Business Day, then the immediately preceding London Business Day).

**Calculation Period** means the period from, and including, the first day of each month to, and including, the last day of each month preceding the relevant Calculation Date.

**Capital Account Ledger** means the ledger maintained by the Cash Manager on behalf of the LLP in respect of each Member to record the balance of each Member's Capital Contributions from time to time;

**Capital Contribution** means in relation to each Member, the aggregate of the capital contributed by that Member to the LLP from time to time by way of Cash Capital Contributions and Capital Contributions in Kind as determined on each Calculation Date in accordance with the formula set out in the LLP Deed.

**Capital Contribution Balance** means the balance of each Member's Capital Contributions as recorded from time to time in the relevant Member's Capital Account.

**Capital Contributions in Kind** means a contribution of Loans and their Related Security to the LLP in an amount equal to (a) the Current Balance of those Loans as at the relevant Transfer Date minus (b) any cash payment paid by the LLP for the Loans and their Related Security on that Transfer Date.

**Capital Distribution** means any return on a Member's Capital Contribution in accordance with the terms of the LLP Deed (and excluding, for the avoidance of doubt, any Deferred Consideration).

**Capitalised Interest** means the amount of interest that would have been paid on a Loan if not for the Borrower under that Loan taking a Payment Holiday.

**Cash Capital Contributions** means a Capital Contribution made in cash.

**LLP Payment Date** means the 16th day of each month or if not a Business Day the next following Business Day.

**Opening Capital Contribution Balance** means the Capital Contribution Balance of each Member on the Programme Date and, in the case of New Members, on the date any such New Member is admitted to the LLP in accordance with the LLP Deed.

The Original Seller and each other Member have agreed that they will amend the calculation above if Capital Contributions are made or deemed made by Members other than the Original Seller.

### *Asset Coverage Test*

Under the terms of the LLP Deed, the LLP and the Members (other than the Liquidation Member) must ensure that on each Calculation Date, the Adjusted Aggregate Loan Amount is in an amount at least equal to the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date (the **Asset Coverage Test**).

If on any Calculation Date the Adjusted Aggregate Loan Amount is less than the aggregate Principal Amount Outstanding of all Covered Bonds as calculated on the relevant Calculation Date, then the LLP (or the Cash Manager on its behalf) will notify the Members thereof and the Members (other than the Liquidation Member) will use all reasonable endeavours to sell sufficient further Loans and their Related Security to the LLP in accordance with the Mortgage Sale Agreement (see *Summary of the Principal Documents – Mortgage Sale Agreement – Sale by Sellers of Loans and their Related Security*) or provide Cash Capital Contributions to ensure that the Asset Coverage Test is met. An HBOS Event of Default shall occur if the Asset Coverage Test is breached on the next following Calculation Date.

For the purposes hereof:

**Adjusted Aggregate Loan Amount** means the amount calculated on each Calculation Date as follows:

$$A + B + C + D + E - (X + Y + Z)$$

where,

A = the lower of (i) and (ii), where:

(i) = the sum of the **Adjusted Current Balance** of each Loan in the Portfolio, which shall be the lower of (1) the actual Current Balance of the relevant Loan in the Portfolio as calculated on the relevant Calculation Date and (2) 60 per cent. of the Indexed Valuation relating to that Loan

### *minus*

the aggregate sum of the following deemed reductions to the aggregate Adjusted Current Balance of the Loans in the Portfolio if any of the following occurred during the previous Calculation Period:

- (1) a Loan or its Related Security is, in the immediately preceding Calculation Period, in breach of the Representations and Warranties contained in the Mortgage Sale Agreement or subject to any other obligation of a Seller to repurchase the relevant Loan and its Related Security, and in each case the relevant Seller has not repurchased the Loan or Loans under the relevant Mortgage Account and their Related Security to the extent required by the terms of the Mortgage Sale Agreement. In this event, the aggregate Adjusted Current Balance of the Loans in the Portfolio (as calculated on the relevant Calculation Date) will be deemed to be reduced by an amount equal to

the Adjusted Current Balance of the relevant Loan or Loans (as calculated on the relevant Calculation Date) under the relevant Mortgage Account; and/or

- (2) a Seller, in any preceding Calculation Period, was in breach of any other material warranty under the Mortgage Sale Agreement and/or a Servicer was, in any preceding Calculation Period, in breach of a material term of a Servicing Agreement. In this event, the aggregate Adjusted Current Balance of the Loans in the Portfolio (as calculated on the relevant Calculation Date) will be deemed to be reduced by an amount equal to the resulting financial loss incurred by the LLP in the immediately preceding Calculation Period (such financial loss to be calculated without double counting and to be reduced by any amount paid (in cash or in kind) to the LLP by the relevant Seller to indemnify the LLP for such financial loss);

AND

- (ii) = the aggregate Current Balance of the Loans in the Portfolio as at the relevant Calculation Date;

*minus*

the aggregate sum of the following deemed reductions to the aggregate Current Balance of the Loans in the Portfolio if any of the following occurred during the previous Calculation Period:

- (1) a Loan or its Related Security is, in the immediately preceding Calculation Period, in breach of the Representations and Warranties contained in the Mortgage Sale Agreement or subject to any other obligation of a Seller to repurchase the relevant Loan and its Related Security, and in each case the relevant Seller has not repurchased the Loan or Loans under the relevant Mortgage Account and their Related Security to the extent required by the terms of the Mortgage Sale Agreement. In this event, the aggregate Current Balance of the Loans in the Portfolio (as calculated on the relevant Calculation Date) will be deemed to be reduced by an amount equal to the Current Balance of the relevant Loan or Loans (as calculated on the relevant Calculation Date) under the relevant Mortgage Account; and/or
- (2) a Seller, in any preceding Calculation Period, was in breach of any other material warranty under the Mortgage Sale Agreement and/or a Servicer was, in the immediately preceding Calculation Period, in breach of a material term of a Servicing Agreement. In this event, the aggregate Current Balance of the Loans in the Portfolio (as calculated on the relevant Calculation Date) will be deemed to be reduced by an amount equal to the resulting financial loss incurred by the LLP in the immediately preceding Calculation Period (such financial loss to be calculated without double counting);

*the result of which is multiplied by* the Asset Percentage (as defined below);

B = the amount of any Principal Receipts on the Loans in the Portfolio up to the end of the immediately preceding Calculation Period (as recorded in the Principal Ledger) which have not been applied as at the relevant Calculation Date to acquire further Loans and their Related Security or otherwise applied in accordance with the LLP Deed and/or the other Transaction Documents;

C = the amount of any Cash Capital Contributions made by the Members (as recorded in the Capital Account Ledger of each Member) or proceeds of Term Advances which have not been applied as at the relevant Calculation Date to acquire further Loans and their Related

Security or otherwise applied in accordance with this Deed and/or the other Transaction Documents;

D = the outstanding principal balance of any Substitution Assets;

E = the amount of any Sale Proceeds standing to the credit of the GIC Account and credited to the Pre-Maturity Liquidity Ledger as at the relevant Calculation Date;

X = 5 per cent. of the aggregate Current Balance of the Loans in the Portfolio, as calculated on the relevant Calculation Date;

Y = 8 per cent. *multiplied by* the **flexible redraw capacity**, being an amount equal to the excess of (1) the maximum amount that Borrowers may draw under Flexible Loans in the Portfolio (whether or not drawn) as determined in respect of the previous Calculation Period over (2) the aggregate Current Balance of all Flexible Loans in the Portfolio on the relevant Calculation Date *multiplied by* 3; and

Z = the weighted average remaining maturity of all Covered Bonds then outstanding *multiplied by* the Sterling Equivalent of the aggregate Principal Amount Outstanding of the Covered Bonds *multiplied by* 0.65 per cent.

**Asset Percentage** means 92.5 per cent. or such other percentage figure as determined from time to time in accordance with the terms of the LLP Deed as follows. On the Calculation Date falling in October, January, April and July of each year, the LLP (or the Cash Manager on its behalf) will calculate the Weighted Average Foreclosure Frequency (**WAFF**) and the Weighted Average Loss Severity (**WALS**) for the Loans in the Portfolio, such calculations to be made on the same basis throughout unless agreed otherwise by the Rating Agencies.

The WAFF and WALS so calculated will be input by the Cash Manager to a cashflow model approved by the Rating Agencies. That model, which tests the credit enhancement required in various cashflow scenarios, will indicate, on the basis of the latest WAFF and WALS figures, the Asset Percentage needed in order to provide credit enhancement to cover all such cashflow scenarios.

Save where otherwise agreed with the Rating Agencies, the Asset Percentage will be adjusted in accordance with the model's process to ensure that sufficient credit enhancement will be maintained, provided that the Asset Percentage may not, at any time, exceed 92.5 per cent.

**Halifax Index** means the index of increases in house prices issued by Halifax in relation to residential properties in the United Kingdom.

**Halifax Price Indexed Valuation** in relation to any property at any date means the Original Valuation of that property increased or decreased as appropriate by the increase or decrease in the Halifax Index since the date of that Original Valuation.

**Indexed Valuation** means at any date in relation to any Loan secured over any Property:

- (a) where the Original Valuation of that Property is equal to or greater than the Halifax Price Indexed Valuation as at that date, the Halifax Price Indexed Valuation; or
- (b) where the Original Valuation of that Property is less than the Halifax Price Indexed Valuation as at that date, the Original Valuation plus 85 per cent. of the difference between the Original Valuation and the Halifax Price Indexed Valuation.

**Mortgage Account** means all Loans secured on the same Property and thereby forming a single mortgage account.

**Original Valuation** in relation to any Property means the value given to that Property by the most recent valuation addressed to the relevant Sellers of the Loan secured over that Property.

#### ***Amortisation Test***

The LLP and the Members (other than the Liquidation Member) must ensure that on each Calculation Date following service of a Notice to Pay on the LLP (but prior to service of an LLP Acceleration Notice) the Amortisation Test Aggregate Loan Amount will be in an amount at least equal to the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date (the **Amortisation Test**).

Following an HBOS Event of Default, if on any Calculation Date the Amortisation Test Aggregate Loan Amount is less than the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date, then the Amortisation Test will be deemed to be breached and an LLP Event of Default will occur. The LLP or the Cash Manager, as the case may be, will immediately notify the Members, the Security Trustee and (whilst Covered Bonds are outstanding) the Bond Trustee of any breach of the Amortisation Test.

The **Amortisation Test Aggregate Loan Amount** will be calculated on each Calculation Date as follows:

$$A + B + C - Z$$

where,

A = the aggregate **Amortisation Test Current Balance** of each Loan, which shall be the lower of (1) the actual Current Balance of the relevant Loan as calculated on the relevant Calculation Date multiplied by M and (2) 100 per cent. of the Indexed Valuation multiplied by M.

Where for all the Loans that are less than 3 months in arrears M = 1 or for all the Loans that are 3 months or more in arrears M = 0.7

B = the amount of any cash standing to the credit of the GIC Account and the principal amount of any Authorised Investments (excluding any Revenue Receipts received in the immediately preceding Calculation Period);

C = the outstanding principal balance of any Substitution Assets;

Z = the weighted average remaining maturity of all Covered Bonds then outstanding **multiplied by** the Sterling Equivalent of the aggregate Principal Amount Outstanding of the Covered Bonds **multiplied by** 0.65 per cent.

#### ***Sale of Selected Loans and their Related Security if the Pre-Maturity Test is breached***

The LLP Deed provides for sales of Selected Loans and their Related Security in circumstances where the Pre-Maturity Test has been breached. The Pre-Maturity Test will be breached if the ratings or Deemed Ratings, as applicable, of the Issuer fall below a specified level and a Hard Bullet Covered Bond is due for repayment within a specified period of time thereafter (see further *Credit Structure – Pre-Maturity Liquidity* below). The LLP will be obliged to sell the Selected Loans and their Related Security to Purchasers, subject to the rights of pre-emption enjoyed by the Sellers to buy the Selected Loans and their Related Security



pursuant to the terms of the Mortgage Sale Agreement, in accordance with the procedure summarised in – *Method of Sale of Selected Loans* below and subject to any Cash Capital Contribution made by the Members. If the Issuer and the Group Guarantors fail to repay any Series of Hard Bullet Covered Bonds on the Final Maturity Date thereof, then following the service of a Notice to Pay on the LLP, the proceeds from any sale of Selected Loans or the Cash Capital Contributions standing to the credit of the Pre-Maturity Liquidity Ledger will be applied to repay the relevant Series of Hard Bullet Covered Bonds. Otherwise, the proceeds will be applied as set out in *Credit Structure – Pre-Maturity Liquidity* below.

***Sale of Selected Loans and their Related Security following service of a Notice to Pay***

After a Notice to Pay has been served on the LLP following the occurrence of an HBOS Event of Default, but prior to service of an LLP Acceleration Notice, the LLP will be obliged to sell Selected Loans and their Related Security in the Portfolio in accordance with the LLP Deed (as described below), subject to the rights of pre-emption enjoyed by the Sellers to buy the Selected Loans and their Related Security pursuant to the Mortgage Sale Agreement. The proceeds from any such sale will be credited to the GIC Account and applied as set out in the Priorities of Payments.

***Method of Sale of Selected Loans***

If the LLP is required to sell Selected Loans and their Related Security to Purchasers following a breach of the Pre-Maturity Test or the occurrence of an HBOS Event of Default, the LLP will be required to ensure that before offering Selected Loans for sale:

- (a) the Selected Loans have been selected from the Portfolio on a random basis as described in the LLP Deed; and
- (b) the Selected Loans have an aggregate Current Balance in an amount (the Required Current Balance Amount) which is as close as possible to the amount calculated as follows:

$$N \times \frac{\text{Current Balance of all the Loans in the Portfolio}}{\text{Required Redemption Amount in respect of each Series of Covered Bonds}}$$

then outstanding

where N is an amount equal to:

- (i) in respect of Selected Loans being sold following a breach of the Pre- Maturity Test, the Required Redemption Amount of the relevant Series of Hard Bullet Covered Bonds less amounts standing to the credit of the Pre-Maturity Liquidity Ledger that are not otherwise required to provide liquidity for any Series of Hard Bullet Covered Bonds which mature prior to or on the same date as the relevant Series of Hard Bullet Covered Bonds; or
- (ii) in respect of Selected Loans being sold following service of a Notice to Pay, the Required Redemption Amount of the Earliest Maturing Covered Bonds less amounts standing to the credit of the GIC Account and the principal amount of any Authorised Investments (excluding all amounts to be applied on the next following LLP Payment Date to repay higher ranking amounts in the Guarantee Priority of Payments and those amounts that are required to repay any Series of Covered Bonds which mature prior to or on the same date as the relevant Series of Covered Bonds).

The LLP will offer the Selected Loans and their Related Security for sale to Purchasers for the best price reasonably available but in any event for an amount not less than the Adjusted Required Redemption



Amount. The **Adjusted Required Redemption Amount** means, the Required Redemption Amount, plus or minus any swap termination amounts payable to or by the LLP in respect of the relevant Series of Covered Bonds less (where applicable):

- (i) amounts standing to the credit of the Pre-Maturity Liquidity Ledger that are not otherwise required to provide liquidity for any Series of Hard Bullet Covered Bonds which mature prior to or on the same date as the relevant Series of Hard Bullet Covered Bonds; or
- (ii) amounts standing to the credit of the GIC Account and the principal balance of any Authorised Investments (excluding all amounts to be applied on the next following LLP Payment Date to repay higher ranking amounts in the Guarantee Priority of Payments and those amounts that are required to repay any Series of Covered Bonds which mature prior to or on the same date as the relevant Series of Covered Bonds).

If the Selected Loans have not been sold (in whole or in part) in an amount equal to the Adjusted Required Redemption Amount by the date which is six months prior to the Final Maturity Date of (in respect of a sale in connection with the Pre-Maturity Test) the relevant Series of Hard Bullet Covered Bonds or (in respect of a sale following service of a Notice to Pay) the Earliest Maturing Covered Bonds (after taking into account all payments, provisions and credits to be made in priority thereto), then the LLP will offer the Selected Loans for sale for the best price reasonably available notwithstanding that such amount may be less than the Adjusted Required Redemption Amount.

In respect of the sale of Selected Loans following service of a Notice to Pay on the LLP, in addition to offering Selected Loans for sale to Purchasers in respect of the Earliest Maturing Covered Bonds, the LLP (subject to the rights of pre-emption enjoyed by the Sellers pursuant to the Mortgage Sale Agreement) is permitted to offer to sell a portfolio of Selected Loans, in accordance with the provisions summarised above, in respect of other Series of Covered Bonds.

The LLP is also permitted to offer for sale to Purchasers part of any portfolio of Selected Loans (a **Partial Portfolio**). Except in circumstances where the portfolio of Selected Loans is being sold within six months of the Final Maturity Date of the Series of Covered Bonds to be repaid from such proceeds, the sale price of the Partial Portfolio (as a proportion of the Adjusted Required Redemption Amount) shall be at least equal to the proportion that the Partial Portfolio bears to the relevant portfolio of Selected Loans.

The LLP will through a tender process appoint a portfolio manager of recognised standing on a basis intended to incentivise the portfolio manager to achieve the best price for the sale of the Selected Loans (if such terms are commercially available in the market) to advise it in relation to the sale of the Selected Loans to Purchasers (except where the Sellers are buying the Selected Loans in accordance with their right of pre-emption in the Mortgage Sale Agreement). The terms of the agreement giving effect to the appointment in accordance with such tender shall be approved by the Security Trustee.

In respect of any sale of Selected Loans and their Related Security following service of a Notice to Pay, the LLP will instruct the portfolio manager to use all reasonable endeavours to procure that Selected Loans are sold as quickly as reasonably practicable (in accordance with the recommendations of the portfolio manager) taking into account the market conditions at that time and the scheduled repayment dates of the Covered Bonds and the terms of the LLP Deed.

The terms of any sale and purchase agreement with respect to the sale of Selected Loans (which shall give effect to the recommendations of the portfolio manager) will be subject to the prior written approval of the Security Trustee. The Security Trustee will not be required to release the Selected Loans from the Security unless the conditions relating to the release of the Security (as described under – *Deed of Charge – Release of Security*, below) are satisfied.

If Purchasers accept the offer or offers from the LLP so that some or all of the Selected Loans shall be sold prior to the next following Final Maturity Date of the Hard Bullet Covered Bonds or, as applicable, the Earliest Maturing Covered Bonds, then the LLP will, subject to the foregoing paragraph, enter into a sale and purchase agreement with the relevant Purchasers which will require inter alia a cash payment from the relevant Purchasers. Any such sale will not include any Representations and Warranties from the LLP in respect of the Loans and the Related Security unless expressly agreed by the Security Trustee or otherwise agreed with the Sellers.

### ***Covenants of the LLP and the Members***

Each of the Members covenants that, subject to the terms of the Transaction Documents, it will not sell, transfer or otherwise dispose of its interest in the LLP without the prior written consent of the LLP and, whilst the Covered Bonds are outstanding, the Security Trustee. Whilst any amounts are outstanding in respect of the Covered Bonds, each of the Members undertakes not to terminate or purport to terminate the LLP or institute any winding-up, administration, insolvency or similar proceedings against the LLP.

The LLP covenants that it will not, save with the prior written consent of the Management Board (and, for so long as any Covered Bonds are outstanding, the consent of the Security Trustee) or as envisaged by the Transaction Documents:

- (a) create or permit to subsist any security interest over the whole or any part of its assets or undertakings, present or future;
- (b) dispose of, deal with or grant any option or present or future right to acquire any of its assets or undertakings or any interest therein or thereto;
- (c) have an interest in a bank account other than as set out in the Transaction Documents;
- (d) incur any indebtedness or give any guarantee or indemnity in respect of any such indebtedness;
- (e) consolidate or merge with or transfer any of its property or assets to another person;
- (f) have any employees, premises or subsidiaries;
- (g) acquire assets other than pursuant to the Mortgage Sale Agreement, the Cash Management Agreement and the LLP Deed; or
- (h) engage in any activities or derive income from any activities within the United States or hold any property if doing so would cause it to be engaged or deemed to be engaged in a trade or business within the United States;
- (i) enter into any contracts, agreements or other undertakings;
- (j) compromise, compound or release any debt due to it; or
- (k) commence, defend, settle or compromise any litigation or other claims relating to it or any of its assets.

### ***Limit on Investing in Substitution Assets and Authorised Investments***

Prior to the service of a Notice to Pay on the LLP, the LLP will be permitted to invest Available Revenue Receipts, Available Principal Receipts and the proceeds of Term Advances in Substitution Assets, provided that the aggregate amount so invested does not exceed 10 per cent. of the total assets of the LLP at any one time and provided that such investments are made in accordance with the terms of the Cash Management Agreement.

Following service of a Notice to Pay on the LLP, all Substitution Assets must be sold by the LLP (or the Cash Manager on its behalf) as quickly as reasonably practicable and the proceeds credited to the GIC Account and the LLP will be permitted to invest all available moneys in Authorised Investments, provided that such investments are made in accordance with the terms of the Cash Management Agreement.

For the purposes hereof:

**Authorised Investments** means:

- (a) Sterling gilt-edged securities; and
- (b) Sterling demand or time deposits, certificates of deposit and short-term debt obligations (including commercial paper) provided that in all cases such investments have a remaining maturity date of 30 days or less and mature on or before the next following LLP Payment Date and the short-term unsecured, unguaranteed and unsubordinated debt obligations of the issuing or guaranteeing entity or the entity with which the demand or time deposits are made (being an authorised person under FSMA) are rated at least A- 1+ by Standard & Poor's, P-1 by Moody's and F1+ by Fitch or their equivalents by three other internationally recognised rating agencies;

**Substitution Assets** means:

- (a) Sterling gilt-edged securities;
- (b) Sterling demand or time deposits, certificates of deposit, long-term debt obligations and short-term debt obligations (including commercial paper) provided that in all cases such investments have a remaining period to maturity of one year or less and the short-term unsecured, unguaranteed and unsubordinated debt obligations or, as applicable, the long-term unsecured, unguaranteed and unsubordinated debt obligations of the issuing or guaranteeing entity or the entity with which the demand or time deposits are made (being an authorised person under the FSMA) are rated at least P-1/Aa3 by Moody's, A-1+/AA- by S&P and F1+/AA- by Fitch or their equivalents by three other internationally recognised rating agencies;
- (c) Sterling denominated government and public securities, as defined from time to time by the FSA, provided that such investments have a remaining period to maturity of one year or less and which are rated at least Aaa by Moody's, AAA by S&P and AAA by Fitch or their equivalents by three other internationally recognised rating agencies; and
- (d) Sterling denominated residential mortgage backed securities provided that such investments have a remaining period to maturity of one year or less, are actively traded in a continuous, liquid market on a recognised stock exchange, are held widely across the financial system, are available in an adequate supply and which are rated at least Aaa by Moody's, AAA by S&P and AAA by Fitch or their equivalents by three other internationally recognised rating agencies,

provided that the aggregate value of the Substitution Assets, at any time, shall not exceed in aggregate an amount equal to 10 per cent. of the total assets of the LLP.

#### ***Other provisions***

The allocation and distribution of Revenue Receipts, Principal Receipts and all other amounts received by the LLP is described under *Cashflows* below.

A management board comprised as at the Programme Date of directors, officers and/or employees of Halifax and the Issuer (the **Management Board**) will act on behalf of the LLP to which (other than any decision to approve the audited accounts of the LLP or to make a resolution for the voluntary winding up of

the LLP, which require a unanimous decision of the Members) the Members delegate all matters. Any decision by the Management Board relating to the admission of a New Member, any change in the LLP's business, any change to the LLP's name and any amendment to the LLP Deed, will be made, whilst any Covered Bonds are outstanding, with the consent of the Security Trustee.

For so long as any Covered Bonds are outstanding, each Member has agreed that it will not terminate or purport to terminate the LLP or institute any winding-up, administration, insolvency or other similar proceedings against the LLP. Furthermore, the Members have agreed *inter alia* not to demand or receive payment of any amounts payable by the LLP (or the Cash Manager on its behalf) or the Security Trustee unless all amounts then due and payable by the LLP to all other creditors ranking higher in the relevant Priorities of Payments have been paid in full.

Each Member will be responsible for the payment of its own tax liabilities and will be required to indemnify the LLP and the other Members from any liabilities which they incur as a result of the relevant Member's non-payment.

Following the appointment of a liquidator to any Member (other than the Liquidation Member), any decisions of the LLP that are reserved to the Members in the LLP Deed shall be made by the Liquidation Member only.

### ***Governing Law***

The LLP Deed is governed by English law.

### **Cash Management Agreement**

The Cash Manager will provide certain cash management services to the LLP pursuant to the terms of a cash management agreement entered into on the Programme Date between the LLP, Halifax in its capacity as the Cash Manager (the **Cash Manager**) and the Security Trustee (as amended and/or restated from time to time, the **Cash Management Agreement**).

The Cash Manager's services include but are not limited to:

- (a) maintaining the Ledgers on behalf of the LLP;
- (b) distributing the Revenue Receipts and the Principal Receipts in accordance with the Priorities of Payment described under *Cashflows*, below;
- (c) determining whether the Asset Coverage Test is satisfied on each Calculation Date in accordance with the LLP Deed, as more fully described under *Credit Structure – Asset Coverage Test*, below;
- (d) determining whether the Amortisation Test is satisfied on each Calculation Date following an HBOS Event of Default in accordance with the LLP Deed, as more fully described under *Credit Structure – Amortisation Test*, below; and
- (e) on each London Business Day, determining whether the Pre-Maturity Test for each Series of Hard Bullet Covered Bonds is satisfied as more fully described under *Credit Structure – Pre-Maturity Liquidity*, below.

For purposes hereof:

**Capital Account Ledgers** means the ledgers maintained by the LLP to record the Capital Contributions of each of the Members.

**Ledgers** includes the Revenue Ledger, the Principal Ledger, the Capital Account Ledger, the Pre-Maturity Liquidity Ledger and the Reserve Ledger.

**Losses** mean all realised losses on the Loans.

**Pre-Maturity Liquidity Ledger** means the ledger on the GIC Account maintained by the Cash Manager pursuant to the Cash Management Agreement to record the credits and debits of moneys available to repay any Series of Hard Bullet Covered Bonds on the Final Maturity Date thereof if the Pre-Maturity Test has been breached.

