

Notes to the Financial Statements

39. Financial instruments continued

(g) Hedge accounting continued

Fair value movements on financial instruments recognised in the Income Statement comprised the following:

	Group	
	2007 £m	2006 £m
Net (losses)/gains on fair value hedging instruments	(372.6)	9.9
Net gains/(losses) on fair value hedged items	349.2	(9.6)
Ineffectiveness on cash flow hedges	(0.1)	-
Total hedge ineffectiveness	(23.5)	0.3
Net loss in fair value on embedded derivatives	(49.7)	(0.1)
Total fair value movements recognised in the Income Statement	(73.2)	0.2

Realised gains less losses on financial instruments recognised in the Income Statement comprised the following:

	Group	
	2007 £m	2006 £m
Realised gains on available-for-sale instruments	4.5	2.1
Realised gains on instruments at amortised cost	1.0	-
Realised gains on instruments at fair value through profit or loss	1.0	-
Total realised gains less losses on financial instruments recognised in the Income Statement	6.5	2.1

40. Risk management

(a) A description of the principal risks to which the Group and Company are exposed is provided on pages 18 to 21.

The following table describes the significant activities undertaken by the Group, the risks associated with such activities and the types of derivatives which are typically used in managing such risks.

Activity	Risk	Type of derivative instrument used
Fixed rate savings products and funding activities in Sterling involving either fixed rate instruments or instruments with embedded options	Sensitivity to changes in interest rates	Interest rate swaps and interest rate futures
Fixed and capped rate mortgage lending and investment activities involving either fixed rate instruments or instruments with embedded options	Sensitivity to changes in interest rates	Interest rate swaps and options
Investment and funding in foreign currencies	Sensitivity to changes in foreign exchange rates	Cross-currency interest rate swaps and foreign exchange contracts
Equity-linked investment products	Sensitivity to changes in equity indices	Equity-linked swaps
Variable rate products	Sensitivity to changes in interest rates	Interest rate swaps

The accounting policy for derivatives and hedge accounting is described in note 1.

(b) Credit risk

Before taking account of any collateral, the maximum exposure to credit risk at 31 December was:

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Cash and balances at central banks	209.2	202.6	209.2	202.6
Treasury bills	185.0	-	185.0	-
Loans and advances to banks	2,392.1	3,301.4	1,901.9	2,413.5
Loans and advances to customers	40,444.5	36,131.7	51,435.4	41,895.5
Debt securities	6,778.7	5,299.9	7,398.2	4,840.9
Derivative financial instruments	1,175.4	291.0	468.6	278.2
Other financial assets	661.0	34.2	659.6	40.3
Total on - Balance Sheet	51,845.9	45,260.8	62,257.9	49,671.0
Irrevocable undrawn loan facilities (off - Balance Sheet) (see note 34)	1,900.7	2,305.7	75.7	522.0
Total maximum exposure to credit risk	53,746.6	47,566.5	62,333.6	50,193.0

In respect of loans and advances to banks and customers and derivative financial instruments the Group and Company may hold reverse repurchase agreements and may also hold cash as security (see notes 39e and 39f). Loans and advances to customers are secured on property.

In respect of Lifetime mortgages, the irrevocable undrawn loan facility is calculated using actuarial assumptions. There is no commitment to advance further cash; the commitment reflects interest expected to roll up on the loans until redemption.

40. Risk management continued**(c) Liquidity risk**

It should be noted that many financial instruments are settled earlier than their contractual maturity dates; in particular, many mortgage loans are repaid early in full or in part.

The Group closely monitors its liquidity position against the Board's liquidity policy. This policy sets out elements of available and required liquidity through reference to and modelling of net lending commitments, short and medium term wholesale commitments, liquidity reserves, retail deposit growth and the requirement for other payments (e.g. dividends and tax). From this, minimum and target liquidity levels are established. Furthermore, liquidity is also measured in proportion to the total Balance Sheet and is subject to trigger levels; these determine the appropriate levels of escalation in order to address any actual or forecast shortfalls. The liquidity policy also requires stress testing through modelling and assessment of any emerging and potentially extreme funding conditions.

