

Notes to the Financial Statements

37. Critical accounting judgements and estimates

In preparation of the Group's and Company's Financial Statements, estimates are made which affect the reported amounts of assets and liabilities; estimates are kept under continuous evaluation. Estimates and judgements are based on historical experience, expectations of future events and other factors.

Judgements:

Financial instrument designation

Upon initial designation, a certain amount of judgement is required in ascertaining within which category, as prescribed in IAS 39, a financial instrument should be designated. The IAS 39 categories are detailed in the accounting policies set out in note 1 and the designation is based on the criteria specified in IAS 39. We note that where financial instruments contain an embedded derivative we have not opted to designate the whole instrument as 'at fair value through profit and loss' which is permissible under the standard.

Qualifying hedge relationships

In designating a financial instrument as part of a qualifying hedge relationship the Group and Company have determined that the hedge is expected to be highly effective over the life of the hedging instrument. In accounting for a derivative as a cash flow hedge the Group and Company have determined that the hedged cash flow exposure relates to highly probable future cash flows.

Impairment of debt securities

Critical judgement is applied in determining whether a debt security is impaired. The factors considered in determining whether an asset is impaired are detailed in note 13.

Securitisations

In applying the Group's policies on securitised financial assets, the Group and Company have considered both the degree of transfer of risks and rewards on assets transferred to another entity and the degree of control exercised by the Group over the other entity:

- When the Group, in substance, controls the entity to which financial assets have been transferred, the entity is included in these consolidated Financial Statements and the transferred assets continue to be recognised in the Group's Balance Sheet.
- When the Company or another Group entity has transferred financial assets to another entity, but has not transferred substantially all of the risks and rewards relating to the transferred assets, the assets continue to be recognised in the transferring entity's Balance Sheet.

Details of the Group's securitisation activities are given in note 12.

Estimates:

Fair value of debt securities

Debt securities are carried at fair value. The method for calculating fair value of debt securities is described in note 13. For the vast majority of debt securities a reliable market price was available at the year end and has been used as the fair value. For those debt securities where a model has been used rather than the quoted market price there are a number of assumptions used in determining the fair value. If the value of these debt securities, excluding synthetic CDOs, used were to increase or decrease by 10% there would be a £2.7m positive or £2.7m negative impact respectively on the Income Statement. For the debt securities that contain an embedded derivative (the synthetic CDOs), a model has been used in certain cases to determine the fair value of the embedded derivative. A number of assumptions are used in determining the fair value. If the value of these embedded derivatives were to increase or decrease by 10% there would be a £10.3m positive or £10.3m negative impact respectively on the Income Statement.

Effective interest rate

Loans and advances to customers are accounted for on an effective interest rate basis, under which the income is spread over the loan's expected life. On a quarterly basis, models are reviewed to re-assess expected life by portfolio of products based upon actual redemptions by product. If the estimated average life of a loan were increased or reduced by one month the Balance Sheet amount of loans and advances to customers at 31 December 2007 would be higher by £3.6m or lower by £3.8m respectively.

Loan impairment

The Group reviews its loan impairment on a quarterly basis. Impairment models use historical loss experience to provide both probabilities of defaults and property forced sale discounts across a portfolio of products. In addition, management applies a risk weighted view on additional factors, such as specific fraud cases. If average house prices were to increase or decrease by 5% the reported impairment at 31 December 2007 would be £9.8m lower or £11.6m higher respectively.

Post-retirement benefit obligations

The net deficit in respect of post-retirement benefit obligations is carried on the Balance Sheet. The value of these obligations is calculated by the Group's actuaries using the assumptions set out in note 25. Note 25 also discloses the impact on the benefit obligations of changes in certain key assumptions.

Provisions

Provisions are carried in respect of certain known or forecast future expenditure, as described in note 26.