**Principal Ledger** means the ledger on the GIC Account of such name maintained by the Cash Manager pursuant to the Cash Management Agreement to record the credits and debits of Principal Receipts in accordance with the terms of the LLP Deed.

**Reserve Ledger** means the ledger on the GIC Account of such name maintained by the Cash Manager pursuant to the Cash Management Agreement, to record the crediting of Revenue Receipts to the Reserve Fund and the debiting of such Reserve Fund in accordance with the terms of the LLP Deed.

**Revenue Ledger** means the ledger on the GIC Account maintained by the Cash Manager pursuant to the Cash Management Agreement to record credits and debits of Revenue Receipts in accordance with the terms of the LLP Deed.

The Cash Management Agreement is governed by English law.

### **Interest Rate Swap Agreements**

Some of the Loans in the Portfolio pay a variable rate of interest for a period of time that may either be linked to the LLP Variable Base Rate or linked to an interest rate other than the LLP Variable Base Rate, such as a rate set by the Bank of England. Other Loans pay a fixed rate of interest for a period of time. However, the interest rate payable by the LLP with respect to the Term Advances is calculated based on LIBOR for one-month sterling deposits. To provide a hedge against the possible variance between:

- (1) the LLP Variable Base Rate payable on the variable rate loans, the rates of interest payable on the Tracker Rate Loans, the fixed rates of interest payable on the Fixed Rate Loans and the rates of interest payable on the Capped Rate Loans (together the **Loan Rates of Interest**) in respect of those Loans sold by the Original Seller to the LLP; and
- (2) LIBOR for one-month sterling deposits,

the LLP, Halifax (in its capacity as interest rate swap provider, the **Original Interest Rate Swap Provider**) and the Security Trustee have entered into an interest rate swap (the **Original Interest Rate Swap**) governed by an ISDA master agreement, including a schedule and confirmation thereto (the **Original Interest Rate Swap Agreement**) on the Programme Date.

Each New Seller (in its capacity as interest rate swap provider, a **New Interest Rate Swap Provider** and, together with the Original Interest Rate Swap Provider and any other New Interest Rate Swap Provider, the **Interest Rate Swap Providers**) will also enter into an interest rate swap (the **New Interest Rate Swap** and, together with the Original Interest Rate Swap, the **Interest Rate Swaps**) with the LLP and the Security Trustee in respect of those Loans sold by the relevant New Seller on substantially the same terms as the Original Interest Rate Swap Agreement (each, a **New Interest Rate Swap Agreement** and, together with the Original Interest Rate Swap Agreement and any other New Interest Rate Swap Agreement, the **Interest Rate Swap Agreements**).

In the event that the relevant ratings of an Interest Rate Swap Provider, or any guarantor, as applicable, is or are, as applicable, downgraded by a Rating Agency below the ratings specified in the relevant Interest Rate Swap Agreement (in accordance with the requirements of the Rating Agencies) for such Interest Rate Swap Provider, and, as a result of the downgrade, the then current ratings of the Covered Bonds would or may, as applicable, be adversely affected, such Interest Rate Swap Provider will be required to take certain remedial measures which may include providing collateral for its obligations, arranging for its obligations to be transferred to an entity with ratings required by the relevant Rating Agency, procuring another entity with rating(s) required by the relevant Rating Agency to become co-obligor in respect of its obligations, or taking such other action as it may agree with the relevant Rating Agency. A failure to take such steps will allow the LLP to terminate the relevant Interest Rate Swap Agreement.

Each Interest Rate Swap Agreement may also be terminated in certain other circumstances (each referred to as an **Interest Rate Swap Early Termination Event**), including:

- at the option of any party to an Interest Rate Swap Agreement, if there is a failure by the other party to pay any amounts due under the relevant Interest Rate Swap Agreement; and
- upon the occurrence of an insolvency of an Interest Rate Swap Provider, or any guarantor, or the merger of one of the parties without an assumption of the obligations under the relevant Interest Rate Swap Agreement (except in respect of a transfer by the LLP to the Security Trustee in its fiduciary capacity).

Upon the termination of an Interest Rate Swap pursuant to an Interest Rate Swap Early Termination Event, the LLP or the relevant Interest Rate Swap Provider may be liable to make a termination payment to the other in accordance with the provisions of the relevant Interest Rate Swap Agreement.

If withholding taxes are imposed on payments made by an Interest Rate Swap Provider under an Interest Rate Swap, the Interest Rate Swap Provider shall always be obliged to gross up these payments. If withholding taxes are imposed on payments made by the LLP to the Interest Rate Swap Provider under an Interest Rate Swap, the LLP shall not be obliged to gross up those payments.

If the LLP is required to sell Selected Loans in the Portfolio in order to provide liquidity in respect of Hard Bullet Covered Bonds following a breach of the Pre-Maturity Test or in respect of the Earliest Maturing Covered Bonds following an HBOS Event of Default and service of a Notice to Pay on the LLP, then to the extent that such Selected Loans include Fixed Rate Loans, either:

- (a) the Interest Rate Swap(s) in connection with such Fixed Rate Loans will partially terminate and any breakage costs payable by or to the LLP in connection with such termination will be taken into account in calculating the Adjusted Required Redemption Amount for the sale of the Selected Loans; or
- (b) such Interest Rate Swap(s) will be partially novated to the purchaser of such Fixed Rate Loans, and such purchaser will thereby become party to a separate interest rate swap transaction with the relevant Interest Rate Swap Provider.

The Interest Rate Swap Agreements are (or, as applicable, will be) governed by English law.

### **Covered Bond Swap Agreements**

HBOSTS (in its capacity as swap provider, the **Covered Bond Swap Provider**) will enter into swap transactions (the **Covered Bond Swaps**, and together with the Interest Rate Swaps, the **Swaps**) with the LLP and the Security Trustee in its fiduciary capacity, each such Covered Bond Swap governed by an ISDA master agreement, including a schedule and confirmation (the **Covered Bond Swap Agreements**), to hedge (after service on the LLP of a Notice to Pay) certain interest rate, currency and/ or other risks in respect of amounts received by the LLP under the Loans and the Interest Rate Swaps and amounts payable by the LLP



under the Covered Bond Guarantee in respect of Covered Bonds. Where required to hedge such risks, there will be one Covered Bond Swap Agreement and Covered Bond Swap in relation to each Series of Covered Bonds. Under the Covered Bond Swaps, after service on the LLP of a Notice to Pay, the Covered Bond Swap Provider will pay to the LLP amounts equivalent to the amounts that would be payable by the LLP under the Covered Bond Guarantee in respect of interest and principal payable under the Covered Bonds and, in return, the LLP will pay to the Covered Bond Swap Provider on each LLP Payment Date an amount in sterling calculated by reference to LIBOR for one-month sterling deposits for the relevant Interest Period plus a spread.

Under the terms of each Covered Bond Swap, in the event that the relevant rating of the Covered Bond Swap Provider (or for such time as the Covered Bond Swap Provider is the Issuer, its Deemed Ratings) or any guarantor, as applicable is downgraded by a Rating Agency below the rating(s) specified in the relevant Covered Bond Swap Agreement (in accordance with the requirements of the Rating Agencies) for the Covered Bond Swap Provider, and, where applicable, as a result of the downgrade, the then current ratings of the Covered Bonds would or may, as applicable, be adversely affected, the Covered Bond Swap Provider will, in accordance with the relevant Covered Bond Swap Agreement, be required to take certain remedial measures which may include providing collateral for its obligations under the Covered Bond Swap, arranging for its obligations under the Covered Bond Swap to be transferred to an entity with the ratings required by the relevant Rating Agency, procuring another entity with the ratings required by the relevant Rating Agency to become co-obligor in respect of its obligations under the Covered Bond Swap, or taking such other action as it may agree with the relevant Rating Agency. A failure to take such steps will allow the LLP to terminate the Covered Bond Swap.

A Covered Bond Swap Agreement may also be terminated in certain other circumstances (each referred to as a **Covered Bond Swap Early Termination Event**), including:

- at the option of any party to the Covered Bond Swap Agreement, if there is a failure by the other party to pay any amounts due under such Covered Bond Swap Agreement; and
- upon the occurrence of an insolvency of the Covered Bond Swap Provider, or any guarantor, or the merger of one of the parties without an assumption of the obligations under the relevant Covered Bond Swap Agreement (except in respect of a transfer by the LLP to the Security Trustee in its fiduciary capacity).

Upon the termination of a Covered Bond Swap, the LLP or the Covered Bond Swap Provider may be liable to make a termination payment to the other in accordance with the provisions of the relevant Covered Bond Swap Agreement. The amount of this termination payment will be calculated and made in sterling.

If withholding taxes are imposed on payments made by the Covered Bond Swap Provider to the LLP under a Covered Bond Swap, the Covered Bond Swap Provider shall always be obliged to gross up those payments. If withholding taxes are imposed on payments made by the LLP to the Covered Bond Swap Provider under a Covered Bond Swap, the LLP shall not be obliged to gross up those payments.

The Covered Bond Swap Agreements are (or, as applicable, will be) governed by English law.

### **Bank Account Agreement**

Pursuant to the terms of a bank account agreement entered into on the Programme Date between the LLP, Bank of Scotland as account bank (in such capacity, the **Account Bank**), the Cash Manager and the Security Trustee (the **Bank Account Agreement**), the LLP will maintain with the Account Bank the accounts described below, which will be operated in accordance with the Cash Management Agreement, the LLP Deed and the Deed of Charge:



- (a) the GIC Account into which are paid all amounts received from Borrowers in respect of Loans in the Portfolio. On each LLP Payment Date as applicable, amounts required to meet the LLP's various creditors and amounts to be distributed to the Members under the LLP Deed will be transferred to the Transaction Account; and
- (b) the Transaction Account into which moneys standing to the credit of the GIC Account will be transferred on each LLP Payment Date and applied by the Cash Manager in accordance with the Priorities of Payments described below under Cashflows.

If the short term, unsecured, unsubordinated and unguaranteed debt obligations of the Account Bank cease to be rated at least A-1+ by S&P, P-1 by Moody's, or F1 by Fitch (the **Account Bank Ratings**) then within 30 London Business Days of such occurrence either:

- the GIC Account and the Transaction Account will be closed and new accounts opened under the terms of a new bank account agreement substantially on the same terms as the Bank Account Agreement opened with a financial institution (i) whose short term, unsecured, unsubordinated and unguaranteed debt obligations are rated at least A-1+ by S&P, P-1 by Moody's, and F1 by Fitch and (ii) which is an authorised person under FSMA; or
- the Account Bank will obtain a guarantee of its obligations under the Bank Account Agreement on terms acceptable to the Security Trustee, acting reasonably, from a financial institution whose short term, unsecured, unsubordinated and unguaranteed debt obligations are rated at least A-1+ by S&P, P-1 by Moody's, and F1 by Fitch,

(in each case, provided that the Rating Agencies then rating the Covered Bonds confirm that the then current ratings of the Covered Bonds would not be adversely affected thereby) unless each Rating Agency confirms that its then current rating of the Covered Bonds will not be adversely affected as a result of the Account Bank Ratings falling below P-1/A-1+/F1 (or the reason for this having occurred) within 15 days of such downgrade. If the Rating Agency confirmations are given as above, reference to the **Account Bank Ratings** shall be deemed to be instead the relevant rating of the Account Bank at the time of such confirmations, but the original rating shall be reinstated if the relevant rating of the Account Bank is subsequently upgraded to the original level.

For the purposes hereof:

**GIC Account** means the account in the name of the LLP held with the Account Bank and maintained subject to the terms of the Guaranteed Investment Contract, the Bank Account Agreement and the Deed of Charge or such additional or replacement account as may be for the time being in place with the prior consent of the Security Trustee.

**Transaction Account** means the account in the name of the LLP held with the Account Bank and maintained subject to the terms of the Bank Account Agreement and the Deed of Charge or such other account as may be for the time being in place with the prior consent of the Security Trustee and designated as such.

The Bank Account Agreement is governed by English law.

### **Stand-by Bank Account Agreement**

Pursuant to the terms of a stand-by bank account agreement entered into on the Programme Date between the LLP, Citibank, N.A. (the **Stand-by Account Bank**), the Cash Manager and the Security Trustee (the **Stand-by Bank Account Agreement**), the LLP will open with the Stand-by Account Bank a stand-by GIC account (the **Stand-by GIC Account**) and a stand-by transaction account (the **Stand-by Transaction**

**Account**) if the LLP cannot find a replacement account bank in accordance with the terms of the Bank Account Agreement or the Account Bank cannot obtain a guarantee of its obligations, in each case if the ratings of the Account Bank fall below the Account Bank Ratings, and the Bank Account Agreement is subsequently terminated or if the Bank Account Agreement is terminated for other reasons. The Stand-by GIC Account and the Stand-by Transaction Account will be operated in accordance with the Cash Management Agreement, the LLP Deed and the Deed of Charge.

References in this Offering Circular to the GIC Account or the Transaction Account include references to the Stand-by GIC Account or the Stand-by Transaction Account when the Stand-by GIC Account and the Stand-by Transaction Account become operative.

References to the **LLP Accounts** mean the GIC Account, the Transaction Account and any additional or replacement accounts opened in the name of the LLP, including the Stand-by GIC Account and the Stand-by Transaction Account.

The Stand-by Bank Account Agreement is governed by English law.

### **Guaranteed Investment Contract**

The LLP has entered into a guaranteed investment contract with Bank of Scotland (in its capacity as GIC provider, the **GIC Provider**) and the Cash Manager on the Programme Date (the **Guaranteed Investment Contract** or **GIC**), pursuant to which the GIC Provider has agreed to pay interest on the moneys standing to the credit thereof at specified rates determined in accordance with the GIC.

The Guaranteed Investment Contract is governed by English law.

### **Stand-by Guaranteed Investment Contract**

The LLP has entered into a stand-by guaranteed investment contract with Citibank, N.A. (the **Stand-by GIC Provider**) on the Programme Date (the **Stand-by Guaranteed Investment Contract**), pursuant to which the Stand-by GIC Provider has agreed to pay interest on the Stand-by GIC Account at specified rates determined in accordance with the Stand-by Guaranteed Investment Contract.

The Stand-by Guaranteed Investment Contract is governed by English law.

### **Corporate Services Agreement**

The Liquidation Member, Holdings, Halifax and the LLP have entered into a corporate services agreement with Structured Finance Management Offshore Limited (the **Corporate Services Provider**) on the Programme Date (the **Corporate Services Agreement**), pursuant to which the Corporate Services Provider has agreed to provide corporate services to the Liquidation Member and Holdings.

The Corporate Services Agreement is governed by Jersey law.

### **Deed of Charge**

Pursuant to the terms of a deed of charge entered into on the Programme Date by the LLP, the Security Trustee and the other Secured Creditors (the **Deed of Charge**), the secured obligations of the LLP and all other obligations of the LLP under or pursuant to the Transaction Documents to which it is a party are secured, *inter alia*, by the following security (the **Security**) over the following property, assets and rights (the **Charged Property**):

- (a) a first fixed charge (which may take effect as a floating charge) over the LLP's interest in the English Loans and their Related Security and other related rights comprised in the Portfolio;
- (b) an assignment by way of first fixed charge over the rights of the LLP in and to the mortgage indemnity guarantee policies;
- (c) an assignation in security of the LLP's interest in the Scottish Loans and their Related Security (comprising the LLP's beneficial interest under the trusts declared by the Sellers pursuant to the Scottish Declarations of Trust);
- (d) an assignment by way of first fixed security over all of the LLP's interests, rights and entitlements under and in respect of any Transaction Document to which it is a party;
- (e) a first fixed charge (which may take effect as a floating charge) over the rights and benefits of the LLP in the LLP Accounts (including the Excess Proceeds) and any other account of the LLP and all amounts standing to the credit of the LLP Accounts and such other accounts;
- (f) a first fixed charge (which may take effect as a floating charge) over the rights and benefits of the LLP in respect of all Authorised Investments and Substitution Assets purchased from time to time from amounts standing to the credit of the LLP Accounts; and
- (g) a first floating charge over (a) all the assets and undertaking of the LLP governed by English law and not, from time to time, subject to any fixed charge in favour of the Security Trustee pursuant to the Deed of Charge and (b) all the assets and undertaking of the LLP located in or governed by the law of Scotland.

In respect of the property, rights and assets referred to in (c) above, fixed security will be created over such property, rights and assets sold to the LLP after the Programme Date by means of deeds supplemental to the Deed of Charge.

**Secured Creditors** means the Security Trustee (in its own capacity and on behalf of the other Secured Creditors), the Bond Trustee (in its own capacity and on behalf of the Covered Bondholders), the Covered Bondholders, the Receiptholders, the Couponholders, the Issuer, the Sellers, the Servicers, the Account Bank, the GIC Provider, the Stand-by Account Bank, the Stand-by GIC Provider, the Cash Manager, the Swap Providers, the Corporate Services Provider, the Paying Agents and any other person which becomes a Secured Creditor pursuant to the Deed of Charge.

### ***Release of Security***

In the event of any sale of Loans (including Selected Loans) and their Related Security by the LLP pursuant to and in accordance with the Transaction Documents, the Security Trustee will (subject to the written request of the LLP), release those Loans from the Security created by and pursuant to the Deed of Charge on the date of such sale but only if:

- (i) the Security Trustee provides its prior written consent to the terms of such sale as described under – *LLP Deed – Method of Sale of Selected Loans* above; and
- (ii) the LLP provides to the Security Trustee a certificate confirming that the Selected Loans being sold have been selected on a random basis.

### ***Enforcement***

If an LLP Acceleration Notice is served on the Issuer and the LLP, the Security Trustee shall be entitled to appoint a Receiver, and/or enforce the Security constituted by the Deed of Charge (including selling the Portfolio), and/or take such steps as it shall deem necessary, subject in each case to being indemnified and/or secured to its satisfaction. All proceeds received by the Security Trustee from the enforcement of the Security will be applied in accordance with the Post-Enforcement Priority of Payments described under Cashflows.

### ***Governing Law***

The Deed of Charge is governed by English law (other than the assignation in security referred to above and any assignation in security granted after the Programme Date pursuant and supplemental to the Deed of Charge which will be governed by Scots law).

## CREDIT STRUCTURE

The Covered Bonds will be direct, unsecured and unconditional obligations of the Issuer and the Group Guarantors only. The LLP has no obligation to pay the Guaranteed Amounts under the Covered Bond Guarantee until the occurrence of an HBOS Event of Default, service by the Bond Trustee on the Issuer and the Group Guarantors of an HBOS Acceleration Notice and on the LLP of a Notice to Pay or, if earlier, following the occurrence of an LLP Event of Default, service by the Bond Trustee of an LLP Acceleration Notice on the Issuer and the LLP. The Issuer will not be relying on payments by the LLP in respect of the Term Advances or receipt of Revenue Receipts or Principal Receipts from the Portfolio in order to pay interest or repay principal under the Covered Bonds.

There are a number of features of the Programme which enhance the likelihood of timely and, as applicable, ultimate payments to Covered Bondholders, as follows:

- the Group Guarantee and the Covered Bond Guarantee provide credit support to the Issuer;
- the Pre-Maturity Test is intended to provide liquidity to the LLP in respect of principal due on the Final Maturity Date of Hard Bullet Covered Bonds;
- the Asset Coverage Test is intended to ensure that the ratio of the LLP's assets to the Covered Bonds is maintained at a certain level;
- the Amortisation Test is intended to test the asset coverage of the LLP's assets in respect of the Covered Bonds following the occurrence of an HBOS Event of Default and service of a Notice of Pay on the LLP;
- a Reserve Fund will be established in the GIC Account to trap Available Revenue Receipts if the Issuer's short-term ratings or Deemed Rating, as applicable, fall below A-1+ by S&P, F1+ by Fitch or P-1 by Moody's;
- under the terms of the Guaranteed Investment Contract, the GIC Provider has agreed to pay a variable rate of interest on all amounts held by the LLP in the GIC Account at a rate of 0.25 per cent. per annum below LIBOR for one-month sterling deposits; and
- under the terms of the Stand-by Guaranteed Investment Contract, the Stand-by GIC Provider has agreed to pay a variable rate of interest on all amounts held by the LLP in the Stand-by GIC Account at a rate of 0.25 per cent. per annum below LIBOR for one-month sterling deposits.

Certain of these factors are considered more fully in the remainder of this section.

### *Guarantees*

Under the terms of the Group Guarantee, if the Issuer defaults in the payment on the due date of any moneys due and payable under the Trust Deed or the Covered Bonds, the Group Guarantors have agreed, on a joint and several basis, to unconditionally pay or procure to be paid unconditionally upon demand the amount in respect of which such default has been made.

The Covered Bond Guarantee provided by the LLP under the Trust Deed guarantees payment of Guaranteed Amounts when the same become Due for Payment in respect of all Covered Bonds issued under the Programme. The Covered Bond Guarantee will not guarantee any amount becoming payable in respect of the Covered Bonds for any other reason, including any accelerated payment pursuant to Condition 9 (*Events of Default and Enforcement*) following the occurrence of an HBOS Event of Default. In this circumstance (and until an LLP Event of Default occurs and an LLP Acceleration Notice is served), the

LLP's obligations will only be to pay the Guaranteed Amounts as they fall Due for Payment on each Scheduled Payment Date.

See further *Summary of the Principal Documents – Trust Deed* as regards the terms of the Guarantees. See further *Cashflows – Guarantee Priority of Payments* as regards the payment of amounts payable by the LLP to Covered Bondholders and other Secured Creditors following the occurrence of an HBOS Event of Default.

### ***Pre-Maturity Liquidity***

Certain Series of Covered Bonds are scheduled to be redeemed in full on the Final Maturity Date therefor without any provision for scheduled redemption other than on the Final Maturity Date (the **Hard Bullet Covered Bonds**). The applicable Final Terms will identify whether any Series of Covered Bonds is a Series of Hard Bullet Covered Bonds. The Pre-Maturity Test is intended to provide liquidity for the Hard Bullet Covered Bonds when the Issuer's credit ratings or Deemed Ratings, as applicable, fall to a certain level. On each London Business Day (each the **Pre-Maturity Test Date**) prior to the occurrence of an HBOS Event of Default or the occurrence of an LLP Event of Default, the LLP or the Cash Manager on its behalf will determine if the Pre-Maturity Test has been breached, and if so, it shall immediately notify the Members and the Security Trustee thereof.

The Issuer will fail and be in breach of the **Pre-Maturity Test** on a Pre-Maturity Test Date if:

- (a) the Issuer's short-term credit rating or Deemed Rating, as applicable, from S&P falls to A-1 (or lower) and the Final Maturity Date of the Series of Hard Bullet Covered Bonds will fall within 6 months from the relevant Pre-Maturity Test Date; or
- (b) the Issuer's (i) long-term credit rating or Deemed Rating, as applicable, from Moody's falls to A2 (or lower) and the Final Maturity Date of the Series of Hard Bullet Covered Bonds will fall within 6 months from the relevant Pre-Maturity Test Date or (ii) short-term credit rating or Deemed Rating, as applicable, from Moody's falls to P-2 (or lower) and the Final Maturity Date of the Series of Hard Bullet Covered Bonds will fall within 12 months from the relevant Pre-Maturity Test Date; or
- (c) the Issuer's short-term credit rating or Deemed Rating, as applicable, from Fitch falls to F1 (or lower) and the Final Maturity Date of the Series of Hard Bullet Covered Bonds will fall within 6 months from the relevant Pre-Maturity Test Date.

Following a breach of the Pre-Maturity Test in respect of a Series of Covered Bonds, the LLP shall offer to sell Selected Loans and their Related Security to Purchasers, subject to:

- (a) any Cash Capital Contribution made by the Members (other than the Liquidation Member) from time to time; and
- (b) any right of pre-emption enjoyed by the Sellers pursuant to the terms of the Mortgage Sale Agreement,

provided that an HBOS Event of Default shall occur if the Pre-Maturity Test in respect of any Series of Hard Bullet Covered Bonds is breached less than six months prior to the Final Maturity Date of that Series of Hard Bullet Covered Bonds, and the relevant parties have not taken the required action (as described above) following the breach within the earlier to occur of (i) 10 Business Days from the date that the Sellers are notified of the breach of the Pre-Maturity Test and (ii) the Final Maturity Date of that Series of Hard Bullet Covered Bonds such that by the end of such period, there shall be an amount equal to the Required Redemption Amount of that Series of Hard Bullet Covered Bonds standing to the credit of the Pre-Maturity Liquidity Ledger (after taking into account the Required Redemption Amount of all other Series of Hard Bullet Covered Bonds which mature prior to or on the same date as the relevant Series of Hard Bullet

Covered Bonds). The method for selling Selected Loans and their Related Security is described in *Summary of Principal Documents - The LLP Deed - Sales of Selected Loans and their Related Security if the Pre-Maturity Test is breached* above. The proceeds of sale of Selected Loans and their Related Security and/or the proceeds of any Cash Contribution as described above, will be recorded to the Pre-Maturity Liquidity Ledger on the GIC Account.

In certain circumstances, Revenue Receipts will also be available to repay a Hard Bullet Covered Bond, as described in *Cashflows - Pre-Acceleration Revenue Priority of Payments below*.

Failure by the Issuer and/or the Group Guarantors to pay the full amount due in respect of a Series of Hard Bullet Covered Bonds on the Final Maturity Date thereof will constitute an HBOS Event of Default. Following service of a Notice to Pay on the LLP, the LLP shall apply funds standing to the Pre-Maturity Liquidity Ledger to repay the relevant Series of Hard Bullet Covered Bonds.

If the Issuer and/or the Group Guarantors fully repay the relevant Series of Hard Bullet Covered Bonds on the Final Maturity Date thereof, cash standing to the credit of the Pre-Maturity Liquidity Ledger on the GIC Account shall be applied by the LLP in accordance with the Pre-Acceleration Principal Priority of Payments, unless:

- (a) the Issuer is failing the Pre-Maturity Test in respect of any other Series of Hard Bullet Covered Bonds, in which case the cash will remain on the Pre-Maturity Liquidity Ledger in order to provide liquidity for that other Series of Hard Bullet Covered Bonds; or
- (b) the Issuer is not failing the Pre-Maturity Test, but the Management Board elects to retain the cash on the Pre-Maturity Liquidity Ledger in order to provide liquidity for any future Series of Hard Bullet Covered Bonds.