The contractual maturities of financial assets and liabilities were as follows:

Group At 31 December 2007	On demand £m	In not more than three months £m	In more than three months but not more than one year £m	In more than one year but not more than five years £m	In more than five years £m	Total £m
Financial assets						
Cash and balances at central banks	21.0	-	-	-	188.2	209.2
Treasury bills	185.0	-	-	-	-	185.0
Loans and advances to banks	576.3	1,561.2	54.8	73.2	126.6	2,392.1
Loans and advances to customers	-	66.9	364.9	1,295.3	38,717.4	40,444.5
Fair value adjustments on portfolio hedging	(53.8)	-	-	-	-	(53.8)
Debt securities	-	2,020.3	283.6	1,228.8	3,246.0	6,778.7
Derivative financial instruments	-	64.3	81.2	775.0	254.9	1,175.4
Other financial assets	2.1	658.9	-	-	-	661.0
Total financial assets	730.6	4,371.6	784.5	3,372.3	42,533.1	51,792.1
Financial liabilities						
Deposits by banks	361.5	667.1	331.8	714.0	-	2,074.4
Customer accounts	15,325.7	1,239.7	5,329.3	2,257.9	-	24,152.6
Fair value adjustments on portfolio hedging	(5.9)	-	-	-	-	(5.9)
Derivative financial instruments	-	8.5	64.9	287.8	137.4	498.6
Debt securities in issue	-	447.1	5,283.9	13,336.1	3,241.0	22,308.1
Subordinated liabilities	-	-	-	128.1	1,125.6	1,253.7
Other capital instruments	-	-	-	-	161.6	161.6
Other financial liabilities	-	141.4	-	-	-	141.4
Total financial liabilities	15,681.3	2,503.8	11,009.9	16,723.9	4,665.6	50,584.5
Group net liquidity gap	(14,950.7)	1,867.8	(10,225.4)	(13,351.6)	37,867.5	1,207.6
Group financial assets at 31 December 2006	1,113.9	3,037.5	1,029.2	3,734.8	36,275.0	45,190.4
Group financial liabilities at 31 December 2006	16,823.7	5,616.0	6,192.9	10,913.8	4,042.4	43,588.8
Group net liquidity gap at 31 December 2006	(15,709.8)	(2,578.5)	(5,163.7)	(7,179.0)	32,232.6	1,601.6

Notes to the Financial Statements

40. Risk management continued

(c) Liquidity risk continued

Company At 31 December 2007	On demand £m	In not more than three months £m	In more than three months but not more than one year £m	In more than one year but not more than five years £m	In more than five years £m	Total £m
Financial assets						
Cash and balances at central banks	21.0	-	-	-	188.2	209.2
Treasury bills	185.0	-	-	-	-	185.0
Loans and advances to banks	340.8	1,561.1	-	-	-	1,901.9
Loans and advances to customers	25,981.6	97.5	234.0	1,115.3	24,007.0	51,435.4
Fair value adjustments on portfolio hedging	(53.8)	-	-	-	-	(53.8)
Debt securities	-	1,960.5	278.7	1,803.9	3,355.1	7,398.2
Derivative financial instruments	-	57.4	60.1	288.3	62.8	468.6
Other financial assets	2.1	657.5	-	-	-	659.6
Total financial assets	26,476.7	4,334.0	572.8	3,207.5	27,613.1	62,204.1
Financial liabilities						
Deposits by banks	115.8	554.2	781.3	207.2	-	1,658.5
Customer accounts	35,691.3	1,038.5	5,220.8	1,651.2	-	43,601.8
Fair value adjustments on portfolio hedging	(5.9)	-	-	-	-	(5.9)
Derivative financial instruments	-	30.0	65.4	258.1	129.7	483.2
Debt securities in issue	-	-	3,371.4	7,766.0	3,271.7	14,409.1
Subordinated liabilities	-	-	-	128.1	1,437.2	1,565.3
Other financial liabilities	-	131.0	-	-	-	131.0
Total financial liabilities	35,801.2	1,753.7	9,438.9	10,010.6	4,838.6	61,843.0
Company net liquidity gap	(9,324.5)	2,580.3	(8,866.1)	(6,803.1)	22,774.5	361.1
Company financial assets at 31 December 2006	19,966.1	2,866.0	881.9	3,156.0	22,730.6	49,600.6
Company financial liabilities at 31 December 2006	29,428.5	4,787.6	3,557.3	7,274.4	3,719.6	48,767.4
Company net liquidity gap at 31 December 2006	(9,462.4)	(1,921.6)	(2,675.4)	(4,118.4)	19,011.0	833.2