Amounts standing to the credit of the Pre-Maturity Liquidity Ledger following the repayment of the Hard Bullet Covered Bonds as described above may, except where the

Management Board has elected or is required to retain such amounts on the Pre-Maturity Liquidity Ledger, also be used to repay the corresponding Term Advance and distribute any excess Available Principal Receipts back to the Members on dates other than LLP Payment Dates, subject to the LLP making provision for higher ranking items in the Pre-Acceleration Principal Priority of Payments.

### ***Asset Coverage Test***

The Asset Coverage Test is intended to ensure that the LLP can meet its obligations under the Covered Bond Guarantee. Under the LLP Deed, the LLP and its Members (other than the Liquidation Member) must ensure that on each Calculation Date the Adjusted Aggregate Loan Amount will be in an amount equal to or in excess of the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date. If the Asset Coverage Test is failed on any Calculation Date, and such failure is not remedied on or before the next following Calculation Date, then an HBOS Event of Default will occur. The Asset Coverage Test is a formula which adjusts the Current Balance of each Loan in the Portfolio and has further adjustments to take account of set-off on a Borrower's current or deposit accounts held with each Seller, set-off associated with drawings made by Borrowers under Flexible Loans and Defaulted Loans that are not repurchased or failure by Sellers, in accordance with the Mortgage Sale Agreement to repurchase or Loans that do not materially comply with the Representations and Warranties on the relevant Transfer Date. See further *Summary of the Principal Loans - LLP Deed - Asset Coverage Test*, above.



### ***Amortisation Test***

The Amortisation Test is intended to ensure that if, following HBOS Event of Default and the service of a Notice to Pay on the LLP (but prior to service on the LLP and the Issuer of an LLP Acceleration Notice), the assets of the LLP available to meet its obligations under the Covered Bond Guarantee fall to a level where Covered Bondholders may not be repaid, an LLP Event of Default will occur and all amounts owing under the Covered Bonds may be accelerated. Under the LLP Deed, the LLP and its Members (other than the Liquidation Member) must ensure that on each Calculation Date following an HBOS Event of Default the Amortisation Test Aggregate Loan Amount will be in an amount at least equal to the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date. The Amortisation Test is a formula which adjusts the Current Balance of each Loan in the Portfolio and has further adjustments to take account of Loans in arrears. See further *Summary of the Principal Documents - LLP Deed - Amortisation Test*, above.

### ***Reserve Fund***

If at any time prior to an HBOS Event of Default the Issuer's short-term, unsecured, unsubordinated and unguaranteed debt obligations or Deemed Ratings, as applicable, cease to be rated A-1+ by S&P, P-1 by Moody's or F1+ by Fitch, the LLP will be required to establish a reserve fund (the **Reserve Fund**) on the GIC Account which will be credited with Available Revenue Receipts up to an amount equal to the Scheduled Interest due on the next following Interest Payment Date on each Series of Covered Bonds (the **Reserve Fund Required Amount**). The LLP will not be required to maintain the Reserve Fund following the occurrence of an HBOS Event of Default.

The Reserve Fund will be funded from Available Revenue Receipts after the LLP has paid all of its obligations in respect of items ranking higher than the Reserve Ledger falling at item (c) of the Pre-Acceleration Revenue Priority of Payments on each LLP Payment Date.

A Reserve Ledger will be maintained by the Cash Manager to record the balance from time to time of the Reserve Fund. Following the occurrence of an HBOS Event of Default and service of a Notice to Pay on the LLP, amounts standing to the credit of the Reserve Fund will be added to certain other income of the LLP in calculating Available Revenue Receipts.

## CASHFLOWS

As described above under **Credit Structure**, until a Notice to Pay is served on the LLP, the Covered Bonds will be obligations of the Issuer and the Group Guarantors only. Neither the Issuer nor any Group Guarantor is reliant, in any way, on the cashflows of the LLP to satisfy their respective obligations under the Covered Bonds.

This section summarises the cashflows of the LLP only, as to the allocation and distribution of amounts standing to the credit of the LLP Accounts and their order of priority (all such orders of priority, the **Priorities of Payments**) (i) prior to an HBOS Event of Default and an LLP Event of Default, (ii) following an HBOS Event of Default (but prior to an LLP Event of Default) and (iii) following an LLP Event of Default in accordance with the LLP Deed or the Deed of Charge, as applicable.

### Definitions

For the purposes hereof:

**Available Principal Receipts** means on a relevant Calculation Date an amount equal to the aggregate of (without double counting):

- (a) the amount of Principal Receipts received during the immediately preceding Calculation Period and credited to the Principal Ledger on the GIC Account (**but excluding** any Principal Receipts received in the Calculation Period beginning in the month in which the relevant Calculation Date falls);
- (b) any other amount standing to the credit of the Principal Ledger including (i) the proceeds of any Term Advance (where such proceeds have not been applied to acquire New Portfolios, refinance an existing Term Advance, invest in Substitution Assets or make a Capital Distribution to a Member), (ii) any Cash Capital Contributions received from a Member and (iii) the proceeds from any sale of Selected Loans pursuant to the terms of the LLP Deed or the Mortgage Sale Agreement;
- (c) following repayment of any Hard Bullet Covered Bonds by the Issuer and the Group Guarantors on the Final Maturity Date thereof, any amounts standing to the credit of the Pre-Maturity Liquidity Ledger in respect of such Series of Hard Bullet Covered Bonds (except where the LLP has elected to or is required to retain such amounts on the Pre-Maturity Liquidity Ledger); and
- (d) all amounts in respect of principal (if any) received by the LLP under the Covered Bond Swap Agreement on the relevant LLP Payment Date (other than any termination payments or Swap Collateral Excluded Amounts).

**Available Revenue Receipts** means on a relevant Calculation Date, an amount equal to the aggregate of:

- (a) the amount of Revenue Receipts received during the previous Calculation Period and credited to the Revenue Ledger on the GIC Account (**but excluding** any Revenue Receipts received in the Calculation Period beginning in the month in which the relevant Calculation Date falls);
- (b) prior to the service of a Notice to Pay, amounts standing to the credit of the Reserve Fund in excess of the Reserve Fund Required Amount;
- (c) other net income of the LLP including all amounts of interest received on the LLP Accounts, the Substitution Assets and Authorised Investments in the preceding Calculation Period and amounts received by the LLP under the Interest Rate Swap Agreements and in respect of interest received by

the LLP under the Covered Bond Swap Agreements on the relevant LLP Payment Date (other than any termination payments or Swap Collateral Excluded Amounts);

- (d) any other Revenue Receipts not referred to in paragraphs (a) to (d) above received during the previous Calculation Period and standing to the credit of the Revenue Ledger on the GIC Account; and
- (e) following the service on the LLP of a Notice to Pay, amounts standing to the credit of the Reserve Fund;

*less*

- (f) Third Party Amounts, which shall be paid on receipt in cleared funds to each Seller (to the extent that the Third Party Amounts relate to Loans serviced by that Seller).

**Covered Bond Swap Rate** means in relation to a Covered Bond or Series of Covered Bonds, the exchange rate specified in the Covered Bond Swap Agreement relating to such Covered Bond or Series of Covered Bonds or, if the Covered Bond Swap Agreement has terminated, the applicable spot rate.

**Earliest Maturing Covered Bonds** means at any time the relevant Series of the Covered Bonds that has the earliest Final Maturity Date as specified in the applicable Final Terms (ignoring any acceleration of amounts due under the Covered Bonds prior to the occurrence of an LLP Event of Default).

**Excluded Swap Termination Amount** means in relation to a Swap Agreement, an amount equal to the amount of any termination payment due and payable (i) to the relevant Swap Provider as a result of a Swap Provider Default with respect to such Swap Provider or (ii) to the relevant Swap Provider following a Swap Provider Downgrade Event with respect to such Swap Provider.

**Final Maturity Date** means the Interest Payment Date on which each Series of Covered Bonds will be redeemed at their Principal Amount Outstanding in accordance with the Conditions.

**Interest Payment Date** means in relation to any Fixed Rate Covered Bond, such date or dates as indicated in the applicable Final Terms and, in relation to any Floating Rate Covered Bond or Index Linked Interest Covered Bond, either:

- (a) the date which falls the number of months or other period specified as the **Specified Period** in the applicable Final Terms after the preceding Interest Payment Date or the Interest Commencement Date (in the case of the first Interest Payment Date); or
- (b) such date or dates as are indicated in the applicable Final Terms.

**LLP Payment Period** means the period from and including an LLP Payment Date to but excluding the next following LLP Payment Date.

**Principal Receipts** means:

- (a) principal repayments under the Loans (including payments of arrears, Accrued Interest and Arrears of Interest as at the relevant Transfer Date of a Loan);
- (b) recoveries of principal from defaulting Borrowers under Loans being enforced (including the proceeds of sale of the relevant Property);
- (c) any payment pursuant to any insurance policy in respect of a property the subject of a Mortgage in connection with a Loan in the Portfolio; and

- (d) the proceeds of the repurchase of any Loan by any Seller from the LLP pursuant to the Mortgage Sale Agreement (including, for the avoidance of doubt, amounts attributable to Accrued Interest and Arrears of Interest thereon as at the relevant repurchase date).

**Reserve Fund Required Amount** means zero unless the Issuer is rated less than A-1+ by S&P or less than P-1 by Moody's or less than F1+ by Fitch, in which case it is the aggregate of the Scheduled Interest due on the next following Interest Payment Date on each Series of Covered Bonds.

**Revenue Receipts** means:

- (a) payments of interest (excluding Accrued Interest and Arrears of Interest as at the relevant Transfer Date of a Loan) and other fees due from time to time under the Loans and other amounts received by the LLP in respect of the Loans other than the Principal Receipts;
- (b) recoveries of interest and outstanding fees from defaulting Borrowers under Loans being enforced; and
- (c) recoveries of interest and/or principal from defaulting Borrowers under Loans in respect of which enforcement procedures have been completed.

**Sale Proceeds** means the cash proceeds realised from the sale of Selected Loans and their Related Security.

**Swap Collateral** means, at any time, any asset (including, without limitation, cash and/or securities) which is paid or transferred by a Swap Provider to the LLP as collateral to secure the performance by such Swap Provider of its obligations under the relevant Swap Agreement together with any income or distributions received in respect of such asset and any equivalent of such asset into which such asset is transformed.

**Swap Collateral Excluded Amounts** means, at any time, the amount of Swap Collateral which may not be applied at that time in satisfaction of the relevant Swap Provider's obligations to the LLP under the terms of the relevant Swap Agreement.

**Swap Provider Default** means the occurrence of an Event of Default or Termination Event (each as defined in each of the Swap Agreements) where the relevant Swap Provider is the Defaulting Party or the sole Affected Party (each as defined in relevant Swap Agreement), as applicable, other than a Swap Provider Downgrade Event.

**Swap Provider Downgrade Event** means the occurrence of an Additional Termination Event or an Event of Default (each as defined in the relevant Swap Agreement) following a failure by the Swap Provider to comply with the requirements of the ratings downgrade provisions set out in the relevant Swap Agreement.

The **Sterling Equivalent** of any amount means (a) in relation to a Covered Bond or Series of Covered Bonds which is denominated in a currency other than sterling, the sterling equivalent of such amount ascertained using the Covered Bond Swap Rate relating to such Covered Bonds and (b) in relation to a Covered Bond or Series of Covered Bonds denominated in sterling, the applicable amount in sterling.

**Third Party Amounts** include:

- (a) payments of insurance premiums due to any provider of mortgage indemnity guarantees;
- (b) amounts under a direct debit which are repaid to the bank making the payment if such bank is unable to recoup that amount itself from its customer account;

- (c) payments by the Borrower of any fees (including Early Repayment Fees) and other charges which are due to the relevant Seller; and
- (d) any amount received from a Borrower for the express purpose of payment being made to a third party for the provision of a service (including giving insurance cover) to either that Borrower or the Seller (in relation to Loans sold by that Seller) or the LLP,

which amounts may be paid daily from moneys on deposit in the GIC Account.

**Allocation and Distribution of Revenue Receipts prior to the service of a Notice to Pay**

Prior to service of a Notice to Pay or an LLP Acceleration Notice on the Issuer and the LLP, Revenue Receipts will be allocated and distributed as described below.

On the Calculation Date immediately preceding each LLP Payment Date, the LLP or the Cash Manager on its behalf shall calculate:

- (a) the amount of Available Revenue Receipts available for distribution on the immediately following LLP Payment Date;
- (b) the Reserve Fund Required Amount; and
- (c) where the Pre-Maturity Test has been breached in respect of a Series of Hard Bullet Covered Bonds, on each Calculation Date falling in the five months prior to the Final Maturity Date of the relevant Series of Hard Bullet Covered Bonds, whether or not the amount standing to the credit of the Pre-Maturity Liquidity Ledger at such date is less than the Required Redemption Amount for the relevant Series of Hard Bullet Covered Bonds at such date (together with the Required Redemption Amount of all other Series of Hard Bullet Covered Bonds which mature prior to or on the same date as the relevant Series of Hard Bullet Covered Bonds).

If an LLP Payment Date is the same as an Interest Payment Date, then the distribution of Available Revenue Receipts under the Pre-Acceleration Revenue Priority of Payments will be delayed until the Issuer and/or the Group Guarantors have made the scheduled interest and/or principal payments on that Interest Payment Date.

***Pre-Acceleration Revenue Priority of Payments***

On each LLP Payment Date, the LLP or the Cash Manager on its behalf will transfer funds from the GIC Account to the Transaction Account, in an amount equal to the amount of Available Revenue Receipts.

Prior to service of a Notice to Pay or service of an LLP Acceleration Notice on the Issuer and the LLP, Available Revenue Receipts will be applied by or on behalf of the LLP on each LLP Payment Date (except for amounts due to third parties by the LLP under paragraphs (a) and (b), which shall be paid when due) in making the following payments and provisions (the **Pre-Acceleration Revenue Priority of Payments**) (in each case only if and to the extent that payments or provisions of a higher priority have been made in full):

- (a) *first*, in or towards satisfaction of any amounts due and payable by the LLP to third parties and incurred without breach by the LLP of the Transaction Documents to which it is a party (and for which payment has not been provided for elsewhere in the relevant Priorities of Payments) and to provide for any such amounts expected to become due and payable by the LLP in the immediately succeeding LLP Payment Period and to pay and discharge any liability of the LLP for taxes;

- (b) *second*, in or towards satisfaction *pro rata* and *pari passu* according to the respective amounts thereof of:
- (i) any remuneration then due and payable to the Servicers and any costs, charges, liabilities and expenses then due or to become due and payable to the Servicers under the provisions of the Servicing Agreements in the immediately succeeding LLP Payment Period, together with applicable VAT (or similar taxes) thereon as provided therein;
  - (ii) any remuneration then due and payable to the Cash Manager and any costs, charges, liabilities and expenses then due or to become due and payable to the Cash Manager under the provisions of the Cash Management Agreement in the immediately succeeding LLP Payment Period, together with applicable VAT (or similar taxes) thereon as provided therein;
  - (iii) amounts (if any) due and payable to the Account Bank (including costs) pursuant to the terms of the Bank Account Agreement, together with applicable VAT (or similar taxes) thereon as provided therein;
  - (iv) amounts due and payable to the Corporate Services Provider pursuant to the terms of the Corporate Services Agreement; and
  - (v) amounts due and payable to the Asset Monitor pursuant to the terms of the Asset Monitor Agreement (other than the amounts referred to in paragraph (j) below), together with applicable VAT (or similar taxes) thereon as provided therein;
- (c) *third*, to pay *pro rata* and *pari passu* any amount due to the Interest Rate Swap Providers (including any termination payment due and payable by the LLP under the relevant Interest Rate Swap Agreement (but excluding any Excluded Swap Termination Amount)) pursuant to the terms of the relevant Interest Rate Swap Agreements;
- (d) *fourth*, towards a credit to the Reserve Ledger on the GIC Account of an amount up to but not exceeding the amount by which the Reserve Fund Required Amount exceeds the existing balance on the Reserve Ledger as calculated on the immediately preceding Calculation Date;
- (e) *fifth*, if the LLP is required to make a deposit to the Pre-Maturity Liquidity Ledger in accordance with the LLP Deed, towards a credit to the GIC Account with a corresponding credit to that Ledger of an amount up to but not exceeding the difference between:
- (i) the Required Redemption Amount as calculated on the immediately preceding Calculation Date for the relevant Series of Hard Bullet Covered Bonds; and
  - (ii) any amounts standing to the credit of the Pre-Maturity Liquidity Ledger on the immediately preceding Calculation Date after deducting from that Ledger the Required Redemption Amounts of all other Series of Hard Bullet Covered Bonds as calculated on that Calculation Date which mature prior to or at the same date as the relevant Series of Hard Bullet Covered Bonds;
- (f) *sixth*, if a Servicer Event of Default has occurred, all remaining Available Revenue Receipts to be credited to the GIC Account (with a corresponding credit to the Revenue Ledger) until such Servicer Event of Default is either remedied or waived by the Security Trustee or a New Servicer is appointed to service the Portfolio (or the relevant part thereof);
- (g) *seventh*, in or towards payment *pro rata* and *pari passu* in accordance with the respective amounts thereof any Excluded Swap Termination Amount due and payable by the LLP under the relevant Interest Rate Swap Agreements;

- (h) *eighth*, towards payment of any amounts due and payable (excluding principal amounts due and payable) to the Issuer pursuant to the terms of the Intercompany Loan Agreement;
- (i) *ninth*, towards payment of any indemnity amount due to the Members pursuant to the LLP Deed;
- (j) *tenth*, towards payment of any indemnity amount due to the Asset Monitor pursuant to the Asset Monitor Agreement;
- (k) *eleventh*, in respect of Deferred Consideration due to the Sellers for the transfer of the Loans and their Related Security to the LLP, to pay all remaining Available Revenue Receipts (except for an amount equal to the profit to be paid to the Members in accordance with (l) below) to the Sellers *pari passu*, but so that only Available Revenue Receipts that are specifically attributable to Loans sold by a relevant Seller shall be paid to that Seller; and
- (l) *twelfth*, towards payment *pro rata* and *pari passu* to the Members of the sum of £3,000 (or such other sum as may be agreed by the Members from time to time) in aggregate, to be allocated and paid to each Member in proportion to their respective Capital Contribution Balances as at the relevant Calculation Date subject to a minimum of £1.00 each, as their profit for their respective interests as Members in the LLP.

#### **Allocation and Distribution of Principal Receipts prior to service of a Notice to Pay**

Prior to service of a Notice to Pay on the LLP or the service of an LLP Acceleration Notice on the Issuer and the LLP, Principal Receipts will be allocated and distributed as described below.

On each Calculation Date, the LLP or the Cash Manager on its behalf will calculate the amount of Available Principal Receipts available for distribution on the immediately following LLP Payment Date.

On each LLP Payment Date, the LLP or the Cash Manager on its behalf will transfer funds from the GIC Account to the Transaction Account, in an amount equal to the lower of (a) the amount required to make the payments described below and (b) the amount of all Available Principal Receipts.

If an LLP Payment Date is the same as an Interest Payment Date or Final Maturity Date, then the distribution of Available Principal Receipts under the Pre-Acceleration Principal Priority of Payments will be delayed until the Issuer and/or Group Guarantors have made scheduled interest and/or principal payments on that Interest Payment Date.

#### ***Pre-Acceleration Principal Priority of Payments***

Prior to service of a Notice to Pay or an LLP Acceleration Notice on the Issuer and the LLP, all Available Principal Receipts (other than Cash Capital Contributions made from time to time by the Issuer, which shall (subject to complying with the Asset Coverage Test) be distributed to the Issuer as a Capital Distribution) will be applied by or on behalf of the LLP on each LLP Payment Date in making the following payments and provisions (the **Pre-Acceleration Principal Priority of Payments**):

- (a) *first*, if the Pre-Maturity Test has been failed by the Issuer in respect of any Series of Hard Bullet Covered Bonds, to credit all Principal Receipts to the Pre-Maturity Liquidity Ledger in an amount up to but not exceeding the difference between:
  - (i) the Required Redemption Amount calculated on the immediately preceding Calculation Date for the relevant Series of Hard Bullet Covered Bonds; and



- (ii) any amounts standing to the credit of the Pre-Maturity Liquidity Ledger on the immediately preceding Calculation Date after deducting from that Ledger the Required Redemption Amount of all other Hard Bullet Covered Bonds, as calculated on that Calculation Date, which mature prior to or on the same date as the relevant Series of Hard Bullet Covered Bonds;
- (b) *second*, to acquire New Loans and their Related Security offered to the LLP by the Sellers in accordance with the terms of the Mortgage Sale Agreement in an amount sufficient to ensure that taking into account the other resources available to the LLP, the LLP is in compliance with the Asset Coverage Test, but so that only Available Principal Receipts that are specifically attributable to Loans sold by a specific Seller shall be firstly applied to acquire New Loans and their Related Security from that Seller and thereafter to the extent that such Seller fails or declines to sell New Loans to the LLP, to acquire New Loans from any Seller and/or to acquire Substitution Assets;
- (c) *third*, to deposit the remaining Principal Receipts in the GIC Account (with a corresponding credit to the Principal Ledger) in an amount sufficient to ensure that taking into account the other resources available to the LLP, the LLP is in compliance with the Asset Coverage Test;
- (d) *fourth*, provided that all amounts outstanding under a Series of Covered Bonds have been repaid in full, in or towards repayment of the corresponding Term Advance related to such Series of Covered Bonds; and
- (e) *fifth*, subject to complying with the Asset Coverage Test, to make a Capital Distribution *pari passu* to each Member (other than the Liquidation Member) by way of distribution of that Member's equity in the LLP in an amount equal to any remaining Available Principal Receipts but so that only Available Principal Receipts that are specifically attributable to Loans sold by a specific Member (in its capacity as a Seller) shall be paid to that Member.

#### **Allocation and Distribution of moneys following service of a Notice to Pay**

At any time after the occurrence of an HBOS Event of Default, service of an HBOS Acceleration Notice on the Issuer and the Group Guarantors and service of a Notice to Pay on the LLP, but prior to service of an LLP Acceleration Notice on the Issuer and the LLP, all moneys (other than Third Party Amounts) will be applied as described below.

On each LLP Payment Date, the LLP or the Cash Manager on its behalf will transfer funds from the GIC Account to the Transaction Account, in an amount equal to the lower of (a) the amount required to make the payments set out in the Guarantee Priority of Payments and (b) the amount standing to the credit of the GIC Account.

The LLP will create and maintain ledgers for each Series of Covered Bonds and record amounts allocated to such Series of Covered Bonds in accordance with paragraph (e) below, and such amounts, once allocated, will only be available to pay amounts due under the Covered Bond Guarantee and amounts due under the Covered Bond Swap relevant in respect of the relevant Series of Covered Bonds on the scheduled repayment date thereof.

#### ***Guarantee Priority of Payments***

If a Notice to Pay is served on the LLP in connection with the Pre-Maturity Test (as set out in the LLP Deed), the LLP shall on the relevant Final Maturity Date apply all moneys standing to the credit of the Pre-Maturity Liquidity Ledger (and transferred to the Transaction Account on the relevant LLP Payment Date) to repay the relevant Series of Hard Bullet Covered Bonds in accordance with the LLP Deed (as described in *Credit Structure — Pre Maturity Liquidity*). Subject thereto, on each LLP Payment Date after the service

of a Notice to Pay on the LLP (but prior to the occurrence of an LLP Event of Default), the LLP or the Cash Manager on its behalf will apply moneys standing to the credit of the Transaction Account to make the following payments and provisions in the following order of priority (the **Guarantee Priority of Payments**) (in each case only if and to the extent that payments or provisions of a higher priority have been made in full):

- (a) *first*, in or towards satisfaction *pro rata* according to the respective amounts thereof of:
  - (i) all amounts due and payable or to become due and payable to the Bond Trustee in the immediately succeeding LLP Payment Period under the provisions of the Trust Deed together with interest and applicable VAT (or similar taxes) thereon as provided therein;
  - (ii) all amounts due and payable or to become due and payable to the Security Trustee in the immediately succeeding LLP Payment Period under the provisions of the Deed of Charge together with interest and applicable VAT (or similar taxes) thereon as provided therein;
  - (iii) any remuneration then due and payable to the Agent Bank and the Agents under the provisions of the Agency Agreement together with applicable VAT (or similar taxes) thereon as provided therein; and
  - (iv) any amounts then due and payable by the LLP to third parties and incurred without breach by the LLP of the Transaction Documents to which it is a party (and for which payment has not been provided for elsewhere) and to provide for any such amounts expected to become due and payable by the LLP in the immediately succeeding LLP Payment Period and to pay or discharge any liability of the LLP for taxes;
- (b) *second*, in or towards satisfaction *pro rata* according to the respective amounts thereof of:
  - (i) any remuneration then due and payable to the Servicers and any costs, charges, liabilities and expenses then due or to become due and payable to the Servicers in the immediately succeeding LLP Payment Period under the provisions of the Servicing Agreements together with applicable VAT (or similar taxes) thereon as provided therein;
  - (ii) any remuneration then due and payable to the Cash Manager and any costs, charges, liabilities and expenses then due or to become due and payable to the Cash Manager in the immediately succeeding LLP Payment Period under the provisions of the Cash Management Agreement, together with applicable VAT (or similar taxes) thereon as provided therein;
  - (iii) amounts (if any) due and payable to the Account Bank (including costs) pursuant to the terms of the Bank Account Agreement, together with applicable VAT (or similar taxes) thereon as provided therein;
  - (iv) amounts due and payable to the Corporate Services Provider pursuant to the Corporate Services Agreement; and
  - (v) amounts due and payable to the Asset Monitor (other than the amounts referred to in paragraph (j) below) pursuant to the terms of the Asset Monitor Agreement, together with applicable VAT (or similar taxes) thereon as provided therein;
- (c) *third*, in or towards satisfaction *pro rata* according to the respective amounts thereof, of any amounts due and payable to the Interest Rate Swap Providers (including any termination payment due and payable by the LLP under the relevant Interest Rate Swap Agreement but excluding any Excluded Swap Termination Amount) pursuant to the terms of the Interest Rate Swap Agreements;

- (d) *fourth*, to pay *pro rata* and *pari passu* according to the respective amounts thereof, of:
- (i) the amounts due and payable to the Covered Bond Swap Provider (other than in respect of principal) *pro rata* and *pari passu* in respect of each relevant Series of Covered Bonds (including any termination payment due and payable by the LLP under the relevant Covered Bond Swap Agreement but excluding any Excluded Swap Termination Amount) in accordance with the terms of the relevant Covered Bond Swap Agreement; and
  - (ii) to the Bond Trustee or (if so directed by the Bond Trustee) the Principal Paying Agent on behalf of the Covered Bondholders *pro rata* and *pari passu* Scheduled Interest that is Due for Payment on each Series of Covered Bonds,

provided that if the amount available for distribution under this paragraph (d) (excluding any amounts received from the Covered Bond Swap Provider) would be insufficient to pay the Sterling Equivalent of the Scheduled Interest that is Due for Payment on each Series of Covered Bonds under (ii) above, the shortfall shall be divided amongst all such Series of Covered Bonds on a *pro rata* basis and the amount payable by the LLP to the Covered Bond Swap Provider in respect of each Series of Covered Bonds under (i) above shall be reduced by the amount of the shortfall applicable to the Covered Bonds in respect of which such payment is to be made;

- (e) *fifth*, to pay or provide for *pro rata* and *pari passu* according to the respective amounts thereof, of:
- (i) the amounts (in respect of principal) due and payable to the Covered Bond Swap Provider *pro rata* and *pari passu* in respect of the relevant Series of Covered Bonds (including any termination payment due and payable by the LLP under the relevant Covered Bond Swap Agreement but excluding any Excluded Swap Termination Amount) in accordance with the terms of the relevant Covered Bond Swap Agreement; and
  - (ii) to the Bond Trustee or (if so directed by the Bond Trustee) the Principal Paying Agent on behalf of the Covered Bondholders *pro rata* and *pari passu* Scheduled Principal that is Due for Payment on each Series of Covered Bonds,

provided that if the amount available for distribution under this paragraph (e) (excluding any amounts received from the Covered Bond Swap Provider) would be insufficient to pay the Sterling Equivalent of the Scheduled Principal that is Due for Payment on the relevant Series of Covered Bonds under (ii) above, the shortfall shall be divided amongst all such Series of Covered Bonds on a *pro rata* basis and the amount payable by the LLP to the Covered Bond Swap Provider in respect of each Series of Covered Bonds under (i) above shall be reduced by the amount of the shortfall applicable to the Covered Bonds in respect of which such payment is to be made;

- (f) *sixth*, to deposit the remaining moneys in the GIC Account for application on the next following LLP Payment Date in accordance with the priority of payments described in paragraphs (a) to (e) (inclusive) above, until the Covered Bonds have been fully repaid or provided for (such that the Required Redemption Amount has been accumulated in respect of each outstanding Series of Covered Bonds);
- (g) *seventh*, in or towards satisfaction *pro rata* and *pari passu* according to the respective amounts thereof of any Excluded Swap Termination Amount due and payable by the LLP to the relevant Swap Provider under the relevant Swap Agreement;
- (h) *eighth*, after the Covered Bonds have been fully repaid or provided for (such that the Required Redemption Amount has been accumulated in respect of each outstanding Series of Covered Bonds),

any remaining moneys will be applied in and towards repayment in full of amounts outstanding under the Intercompany Loan Agreement;

- (i) *ninth*, towards payment of any indemnity amount due to the Members pursuant to the LLP Deed;
- (j) *tenth*, towards payment of certain costs, expenses and indemnity amounts due by the LLP to the Asset Monitor pursuant to the Asset Monitor Agreement; and
- (k) *eleventh*, thereafter any remaining moneys will be applied in accordance with the LLP Deed.

**Application of moneys received by the Security Trustee following the occurrence of an LLP Event of Default and enforcement of the Security**

Under the terms of the Deed of Charge, all moneys received or recovered by the Security Trustee (or a Receiver appointed on its behalf) following the occurrence of an LLP Event of Default and service of an LLP Acceleration Notice on the Issuer and the LLP will be applied following the enforcement of the Security in the following order of priority (the **Post-Enforcement Priority of Payments**) (in each case only if and to the extent that payments or provisions of a higher priority have been made in full):

- (a) *first*, in or towards satisfaction *pro rata* according to the respective amounts thereof of:
  - (i) all amounts due and payable or to become due and payable to the Bond Trustee under the provisions of the Trust Deed together with interest and applicable VAT (or similar taxes) thereon as provided therein;
  - (ii) all amounts due and payable or to become due and payable to the Security Trustee and any Receiver appointed by the Security Trustee under the provisions of the Deed of Charge together with interest and applicable VAT (or similar taxes) thereon as provided therein; and
  - (iii) any remuneration then due and payable to the Agent Bank and the Agents under or pursuant to the Agency Agreement together with applicable VAT (or similar taxes) thereon as provided therein;
- (b) *second*, in or towards satisfaction *pro rata* according to the respective amounts thereof of:
  - (i) any remuneration then due and payable to the Servicers and any costs, charges, liabilities and expenses then due or to become due and payable to the Servicers under the provisions of the Servicing Agreements, together with applicable VAT (or similar taxes) thereon as provided therein;
  - (ii) any remuneration then due and payable to the Cash Manager and any costs, charges, liabilities and expenses then due or to become due and payable to the Cash Manager under the provisions of the Cash Management Agreement, together with applicable VAT (or similar taxes) thereon as provided therein;
  - (iii) amounts due to the Account Bank or, as applicable, the Standby Account Bank (including costs) pursuant to the terms of the Bank Account Agreement or as applicable, the Stand-by Bank Account Agreement, together with applicable VAT (or similar taxes) thereon as provided therein; and
  - (iv) amounts (including costs and expenses) due to the Corporate Services Provider pursuant to the terms of the Corporate Services Agreement;

- (c) *third*, to pay *pro rata* and *pari passu* according to the respective amounts thereof, of any amounts due and payable to the Interest Rate Swap Providers (including any termination payment (but excluding any Excluded Swap Termination Amounts)) pursuant to the terms of the Interest Rate Swap Agreements;
- (d) *fourth*, to pay *pro rata* and *pari passu* according to the respective amounts thereof, of:
  - (i) the amounts due and payable to the Covered Bond Swap Provider *pro rata* and *pari passu* in respect of each relevant Series of Covered Bonds (including any termination payment due and payable by the LLP under the relevant Covered Bond Swap Agreement (but excluding any Excluded Swap Termination Amount)) in accordance with the terms of the relevant Covered Bond Swap Agreement; and
  - (ii) to the Bond Trustee on behalf of the Covered Bondholders *pro rata* and *pari passu* in respect of interest and principal due and payable on each Series of Covered Bonds,

provided that if the amount available for distribution under this paragraph (d) (excluding any amounts received from the Covered Bond Swap Provider) would be insufficient to pay the Sterling Equivalent of the interest and principal due and payable on each Series of Covered Bonds under (d)(ii) above, the shortfall shall be divided amongst all such Series of Covered Bonds on a *pro rata* basis and the amount payable by the LLP to the Covered Bond Swap Provider in respect of each Series of Covered Bonds under (d)(i) above shall be reduced by the amount of the shortfall applicable to the Covered Bonds in respect of which such payment is to be made;

- (e) *fifth*, in or towards satisfaction *pro rata* and *pari passu* according to the respective amounts thereof, of any Excluded Swap Termination Amounts due and payable by the LLP to the relevant Swap Provider under the relevant Swap Agreement;
- (f) *sixth*, after the Covered Bonds have been fully repaid, any remaining moneys shall be applied in or towards repayment in full of all amounts outstanding under the Intercompany Loan Agreement;
- (g) *seventh*, towards payment of any indemnity amount due to the Members pursuant to the LLP Deed; and
- (h) *eighth*, thereafter any remaining moneys shall be applied in or towards payment to the Members pursuant to the LLP Deed.

## THE PORTFOLIO

The Initial Portfolio and each New Portfolio acquired by the LLP (the **Portfolio**), consisting of Loans and their Related Security sold by Sellers to the LLP from time to time, in accordance with the terms of the Mortgage Sale Agreement, as more fully described under *Summary of the Principal Documents - Mortgage Sale Agreement*.

For the purposes hereof:

**Initial Portfolio** means the portfolio of Loans and their Related Security, particulars of which are set out in the Mortgage Sale Agreement (other than any Loans and their Related Security which have been redeemed in full prior to the First Transfer Date), and all right, title, interest and benefit of the Original Seller in and to:

- (a) all payments of principal and interest (including, for the avoidance of doubt, all Accrued Interest, Arrears of Interest, Capitalised Expenses and Capitalised Arrears) and other sums due or to become due in respect of such Loans and Related Security including, without limitation, the right to demand, sue for, recover and give receipts for all principal moneys, interest and costs and the right to sue on all covenants and any undertakings made or expressed to be made in favour of the Original Seller under the applicable Mortgage Terms;
- (b) subject where applicable to the subsisting rights of redemption of Borrowers, all Deeds of Consent (as defined in the Master Definitions and Construction Agreement), Deeds of Postponement (as defined in the Master Definitions and Construction Agreement), MHA Documentation (as defined in the Master Definitions and Construction Agreement) or any collateral security for the repayment of the relevant Loans;
- (c) the right to exercise all the powers of the Original Seller in relation thereto;
- (d) all the estate and interest in the Properties vested in the Original Seller;
- (e) each Certificate of Title and Valuation Report (in each case where available) and any right of action of the Original Seller against any solicitor, licensed conveyancer, qualified conveyancer, valuer or other person in connection with any report, valuation, opinion, certificate or other statement of fact or opinion given in connection with such Loans and Related Security, or any part thereof or affecting the decision of the Original Seller to make or offer to make any such Loan or part thereof;
- (f) all rights, title and interests of the Original Seller (including, without limitation, the proceeds of all claims) to which the Seller is entitled under the Buildings Policies (as defined in the Master Definitions and Construction Agreement) and the Properties in Possession Cover (as defined in the Master Definitions and Construction Agreement); and
- (g) the MIG Policies (as defined in the Master Definitions and Construction Agreement), so far as they relate to the Loans comprised in that portfolio of Loans and their Related Security, including the right to receive the proceeds of any claim.

**New Portfolio** means in each case the portfolio of New Loans and their Related Security (other than any New Loans and their Related Security which have been redeemed in full prior to the Transfer Date or which do not otherwise comply with the terms of the Mortgage Sale Agreement as at the Transfer Date), particulars of which are set out in the relevant New Portfolio Notice or in a document stored upon electronic media (including, but not limited to, a CD-ROM), and all right, title, interest and benefit of the relevant Seller in and to the rights and assets set out in paragraphs (a) to (g) above (except that the “relevant Seller” should be read in place of “Original Seller”).

See also the following risk factors under *Risk Factors - Risk Factors relating to the LLP - Limited description of the Portfolio - Maintenance of Portfolio - Changes to the Lending Criteria of the Sellers and - The Loans of New Sellers may be included in the Portfolio.*



## DESCRIPTION OF LIMITED LIABILITY PARTNERSHIPS

Since 6 April 2001 it has been possible to incorporate a limited liability partnership in England, Wales and Scotland (but not Northern Ireland) under the Limited Liability Partnership Act 2000 (the **LLPA 2000**). Limited liability partnerships are legal entities that provide limited liability to the members of a limited liability partnership combined with the benefits of the flexibility afforded to partnerships and the legal personality afforded to companies.

### **Corporate characteristics**

A limited liability partnership is more like a company than a partnership. A limited liability partnership is a body corporate with its own property and liabilities, separate from its members. Like shareholders in a limited company, the liability of the members of a limited liability partnership is limited to the amount of their capital because it is a separate legal entity and when the members decide to enter into a contract, they bind the limited liability partnership in the same way that directors bind a company. Members may be liable for their own negligence and other torts, like company directors, if they have assumed a personal duty of care and have acted in breach of that duty. Third parties can assume that members, like company directors, are authorised to act on behalf of the limited liability partnership.

The provisions of the Companies Act 1985, the Limited Liability Partnerships (Amendment) Regulations 2001 and the Insolvency Act 1986 have been modified by the Limited Liability Partnerships Regulations 2005 so as to apply most of the insolvency and winding up procedures for companies equally to a limited liability partnership and its members. As a distinct legal entity a limited liability partnership can grant fixed and floating security over its assets and a limited liability partnership will survive the insolvency of any of its members. An administrator or liquidator of an insolvent member would be subject to the terms of the members' agreement relating to the limited liability partnership but a liquidator of an insolvent member may not take part in the administration of the limited liability partnership or its business.

Limited liability partnerships must file annual returns and audited annual accounts at Companies House for each financial year in the same way as companies.

### **Partnership characteristics**

A limited liability partnership retains certain characteristics of a partnership. It has no share capital and there are no capital maintenance requirements. The members are free to agree how to share profits, who is responsible for management and how decisions are made, when and how new members are appointed and the circumstances in which its members retire. The members' agreement is a private document and there is no obligation to file it at Companies House.

### **Taxation**

Limited liability partnerships are tax transparent except in certain winding-up proceedings. As such, the members of a limited liability partnership, and not the limited liability partnership itself, are taxed in relation to the business of the limited liability partnership in broadly the same way that the members of a partnership are taxed in relation to the business of that partnership.

## BOOK-ENTRY CLEARANCE SYSTEMS

*The information set out below is subject to any change in or reinterpretation of the rules, regulations and procedures of DTC, Euroclear or Clearstream, Luxembourg (together, the **Clearing Systems**) currently in effect. The information in this section concerning the Clearing Systems has been obtained from sources that the Issuer and the Guarantors believe to be reliable, but none of the Issuer, the Guarantors nor any Dealer takes any responsibility for the accuracy thereof. Investors wishing to use the facilities of any of the Clearing Systems are advised to confirm the continued applicability of the rules, regulations and procedures of the relevant Clearing System. None of the Issuer, the Guarantors nor any other party to the Agency Agreement will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the Covered Bonds held through the facilities of any Clearing System or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.*

### Book-entry Systems

#### **DTC**

DTC has advised the Issuer that it is a limited purpose trust company organised under the New York Banking Law, a “banking organisation” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code and a “clearing agency” registered pursuant to Section 17A of the Exchange Act. DTC holds and provides asset servicing for securities that its participants (**Direct Participants**) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities through electronic computerised book-entry transfers and pledges between Direct Participants’ accounts, thereby eliminating the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations and certain other organisations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (**DTCC**). DTCC, in turn, is owned by a number of Direct Participants of DTC and Members of the National Securities Clearing Corporation Government Securities Clearing Corporation, MBS Clearing Corporation, and Emerging Markets Clearing Corporation (NSCC, GSCC, MBSCC, and EMCC, also subsidiaries of DTCC), as well as by the New York Stock Exchange, Inc., the American Stock Exchange LLC and the National Association of Securities Dealers, Inc. Access to the DTC System is also available to others such as securities brokers and dealers, banks, trust companies and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (**Indirect Participants**). DTC has Standard & Poor’s highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at [www.dtcc.com](http://www.dtcc.com).

Purchases of DTC Covered Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the DTC Covered Bonds on DTC’s records. The ownership interest of each actual purchaser of each Covered Bond (**Beneficial Owner**) is in turn to be recorded on the Direct and Indirect Participant’s records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the DTC Covered Bonds are to be accomplished by entries made on the books of Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in DTC Covered Bonds, except in the event that use of the book-entry system for the DTC Covered Bonds is discontinued.

To facilitate subsequent transfers, all DTC Covered Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. or such other nominee as may be requested by an authorised representative of DTC. The deposit of DTC Covered Bonds with DTC and their registration in the name of Cede & Co. or such other nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the DTC Covered Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such DTC Covered Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Redemption notices shall be sent to DTC. If less than all of the DTC Covered Bonds within an issue are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such issue to be redeemed.

Neither DTC nor Cede & Co. (nor such other DTC nominee) will consent or vote with respect to DTC Covered Bonds unless authorised by a Direct Participant in accordance with DTC's Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Issuer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the DTC Covered Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal and interest payments on the DTC Covered Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorised representative of DTC. DTC's practice is to credit Direct Participants' accounts, upon DTC's receipt of funds and corresponding detail information from the Issuer or the Principal Paying Agent, on the payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name", and will be the responsibility of such Participant and not of DTC or its nominee, the Principal Paying Agent or the Issuer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of redemption proceeds, distributions, and dividend payments to Cede & Co. (or such other nominee as may be requested by an authorised representative of DTC) is the responsibility of Issuer or Agent, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

Under certain circumstances, DTC will exchange the DTC Covered Bonds for Registered Definitive Covered Bonds, which it will distribute to its Participants in accordance with their proportionate entitlements and which, if representing interests in a Rule 144A Global Covered Bond, will be legended as set forth under *Subscription and Sale*.

Since DTC may only act on behalf of Direct Participants, who in turn act on behalf of Indirect Participants, any Beneficial Owner desiring to pledge DTC Covered Bonds to persons or entities that do not participate in DTC, or otherwise take actions with respect to such DTC Covered Bonds, will be required to withdraw its Registered Covered Bonds from DTC as described below.

### ***Euroclear and Clearstream, Luxembourg***

Euroclear and Clearstream, Luxembourg each holds securities for its customers and facilitates the clearance and settlement of securities transactions by electronic book-entry transfer between their respective account holders. Euroclear and Clearstream, Luxembourg provide various services including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Euroclear and Clearstream, Luxembourg also deal with domestic securities markets in several countries through established depository and custodial relationships. Euroclear and Clearstream, Luxembourg have established an electronic bridge between their two systems across which their respective participants may settle trades with each other.

Euroclear and Clearstream, Luxembourg customers are world-wide financial institutions, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations. Indirect access to Euroclear and Clearstream, Luxembourg is available to other institutions that clear through or maintain a custodial relationship with an account holder of either system.

### **Book-entry Ownership of and Payments in respect of DTC Covered Bonds**

The Issuer may apply to DTC in order to have any Tranche of Covered Bonds represented by a Registered Global Covered Bond accepted in its book-entry settlement system. Upon the issue of any such Registered Global Covered Bond, DTC or its custodian will credit, on its internal book-entry system, the respective nominal amounts of the individual beneficial interests represented by such Registered Global Covered Bond to the accounts of persons who have accounts with DTC. Such accounts initially will be designated by or on behalf of the relevant Dealer. Ownership of beneficial interests in such a Registered Global Covered Bond will be limited to Direct Participants or Indirect Participants, including, in the case of any Regulation S Global Covered Bond, the respective depositories of Euroclear and Clearstream, Luxembourg. Ownership of beneficial interests in a Registered Global Covered Bond accepted by DTC will be shown on, and the transfer of such ownership will be effected only through, records maintained by DTC or its nominee (with respect to the interests of Direct Participants) and the records of Direct Participants (with respect to interests of Indirect Participants).

Payments in U.S. dollars of principal and interest in respect of a Registered Global Covered Bond accepted by DTC will be made to the order of DTC or its nominee as the registered holder of such Covered Bond. In the case of any payment in a currency other than U.S. dollars, payment will be made to the Exchange Agent on behalf of DTC or its nominee and the Exchange Agent will (in accordance with instructions received by it) remit all or a portion of such payment for credit directly to the beneficial holders of interests in the Registered Global Covered Bond in the currency in which such payment was made and/or cause all or a portion of such payment to be converted into U.S. dollars and credited to the applicable Participants' account.

The Issuer expects DTC to credit accounts of Direct Participants on the applicable payment date in accordance with their respective holdings as shown in the records of DTC unless DTC has reason to believe that it will not receive payment on such payment date. The Issuer also expects that payments by Participants to beneficial owners of Covered Bonds will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers, and will be the responsibility of such Participant and not the responsibility of DTC, the Bond Trustee, the Security Trustee, the Principal Paying Agent, the Bond Registrar or the Issuer. Payment of principal, premium, if any, and interest, if any, on Covered Bonds to DTC is the responsibility of the Issuer.

## Transfers of Covered Bonds Represented by Registered Global Covered Bonds

Transfers of any interests in Covered Bonds represented by a Registered Global Covered Bond within DTC, Euroclear and Clearstream, Luxembourg will be effected in accordance with the customary rules and operating procedures of the relevant clearing system. The laws in some States within the United States require that certain persons take physical delivery of securities in definitive form. Consequently, the ability to transfer Covered Bonds represented by a Registered Global Covered Bond to such persons may depend upon the ability to exchange such Covered Bonds for Covered Bonds in definitive form. Similarly, because DTC can only act on behalf of Direct Participants in the DTC system who in turn act on behalf of Indirect Participants, the ability of a person having an interest in Covered Bonds represented by a Registered Global Covered Bond accepted by DTC to pledge such Covered Bonds to persons or entities that do not participate in the DTC system or otherwise to take action in respect of such Covered Bonds may depend upon the ability to exchange such Covered Bonds for Covered Bonds in definitive form. The ability of any holder of Covered Bonds represented by a Registered Global Covered Bond accepted by DTC to resell, pledge or otherwise transfer such Covered Bonds may be impaired if the proposed transferee of such Covered Bonds is not eligible to hold such Covered Bonds through a direct or indirect participant in the DTC system.

Subject to compliance with the transfer restrictions applicable to the Registered Covered Bonds described under *Subscription and Sale*, cross-market transfers between DTC, on the one hand, and directly or indirectly through Clearstream, Luxembourg or Euroclear accountholders, on the other, will be effected by the relevant clearing system in accordance with its rules and through action taken by the Bond Registrar, the Principal Paying Agent and any custodian (**Custodian**) with whom the relevant Registered Global Covered Bonds have been deposited.

On or after the Issue Date for any Series, transfers of Covered Bonds of such Series between accountholders in Clearstream, Luxembourg and Euroclear and transfers of Covered Bonds of such Series between participants in DTC will generally have a settlement date three business days after the trade date (T+3). The customary arrangements for delivery versus payment will apply to such transfers.

Cross-market transfers between accountholders in Clearstream, Luxembourg or Euroclear and DTC participants will need to have an agreed settlement date between the parties to such transfer. Because there is no direct link between DTC, on the one hand, and Clearstream, Luxembourg and Euroclear, on the other, transfers of interests in the relevant Registered Global Covered Bonds will be effected through the Bond Registrar, the Principal Paying Agent and the Custodian receiving instructions (and, where appropriate, certification) from the transferor and arranging for delivery of the interests being transferred to the credit of the designated account for the transferee. In the case of cross-market transfers, settlement between Euroclear or Clearstream, Luxembourg accountholders and DTC participants cannot be made on a delivery versus payment basis. The securities will be delivered on a free delivery basis and arrangements for payment must be made separately.

DTC, Clearstream, Luxembourg and Euroclear have each published rules and operating procedures designed to facilitate transfers of beneficial interests in Registered Global Covered Bonds among participants and accountholders of DTC, Clearstream, Luxembourg and Euroclear. However, they are under no obligation to perform or continue to perform such procedures, and such procedures may be discontinued or changed at any time. None of the Bond Trustee, the Security Trustee, the Issuer, the Guarantors, the Agents or any Dealer will be responsible for any performance by DTC, Clearstream, Luxembourg or Euroclear or their respective direct or indirect participants or accountholders of their respective obligations under the rules and procedures governing their operations and none of them will have any liability for any aspect of the records relating to or payments made on account of beneficial interests in the Covered Bonds represented by Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial interests.



## TAXATION

Purchasers of Covered Bonds who are unsure of their tax treatment as Covered Bondholders (including the effect of the HBOS Group Reorganisation Act 2006 on the Covered Bonds) should consult their own professional tax advisers.

### United Kingdom Taxation

*The following is a general description of certain United Kingdom withholding tax considerations relating to the Covered Bonds (and the potential consequences flowing from the implementation of the HBOS Group Reorganisation Act 2006) based on the Issuer's understanding of current law and Her Majesty's Revenue and Customs (HMRC) published practice in the United Kingdom. It does not purport to be a complete analysis of all tax considerations relating to the Covered Bonds. It only applies to the position of persons who are the absolute beneficial owners of Covered Bonds and may not apply to certain classes of persons such as dealers. This summary is based upon the law as in effect on the date of this Offering Circular and is subject to any change in law that may take effect after such date.*

### ***Payment of Interest by the Issuer on the Covered Bonds***

The Issuer, provided that it continues to be a bank within the meaning of section 991 of the Income Tax Act 2007 (ITA), and provided that the interest on the Covered Bonds is paid in the ordinary course of its business within the meaning of section 878 of ITA, will be entitled to make payment of interest without withholding or deduction for or on account of United Kingdom income tax.

Interest on the Covered Bonds may also be paid without withholding or deduction for or on account of United Kingdom tax where (i) the Covered Bonds are listed on a "recognised stock exchange", as defined in section 1005 of ITA (the London Stock Exchange and the Luxembourg Stock Exchange are recognised stock exchanges and, securities will be treated as listed on the London Stock Exchange if they are admitted to the Official List and have been admitted to trading by the London Stock Exchange and securities will be treated as listed on the Luxembourg Stock Exchange if they are listed by the competent authority in Luxembourg and admitted to trading by the Luxembourg Stock Exchange); (ii) the maturity of the Covered Bond is less than 365 days; or (iii) the interest on the Covered Bond is paid by a company and, at the time the payment is made, the Issuer reasonably believes (and any person by or through whom interest on the Covered Bond is paid reasonably believes) that the interest constitutes an "excepted payment" within the meaning of sections 933 to 937 of ITA, provided that HMRC has not given a direction (in circumstances where it has reasonable grounds to believe the payment of interest is not an "excepted payment") that the interest should be paid under deduction of tax.

In other cases, an amount must generally be withheld from payments of interest on the Covered Bonds on account of United Kingdom income tax at the savings rate (currently 20 per cent.), subject to any direction to the contrary by HMRC under an applicable double taxation treaty that a larger rate of or no withholding tax should be withheld.

The United Kingdom Finance Bill 2007 contains a proposed new statutory meaning of references to securities which are "listed" on a recognised stock exchange. The draft legislation provides that securities will be treated as listed on a recognised stock exchange if (and only if) they are admitted to trading on that exchange and either they are included in the United Kingdom official list (within the meaning of Part 6 of the Financial Services and Markets Act 2000) or they are officially listed, in accordance with provisions corresponding to those generally applicable in European Economic Area states, in a country outside the United Kingdom in which there is a recognised stock exchange. It is understood that this new definition is not intended to alter the position described above in respect of securities that are listed and admitted to

trading on a market of a stock exchange which was already designated as a recognised stock exchange before 21 March 2007, such as the London Stock Exchange and the Luxembourg Stock Exchange.