The contractual undiscounted cash flows associated with financial liabilities were as follows:

Group Financial liabilities At 31 December 2007	On demand £m	In not more than three months £m	In more than three months but not more than one year £m	In more than one year but not more than five years £m	In more than five years £m	Total £m
Deposits by banks	361.5	690.7	374.9	792.5	-	2,219.6
Customer accounts	15,325.7	1,361.1	5,642.3	2,506.3	-	24,835.4
Derivative financial instruments	-	41.7	118.7	90.3	(317.4)	(66.7)
Debt securities in issue	-	753.8	6,185.7	15,516.1	5,647.4	28,103.0
Subordinated liabilities	-	17.2	51.7	389.8	1,632.9	2,091.6
Other capital instruments	-	2.2	6.7	35.6	365.2	409.7
Other financial liabilities	-	141.4	-	-	-	141.4
Irrevocable undrawn loan facilities	312.3	-	-	-	-	312.3
Total	15,999.5	3,008.1	12,380.0	19,330.6	7,328.1	58,046.3

Included in the above are the following expected cash flows arising on cash flow hedges (positive = outflow); no impact is anticipated on the Income Statement due to the hedging in place.

Cash flow hedges	-	0.2	(15.1)	(51.0)	(8.3)	(74.2)
------------------	---	-----	--------	--------	-------	--------

40. Risk management continued**(c) Liquidity risk continued**

Group Financial liabilities At 31 December 2006	On demand £m	In not more than three months £m	In more than three months but not more than one year £m	In more than one year but not more than five years £m	In more than five years £m	Total £m
Deposits by banks	358.1	522.3	330.1	374.6	-	1,585.1
Customer accounts	16,465.6	2,396.5	1,675.4	2,048.5	1.1	22,587.1
Derivative financial instruments	-	77.2	178.9	556.1	243.0	1,055.2
Debt securities in issue	-	2,873.2	4,791.8	9,716.1	4,503.8	21,884.9
Subordinated liabilities	-	15.6	46.8	365.1	1,705.3	2,132.8
Other capital instruments	-	2.1	6.2	33.0	375.7	417.0
Other financial liabilities	-	128.5	-	-	-	128.5
Irrevocable undrawn loan facilities	985.0	-	-	-	-	985.0
Total	17,808.7	6,015.4	7,029.2	13,093.4	6,828.9	50,775.6

Included in the above are the following expected cash flows arising on cash flow hedges (positive = outflow); no impact is anticipated on the Income Statement due to the hedging in place.

Cash flow hedges	-	4.7	(2.9)	3.6	(5.5)	(0.1)
------------------	---	-----	-------	-----	-------	-------

Company Financial liabilities At 31 December 2007	On demand £m	In not more than three months £m	In more than three months but not more than one year £m	In more than one year but not more than five years £m	In more than five years £m	Total £m
Deposits by banks	115.8	575.4	822.1	230.0	-	1,743.3
Customer accounts	35,691.3	1,147.3	5,504.3	1,832.8	-	44,175.7
Derivative financial instruments	-	60.0	180.7	154.3	(333.8)	61.2
Debt securities in issue	-	198.1	3,965.8	9,340.0	5,700.9	19,204.8
Subordinated liabilities	-	21.5	64.6	458.4	2,171.1	2,715.6
Other financial liabilities	-	131.0	-	-	-	131.0
Irrevocable undrawn loan facilities	75.7	-	-	-	-	75.7
Total	35,882.8	2,133.3	10,537.5	12,015.5	7,538.2	68,107.3

Included in the above are the following expected cash flows arising on cash flow hedges (positive = outflow); no impact is anticipated on the Income Statement due to the hedging in place.