### ***Provision of Information***

Covered Bondholders may wish to note that HMRC has power to obtain information (including the name and address of the beneficial owner of the interest) from any person in the United Kingdom who either credits or pays interest to or receives interest for the benefit of a Covered Bondholder. HMRC also has power to obtain information from any person in the United Kingdom who pays amounts payable on the redemption of Covered Bonds which are deeply discounted securities for the purposes of the Income Tax (Trading and Other Income) Act 2005 to or receives such amounts for the benefit of another person although HMRC practice indicates that HMRC will not exercise its power to require this information where such amounts are paid on or before 5 April 2008. Such information may include the name and address of the beneficial owner of the amount payable on redemption. Any information obtained under the provisions described above may, in certain circumstances, be exchanged by HMRC with the tax authorities of the jurisdiction in which the Covered Bondholder is resident for tax purposes.

### ***Payments by the Guarantors***

If a Guarantor makes any payment in respect of interest on the Covered Bonds (or any other amounts due under the Covered Bonds other than the repayment of amounts subscribed for under the Covered Bonds) such payment may (unless the Covered Bonds in question have a maturity of less than 365 days) be subject to United Kingdom withholding tax, whether or not the Covered Bonds are listed on a “recognised stock exchange” within the meaning of section 1005 of ITA.

If payments by a Group Guarantor are subject to any withholding or deduction for or on account of tax, additional amounts may become payable by such Group Guarantor subject to Condition 8. The LLP will not be required to pay such additional amounts.

### **Transfer of assets and liabilities of the Issuer**

As mentioned above, the HBOS Group Reorganisation Act 2006 (the **Act**) provides for the assets and liabilities of the Issuer to be transferred to Bank of Scotland plc and this is expected to occur on 17 September 2007. The United Kingdom corporation tax treatment of Covered Bondholders which are United Kingdom tax resident companies in relation to the transfer of assets and liabilities will depend on the way in which that transfer is treated in the Covered Bondholders’ financial accounts. Other United Kingdom resident Covered Bondholders may be treated as disposing of their Covered Bonds on the transfer of the Issuers’ assets and liabilities. Whether or not a charge to capital gains tax will arise on the transfer of assets and liabilities may depend on the currency of the Covered Bonds, the value of the Covered Bonds and the particular circumstances of the Covered Bondholders.

### **European Union Savings Directive**

Under European Union Council Directive 2003/48/EC on the taxation of savings income, Member States of the European Union are required to provide the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State. However, for a transitional period, Belgium, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange within certain other countries). A number of non-European



Union countries and territories including Switzerland have agreed to adopt similar measures (a withholding system in the case of Switzerland).

If a payment were to be made or collected through a Member State of the European Union which has opted for a withholding system and an amount of, or in respect of tax were to be withheld from that payment, none of the Issuer, the Paying Agent, the Guarantors or any other person would be obliged to pay additional amounts with respect to any Covered Bond as a result of the imposition of such withholding tax. The Issuer is required to maintain a Paying Agent in a Member State of the European Union that does not impose an obligation to withhold or deduct tax pursuant to the Directive.

## **Luxembourg Taxation**

*The following summary is of a general nature and is included herein solely for information purposes. It is based on the laws presently in force in Luxembourg, though it is not intended to be, nor should it be construed to be, legal or tax advice. Prospective investors in the Covered Bonds should therefore consult their own professional advisers as to the effects of state, local or foreign laws, including Luxembourg tax law, to which they may be subject.*

### **Withholding Tax**

#### *(i) Non-resident holders of Covered Bonds*

Under Luxembourg general tax laws currently in force and subject to the laws of 21 June 2005 (the **Laws**) mentioned below, there is no withholding tax on payments of principal, premium or interest made to non-resident holders of Covered Bonds, nor on accrued but unpaid interest in respect of the Covered Bonds, nor is any Luxembourg withholding tax payable upon redemption or repurchase of the Covered Bonds held by non-resident holders of Covered Bonds.

Under the Laws implementing the EC Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments and ratifying the treaties entered into by Luxembourg and certain dependent and associated territories of EU Member States (the **Territories**), payments of interest or similar income made or ascribed by a paying agent established in Luxembourg to or for the immediate benefit of an individual beneficial owner or a residual entity, as defined by the Laws, which is a resident of, or established in, an EU Member State (other than Luxembourg) or one of the Territories will be subject to a withholding tax unless the relevant recipient has adequately instructed the relevant paying agent to provide details of the relevant payments of interest or similar income to the fiscal authorities of his/her/its country of residence or establishment, or, in the case of an individual beneficial owner, has provided a tax certificate issued by the fiscal authorities of his/her country of residence in the required format to the relevant paying agent. Where withholding tax is applied, it will be levied at a rate of 15 per cent. during the first three-year period starting 1 July 2005, at a rate of 20 per cent. for the subsequent three-year period and at a rate of 35 per cent. thereafter. Responsibility for the withholding of the tax will be assumed by the Luxembourg paying agent. Payments of interest under the Covered Bonds coming within the scope of the Laws would at present be subject to withholding tax of 15 per cent.

#### *(ii) Resident holders of Covered Bonds*

Under Luxembourg general tax laws currently in force and subject to the law of 23 December 2005 (the **Law**) mentioned below, there is no withholding tax on payments of principal, premium or interest made to Luxembourg resident holders of Covered Bonds, nor on accrued but unpaid interest in respect of Covered Bonds, nor is any Luxembourg withholding tax payable upon redemption or repurchase of Covered Bonds held by Luxembourg resident holders of Covered Bonds.

Under the Law payments of interest or similar income made or ascribed by a paying agent established in Luxembourg to or for the immediate benefit of an individual beneficial owner who is a resident of Luxembourg will be subject to a withholding tax of 10 per cent. Such withholding tax will be in full discharge of income tax if the beneficial owner is an individual acting in the course of the management of his/her private wealth. Responsibility for the withholding of the tax will be assumed by the Luxembourg paying agent. Payments of interest under the Covered Bonds coming within the scope of the Law would be subject to withholding tax of 10 per cent.

## **U.S. Federal Income Taxation**

To ensure compliance with U.S. Internal Revenue Service Circular 230, prospective investors are hereby notified that: (a) any discussion of federal tax issues contained or referred to in this Offering Circular is not intended or written to be used, and cannot be used by prospective investors for the purpose of avoiding penalties that may be imposed on them under the Internal Revenue Code; (b) such discussion is written in connection with the promotion or marketing of the transactions or matters addressed herein; and (c) prospective investors should seek advice based on their particular circumstances from an independent tax adviser.

Notwithstanding any provision herein and the otherwise confidential nature of this Offering Circular and its contents, and effective from the date of commencement of discussions concerning any of the transactions described or contemplated herein (the **Transactions**), each party hereto (and each employee, representative, or other agent of such party) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the Transactions and all materials of any kind (including opinions or other tax analyses) that are provided to it relating to such tax treatment and tax structure, except to the extent that any such disclosure could reasonably be expected to cause a Transaction not to be in compliance with securities laws. In addition, no person may disclose the name of or identifying information with respect to any party identified herein or other non-public business or financial information that is unrelated to the tax treatment or tax structure of the Transactions without the prior consent of the Issuer. For purposes of this paragraph, the tax treatment of the Transactions is the purported or claimed U.S. federal income tax treatment of the Transactions, and the tax structure of the Transactions is any fact that may be relevant to understanding the purported or claimed U.S. federal income tax treatment of the Transactions

The following is a summary of certain material U.S. federal income tax consequences of the acquisition, ownership and disposition of Covered Bonds by a U.S. Holder (as defined below). This summary does not address the material U.S. federal income tax consequences of every type of Covered Bond which may be issued under the Programme, and the applicable Final Terms may contain additional or modified disclosure concerning the material U.S. federal income tax consequences relevant to such type of Covered Bonds as are issued thereunder. This summary deals only with purchasers of Covered Bonds that are U.S. Holders, that will hold the Covered Bonds as capital assets, and that acquire Covered Bonds at initial issuance. The discussion does not cover all aspects of U.S. federal income taxation that may be relevant to, or the actual tax effect that any of the matters described herein will have on, the acquisition, ownership or disposition of Covered Bonds by particular investors, and does not address state, local, foreign or other tax laws. In particular, this summary does not discuss all of the tax considerations that may be relevant to certain types of investors subject to special treatment under the U.S. federal income tax laws (such as banks, insurance companies, investors liable for the alternative minimum tax, individual retirement accounts and other tax-deferred accounts, tax-exempt organisations, dealers in securities or currencies, traders in securities that elect to use a mark-to-market method of accounting, persons that own (or are deemed to own) 10 per cent. or more (by voting power) shares in the Issuer, persons who have ceased to be U.S. citizens or to be taxed as resident aliens, investors that will hold the Covered Bonds as part of straddles, hedging transactions or conversion transactions for U.S. federal income tax purposes, or whose functional currency is not the U.S.

dollar). This discussion also does not address any tax consequences applicable to holders of equity interests in a holder of the Covered Bonds. This discussion applies only to holders of Registered Covered Bonds.

As used herein, the term “U.S. Holder” means a beneficial owner of Covered Bonds that is for U.S. federal income tax purposes, (i) a citizen or resident of the United States, (ii) a corporation, or other entity treated as a corporation, created or organised under the laws of the United States or any State thereof, (iii) an estate the income of which is subject to U.S. federal income tax without regard to its source, or (iv) a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust, or that is otherwise treated as a United States person. The tax consequences to a partner in a partnership holding Covered Bonds will generally depend upon the status of the partner and the activities of the partnership. A partner in a partnership holding Covered Bonds should consult its tax adviser regarding the tax consequences of an investment in Covered Bonds.

This summary is based on the tax laws of the United States including the Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations thereunder (the “Treasury Regulations”), published rulings and court decisions, all as currently in effect and all of which are subject to change at any time, possibly with retroactive effect.

**THE SUMMARY OF U.S. FEDERAL INCOME TAX CONSEQUENCES SET OUT BELOW IS FOR GENERAL INFORMATION ONLY. PROSPECTIVE PURCHASERS SHOULD CONSULT THEIR TAX ADVISERS AS TO THE PARTICULAR TAX CONSEQUENCES TO THEM OF OWNING THE COVERED BONDS, THE APPLICABILITY AND EFFECT OF STATE, LOCAL, FOREIGN AND OTHER TAX LAWS AND POSSIBLE CHANGES IN TAX LAW.**

The Issuer generally intends to treat Covered Bonds issued under the Programme as debt, unless otherwise indicated in the applicable Final Terms. Certain Covered Bonds, however, such as Index Linked Redemption Covered Bonds, may be treated as equity for U.S. federal income tax purposes. The applicable Final Terms may contain modified disclosure concerning the tax treatment of Covered Bonds to which a treatment other than as debt may apply. The following disclosure applies only to Covered Bonds that are treated as debt for U.S. federal income tax purposes.

### ***Payment of Interest***

#### ***General***

Interest on a Covered Bond, whether payable in U.S. dollars or a currency, composite currency or basket of currencies other than U.S. dollars (**foreign currency interest on a Foreign Currency Covered Bond**), other than interest on a “Discount Covered Bond” that is not “qualified stated interest” (each as defined below under “Original Issue Discount —General”), will be taxable to a U.S. Holder as ordinary income at the time it is received or accrued, depending on the holder’s method of accounting for tax purposes. Interest paid by the Issuer on the Covered Bonds and OID, if any, accrued with respect to the Covered Bonds (as described below under “Original Issue Discount”) generally will constitute income from sources outside the United States subject to the rules regarding the foreign tax credit allowable to a U.S. Holder. Prospective purchasers should consult their tax advisers concerning the foreign tax credit implications of any payment of United Kingdom taxes.

## ***Original Issue Discount***

### *General*

The following is a summary of the principal U.S. federal income tax consequences of the ownership of Covered Bonds issued with original issue discount (**OID**). The following summary does not discuss Covered Bonds that are characterized as contingent payment debt instruments for U.S. federal income tax purposes.

A Covered Bond, other than a Covered Bond with a term of one year or less (a **Short-Term Covered Bond**), will be treated as issued with OID (a **Discount Covered Bond**) if the excess of the Covered Bond's "stated redemption price at maturity" over its issue price is equal to or more than a *de minimis* amount (0.25 per cent. of the Covered Bond's stated redemption price at maturity multiplied by the number of complete years to its maturity). An obligation that provides for the payment of amounts other than qualified stated interest before maturity (an **instalment obligation**) will be treated as a Discount Covered Bond if the excess of the Covered Bond's stated redemption price at maturity over its issue price is greater than 0.25 per cent. of the Covered Bond's stated redemption price at maturity multiplied by the weighted average maturity of the Covered Bond. A Covered Bond's weighted average maturity is the sum of the following amounts determined for each payment on a Covered Bond (other than a payment of qualified stated interest): (i) the number of complete years from the issue date until the payment is made multiplied by (ii) a fraction, the numerator of which is the amount of the payment and the denominator of which is the Covered Bond's stated redemption price at maturity. Generally, the issue price of a Covered Bond will be the first price at which substantial amount of Covered Bonds included in the issue of which the Covered Bond is a part is sold to persons other than bond houses, brokers, or similar persons or organisations acting in the capacity of underwriters, placement agents, or wholesalers. The stated redemption price at maturity of a Covered Bond is the total of all payments provided by the Covered Bond that are not payments of "qualified stated interest." A qualified stated interest payment is generally any one of a series of stated interest payments on a Covered Bond that are unconditionally payable at least annually at a single fixed rate (with certain exceptions for lower rates paid during some periods), or a variable rate (in the circumstances described below under "Variable Interest Rate Covered Bonds"), applied to the outstanding principal amount of the Covered Bond. Solely for the purposes of determining whether a Covered Bond has OID, the Issuer will be deemed to exercise any call option that has the effect of decreasing the yield on the Covered Bond, and the U.S. Holder will be deemed to exercise any put option that has the effect of increasing the yield on the Covered Bond. If a Covered Bond has *de minimis* OID, a U.S. Holder must include the *de minimis* amount in income as stated principal payments are made on the Covered Bond, unless the holder makes the election described below under "—Election to Treat All Interest as Original Issue Discount". A U.S. Holder can determine the includible amount with respect to each such payment by multiplying the total amount of the Covered Bond's *de minimis* OID by a fraction equal to the amount of the principal payment made divided by the stated principal amount of the Covered Bond.

U.S. Holders of Discount Covered Bonds must include OID in income calculated on a constant-yield method before the receipt of cash attributable to the income, and generally will have to include in income increasingly greater amounts of OID over the life of the Discount Covered Bonds. The amount of OID includible in income by a U.S. Holder of a Discount Covered Bond is the sum of the daily portions of OID with respect to the Discount Covered Bond for each day during the taxable year or portion of the taxable year on which the U.S. Holder holds the Discount Covered Bond (**accrued OID**). The daily portion is determined by allocating to each day in any "accrual period" a pro rata portion of the OID allocable to that accrual period. Accrual periods with respect to a Covered Bond may be of any length selected by the U.S. Holder and may vary in length over the term of the Covered Bonds as long as (i) no accrual period is longer than one year and (ii) each scheduled payment of interest or principal on the Covered Bond occurs on either the final or first day of an accrual period. The amount of OID allocable to an accrual period equals the excess of (a) the product of the Discount Covered Bond's adjusted issue price at the beginning of the accrual period

and the Discount Covered Bond's yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period) over (b) the sum of the payments of qualified stated interest on the Covered Bond allocable to the accrual period. The "adjusted issue price" of a Discount Covered Bond at the beginning of any accrual period is the issue price of the Covered Bond increased by (x) the amount of accrued OID for each prior accrual period and decreased by (y) the amount of any payments previously made on the Covered Bond that were not qualified stated interest payments.

#### *Acquisition Premium*

A U.S. Holder that purchases a Discount Covered Bond for an amount less than or equal to the sum of all amounts payable on the Covered Bond after the purchase date, other than payments of qualified stated interest, but in excess of its adjusted issue price (any such excess being **acquisition premium**) and that does not make the election described below under "*Election to Treat All Interest as Original Issue Discount*", is permitted to reduce the daily portions of OID by a fraction, the numerator of which is the excess of the U.S. Holder's adjusted basis in the Discount Covered Bond immediately after its purchase over the Discount Covered Bond's adjusted issue price, and the denominator of which is the excess of the sum of all amounts payable on the Discount Covered Bond after the purchase date, other than payments of qualified stated interest, over the Discount Covered Bond's adjusted issue price.

#### *Market Discount*

A Covered Bond, other than a Short-Term Bond, generally will be treated as purchased at a market discount (a **Market Discount Covered Bond**) if the Covered Bond's stated redemption price at maturity or, in the case of a Discount Covered Bond, the Covered Bond's "revised issue price", exceeds the amount for which the U.S. Holder purchased the Covered Bond by at least 0.25 per cent. of the Covered Bond's stated redemption price at maturity or revised issue price, respectively, multiplied by the number of complete years to the Covered Bond's maturity (or, in the case of a Covered Bond that is an installment obligation, the Covered Bond's weighted average maturity). If this excess is not sufficient to cause the Covered Bond to be a Market Discount Covered Bond, then the excess constitutes "*de minimis market discount*". For this purpose, the "revised issue price" of a Bond generally equals its issue price, increased by the amount of any OID that has accrued on the Bond and decreased by the amount of any payments previously made on the Bond that were not qualified stated interest payments.

Under the market discount rules, a U.S. Holder will be required to treat any principal payment (or, in the case of a Discount Covered Bond, any payment that does not constitute qualified stated interest) on, or any gain realized on the sale, exchange, retirement or other disposition of, a Market Discount Covered Bond as ordinary income to the extent of the lesser of (i) the amount of such payment or realized gain or (ii) the market discount which has not previously been included in income and is treated as having accrued on such Market Discount Covered Bond at the time of such payment or disposition. Market discount will be considered to accrue ratably during the period from the date of acquisition to the maturity date of the Market Discount Covered Bond, unless the U.S. Holder elects to accrue market discount under a constant yield method.

A U.S. Holder may be required to defer the deduction of all or a portion of the interest paid or accrued on any indebtedness incurred or maintained to purchase or carry a Market Discount Covered Bond until the maturity of such Market Discount Covered Bond or certain earlier dispositions, because a current deduction is only allowed to the extent the interest expense exceeds an allocable portion of market discount. A U.S. Holder may elect to include market discount in income currently as it accrues (under either a ratable or a constant yield method), in which case the rules described above regarding the treatment as ordinary income of gain upon the disposition of the Market Discount Covered Bond and upon the receipt of certain cash



payments and regarding the deferral of interest deductions will not apply. Generally, such currently included market discount is treated as ordinary interest income for U.S. federal income tax purposes. Such an election will apply to all debt instruments acquired by the U.S. Holder on or after the first day of the first taxable year to which such election applies and may be revoked only with the consent of the Internal Revenue Service (the **IRS**).

#### *Election to Treat All Interest as Original Issue Discount*

A U.S. Holder may elect to include in gross income all interest that accrues on a Covered Bond using the constant-yield method described above under “Original Issue Discount—General,” with certain modifications. For purposes of this election, interest includes stated interest, OID, *de minimis* OID, market discount, *de minimis* market discount and unstated interest, as adjusted by any amortisable bond premium (described below under “Covered Bonds Purchased at a Premium”) or acquisition premium. If a U.S. Holder makes this election for the Covered Bond, then, when the constant-yield method is applied the issue price of the Covered Bond will equal its cost, the issue date of the Covered Bond will be the date of acquisition, and no payments on the Covered Bond will be treated as payments of qualified stated interest. This election will generally apply only to the Covered Bond with respect to which it is made and may not be revoked without the consent of the IRS. However, if the Covered Bond has amortisable bond premium, the U.S. Holder will be deemed to have made an election to apply amortisable bond premium against interest for all debt instruments with amortisable bond premium, other than debt instruments the interest on which is excludible from gross income, held as of the beginning of the taxable year to which the election applies or any taxable year thereafter. If the election to apply the constant-yield method to all interest on a Covered Bond is made with respect to a Market Discount Covered Bond, the electing U.S. Holder will be treated as having made the election discussed above under “Market Discount” to include market discount in income currently over the life of all debt instruments with market discount held or thereafter acquired by the U.S. Holder. U.S. Holders should consult their tax advisers concerning the propriety and consequences of this election.

#### *Variable Interest Rate Covered Bonds*

Covered Bonds that provide for interest at variable rates (**Variable Interest Rate Covered Bonds**) generally will bear interest at a “qualified floating rate” and thus will be treated as “variable rate debt instruments” under Treasury Regulations governing accrual of OID. A Variable Interest Rate Covered Bond will qualify as a “variable rate debt instrument” if (a) its issue price does not exceed the total noncontingent principal payments due under the Variable Interest Rate Covered Bond by more than a specified *de minimis* amount and (b) it provides for stated interest, paid or compounded at least annually, at (i) one or more qualified floating rates, (ii) a single fixed rate and one or more qualified floating rates, (iii) a single objective rate, or (iv) a single fixed rate and a single objective rate that is a qualified inverse floating rate.

A “qualified floating rate” is any variable rate where variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the Variable Interest Rate Covered Bond is denominated. A fixed multiple of a qualified floating rate will constitute a qualified floating rate only if the multiple is greater than 0.65 but not more than 1.35. A variable rate equal to the product of a qualified floating rate and a fixed multiple that is greater than 0.65 but not more than 1.35, increased or decreased by a fixed rate, will also constitute a qualified floating rate. In addition, two or more qualified floating rates that can reasonably be expected to have approximately the same values throughout the term of the Variable Interest Rate Covered Bond (e.g., two or more qualified floating rates with values within 25 basis points of each other as determined on the Variable Interest Rate Covered Bond’s issue date) will be treated as a single qualified floating rate. Notwithstanding the foregoing, a variable rate that would otherwise constitute a qualified floating rate but which is subject to one or more restrictions such as a maximum numerical limitation (i.e., a cap) or a minimum numerical limitation (i.e., a

floor) may, under certain circumstances, fail to be treated as a qualified floating rate unless the cap or floor is fixed throughout the term of the Covered Bond.

An “objective rate” is a rate that is not itself a qualified floating rate but which is determined using a single fixed formula and which is based on objective financial or economic information (e.g., one or more qualified floating rates or the yield of actively traded personal property). A rate will not qualify as an objective rate if it is based on information that is within the control of the Issuer (or a related party) or that is unique to the circumstances of the Issuer (or a related party), such as dividends, profits or the value of the Issuer’s stock (although a rate does not fail to be an objective rate merely because it is based on the credit quality of the Issuer). Other variable interest rates may be treated as objective rates if so designated by the IRS in the future. Despite the foregoing, a variable rate of interest on a Variable Interest Rate Covered Bond will not constitute an objective rate if it is reasonably expected that the average value of the rate during the first half of the Variable Interest Rate Covered Bond’s term will be either significantly less than or significantly greater than the average value of the rate during the final half of the Variable Interest Rate Covered Bond’s term. A “qualified inverse floating rate” is any objective rate where the rate is equal to a fixed rate minus a qualified floating rate, as long as variations in the rate can reasonably be expected to inversely reflect contemporaneous variations in the qualified floating rate. If a Variable Interest Rate Covered Bond provides for stated interest at a fixed rate for an initial period of one year or less followed by a variable rate that is either a qualified floating rate or an objective rate for a subsequent period and if the variable rate on the Variable Interest Rate Covered Bond’s issue date is intended to approximate the fixed rate (e.g., the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than 25 basis points), then the fixed rate and the variable rate together will constitute either a single qualified floating rate or objective rate, as the case may be.

A qualified floating rate or objective rate in effect at any time during the term of the instrument must be set at a “current value” of that rate. A **current value** of a rate is the value of the rate on any day that is no earlier than 3 months prior to the first day on which that value is in effect and no later than 1 year following that first day.

If a Variable Interest Rate Covered Bond that provides for stated interest at either a single qualified floating rate or a single objective rate throughout the term thereof qualifies as a “variable rate debt instrument”, then any stated interest on the Covered Bond which is unconditionally payable in cash or property (other than debt instruments of the Issuer) at least annually will constitute qualified stated interest and will be taxed accordingly. Thus, a Variable Interest Rate Covered Bond that provides for stated interest at either a single qualified floating rate or a single objective rate throughout the term thereof and that qualifies as a “variable rate debt instrument” will generally not be treated as having been issued with OID unless the Variable Interest Rate Covered Bond is issued at a “true discount” (i.e., at a price below the Covered Bond’s stated principal amount) in excess of a specified *de minimis* amount. OID on a Variable Interest Rate Covered Bond arising from true discount is allocated to an accrual period using the constant yield method described above by assuming that the variable rate is a fixed rate equal to (i) in the case of a qualified floating rate or qualified inverse floating rate, the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate, or (ii) in the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that reflects the yield that is reasonably expected for the Variable Interest Rate Covered Bond.

In general, any other Variable Interest Rate Covered Bond that qualifies as a “variable rate debt instrument” will be converted into an equivalent fixed rate debt instrument for purposes of determining the amount and accrual of OID and qualified stated interest on the Variable Interest Rate Covered Bond. Such a Variable Interest Rate Covered Bond must be converted into an equivalent fixed rate debt instrument by substituting any qualified floating rate or qualified inverse floating rate provided for under the terms of the Variable Interest Rate Covered Bond with a fixed rate equal to the value of the qualified floating rate or



qualified inverse floating rate, as the case may be, as of the Variable Interest Rate Covered Bond's issue date. Any objective rate (other than a qualified inverse floating rate) provided for under the terms of the Variable Interest Rate Covered Bond is converted into a fixed rate that reflects the yield that is reasonably expected for the Variable Interest Rate Covered Bond. In the case of a Variable Interest Rate Covered Bond that qualifies as a "variable rate debt instrument" and provides for stated interest at a fixed rate in addition to either one or more qualified floating rates or a qualified inverse floating rate, the fixed rate is initially converted into a qualified floating rate (or a qualified inverse floating rate, if the Variable Interest Rate Covered Bond provides for a qualified inverse floating rate). Under these circumstances, the qualified floating rate or qualified inverse floating rate that replaces the fixed rate must be such that the fair market value of the Variable Interest Rate Covered Bond as of the Variable Interest Rate Covered Bond's issue date is approximately the same as the fair market value of an otherwise identical debt instrument that provides for either the qualified floating rate or qualified inverse floating rate rather than the fixed rate. Subsequent to converting the fixed rate into either a qualified floating rate or a qualified inverse floating rate, the Variable Interest Rate Covered Bond is converted into an equivalent fixed rate debt instrument in the manner described above.

Once the Variable Interest Rate Covered Bond is converted into an equivalent fixed rate debt instrument pursuant to the foregoing rules, the amount of OID and qualified stated interest, if any, are determined for the equivalent fixed rate debt instrument by applying the general OID rules to the equivalent fixed rate debt instrument and a U.S. Holder of the Variable Interest Rate Covered Bond will account for the OID and qualified stated interest as if the U.S. Holder held the equivalent fixed rate debt instrument. In each accrual period, appropriate adjustments will be made to the amount of qualified stated interest or OID assumed to have been accrued or paid with respect to the equivalent fixed rate debt instrument in the event that these amounts differ from the actual amount of interest accrued or paid on the Variable Interest Rate Covered Bond during the accrual period.

If a Variable Interest Rate Covered Bond, such as a Covered Bond the payments on which are determined by reference to an index, does not qualify as a "variable rate debt instrument", then the Variable Interest Rate Covered Bond will be treated as a contingent payment debt instrument. Prospective purchasers should consult with their own tax advisers concerning the proper U.S. federal income tax treatment of Variable Interest Rate Covered Bonds that are treated as contingent payment debt.

#### *Short-Term Covered Bonds*

In general, an individual or other cash basis U.S. Holder of a Short-Term Covered Bond is not required to accrue OID (calculated as set forth below for the purposes of this paragraph) for U.S. federal income tax purposes unless it elects to do so (but may be required to include any stated interest in income as the interest is received). Accrual basis U.S. Holders and certain other U.S. Holders are required to accrue OID on Short-Term Covered Bonds on a straight-line basis or, if the U.S. Holder so elects, under the constant-yield method (based on daily compounding). In the case of a U.S. Holder not required and not electing to include OID in income currently, any gain realized on the sale or retirement of the Short-Term Covered Bond will be ordinary income to the extent of the OID accrued on a straight-line basis (unless an election is made to accrue the OID under the constant-yield method) through the date of sale or retirement. U.S. Holders who are not required and do not elect to accrue OID on Short-Term Covered Bonds will be required to defer deductions for interest on borrowings allocable to Short-Term Covered Bonds in an amount not exceeding the deferred income until the deferred income is realized.

For purposes of determining the amount of OID subject to these rules, all interest payments on a Short-Term Covered Bond are included in the Short-Term Covered Bond's stated redemption price at maturity. A U.S. Holder may elect to determine OID on a Short-Term Covered Bond as if the Short-Term Covered Bond had been originally issued to the U.S. Holder as the U.S. Holder's purchase price for the Short-Term Covered

Bond. This election shall apply to all obligations with a maturity of one year or less acquired by the U.S. Holder on or after the first day of the first taxable year to which the election applies, and may not be revoked without the consent of the IRS.

#### ***Covered Bonds Purchased at a Premium***

A U.S. Holder that purchases a Covered Bond for an amount in excess of its principal amount, or for a Discount Covered Bond, its stated redemption price at maturity, may elect to treat the excess as “amortisable bond premium”, in which case the amount required to be included in the U.S. Holder’s income each year with respect to interest on the Covered Bond will be reduced by the amount of amortisable bond premium allocable (based on the Covered Bond’s yield to maturity) to that year. Any election to amortise bond premium shall apply to all bonds (other than bonds the interest on which is excludable from gross income for U.S. federal income tax purposes) held by the U.S. Holder at the beginning of the first taxable year to which the election applies or thereafter acquired by the U.S. Holder, and is irrevocable without the consent of the IRS. See also *Original Issue Discount—Election to Treat All Interest as Original Issue Discount*. A U.S. Holder that does not elect to take bond premium (other than acquisition premium) into account currently will recognise a capital loss when the Covered Bond matures.

#### ***Modifications to the Terms and Conditions of the Covered Bonds***

Certain modifications to the terms of the Covered Bonds described in Condition 15, including the assumption by either of the Group Guarantors, or a Subsidiary thereof, of the obligations of the Issuer as primary obligor, or the resignation of either HBOS or Bank of Scotland as a Group Guarantor, may constitute taxable events. If any modification to the terms and conditions of the Covered Bonds, including the substitution of a new primary obligor for the Issuer and/or the resignation of one or both of the Group Guarantors, were a taxable event, such modification would be treated for U.S. federal income tax purposes as an exchange of the Covered Bond for a new Covered Bond at the time the modification occurs (a **Deemed Exchange**) for an amount equal to the fair market value of the new Covered Bond. As a result, pursuant to a Deemed Exchange, a U.S. Holder of a Covered Bond may be required to recognize gain for U.S. federal income tax purposes despite not having received any actual distributions of income in connection with the Deemed Exchange. (See *Purchase, Sale and Retirement of Covered Bonds* below.)

#### ***Purchase, Sale and Retirement of Covered Bonds***

A U.S. Holder’s tax basis in a Covered Bond will generally be its cost, increased by the amount of any OID or market discount included in the U.S. Holder’s income with respect to the Covered Bond and the amount, if any, of income attributable to *de minimis* OID and *de minimis* market discount included in the U.S. Holder’s income with respect to the Covered Bond, and reduced by (i) the amount of any payments that are not qualified stated interest payments, and (ii) the amount of any amortisable bond premium applied to reduce interest on the Covered Bond.

A U.S. Holder will generally recognise gain or loss on the sale or retirement of a Covered Bond equal to the difference between the amount realised on the sale or retirement and the tax basis of the Covered Bond. Except to the extent described above under *Original Issue Discount—Market Discount* or *Original Issue Discount—Short Term Covered Bonds* or attributable to accrued but unpaid interest or changes in exchange rates (as discussed below), gain or loss recognised on the sale or retirement of a Covered Bond will be capital gain or loss and generally will be treated as from U.S. sources for purposes of the U.S. foreign tax credit limitation and may be taxable at reduced rates in the case of a U.S. Holder that is an individual, estate or trust, if the Covered Bonds are held for more than one year. The deductibility of capital losses is subject to limitations.

## ***Foreign Currency Covered Bonds***

### ***Interest***

If an interest payment is denominated in, or determined by reference to, a foreign currency, the amount of income recognised by a cash basis U.S. Holder will be the U.S. dollar value of the interest payment, based on the exchange rate in effect on the date of receipt, regardless of whether the payment is in fact converted into U.S. dollars.

An accrual basis U.S. Holder may determine the amount of income recognised with respect to an interest payment denominated in, or determined by reference to, a foreign currency in accordance with either of two methods. Under the first method, the amount of income accrued will be based on the average exchange rate in effect during the interest accrual period (or, in the case of an accrual period that spans two taxable years of a U.S. Holder, the part of the period within the taxable year).

Under the second method, the U.S. Holder may elect to determine the amount of income accrued on the basis of the exchange rate in effect on the last day of the accrual period (or, in the case of an accrual period that spans two taxable years, the exchange rate in effect on the last day of the part of the period within the taxable year). Additionally, if a payment of interest is actually received within five business days of the last day of the accrual period, an electing accrual basis U.S. Holder may instead translate the accrued interest into U.S. dollars at the exchange rate in effect on the day of actual receipt. Any such election will apply to all debt instruments held by the U.S. Holder at the beginning of the first taxable year to which the election applies or thereafter acquired by the U.S. Holder, and will be irrevocable without the consent of the IRS.

Upon receipt of an interest payment (including a payment attributable to accrued but unpaid interest upon the sale or retirement of a Covered Bond) denominated in, or determined by reference to, a foreign currency, the U.S. Holder may recognise U.S. source exchange gain or loss (taxable as ordinary income or loss) equal to the difference between the amount received (translated into U.S. dollars at the spot rate on the date of receipt) and the amount previously accrued, regardless of whether the payment is in fact converted into U.S. dollars.

### ***OID***

OID for each accrual period on a Discount Covered Bond that is denominated in, or determined by reference to, a foreign currency, will be determined in the foreign currency and then translated into U.S. dollars in the same manner as stated interest accrued by an accrual basis U.S. Holder, as described above under *Foreign Currency Covered Bonds—Interest*. Upon receipt of an amount attributable to OID (whether in connection with a payment on the Covered Bond or a sale of the Covered Bond), a U.S. Holder may recognise U.S. source exchange gain or loss (taxable as ordinary income or loss) equal to the difference between the amount received (translated into U.S. dollars at the spot rate on the date of receipt) and the amount previously accrued, regardless of whether the payment is in fact converted into U.S. dollars.

### ***Bond Premium***

Bond premium (including acquisition premium) on a Covered Bond that is denominated in, or determined by reference to, a foreign currency, will be computed in units of the foreign currency, and any such bond premium that is taken into account currently will reduce interest income in units of the foreign currency.

On the date bond premium offsets interest income, a U.S. Holder may recognise U.S. source exchange gain or loss (taxable as ordinary income or loss) measured by the difference between the spot rate in effect on that date, and on the date the Covered Bonds were acquired by the U.S. Holder.

### *Purchase, Sale and Retirement of Covered Bonds*

As discussed above under *Purchase, Sale and Retirement of Covered Bonds*, a U.S. Holder will generally recognise gain or loss on the sale or retirement of a Covered Bond equal to the difference between the amount realised on the sale or retirement and its tax basis in the Covered Bond. A U.S. Holder's tax basis in a Foreign Currency Covered Bond will be determined by reference to the U.S. dollar cost of the Covered Bond. The U.S. dollar cost of a Covered Bond purchased with foreign currency will generally be the U.S. dollar value of the purchase price on the date of purchase or, in the case of Covered Bonds traded on an established securities market, as defined in the applicable Treasury Regulations, that are purchased by a cash basis U.S. Holder (or an accrual basis U.S. Holder that so elects), on the settlement date for the purchase.

The amount realised on a sale or retirement for an amount in foreign currency will be the U.S. dollar value of this amount on the date of sale or retirement or, in the case of Covered Bonds traded on an established securities market, as defined in the applicable Treasury Regulations, sold by a cash basis U.S. Holder (or an accrual basis U.S. Holder that so elects), on the settlement date for the sale. Such an election by an accrual basis U.S. Holder must be applied consistently from year to year and cannot be revoked without the consent of the IRS.

A U.S. Holder will recognise U.S. source exchange rate gain or loss (taxable as ordinary income or loss) on the sale or retirement of a Covered Bond equal to the difference, if any between the U.S. dollar values of the U.S. Holder's purchase price for the Covered Bond (or, if less, the principal amount of the Covered Bond) (i) on the date of sale or retirement and (ii) the date on which the U.S. Holder acquired the Covered Bond. Any such exchange rate gain or loss will be realised only to the extent of total gain or loss realised on the sale or retirement.

### *Disposition of Foreign Currency*

Foreign currency received as interest on a Covered Bond or on the sale or retirement of a Covered Bond will generally have a tax basis equal to its U.S. dollar value at the time the interest is received or at the time of the sale or retirement. Foreign currency that is purchased will generally have a tax basis equal to the U.S. dollar value of the foreign currency on the date of purchase. Any gain or loss recognised on a sale or other disposition of a foreign currency (including its use to purchase Covered Bonds or upon exchange for U.S. dollars) will be U.S. source ordinary income or loss.

### ***Backup Withholding and Information Reporting***

In general, payments of interest and accrued OID on, and the proceeds of a sale, redemption or other disposition of, the Covered Bonds, payable to a U.S. Holder within the United States or by a U.S. paying agent or certain other U.S.-related intermediaries will be reported to the IRS and to the U.S. Holder as may be required under applicable regulations. Backup withholding may apply to these payments and to accruals of OID if the U.S. Holder fails to provide an accurate taxpayer identification number or certification of exempt status or otherwise to comply with the applicable backup withholding requirements. Certain U.S. Holders (including, among others, corporations) are not subject to information reporting or backup withholding. U.S. Holders should consult their tax advisers as to their qualification for exemption from information reporting and/or backup withholding and the procedure for obtaining an exemption.

### ***Disclosure Requirements***

Treasury Regulations meant to require the reporting of certain tax shelter transactions (**Reportable Transactions**) could be interpreted to cover transactions generally not regarded as tax shelters, including certain foreign currency transactions. Under the Treasury Regulations, certain transactions may be

characterised as Reportable Transactions including, in certain circumstances, a sale, exchange, retirement or other taxable disposition of a Foreign Currency Covered Bond and/or a Covered Bond issued with OID. Persons considering the purchase of such Covered Bonds should consult with their own tax advisers to determine the tax return obligations, if any, with respect to an investment in such Covered Bonds, including any requirement to file IRS Form 8886 (Reportable Transaction Disclosure Statement).

### **ERISA Considerations**

The Rule 144A Global Covered Bonds and Definitive IAI Registered Covered Bonds are eligible for purchase by employee benefit plans and other plans subject to the US Employee Retirement Income Security Act of 1974, as amended (**ERISA**), and/or the provisions of section 4975 of the Internal Revenue Code of 1986, as amended (the **Code**) and by governmental plans that are subject to state, local or other federal law of the United States that is substantially similar to ERISA or section 4975 of the Code, subject to consideration of the issues described in this section. ERISA imposes certain requirements on **employee benefit plans** (as defined in section 3(3) of ERISA) subject to ERISA, including entities such as collective investment funds and separate accounts whose underlying assets include the assets of such plans (collectively, **ERISA Plans**) and on those persons who are fiduciaries with respect to ERISA Plans. Investments by ERISA Plans are subject to ERISA's general fiduciary requirements, including the requirements of investment prudence and diversification and the requirement that an ERISA Plan's investments be made in accordance with the documents governing the Plan. The prudence of a particular investment must be determined by the responsible fiduciary of an ERISA Plan by taking into account the ERISA Plan's particular circumstances and all of the facts and circumstances of the investment including, but not limited to, the matters discussed under "Risk factors" and the fact that in the future there may be no market in which such fiduciary will be able to sell or otherwise dispose of the Rule 144A Global Covered Bonds and Definitive IAI Registered Covered Bonds.

Section 406 of ERISA and section 4975 of the Code prohibit certain transactions involving the assets of an ERISA Plan (as well as those plans that are not subject to ERISA but which are subject to section 4975 of the Code, such as individual retirement accounts (together with ERISA Plans, the **Plans**)) and certain persons (referred to as **parties in interest** or **disqualified persons**) having certain relationships to such Plans, unless a statutory or administrative exemption is applicable to the transaction. A party in interest or disqualified person who engages in a prohibited transaction may be subject to excise taxes and other penalties and liabilities under ERISA and the Code.

The Original Seller, the Issuer, the Guarantors, the Servicer, the Security Trustee or any other party to the transactions contemplated by the Transaction Documents may be parties in interest or disqualified persons with respect to many Plans. Prohibited transactions within the meaning of section 406 of ERISA or section 4975 of the Code may arise if any of the Rule 144A Global Covered Bonds and Definitive IAI Registered Covered Bonds are acquired or held by a Plan with respect to which Original Seller, the Issuer, the Guarantors, the Servicer, the Security Trustee or any other party to the transactions contemplated by the Transaction Documents is a party in interest or a disqualified person. Certain exemptions from the prohibited transaction provisions of section 406 of ERISA and section 4975 of the Code may be applicable, however, depending in part on the type of Plan fiduciary making the decision to acquire any such Covered Bonds and the circumstances under which such decision is made. Included among these exemptions are Prohibited Transaction Class Exemption (**PTCE**) 91-38 (relating to investments by bank collective investment funds), PTCE 84-14 (relating to transactions effected by a "qualified professional asset manager"), PTCE 95-60 (relating to transactions involving insurance company general accounts), PTCE 90-1 (relating to investments by insurance company pooled separate accounts) and PTCE 96-23 (relating to transactions determined by in-house asset managers). There can be no assurance that any of these class exemptions or any other exemption will be available with respect to any particular transaction involving any such Covered Bonds.



Each purchaser and subsequent transferee of any Rule 144A Global Covered Bonds or Definitive IAI Registered Covered Bonds will be deemed by such purchase or acquisition of any such Covered Bond to have represented and warranted, on each day from the date on which the purchaser or transferee acquires such note through and including the date on which the purchaser or transferee disposes of such note, either that (A) it is not a Plan or an entity whose underlying assets include the assets of any Plan or a governmental plan which is subject to any federal, state or local law of the United States that is substantially similar to the provisions of section 406 of ERISA or section 4975 of the Code or (B) its purchase, holding and disposition of such note will not result in a prohibited transaction under section 406 of ERISA or section 4975 of the Code (or, in the case of a governmental plan, any substantially similar federal, state or local law of the United States) for which an exemption is not available.

In addition, section 3(42) of ERISA and a regulation promulgated by the US Department of Labor at, 29 C.F.R. section 2510.3-101 (collectively, the **Plan Asset Regulation**), describe what constitutes the assets of a Plan with respect to the Plan's investment in an entity for purposes of certain provisions of ERISA, including the fiduciary responsibility provisions of Title I of ERISA, and section 4975 of the Code. Under the Plan Asset Regulation, if a Plan invests in an "equity interest" of an entity that is neither a "publicly-offered security" nor a security issued by an investment company registered under the Investment Company Act, the Plan's assets include both the equity interest and an undivided interest in each of the entity's underlying assets, unless one of the exceptions to such treatment described in the Plan Asset Regulation applies. Under the Plan Asset Regulation, a security which is in form debt may be considered an "equity interest" if it has "substantial equity features". If the issuing entity were deemed under the Plan Asset Regulation to hold plan assets by reason of a Plan's investment in any of the Rule 144A Global Covered Bonds or Definitive IAI Registered Covered Bonds, such plan assets would include an undivided interest in the assets held by the issuing entity and transactions by the issuing entity would be subject to the fiduciary responsibility provisions of Title I of ERISA and the prohibited transaction provisions of ERISA and section 4975 of the Code. While no assurance can be given, the issuing entity believes that the Rule 144A Global Covered Bonds and Definitive IAI Registered Covered Bonds should not be treated as "equity interests" for the purposes of the Plan Asset Regulation.

Any insurance company proposing to purchase any of the Rule 144A Global Covered Bonds and Definitive IAI Registered Covered Bonds using the assets of its general account should consider the extent to which such investment would be subject to the requirements of ERISA in light of the US Supreme Court's decision in *John Hancock Mutual Life Insurance Co. v. Harris Trust and Savings Bank* and under any subsequent guidance that may become available relating to that decision. In particular, such an insurance company should consider the retroactive and prospective exemptive relief granted by the US Department of Labor for transactions involving insurance company general accounts in PTCE 95-60, 60 Fed. Reg. 35925 (12 July 1995), the enactment of section 401(c) of ERISA by the Small Business Job Protection Act of 1996 (including, without limitation, the expiration of any relief granted thereunder) and the Insurance Company General Account Regulations, 65 Fed. Reg. No. 3 (5 January 2000) (to be codified at 29 C.F.R. pt. 2550) that became generally applicable on 5 July 2001.

Each Plan fiduciary who is responsible for making the investment decisions whether to purchase or commit to purchase and to hold any of the Rule 144A Global Covered Bonds and Definitive IAI Registered Covered Bonds should determine whether, under the documents and instruments governing the Plan, an investment in such Covered Bonds is appropriate for the Plan, taking into account the overall investment policy of the Plan and the composition of the Plan's investment portfolio. Any Plan proposing to invest in such Covered Bonds (including any governmental plan) should consult with its counsel to confirm that such investment will not result in a non-exempt prohibited transaction and will satisfy the other requirements of ERISA and the Code (or, in the case of a governmental plan, any substantially similar state, local or other federal law).

The sale of any Rule 144A Global Covered Bonds or Definitive IAI Registered Covered Bonds to a Plan is in no respect a representation by the Original Seller, the Issuer, the Guarantors, the Servicer, the Security Trustee or any other party to the transactions contemplated by the Transaction Documents that such an investment meets all relevant legal requirements with respect to investments by Plans generally or any particular Plan, or that such an investment is appropriate for Plans generally or any particular Plan.



## SUBSCRIPTION AND SALE AND TRANSFER AND SELLING RESTRICTIONS

The Dealers have, in a programme agreement (as the same may be amended and/or supplemented and/or restated from time to time, the **Programme Agreement**) dated the Programme Date agreed with the Issuer and the Guarantors a basis upon which such Dealers or any of them may from time to time agree to purchase Covered Bonds. Any such agreement will extend to those matters stated under *Form of the Covered Bonds* and *Terms and Conditions of the Covered Bonds*. In the Programme Agreement, the Issuer (failing which, the Group Guarantors) has agreed to reimburse the Dealers for certain of their expenses in connection with the establishment and any future update of the Programme and the issue of Covered Bonds under the Programme and to indemnify the Dealers against certain liabilities incurred by them in connection therewith.

### Transfer Restrictions

*As a result of the following restrictions, purchasers of Covered Bonds in the United States are advised to consult legal counsel prior to making any purchase, offer, sale, resale or other transfer of such Covered Bonds.*

Each purchaser of Registered Covered Bonds (other than a person purchasing an interest in a Registered Global Covered Bond with a view to holding it in the form of an interest in the same Global Covered Bond) or person wishing to transfer an interest from one Registered Global Covered Bond to another or from global to definitive form or vice versa, will be required to acknowledge, represent and agree as follows (terms used in this paragraph that are defined in Rule 144A or in Regulation S are used herein as defined therein):

- (i) that either: (a) it is a QIB, purchasing (or holding) the Covered Bonds for its own account or for the account of one or more QIBs and it is aware that any sale to it is being made in reliance on Rule 144A, (b) it is an Institutional Accredited Investor which has delivered an IAI Investment Letter or (c) it is outside the United States and is not a U.S. person;
- (ii) that the Covered Bonds are being offered and sold in a transaction not involving a public offering in the United States within the meaning of the Securities Act, and that the Covered Bonds and the Covered Bond Guarantee have not been and will not be registered under the Securities Act or any applicable U.S. State securities laws and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except as set forth below;
- (iii) that, unless it holds an interest in a Regulation S Global Covered Bond and either is a person located outside the United States or is not a U.S. person, if in the future it decides to resell, pledge or otherwise transfer the Covered Bonds or any beneficial interests in the Covered Bonds, it will do so, prior to the date which is two years after the later of the last Issue Date for the Series and the last date on which the Issuer or an affiliate of the Issuer was the owner of such Covered Bonds, only (a) to the Issuer or any affiliate thereof, (b) inside the United States to a person whom the seller reasonably believes is a QIB purchasing for its own account or for the account of a QIB in a transaction meeting the requirements of Rule 144A, (c) outside the United States in compliance with Rule 903 or Rule 904 under the Securities Act, (d) pursuant to the exemption from registration provided by Rule 144 under the Securities Act (if available) or (e) pursuant to an effective registration statement under the Securities Act, in each case in accordance with all applicable U.S. State securities laws;
- (iv) that it will, and will require each subsequent holder to, notify any purchaser of the Covered Bonds from it of the resale restrictions referred to in paragraph (iii) above, if then applicable;
- (v) that Covered Bonds initially offered in the United States to QIBs will be represented by one or more Rule 144A Global Covered Bonds, that Covered Bonds offered to Institutional Accredited Investors

will be in the form of Definitive IAI Registered Covered Bonds and that Covered Bonds offered outside the United States in reliance on Regulation S will be represented by one or more Regulation S Global Covered Bonds;

- (vi) that the Covered Bonds, other than the Regulation S Global Covered Bonds, will bear a legend to the following effect unless otherwise agreed to by the Issuer:

“THIS SECURITY HAS NOT BEEN REGISTERED UNDER THE U.S. SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT), OR ANY OTHER APPLICABLE U.S. STATE SECURITIES LAWS AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD WITHIN THE UNITED STATES OR TO, OR FOR THE ACCOUNT OR BENEFIT OF, U.S. PERSONS EXCEPT AS SET FORTH IN THE FOLLOWING SENTENCE. BY ITS ACQUISITION HEREOF, THE HOLDER (A) REPRESENTS THAT (1) IT IS A “QUALIFIED INSTITUTIONAL BUYER” (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT) PURCHASING THE SECURITIES FOR ITS OWN ACCOUNT OR FOR THE ACCOUNT OF ONE OR MORE QUALIFIED INSTITUTIONAL BUYERS OR (2) IT IS AN INSTITUTIONAL “ACCREDITED INVESTOR” (AS DEFINED IN RULE 501(A)(1), (2), (3) OR (7) UNDER THE SECURITIES ACT) (AN **INSTITUTIONAL ACCREDITED INVESTOR**); (B) AGREES THAT IT WILL NOT RESELL OR OTHERWISE TRANSFER THE SECURITIES EXCEPT IN ACCORDANCE WITH THE AGENCY AGREEMENT IN RESPECT OF THIS SECURITY (THE **AGENCY AGREEMENT**) AND, PRIOR TO THE DATE WHICH IS TWO YEARS AFTER THE LATER OF THE LAST ISSUE DATE FOR THE SERIES AND THE LAST DATE ON WHICH THE ISSUER OR AN AFFILIATE OF THE ISSUER WAS THE OWNER OF SUCH SECURITIES OTHER THAN (1) TO THE ISSUER OR ANY AFFILIATE THEREOF, (2) INSIDE THE UNITED STATES TO A PERSON WHOM THE SELLER REASONABLY BELIEVES IS A QUALIFIED INSTITUTIONAL BUYER WITHIN THE MEANING OF RULE 144A UNDER THE SECURITIES ACT PURCHASING FOR ITS OWN ACCOUNT OR FOR THE ACCOUNT OF A QUALIFIED INSTITUTIONAL BUYER IN A TRANSACTION MEETING THE REQUIREMENTS OF RULE 144A, (3) OUTSIDE THE UNITED STATES IN COMPLIANCE WITH RULE 903 OR RULE 904 UNDER THE SECURITIES ACT, (4) PURSUANT TO THE EXEMPTION FROM REGISTRATION PROVIDED BY RULE 144 UNDER THE SECURITIES ACT (IF AVAILABLE) OR (5) PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT, IN EACH CASE IN ACCORDANCE WITH ALL APPLICABLE SECURITIES LAWS OF THE STATES OF THE UNITED STATES AND ANY OTHER JURISDICTION; AND (C) IT AGREES THAT IT WILL DELIVER TO EACH PERSON TO WHOM THIS SECURITY IS TRANSFERRED A NOTICE SUBSTANTIALLY TO THE EFFECT OF THIS LEGEND.