Cash flow hedges	-	0.2	(15.1)	(51.0)	(8.3)	(74.2)
------------------	---	-----	--------	--------	-------	--------

Company Financial liabilities At 31 December 2006	On demand £m	In not more than three months £m	In more than three months but not more than one year £m	In more than one year but not more than five years £m	In more than five years £m	Total £m
Deposits by banks	152.6	422.7	331.7	-	-	907.0
Customer accounts	29,275.9	2,144.4	1,534.4	1,950.9	-	34,905.6
Derivative financial instruments	-	45.3	159.4	392.2	82.0	678.9
Debt securities in issue	-	2,290.8	2,075.8	6,144.7	3,748.8	14,260.1
Subordinated liabilities	-	19.5	58.6	428.0	2,261.6	2,767.7
Other financial liabilities	-	121.7	-	-	-	121.7
Irrevocable undrawn loan facilities	522.0	-	-	-	-	522.0
Total	29,950.5	5,044.4	4,159.9	8,915.8	6,092.4	54,163.0

Included in the above are the following expected cash flows arising on cash flow hedges (positive = outflow); no impact is anticipated on the Income Statement due to the hedging in place.

Cash flow hedges	-	4.7	(2.9)	3.6	(5.5)	(0.1)
------------------	---	-----	-------	-----	-------	-------

The above amounts differ from the Balance Sheet carrying values because the Balance Sheet amounts are based on discounted cashflows, and also because the above amounts include associated cashflows including interest; future interest payments have been estimated based on the Bank of England base rate at the Balance Sheet date of 5.50% (2006: 5.00%).

Subordinated liabilities include perpetual instruments as detailed in note 27. The amounts above assume these instruments will be redeemed on 31 December 2032.

Notes to the Financial Statements

40. Risk management continued

(d) Interest rate risk

Market risk is the potential adverse change in Group income or Group net worth arising from movements in interest rates, exchange rates or other market prices. Effective identification and management of market risk is essential for maintaining stable net interest income.

The most significant form of market risk to which the Group is exposed is interest rate risk. This typically arises from mismatches between the re-pricing dates of the interest-bearing assets and liabilities on the Group's Balance Sheet, and from the investment profile of the Group's capital and reserves. Treasury is responsible for managing this exposure within the risk exposure limits set out in the Balance Sheet Management policy, as approved by ALCO and the Board. This policy sets out the nature of the market risks that may be taken along with aggregate risk limits, and stipulates the procedures, instruments and controls to be used in managing market risk.

It is ALCO's responsibility to approve strategies for managing market risk exposures and to ensure that Treasury implements the strategies so that the exposures are managed within the Group's approved policy limits.

The Group assesses its exposure to interest rate movements using a number of techniques. However, there are two principal methods:

- a) a static framework that considers the impact on the current Balance Sheet of an immediate movement of interest rates; and
- b) a dynamic modelling framework that considers the projected change to both the Balance Sheet and product (mortgage and savings) rates over the following year under various interest rate scenarios.

The results of these analyses are presented to senior management in order to identify, measure and manage the Group's exposure to interest rate risk. The Group remained within all its interest rate risk exposure limits during the year and preceding year.

Limits are placed on the sensitivity of the Group Balance Sheet to movements in interest rates. Exposures are reviewed as appropriate by senior management and the Board with a frequency between daily and monthly, related to the granularity of the position. For example, the overall Group Balance Sheet interest rate risk exposure position is monitored monthly whilst several specific portfolios within the Balance Sheet are reviewed more frequently on a daily or weekly basis. This reflects the dynamics and materiality of the various portfolios.

Interest rate risk exposure is predominantly managed through the use of interest rate derivatives, principally interest rate swaps and interest rate futures contracts. Interest rate swaps are over-the-counter arrangements with highly rated banking counterparties, while futures contracts are transacted through regulated Futures Exchanges. The Group also uses asset and liability positions to offset exposures naturally wherever possible to minimise the costs and risks of arranging transactions external to the Group.

In general, swaps which have been taken out to manage Group interest rate risk are held by the Company even where the related financial instruments are held by other Group entities. In these cases, the Company's interest rate risk is managed by either creating swaps between the Company and the entities which hold the instruments or by setting the interest rate terms on loan balances between the Company and those entities, in each case in order to reduce the Company's interest rate risk to a low and acceptable level.

Interest rate sensitivities are reported to ALCO monthly and are calculated using a range of interest rate scenarios, including non parallel shifts in the yield curve. The sensitivities below are based upon reasonably possible changes in interest rates and they assume parallel shifts in the yield curve. At the Balance Sheet date a 1% increase or decrease in interest rates compared to actual rates would improve/(reduce) annual net interest income by the following amounts, prior to mitigation:

	2007 £m	Group 2006 £m
1% increase	4.4	0.7
1% decrease	(8.2)	4.2

At the Balance Sheet date a 1% increase or decrease in interest rates compared to actual rates would increase/(decrease) equity by the following amounts, prior to mitigation:

	2007 £m	Group 2006 £m
1% increase	(16.0)	(19.2)
1% decrease	17.1	2.6

In January 2007, the Group and Company established a modest trading book, which is subject to a risk limit framework that is reported daily. The trading book held no significant interest rate risk as at 31 December 2007.

40. Risk management continued**(e) Foreign currency risk**

The Group's policy is to hedge all material foreign currency exposures. Due to the use of derivatives, at 31 December 2007 and 31 December 2006 the Group and Company had no net material exposure to foreign exchange fluctuations or changes in foreign currency interest rates. The impact on the Group's profit and equity of reasonably possible changes in exchange rates compared to actual rates would have been immaterial at 31 December 2007 and 31 December 2006.

Excluding the effects of derivatives, the amounts of financial assets and liabilities denominated in foreign currencies were:

Group At 31 December 2007	Sterling £m	Euro £m	US\$ £m	Other £m	Total £m
Financial assets					
Cash and balances at central banks	209.2	-	-	-	209.2
Treasury bills	185.0	-	-	-	185.0
Loans and advances to banks	2,203.5	123.6	65.0	-	2,392.1
Loans and advances to customers	40,444.5	-	-	-	40,444.5
Fair value adjustments on portfolio hedging	(53.8)	-	-	-	(53.8)
Debt securities	4,308.5	1,867.9	602.3	-	6,778.7
Derivative financial instruments	1,129.4	42.4	1.6	2.0	1,175.4
Other financial assets	657.1	3.3	0.6	-	661.0
Total financial assets	49,083.4	2,037.2	669.5	2.0	51,792.1
Financial liabilities					
Deposits by banks	1,118.9	759.0	196.5	-	2,074.4
Customer accounts	23,936.2	127.2	89.2	-	24,152.6
Fair value adjustments on portfolio hedging	(5.9)	-	-	-	(5.9)
Derivative financial instruments	448.5	37.5	9.1	3.5	498.6
Debt securities in issue	5,830.6	12,779.9	2,541.9	1,155.7	22,308.1
Subordinated liabilities	1,253.7	-	-	-	1,253.7
Other capital instruments	161.6	-	-	-	161.6
Other financial liabilities	119.1	18.6	-	3.7	141.4
Total financial liabilities	32,862.7	13,722.2	2,836.7	1,162.9	50,584.5
Net financial assets/(liabilities)	16,220.7	(11,685.0)	(2,167.2)	(1,160.9)	1,207.6
Group At 31 December 2006					
Financial assets					
Cash and balances at central banks	202.6	-	-	-	202.6
Loans and advances to banks	2,997.0	176.5	127.9	-	3,301.4
Loans and advances to customers	36,131.7	-	-	-	36,131.7
Fair value adjustments on portfolio hedging	(70.4)	-	-	-	(70.4)
Debt securities	3,136.5	1,384.5	778.9	-	5,299.9
Derivative financial instruments	264.0	22.1	4.0	0.9	291.0
Other financial assets	16.0	18.2	-	-	34.2
Total financial assets	42,677.4	1,601.3	910.8	0.9	45,190.4
Financial liabilities					
Deposits by banks	751.5	352.9	408.0	-	1,512.4
Customer accounts	21,793.0	237.2	170.8	-	22,201.0
Derivative financial instruments	469.1	22.9	1.4	-	493.4
Debt securities in issue	5,621.6	9,219.7	1,950.2	1,049.8	17,841.3
Subordinated liabilities	1,247.0	-	-	-	1,247.0
Other capital instruments	165.2	-	-	-	165.2
Other financial liabilities	112.5	13.8	-	2.2	128.5
Total financial liabilities	30,159.9	9,846.5	2,530.4	1,052.0	43,588.8
Net financial assets/(liabilities)	12,517.5	(8,245.2)	(1,619.6)	(1,051.1)	1,601.6