THIS SECURITY AND RELATED DOCUMENTATION (INCLUDING, WITHOUT LIMITATION, THE AGENCY AGREEMENT REFERRED TO HEREIN) MAY BE AMENDED OR SUPPLEMENTED FROM TIME TO TIME, WITHOUT THE CONSENT OF, BUT UPON NOTICE TO, THE HOLDERS OF SUCH SECURITIES SENT TO THEIR REGISTERED ADDRESSES, TO MODIFY THE RESTRICTIONS ON AND PROCEDURES FOR REALES AND OTHER TRANSFERS OF THIS SECURITY TO REFLECT ANY CHANGE IN APPLICABLE LAW OR REGULATION (OR THE INTERPRETATION THEREOF) OR IN PRACTICES RELATING TO REALES OR OTHER TRANSFERS OF RESTRICTED SECURITIES GENERALLY. THE HOLDER OF THIS SECURITY SHALL BE DEEMED, BY ITS ACCEPTANCE OR PURCHASE HEREOF, TO HAVE AGREED TO ANY SUCH AMENDMENT OR SUPPLEMENT (EACH OF WHICH SHALL BE CONCLUSIVE AND BINDING ON THE HOLDER HEREOF AND ALL FUTURE HOLDERS OF THIS SECURITY AND ANY SECURITIES ISSUED IN EXCHANGE OR SUBSTITUTION THEREFOR, WHETHER OR NOT ANY NOTATION THEREOF IS MADE HEREON).”;

- (vii) if it is outside the United States and is not a U.S. person, that if it should resell or otherwise transfer the Covered Bonds prior to the expiration of the distribution compliance period (defined as 40 days after the completion of the distribution of the Tranche of Covered Bonds of which such Covered Bonds are a part, as determined and certified by the relevant Dealer, in the case of a non-syndicated issue, or the Lead Manager, in the case of a syndicated issue), it will do so only (a)(i) outside the United States in compliance with Rule 903 or 904 under the Securities Act or (ii) to a QIB in compliance with Rule 144A and (b) in accordance with all applicable U.S. State securities laws; and it acknowledges that the Regulation S Global Covered Bonds will bear a legend to the following effect unless otherwise agreed to by the Issuer:

“THIS SECURITY HAS NOT BEEN AND WILL NOT BE REGISTERED UNDER THE U.S. SECURITIES ACT OF 1933, AS AMENDED (THE **SECURITIES ACT**), OR ANY APPLICABLE U.S. STATE SECURITIES LAWS AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD WITHIN THE UNITED STATES OR TO, OR FOR THE ACCOUNT OR BENEFIT OF, U.S. PERSONS EXCEPT IN ACCORDANCE WITH THE AGENCY AGREEMENT IN RESPECT OF THIS SECURITY AND PURSUANT TO AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OR PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT. UNTIL THE EXPIRY OF THE PERIOD OF 40 DAYS AFTER THE COMPLETION OF THE DISTRIBUTION OF ALL THE COVERED BONDS OF THE TRANCHE OF WHICH THIS COVERED BOND FORMS PART, SALES MAY NOT BE MADE IN THE UNITED STATES OR TO U.S. PERSONS UNLESS MADE (I) PURSUANT TO RULE 903 OR 904 OF REGULATION S UNDER THE SECURITIES ACT OR (II) TO QUALIFIED INSTITUTIONAL BUYERS AS DEFINED IN, AND IN TRANSACTIONS PURSUANT TO, RULE 144A UNDER THE SECURITIES ACT.”; and

- (viii) that the Issuer and others will rely upon the truth and accuracy of the foregoing acknowledgements, representations and agreements and agrees that if any of such acknowledgements, representations or agreements made by it are no longer accurate, it shall promptly notify the Issuer; and if it is acquiring any Covered Bonds as a fiduciary or agent for one or more accounts it represents that it has sole investment discretion with respect to each such account and that it has full power to make the foregoing acknowledgements, representations and agreements on behalf of each such account.

Institutional Accredited Investors who purchase Registered Covered Bonds in definitive form offered and sold in the United States in reliance upon the exemption from registration provided by Regulation D of the Securities Act are required to execute and deliver to the Bond Registrar an IAI Investment Letter. Upon execution and delivery of an IAI Investment Letter by an Institutional Accredited Investor, Covered Bonds will be issued in definitive registered form, see *Form of the Covered Bonds*.

The IAI Investment Letter will state, among other things, the following:

- (i) that the Institutional Accredited Investor has received a copy of the Offering Circular and such other information as it deems necessary in order to make its investment decision;
- (ii) that the Institutional Accredited Investor understands that any subsequent transfer of the Covered Bonds is subject to certain restrictions and conditions set forth in the Offering Circular and the Covered Bonds (including those set out above) and that it agrees to be bound by, and not to resell, pledge or otherwise transfer the Covered Bonds except in compliance with, such restrictions and conditions and the Securities Act;
- (iii) that, in the normal course of its business, the Institutional Accredited Investor invests in or purchases securities similar to the Covered Bonds;

- (iv) that the Institutional Accredited Investor is an institution that is an accredited investor within the meaning of Rule 501(a)(1), (2), (3) or (7) of Regulation D under the Securities Act and has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of its investment in the Covered Bonds, and it and any accounts for which it is acting are each able to bear the economic risk of its or any such accounts' investment for an indefinite period of time;
- (v) that the Institutional Accredited Investor is acquiring the Covered Bonds purchased by it for its own account or for one or more accounts (each of which is an Institutional Accredited Investor) as to each of which it exercises sole investment discretion and not with a view to any distribution of the Covered Bonds, subject, nevertheless, to the understanding that the disposition of its property shall at all times be and remain within its control; and
- (vi) that, in the event that the Institutional Accredited Investor purchases Covered Bonds, it will acquire Covered Bonds having a minimum purchase price of at least U.S.\$500,000 (or the approximate equivalent in another Specified Currency).

No sale of Legended Covered Bonds in the United States to any one purchaser will be for less than U.S.\$100,000 (or the approximate equivalent in another Specified Currency) principal amount or, in the case of sales to Institutional Accredited Investors, U.S.\$500,000 (or the approximate equivalent in another Specified Currency) principal amount and no Legended Covered Bond will be issued in connection with such a sale in a smaller principal amount. If the purchaser is a non-bank fiduciary acting on behalf of others, each person for whom it is acting must purchase at least U.S.\$100,000 (or the approximate equivalent in another Specified Currency) or, in the case of sales to Institutional Accredited Investors, U.S.\$500,000 (or the approximate equivalent in another Specified Currency) principal amount of Registered Covered Bonds.

Dealers may arrange for the resale of Covered Bonds to QIBs pursuant to Rule 144A and each such purchaser of Covered Bonds is hereby notified that the Dealers may be relying on the exemption from the registration requirements of the Securities Act provided by Rule 144A. The minimum aggregate principal amount of Covered Bonds which may be purchased by a QIB pursuant to Rule 144A is U.S.\$100,000 (or the approximate equivalent in another Specified Currency).

### *United States*

The Covered Bonds and the Guarantees have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

The Covered Bonds in bearer form are subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a United States person, except in certain transactions permitted by U.S. tax regulations. Terms used in this paragraph have the meanings given to them by the U.S. Internal Revenue Code of 1986, as amended, and regulations thereunder.

In connection with any Covered Bonds which are offered or sold outside the United States in reliance on Regulation S (**Regulation S Covered Bonds**), each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that it will not offer, sell or deliver such Regulation S Covered Bonds (i) as part of their distribution at any time or (ii) otherwise until 40 days after the later of the commencement of the offering and the completion of the distribution of the tranche of Covered Bonds of which such Covered Bonds are a part, as determined and certified by the relevant Dealer in the case of a non-syndicated issue or, in the case of an issue of Covered Bonds on a syndicated basis, the relevant Lead Manager, of all Covered Bonds of the Tranche of which such Covered Bonds are a part, within the United States or to, or for the account or benefit of, U.S. persons. Each Dealer

has further agreed, and each further Dealer appointed under the Programme will be required to agree, that it will send to each Dealer to which it sells any Regulation S Covered Bonds during the distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the Covered Bonds within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

Until 40 days after the commencement of the offering of any Series of Covered Bonds, an offer or sale of such Covered Bonds within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with an available exemption from registration under the Securities Act.

Dealers may arrange for the resale of Covered Bonds to QIBs pursuant to Rule 144A and each such purchaser of Covered Bonds is hereby notified that the Dealers may be relying on the exemption from the registration requirements of the Securities Act provided by Rule 144A. The minimum aggregate principal amount of Covered Bonds which may be purchased by a QIB pursuant to Rule 144A is U.S.\$100,000 (or the approximate equivalent in another Specified Currency).

Each issuance of Index Linked Covered Bonds or Dual Currency Covered Bonds shall be subject to such additional U.S. selling restrictions as the Issuer and the relevant Dealer(s) may agree as a term of the issuance and purchase of such Covered Bonds, which additional selling restrictions shall be set out in the applicable Final Terms.

### ***European Economic Area***

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a **Relevant Member State**), each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the **Relevant Implementation Date**) it has not made and will not make an offer of Covered Bonds to the public in that Relevant Member State, except that it may, with effect from and including the Relevant Implementation Date, make an offer of Covered Bonds to the public in that Relevant Member State:

- (a) in (or in Germany, where the offer starts within) the period beginning on the date of publication of a prospectus in relation to those Covered Bonds which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and notified to the competent authority in that Relevant Member State, all in accordance with the Prospectus Directive and ending on the date which is 12 months after the date of such publication;
- (b) at any time to legal entities which are authorised or regulated to operate in the financial markets or, if not so authorised or regulated, whose corporate purpose is solely to invest in securities;
- (c) at any time to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than €43,000,000 and (3) an annual net turnover of more than €50,000,000, as shown in its last annual or consolidated accounts; or
- (d) at any time in any other circumstances which do not require the publication by the Issuer of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression an “offer of Covered Bonds to the public” in relation to any Covered Bonds in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Covered Bonds to be offered so as to enable an investor to decide to purchase or subscribe the Covered Bonds, as the same may be varied in that Member



State by any measure implementing the Prospectus Directive in that Member State and the expression **Prospectus Directive** means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

### *United Kingdom*

Each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that:

- (i) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Covered Bonds in circumstances in which Section 21(1) of the FSMA does not or, in the case of the Issuer or Bank of Scotland, as Group Guarantor, would not, if either were not an authorised person, apply to the Issuer, the Group Guarantors, or the LLP; and
- (ii) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to any Covered Bonds in, from or otherwise involving the United Kingdom.

### *Japan*

The Covered Bonds have not been and will not be registered under the Securities and Exchange Law of Japan (the **Securities and Exchange Law**) and each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it has not offered and will not offer or sell any Covered Bonds, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organised under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

### *General*

Each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will (to the best of its knowledge and belief) comply with all applicable securities laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers Covered Bonds or possesses or distributes this Offering Circular and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of Covered Bonds under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and none of the Issuer, the Group Guarantors, the LLP, the Bond Trustee, the Security Trustee nor any of the other Dealers shall have any responsibility therefor.

None of the Issuer, the Group Guarantors, the LLP, the Bond Trustee, the Security Trustee or any of the Dealers represents that Covered Bonds may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating such sale.

With regard to each Tranche, the relevant Dealer(s) will be required to comply with such other restrictions as the Issuer and the relevant Dealer(s) shall agree and as shall be set out in the applicable Final Terms.

## **INDEPENDENT AUDITORS**

The Consolidated Financial Statements of the Group incorporated by reference in this Offering Circular have been audited by KPMG Audit Plc, independent auditors, as stated in their report thereon appearing herein.



## GENERAL INFORMATION

### Authorisation

The Programme and the issue of Covered Bonds have been duly authorised by a resolution of a committee of the board of directors of the Issuer dated 14 July 2003, the giving of the Covered Bond Guarantee has been duly authorised by a resolution of a committee of the board of directors of each of the Members of the LLP dated 14 July, 2003 and the giving of each Group Guarantee has been duly authorised by a resolution of a committee of the board of directors of each of Bank of Scotland and HBOS passed on 14 July 2003, respectively.

The update of the Programme has been duly authorised by:

1. a resolution of the board of directors of the Issuer dated 5 May 2006 and subsequent resolutions of a committee of the board of directors of the Issuer dated 22 January 2007 and 26 April 2007;
2. resolutions of the boards of directors of Bank of Scotland, HBOS and the Original Seller dated 28 February 2006 and subsequent resolutions of committees of the boards of directors of HBOS, Bank of Scotland and the Original Seller dated 24 January 2007 and 27 April 2007; and
3. a resolution of the management board of the LLP dated 7 February 2007.

### Approval, Listing and Admission to Trading of Covered Bonds

Application has been made to the CSSF to approve this document as a base prospectus. Application has also been made to the Luxembourg Stock Exchange for the Covered Bonds issued under the Programme to be admitted to trading on the Luxembourg Stock Exchange's regulated market and listed on the Official List of the Luxembourg Stock Exchange. The Luxembourg Stock Exchange's regulated market is a regulated market for the purposes of the Investment Services Directive (Directive 93/22/EEC).

### Documents Available

So long as Covered Bonds are capable of being issued under the Programme, copies of the following documents will, when published, be available free of charge during usual business hours on any weekday (Saturdays, Sundays and public holidays excepted) from the registered office of the Issuer and from the specified office of the Paying Agent for the time being in Luxembourg:

- (i) the Memorandum and Articles of Association of the Issuer and the constitutive documents of the Guarantors;
- (ii) the consolidated audited financial statements of each of the Issuer and each of the Group Guarantors in respect of the financial periods ended 31 December 2005 and 2006 and the non-consolidated audited financial statements of the LLP in respect of financial periods ended 31 December 2005 and 2006, in each case together with any audit or review reports prepared in connection therewith. The Issuer and the Group Guarantors each currently prepares audited consolidated and non-consolidated accounts on an annual basis. The LLP prepares audited non-consolidated accounts on an annual basis;
- (iii) the most recently published audited annual financial statements of the Issuer, the Guarantors and the most recently published unaudited interim financial statements (if any) of the Issuer and the Group Guarantors, in each case together with any audit or review reports prepared in connection therewith. The Issuer and the Group Guarantors each currently prepares unaudited consolidated and non-

consolidated interim accounts on a semi-annual basis. The LLP is currently not required to produce any interim financial statements;

- (iv) an accountant's report issued by KPMG Audit plc, the auditors of the LLP, in respect of the LLP's financial statements as at the date hereof;
- (v) the forms of the Global Covered Bonds, the Covered Bonds in definitive form, the Receipts, the Coupons and the Talons;
- (vi) a copy of this Offering Circular;
- (vii) any future offering circulars, prospectuses, information memoranda and supplements to this Offering Circular and any other documents incorporated herein including Final Terms (including a Final Terms relating to an unlisted Covered Bond) or therein by reference; and
- (viii) each of the following transaction documents (the **Transaction Documents**), namely:
  - Mortgage Sale Agreement
  - each Scottish Declaration of Trust
  - each Servicing Agreement
  - Asset Monitor Agreement
  - Intercompany Loan Agreement
  - LLP Deed
  - Deed of Admission
  - Cash Management Agreement
  - each Interest Rate Swap Agreement
  - each Covered Bond Swap Agreement
  - Guaranteed Investment Contract
  - Stand-by Guaranteed Investment Contract
  - Bank Account Agreement
  - Stand-by Bank Account Agreement
  - Corporate Services Agreement
  - Deed of Charge (and any documents entered into pursuant to the Deed of Charge)
  - Trust Deed
  - Agency Agreement
  - Programme Agreement
  - the Deed Poll
  - each Subscription Agreement (as applicable in the case of each issue of Covered Bonds admitted to trading on the Luxembourg Stock Exchange's regulated market subscribed pursuant to a subscription agreement)
  - Master Definitions and Construction Agreement.

In addition, copies of this Offering Circular and each document incorporated herein by reference are available on the Luxembourg Stock Exchange's website at [www.bourse.lu](http://www.bourse.lu).

### **Clearing Systems**

The Bearer Covered Bonds have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The appropriate Common Code and ISIN for each Tranche of Bearer Covered Bonds allocated by Euroclear will be specified in the applicable Final Terms. In addition, the Issuer may make an application for any Registered Covered Bonds to be accepted for trading in book-entry form by DTC. The CUSIP and/or CINS numbers for each Tranche of Registered Covered Bonds, together with the relevant ISIN and Common Code, will be specified in the applicable Final Terms. If the Covered Bonds are to clear through an additional or alternative clearing system the appropriate information will be specified in the applicable Final Terms.

The address of Euroclear is Euroclear Bank SA/NV, 1 Boulevard du Roi Albert II, B-1210 Brussels; the address of Clearstream, Luxembourg is Clearstream Banking, 42 Avenue JF Kennedy, L-1855 Luxembourg; and the address of DTC is 55 Water Street, 25th Floor, New York, NY 10041-0099, United States.

### **Conditions for determining price**

The price and amount of Covered Bonds to be issued under the Programme will be determined by the Issuer and the relevant Dealer at the time of issue in accordance with prevailing market conditions.

### **Significant or Material Change**

There has been no significant change in the financial or trading position of the Issuer, Bank of Scotland, HBOS or the LLP since 31 December 2006. There has been no material adverse change in the financial position or prospects of the Issuer and the Guarantors since 31 December 2006.

### **Litigation**

Neither the Issuer, either Group Guarantor nor the LLP is or has been involved in any governmental legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Issuer, either Group Guarantor or the LLP is aware) which may have or have had in the 12 months preceding the date of this document a significant effect on the financial position or profitability of the Issuer, either Group Guarantor or the LLP.

### **Auditors**

The auditors of the Issuer and each of the Guarantors are KPMG Audit Plc, chartered accountants with the Institute of Chartered Accountants in England and Wales and regulated by the Audit Inspection Unit for the Public Oversight Board and Financial Reporting Council. KPMG Audit Plc have audited, without qualification, in accordance with generally accepted auditing standards in the United Kingdom, the Issuer's accounts for each of the two financial years ended on 31 December 2005 and 2006, each of the Group Guarantor's accounts for each of the two financial years ended on 31 December 2005 and 2006, and the LLP's accounts for the financial period to 31 December 2005 and for the financial year ended on 31 December 2006.

## **Reports**

The Trust Deed provides that the Bond Trustee may rely on reports or other information from professional advisers or other experts in accordance with the provisions of the Trust Deed, whether or not any such report or other information, or engagement letter or other document entered into by the Bond Trustee and the relevant person in connection therewith, contains any monetary or other limit on the liability of the relevant person.

So long as the Covered Bonds are admitted to trading on the Luxembourg Stock Exchange's regulated market and to listing on the Luxembourg Stock Exchange, the Issuer or a Guarantor shall notify the CSSF and the Luxembourg Stock Exchange of any replacement or substitution of the Issuer or a Guarantor by filing with the CSSF and the Luxembourg Stock Exchange a supplement to this Offering Circular. In addition, the Issuer or such Guarantor will publish a notice in respect of such replacement or substitution in accordance with Condition 14 of the Conditions.

## **Post-issuance information**

The Issuer does not intend to provide post-issuance information except if required by any applicable laws and regulations.

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## **ANNEX A – DESCRIPTIONS OF CERTAIN DIFFERENCES AMONG IFRS, U.K. GAAP AND U.S. GAAP**

### **Descriptions of Certain Differences between IFRS and U.S. Generally Accepted Accounting Principles**

The statutory consolidated financial statements of HBOS as of and for the year ended 31 December 2006 are prepared in accordance with International Financial Reporting Standards as adopted by the European Union (**IFRS**). The HBOS Group's statutory consolidated financial statements also comply with the relevant provisions of Part VII of the Companies Act 1985, as amended by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004. Additionally the Group has applied Financial Reporting Standard 27 'Life Assurance' issued by the UK Accounting Standards Board as appropriate. Such principles may vary from U.S. GAAP. Set out below are descriptions of certain accounting differences between IFRS and U.S. GAAP that could have a significant effect on profit attributable to Parent Company shareholders for the year ended 31 December 2006 and shareholders' equity (excluding minority interests) as of 31 December 2006 as shown under IFRS in the consolidated financial statements as of and for the year ended 31 December 2006. This annex does not provide a comprehensive analysis of such differences. HBOS has not quantified the effect of differences between IFRS and U.S. GAAP, nor prepared consolidated financial statements under U.S. GAAP, nor undertaken a reconciliation of IFRS and U.S. GAAP financial statements. Had HBOS undertaken any such quantification or preparation or reconciliation, other potentially significant accounting and disclosure differences may have come to its attention which are not identified below. Accordingly, HBOS does not provide any assurance that the differences identified below represent all the principal differences between IFRS and U.S. GAAP relating to HBOS. Furthermore, no attempt has been made to identify future differences between IFRS and U.S. GAAP. Finally, no attempt has been made to identify all differences between IFRS and U.S. GAAP that may affect the financial statements as a result of transactions or events that may occur in the future.

Using the exemptions within IFRS 1 "First-time adoption of International Financial Standards", IAS 32 "Financial Instruments: Disclosure and Presentation", IAS 39 "Financial Instruments: Recognition and Measurement" and IFRS 4 "Insurance Contracts" only became effective from 1 January 2005. Where the implementation of these standards resulted in a change in accounting policy from 1 January 2005, the 2004 comparatives presented in the statutory consolidated financial statements do not reflect the provisions of these standards but instead reflect the application of HBOS's relevant previous U.K. GAAP accounting policies. The descriptions of certain differences between IFRS and U.S. GAAP that follow consider only IFRS as applied to the financial information for 2005. For descriptions of certain differences between U.K. GAAP and U.S. GAAP as they relate to 2004, see *Descriptions of Certain Differences between U.K. and U.S. Generally Accepted Accounting Principles* below.

In making an investment decision, investors must rely upon their own examinations of us, the terms of the Offering and our financial statements. Potential investors should consult their own professional advisers for an understanding of the differences between IFRS and U.S. GAAP and how those differences might have affected the financial information contained in this Offering Circular. The summary does not purport to be complete and is subject and qualified in its entirety by reference to the pronouncements of the IASB together with the pronouncements of the U.S. accounting profession.

### **Goodwill and Other Intangible Assets**

Under IFRS, the excess of the cost of a business combination over the interest in the net fair value of the identifiable assets, liabilities and contingent liabilities at the date of acquisition, of subsidiary undertakings, associated undertakings (including jointly controlled entities) and other businesses, is

capitalized as goodwill. After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill carried in the consolidated balance sheet is subject to a six monthly impairment review by comparing the value in use with the carrying value. When this indicates that the carrying value is not recoverable, it is written down through the income statement by the amount of any impaired loss identified. IFRS 3 “Business Combinations” has not been applied retrospectively to business combinations that occurred before 1 January 2004. Accumulated amortization on goodwill arising before 1 January 2004 has not therefore been reversed. Under UK GAAP, goodwill arising on acquisitions prior to 1 January 1998 was written off to reserves in the year in which it arose and has not been reinstated. Goodwill arising after 31 December 1997 was capitalized. The goodwill was amortized by equal instalments over its estimated useful life, not exceeding 20 years. The carrying amount of goodwill existing at 31 December 2003 under U.K. GAAP was carried forward under the transition rules of IFRS.

Under U.S. GAAP, SFAS 141 “Business Combinations” and SFAS 142 “Goodwill and Other Intangible Assets”, the excess of the cost of an acquired business over the net amounts assigned to assets acquired and liabilities assumed represents goodwill. The provisions of SFAS 141 provide specific criteria for the initial recognition of intangible assets apart from goodwill. Under SFAS 142, goodwill is no longer amortized from 1 January 2002, but is subject to impairment reviews annually or on a more frequent basis in certain circumstances. SFAS 142 provides a model and methodology to test for and measure goodwill impairment. The two-step model provides a test for potential impairment (step 1) and if necessary, a measurement of the impairment (step 2). Step 1 tests for potential impairment by comparing the fair value of the reporting unit with its carrying amount. If the fair value of the reporting unit is greater than its carrying amount, then there is no impairment. If the reporting unit’s carrying amount is greater than its fair value, then step 2 must be completed to measure the amount of impairment. Step 2 compares the implied fair value of the goodwill of the reporting unit with the carrying amount of the goodwill. If the carrying amount of the reporting unit’s goodwill exceeds the implied fair value of that goodwill, then an impairment loss must be recognized for an amount equal to that excess. Goodwill cannot subsequently be increased to its original carrying amount.

### **Pension costs**

Under IFRS the HBOS Group’s net obligation in respect of defined benefit pension plans is calculated separately for each plan. The net obligation represents the present value of the future benefits owed to employees in return for their service in the current and prior periods, after the deduction of the fair value of any plan assets. The calculation of the pension liability is performed by a qualified actuary using the projected unit credit method.

HBOS has elected to take directly to equity actuarial gains and losses that arise in the period in which they are incurred. HBOS therefore does not use the corridor approach available under IFRS.

The discount rate used is the market yield on high quality corporate bonds at the balance sheet date that have maturity dates approximating to the terms of the Group’s obligation.

The charge to the income statement includes current service cost, past service cost, the interest cost of the scheme liabilities and the expected return on scheme assets.

Under U.S.GAAP the pension expense for defined benefit pension plans is based on annual actuarial valuations. The current service cost, the interest cost (being the unwinding of the discount on the plans’ projected benefit obligations) and the expected return on assets (calculated using the market or market related value of assets) for the period are all charged/credited to operating profit. At a minimum the cumulative amounts arising from changes in the assumptions used for actuarial valuations and any differences between the actual and expected returns on the plans assets must be amortized through operating

profit over the average remaining service lives of the employees where the unrecognized net gain or loss exceeds a pre-determined level.

In addition, under U.S. GAAP, an additional minimum pension liability is recognized when the accumulated benefit obligation exceeds the fair value of plan assets to the extent that this amount is not covered by the net liability recognized in the balance sheet. In this case, a charge is made to other comprehensive income to the extent that the additional liability exceeds the amount of unrecognized prior service cost.

### **Investment properties**

Under IFRS investment properties, which are defined as properties which are held either to earn rental income or for capital appreciation or both, are initially recognized at cost and are fair valued annually. Any gains or losses arising from a change in the fair value are recognized in the income statement in the period that they occur. Investment properties are not depreciated.

Under U.S. GAAP, investment property that does not qualify for “separate account” accounting under SOP 03-1 (see below) is initially recognized at cost. Except for non-depreciable land, depreciation is charged to earnings to write off the cost of such property less its estimated residual value over its useful economic life. If circumstances indicate that the carrying amount of such property may not be recoverable, the property would be tested for recoverability by comparing the sum of the undiscounted cash flows expected to result from its use and eventual disposition with its carrying amount. If the carrying amount of the property is not fully recoverable, an impairment loss is recognized equal to the amount by which its carrying amount exceeds its fair value.

### **Long Term Assurance Business**

Under IFRS Long Term Assurance Business has been classified in accordance with IFRS 4 as follows:

- Insurance contracts – contracts containing significant insurance risk;
- Investment contracts with Discretionary Participating Features (**DPF**) – contracts that do not contain significant insurance risk but that contain discretionary participation features, which are with-profit contracts; and
- Investment contracts – contracts that have neither significant insurance risk nor a DPF.

Insurance contracts and investment contracts with DPF including both traditional and unitised with profits contracts are calculated with reference to the expected payout using realistic and where applicable market consistent assumptions in accordance with FRS27 (UK GAAP). In the case of the former, premiums are recognised as revenue when due from the policyholder and claims payable are recorded when notified. In the case of the latter, deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability.

Insurance contract liabilities within the non profit funds are calculated in accordance with the Integrated Prudential Sourcebook (**PRU**) issued by the UK Financial Services Authority. These are adjusted to remove excessively prudent closure provisions and certain other reserves required under the PRU rules. Premiums are recognised as revenue when due from the policyholder. Claims are the estimated cost of all claims arising during the period. Estimates are based upon an assessment of the likely costs taking account of all known facts. The accounting policies set out above in respect of the measurement of the policyholder liabilities include liability adequacy testing that meet the requirements of IFRS 4. Where the expected value of claims and expenses attributable to unexpired risk periods exceed the value of unearned premiums less

Deferred Acquisition Costs (**DAC**), at the balance sheet date, additional provisions are made for the anticipated losses.

The unallocated surplus is accounted for as a liability as permitted by IFRS 4. The carrying value of the unallocated surplus is determined as the residual assets of the with-profit fund after providing for the with-profits liabilities in accordance with the policies described above.

The HBOS Group places a value on the insurance contracts and investment contracts with DPF, which represents the present value of future cash flows attributable to the Group with respect to these contracts. The change in Value In Force (**VIF**) is accounted for as revenue.

In-force business is defined as all policies where the first premium has been paid. For traditional with-profits business, the surplus attributable to the Group equates to one ninth of the cost of the bonuses declared in any year. The level of assumed future bonuses is calculated by projecting the portfolio of with-profits business forward and applying reversionary and terminal bonus rates so as to exhaust the projected surplus of assets attributable to with-profit policyholders.

The Group's investment contracts, which include collective investment schemes, are primarily unit-linked. These contracts are managed and evaluated on a fair value basis in accordance with the terms of the contracts as benefits are linked to the fair value of the assets supporting the contracts. Accordingly, the investment contract liabilities have been designated at fair value through the income statement with fair value changes recognised through change in investment contract liabilities. The fair value of the liabilities is estimated using a valuation technique. In accordance with this technique the liability is established as the bid value of the assets held to match the liability, less an allowance in relation to deductions made to the liability for capital gains tax on the gains relating to the matching assets.

Deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability with other changes recognized in the income statement.

Revenue in relation to investment management services is recognized as the services are provided. Incremental costs directly attributable to securing the Group's contractual right to benefit from providing investment management services in relation to investment contracts, other than through a business combination or portfolio transfer, is recognized as an asset if it is probable that they will be recovered. Incremental costs include commissions paid to intermediaries and other similar costs. This asset, referred to as deferred origination costs (**DOC**), is amortized as the related investment management revenue is recognized, and its recoverability assessed at each balance sheet date on a portfolio basis.

The assets held in support of the Long Term Assurance Business including those within shareholders' funds are monitored and evaluated on a fair value basis in accordance with the investment strategy. This basis is consistent with the method used for regulatory purposes. Accordingly the Group has designated these assets as at fair value through the income statement. Interest, dividends, foreign exchange gains and losses, and fair value movements including movement on derivatives held to manage the return on those assets are recorded in net investment income related to insurance and investment business.

Under U.S. GAAP, long term assurance products are generally accounted for under SFAS 60 "Accounting and Reporting by Insurance Enterprises", SFAS 97 "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments" and SOP 03-1 "Accounting and Reporting by Insurance Enterprises", in accordance with the nature of the underlying product and the level of insurance risk. U.S. GAAP has detailed and specific guidance concerning accounting for insurance and investment contracts which may give rise to recognition, measurement, classification and presentation differences compared to IFRS. In particular:

- Under SOP 03-1, which is effective from 2004, long-term assurance assets and liabilities are reported on a “separate account” basis only if detailed criteria are met. The portion of such separate account assets representing contract holder funds should be measured at fair value. If a separate account arrangement does not meet the criteria, assets representing contract holder funds should be accounted for as “general account” assets in accordance with SFAS 60 (in general, consistently with other U.S.GAAP requirements for such assets).
- U.S. GAAP does not permit embedded value accounting.

### **Share-based payments**

The Group operates various equity-settled, share-based compensation schemes in exchange for employee services received. Under IFRS, the fair values of options or shares granted is determined at the date of grant and expensed over the vesting period. The fair values of the options or shares granted are measured using various models, taking into account the terms and conditions upon which the options and shares were granted. At each balance sheet date the Group revises its estimate of the number of options or shares that it expects to vest and spreads any adjustments required to the income statement over the vesting period except for those which relate to a market condition.

U.S. GAAP encourages companies to account for equity-based instruments issued under compensation plans at their fair value, generally measured at the date at which the instruments are granted. Detailed guidance is provided by SFAS 123 and SFAS 123(R). For 2005, U.S. GAAP also permitted the intrinsic value –based method of accounting under which the compensation cost, being the excess, if any, of the quoted market price of the stock at the measurement date over the exercise price, must be recognized in the income statement over the vesting period.

### **Securitisations and special purpose entities**

Under IFRS, subsidiaries and special purpose entities are entities controlled by the Group. Control is defined where the HBOS Group has power, directly or indirectly, to govern the financial and operating policies of such entities. Loans and advances to customers include advances that are subject to non-returnable finance arrangements following securitisation of portfolios of mortgages and other advances. The principal benefits of these advances were acquired by special purpose securitisation companies that fund their purchase primarily through the issue of floating rate notes. These floating rate notes are accounted for as debt securities in issue on the balance sheet.

Under U.S GAAP, transfers of financial assets are treated as sales under SFAS 140 and the assets derecognized only where specified criteria are met. When a transfer qualifies for sale accounting, a gain or loss is recognized at the time of sale along with any servicing asset/liability that shall be amortized over the servicing period. A transfer that does not qualify as a sale is accounted for as a secured financing on a gross basis. A company does not consolidate a “qualifying special purpose entity” to which it has transferred financial assets but is required to consolidate “variable interest entities” of which it is the primary beneficiary. Conversely, a company does not consolidate “variable interest entities” of which it is not the primary beneficiary.

### **Preference Shares**

Under IFRS, preference shares are classified as debt where they are redeemable on a specific date or at the option of the shareholders or if dividend payments are not discretionary. Dividends on preference shares classified as debt are recognized in the income statement through interest payable. Other preference

shares are classed as equity. Dividends on preference shares classified as equity are presented as a deduction in the statement of changes in equity.

Under U.S. GAAP there is a mezzanine level shown separately from both debt and shareholders' equity. Preference shares whose redemption is at the option of the shareholder are reported at this level. Preference shares whose redemption is at the option of HBOS are classified as part of shareholders equity. Equity dividends are presented as a deduction in the statement of changes in shareholders' equity. Preference shares that are mandatorily redeemable are classified as liabilities, with dividends treated as an interest expense in the income statement.

## **Derivatives**

Under IFRS, derivatives are initially recognized at fair value on the date the contract is entered into. Fair values of exchange traded derivatives are obtained from quoted market prices. Fair values of over-the-counter (OTC) derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

In the normal course of business, the fair value of a derivative on initial recognition is considered to be the transaction price (the fair value of the consideration given or received). However, in certain circumstances the fair value of an instrument will be evidenced by comparison with other observable current market transactions in the same instrument (without modification or repackaging) or will be based on a valuation technique whose variables include only data from observable markets, including interest yield rate curves, option volatilities and currency rates.

Derivatives may be embedded in other financial instruments. An embedded derivative is treated as a separate derivative when its economic characteristics and risks are not clearly related to those of the host contract, its terms are the same as those of a stand-alone derivative, and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes in fair value recognized in the income statement.

Derivatives are classified as assets when their fair value is positive or as liabilities when their fair value is negative.

The gain or loss on remeasurement to fair value at the balance sheet date is taken to the income statement unless cash flow hedging is employed. Hedge accounting is applied to financial instruments designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Under IFRS changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, together with changes in the fair values of the assets or liabilities or groups thereof that are attributable to the hedged risks. If this hedge is highly effective then the net impact on the income statement is minimised. If the hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of a hedged item is amortized to the income statement based on a recalculated effective interest rate over the remaining expected life.

Under IFRS the effective portion of changes in the fair values of derivatives that are designated and qualify as cash flow hedges are recognized in equity. Any gain or loss relating to an ineffective portion is recognized immediately in the income statement. Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect the income statement. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is



recognized in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Under IFRS hedges of net investments in foreign operations are accounted for in a similar manner to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognized in equity; the gain or loss relating to the ineffective portion is recognized immediately in the income statement. When a foreign operation is sold, gains and losses accumulated in equity are recognized in the income statement as part of the gain or loss on sale.

IFRS requires that at inception and throughout its life, each hedge must be expected to be highly effective to qualify for hedge accounting. Actual effectiveness must also be demonstrated on an ongoing basis. The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted for assessing hedge effectiveness will depend on risk management strategies implemented. A hedge is regarded as effective if the change in fair value or cash flows of the hedge and hedged item are correlated within a range of 80 per cent. to 125 per cent. either for the period since effectiveness was last tested or cumulatively since inception

U.S. GAAP requires all derivatives (including certain derivatives embedded in other instruments) to be recorded at fair value (as interpreted by the requirements of EITF 03-03). If certain conditions are met then the derivative may be designated as a fair value hedge, a cash flow hedge or a hedge of the foreign currency exposure of a net investment in a foreign subsidiary. The change in the value of a fair value hedge is recorded in income along with the attributable change in fair value of the hedged asset or liability. The change in value of a cash flow hedge (to the extent it is an effective hedge) is recorded in other comprehensive income and reclassified to earnings as the hedged cash flows affect earnings. The change in the value of a net investment hedges (to the extent it is an effective hedge) is recorded in the currency translation reserve and only released to income when the underlying investment is sold. All other changes in the fair values of derivatives are included in earnings.

### **Financial assets and liabilities at fair value through profit and loss**

Under IFRS, a financial instrument, other than one held for trading, is classified as at fair value where it eliminates or significantly reduces a measurement or recognition inconsistency, applies to a group of financial assets, financial liabilities or a combination of both that is managed and its performance evaluated on a fair value basis or relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.

Financial assets and financial liabilities so designated are recognised initially at fair value and are subsequently measured at fair value. The designation once made is irrevocable in respect of the financial instrument to which it relates. Gains and losses from changes in the fair value of such assets and liabilities are recognized in the income statement as they arise.

Under U.S. GAAP there is no option to designate financial assets or liabilities at fair value with changes in fair value recognized in the income statement.

### **Acceptances**

Under IFRS acceptances outstanding and the matching customers' liabilities are not reflected in the consolidated balance sheet, but are disclosed as a supplementary note to the consolidated financial statements.

Under U.S. GAAP, acceptances outstanding and the matching customers' liabilities are reflected in the consolidated balance sheet.



## **Differences between U.K. GAAP and IFRS**

The significant differences applicable to the Group's accounts as a result of adopting IFRS are detailed within notes 53 to 57 together with note 35 to the Group's statutory consolidated financial statements for the year ended 31 December 2005.

## **Descriptions of Certain Differences Between U.K. and U.S. Generally Accepted Accounting Principles**

The Group prepared its statutory consolidated financial statements as of and for the year ended 31 December 2004 in accordance with the U.K. Companies Act 1985, as applicable to banking groups, and U.K. GAAP. Such principles may vary from U.S. GAAP. Set out below are descriptions of certain accounting differences between U.K. GAAP and U.S. GAAP that could have a significant effect on profit attributable to shareholders and shareholders' funds as shown under U.K. GAAP in the statutory consolidated financial statements of the Group as of and for the year ended 31 December 2004. This annex does not provide a comprehensive analysis of such differences. HBOS has not quantified the effect of differences between U.K. GAAP and U.S. GAAP, nor prepared consolidated financial statements under U.S. GAAP, nor undertaken a reconciliation of U.K. GAAP and U.S. GAAP financial statements. Had HBOS undertaken any such quantification or preparation or reconciliation, other potentially significant accounting and disclosure differences may have come to its attention which are not identified below. Accordingly, HBOS does not provide any assurance that the differences identified below represent all the principal differences between U.K. GAAP and U.S. GAAP relating to HBOS. Furthermore, no attempt has been made to identify differences between U.K. GAAP and U.S. GAAP arising or that may arise after 31 December 2004. Finally, no attempt has been made to identify all differences between D.K. GAAP and U.S. GAAP that may affect the financial statements as a result of transactions or events that may occur in the future.

In making all investment decision, investors must rely upon their own examinations of us, the terms of the Offering and our financial statements. Potential investors should consult their own professional advisors for an understanding of the differences between U.K. GAAP and U.S. GAAP and how those differences might have affected the financial information contained in this Offering Circular. The summary does not purport to be complete and is subject and qualified in its entirety by reference to the pronouncements of the U.K. accounting profession, together with the

## **Deferred Taxation**

Under U.K. GAAP, deferred tax was recognized in full, in respect of timing differences between the treatment of certain items for taxation and accounting purposes which had arisen but not reversed by the balance sheet date (except as otherwise required by Financial Reporting Standards (**FRS**) 19), based on the corporation tax rate expected when the timing differences reverse.

Under U.S. GAAP, deferred taxation is provided on all taxable temporary differences between the tax and book bases of assets and liabilities at the applicable statutory rate enacted at the reporting date, including differences between assigned values and tax bases of assets and liabilities (except non-deductible goodwill) recognized in a business combination. A valuation allowance is recorded to reduce deferred tax assets to the amount which "more likely than not" will be realized in the future

## **Pension Costs**

Under U.K. GAAP pension fund liabilities were assessed by independent professionally qualified actuaries, normally at triennial valuations and at intervening dates if considered necessary. In accordance with the requirements of Statement of Standard Accounting Practice No 24 ("SSAP 24"), pension costs were

charged against profits using actuarial valuation methods intended to spread the pension cost evenly over the average service periods of the current employees in the schemes. Under this standard the actuarial cost for the year of providing pensions for applicable persons employed by the Group during the year was charged against profits. SSAP 24 permitted this charge to be reduced by offsetting any actuarial surpluses within the relevant pension schemes.

Under U.S. GAAP, the pension expense for defined benefit pension plans is based on annual actuarial valuations. The current service cost, the interest cost (being the unwinding of the discount on the plans' projected benefit obligations) and the expected return on assets (calculated using the market or market related value of assets) for the period are all charged/credited to operating profit. At a minimum, the cumulative amounts arising from changes in the assumptions used for actuarial valuations and any differences between the actual and expected returns on the plans assets must be amortized through operating profit over the average remaining service lives or the employees where the unrecognized net gain or loss exceeds a pre-determined level.

In addition, under U.S. GAAP, an additional minimum pension liability is recognized when the accumulated benefit obligation exceeds the fair value of plan assets to the extent that this amount is not covered by the net liability recognized in the balance sheet. In this case, a charge is made to other comprehensive income to the extent that the additional liability exceeds the amount of unrecognized prior service cost.

### **Income from Long-Term Assurance Business**

Under U.K. GAAP, income from long term assurance business was accounted for using the embedded value basis. The income represented the change in the surplus attributable to the HBOS Group, including minority interests, and the net present value of the in-force business. The value was a prudent estimate of the net present value of future cash flows attributable to the shareholders, based on the market value of the assets at the balance sheet date, using assumptions which reflected experience and a long-term outlook [or the economy and then discounting at an appropriate risk discount rate.

Under U.S. GAAP, long term assurance products are generally accounted for under SPAS 60 "Accounting and Reporting by Insurance Enterprises", SPAS 97 "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments" and SOP 03-1 "Accounting and Reporting by Insurance Enterprises", in accordance with the nature of the underlying product and the level of insurance risk. U.S. GAAP has detailed and specific guidance concerning accounting for insurance and investment contracts, which may give rise to recognition, measurement, classification and presentation compared to U.K. GAAP. In particular:

- Under SOP 03-1, which is effective from 2004, long-term assurance assets and liabilities are reported on a "separate account" basis only if detailed criteria are met. The portion of such separate account assets representing contract holder funds should be measured at fair value. If a separate account arrangement does not meet the criteria, assets representing contract holder funds should be accounted for as "general account" assets in accordance with SFAS 60 (in general, consistently with other U.S. GAAP requirement for such assets).
- U.S. GAAP does not permit embedded value accounting.

### **Proposed Final Dividend**

Under U.K. GAAP HBOS recorded the proposed final dividend, which is declared after the last day of December each year, in the period to which it related.

Under U.S. GAAP, dividends are recorded in the period in which they are declared.

### **Equipment Leased to Customers**

Under U.K GAAP the Group credited leasing income and income from installment credit agreements to profit by spreading interest and charges over the period of repayment in proportion to the net cash investment, taking into account tax payments and receipts associated with the lease. Leases were classified as finance leases when the substance of the agreement was that of a finance transaction and the lessee assumed substantially all of the risks and benefits relating to the asset. All other leases were classified as operating leases. Operating leased assets were depreciated over their useful lives such that, for each asset, rentals less depreciation were recognized at a constant periodic rate of return on the net cash invested in the leased asset.

Under U.S. GAAP, income from equipment leased to customers under direct financing capital leases is recognized by amortizing the unearned income, using a method which results in a level rate of return on investment. Generally no account is taken of the tax flows generated by the lease. Leases are classified as capital leases when any of the criteria under SFAS 13 "Accounting for Leases" are met. Operating leased assets are depreciated such that the depreciation charge is at least equal to that which would have arisen on a straight line basis.

### **Goodwill and Other Intangible Assets**

Under U.K. GAAP the excess of the fair value of purchase consideration over the fair value of net assets at the date of acquisition of subsidiary undertakings, associated undertakings (including joint ventures) and other businesses arising on acquisitions after 31 December 1997 was capitalized. This goodwill was amortized by equal installments over its estimated useful life, not exceeding 20 years. Goodwill arising on acquisitions prior to 1 January 1998 was written off to reserves in the year in which it arose and has not been reinstated, as permitted by FRS 10 "Goodwill and Intangible Assets". On the disposal of subsidiary undertakings and other businesses any related goodwill charged directly to reserves prior to 1 January 1998 was reinstated and included in the calculation of the profit or loss on disposal.

Goodwill carried in the consolidated balance sheet was subject to impairment review when events or changes in circumstances indicated that the carrying amount may not be recoverable and was written down by the amount of any impairment loss identified in the year. Impairment charges, if any, were included within goodwill amortization.

Under U.S. GAAP, SFAS 141 "Business Combinations" and SFAS 142 "Goodwill and Other Intangible Assets", the excess of the cost of an acquired business over the net amounts assigned to assets acquired and liabilities assumed represents goodwill. The provisions of SFAS 141 provide specific criteria for the initial recognition of intangible assets apart from goodwill. Under SFAS 142, goodwill is no longer amortized from 1 January 2002, but is subject to impairment reviews annually or on a more frequent basis in certain circumstances. SFAS 142 provides a model and methodology to test for and measure goodwill impairment. The two-step model provides a test for potential impairment (step 1) and if necessary, a measurement of the impairment (step 2). Step 1 tests for potential impairment by comparing the fair value of the reporting unit with its carrying amount. If the fair value of the reporting unit is greater than its carrying amount, then there is no impairment. If the reporting unit's carrying amount is greater than its fair value, then step 2 must be completed to measure the amount of impairment. Step 2 compares the implied fair value of the goodwill of the reporting unit with the carrying amount of the goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, then an impairment loss must be recognized for an amount equal to that excess. Goodwill cannot subsequently be increased to its original carrying amount.

## **Debt Securities and Equity Shares**

Under U.K. GAAP the Group included debt securities (and other fixed interest securities) held for trading at market value and included gains or losses within dealing profits in the profit and loss account. Debt securities (and other fixed interest securities) held for the longer term were included at cost less amounts written off and adjusted for the amortization of premiums or discounts arising on purchase of investments redeemable at fixed dates. Such premiums or discounts were taken to revenue evenly over the period to redemption and gains or losses on realization of such securities were taken to revenue as "Profit on sale of investment securities" as they arose. Equity shares held for investment were stated at cost less amounts written off.

U.S. GAAP requires classification of debt securities and readily marketable equity shares within one of three categories; (i) held to maturity; (ii) available for sale; and (iii) trading. Held to maturity securities are measured at amortized cost and include debt securities where a positive intent and ability to hold the securities to maturity exists. Trading securities are those securities bought principally with a view to selling them in the near term and are measured at fair value with unrealized holding gains and losses included in earnings. Available for sale securities are those not classified as either held to maturity or trading securities. Such securities are measured at fair value with unrealized holding gains and losses excluded from earnings and reported (net of applicable taxes and minority interests) in a separate component of other comprehensive income within stockholders' equity, Foreign exchange gains or losses on foreign currency denominated available for sale securities are also excluded from earnings and recorded as part of the same separate component of stockholders' equity. Equity shares that are not readily marketable are carried at cost. In all cases, an other-than-temporary impairment in value of a security is charged to earnings.

## **Acceptances**

Under U.K. GAAP acceptances outstanding and the matching customers' liabilities are not reflected in the consolidated balance sheet, but were disclosed as memorandum items below the consolidated balance sheet.

Under U.S. GAAP, acceptances outstanding and the matching customers' liabilities are reflected in the consolidated balance sheet.

## **Loan Origination Fees**

Under U.S. GAAP, certain loan origination fees, in respect of services provided, were recognized in the profit and loss account on the basis of work done. Fees receivable in respect of bearing risk were recognized over the period of the advance or risk exposure. Mortgage incentive costs were charged to the profit and loss account as they were incurred.

Under U.S. GAAP, certain loan origination costs and loan origination fees, to the extent they are not offset by related direct costs, are deferred and amortized through the profit and loss account over the life of the loan.

## **Stock Based Compensation**

Under U.K. GAAP equity based instruments, such as share options, issued under compensation plans were accounted for within the share capital and share premium accounts on the balance sheet when exercised.

U.S. GAAP encourages companies to account for equity based instruments issued under compensation plans at their fair value, generally measured at the date at which the instruments are granted.

Detailed guidance is provided by SFAS123 and SFAS123(R). For 2004 and prior years U.S. GAAP also permitted the intrinsic value-based method of accounting under which the compensation cost, being the excess, if any, of the quoted market price of the stock at the measurement date over the exercise price, must be recognized in the profit and loss account over the vesting period.

### **Foreign Exchange**

Under U.K. GAAP, foreign currency earnings of overseas entities were translated using period-end exchange rates or at a forward exchange rate.

Under U.S. GAAP, foreign currency earnings must be translated using the average exchange rate prevailing for each period.

### **Securitisations and special purpose entities**

Under U.K. GAAP, where undertakings had issued debt securities or entered into funding arrangements with lenders through special-purpose entities in order to finance specific assets, the balances were either accounted for on the basis of linked presentation or through separate recognition of the gross assets and related funding, in accordance with FRS 5. The special-purpose entities were treated as “quasi-subsidiaries” and were consolidated in accordance with FRS 5.

Under U.S. GAAP, transfers of financial assets are treated as sales under SFAS 140 and the assets de-recognized only where specified criteria are met. When a transfer qualifies for sale accounting, a gain or loss is recognized at the time of sale along with any servicing asset/liability that shall be amortized over the servicing period. A transfer that does not qualify as a sale is accounted for as a secured financing on a gross basis. A company does not consolidate a “qualifying special purpose entity” to which it has transferred financial assets but is required to consolidate “variable interest entities” of which it is the primary beneficiary. Conversely, a company does not consolidate “variable interest entities” of which it is not the primary beneficiary.

### **Preference Shares**

Under U.K. GAAP preference shares were classified within shareholders funds with dividends treated as a distribution of profits.

Under U.S. GAAP there is a mezzanine level shown separately from both debt and shareholders' equity. Preference shares whose redemption is at the option of the shareholder are reported at this level. Preference shares whose redemption is at the option of HBOS are classified as part of shareholders equity. Equity dividends are presented as a deduction in the statement of changes in shareholders' equity. Preference shares that are mandatory redeemable are classified as liabilities, with dividends treated as an interest expense in the income statement.

### **Derivatives**

Under U.K GAAP, derivatives used for hedging purposes were measured on an accruals basis in line with the underlying instruments being hedged. Trading derivatives were carried in the accounts at fair value.

U.S. GAAP, requires all derivatives (including certain derivatives embedded in other instruments) to be recorded at fair value (as interpreted by the requirements of EITF 02-03). If certain conditions are met then the derivative may be designated as a fair value hedge, cash flow hedge or hedge of the foreign currency exposure of a net investment in a foreign subsidiary. The change in the value of a fair value hedge is recorded in income along with the attributable change in fair value of the hedged asset or liability. The change in value

of a cash flow hedge (to the extent it is an effective hedge) is recorded in other comprehensive income and reclassified to earnings as the hedged cash flows affect earnings. The change in the value of a net investment hedge (to the extent it is an effective hedge) is recorded in the currency translation reserve and only released to income when the underlying investment is sold. All other changes in the fair values of derivatives are included in earnings.

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