Notes to the Financial Statements

40. Risk management continued

(e) Foreign currency risk

Company At 31 December 2007	Sterling £m	Euro £m	US\$ £m	Other £m	Total £m
Financial assets					
Cash and balances at central banks	209.2	-	-	-	209.2
Treasury bills	185.0	-	-	-	185.0
Loans and advances to banks	1,713.3	123.6	65.0	-	1,901.9
Loans and advances to customers	46,314.4	4,304.7	-	816.3	51,435.4
Fair value adjustments on portfolio hedging	(53.8)	-	-	-	(53.8)
Debt securities	4,928.0	1,867.9	602.3	-	7,398.2
Derivative financial instruments	422.6	42.4	1.6	2.0	468.6
Other financial assets	655.7	3.3	0.6	-	659.6
Total financial assets	54,374.4	6,341.9	669.5	818.3	62,204.1
Financial liabilities					
Deposits by banks	737.0	746.5	175.0	-	1,658.5
Customer accounts	43,474.1	97.1	30.6	-	43,601.8
Fair value adjustments on portfolio hedging	(5.9)	-	-	-	(5.9)
Derivative financial instruments	433.1	37.5	9.1	3.5	483.2
Debt securities in issue	2,825.3	10,082.1	346.0	1,155.7	14,409.1
Subordinated liabilities	1,565.3	-	-	-	1,565.3
Other financial liabilities	108.7	18.6	-	3.7	131.0
Total financial liabilities	49,137.6	10,981.8	560.7	1,162.9	61,843.0
Net financial assets/(liabilities)	5,236.8	(4,639.9)	108.8	(344.6)	361.1

Company At 31 December 2006	Sterling £m	Euro £m	US\$ £m	Other £m	Total £m
Financial assets					
Cash and balances at central banks	202.6	-	-	-	202.6
Loans and advances to banks	2,109.1	176.5	127.9	-	2,413.5
Loans and advances to customers	37,814.2	3,427.1	-	654.2	41,895.5
Fair value adjustments on portfolio hedging	(70.4)	-	-	-	(70.4)
Debt securities	2,677.5	1,384.5	778.9	-	4,840.9
Derivative financial instruments	251.2	22.1	4.0	0.9	278.2
Other financial assets	22.1	18.2	-	-	40.3
Total financial assets	43,006.3	5,028.4	910.8	655.1	49,600.6
Financial liabilities					
Deposits by banks	165.7	327.6	392.5	-	885.8
Customer accounts	34,226.9	202.4	113.5	-	34,542.8
Derivative financial instruments	384.5	22.9	1.4	-	408.8
Debt securities in issue	2,383.1	6,874.9	938.7	1,049.8	11,246.5
Subordinated liabilities	1,561.8	-	-	-	1,561.8
Other liabilities	105.7	13.8	-	2.2	121.7
Total financial liabilities	38,827.7	7,441.6	1,446.1	1,052.0	48,767.4
Net financial assets/(liabilities)	4,178.6	(2,413.2)	(535.3)	(396.9)	833.2

(f) Concentrations of risk

The Group operates primarily in the UK and adverse changes to the UK economy could impact all areas of the Group's business. Loans and advances to customers are all secured on property in the UK. 59% (2006: 58%) of loans and advances to customers are concentrated in the buy-to-let market; the remaining balances are mainly secured on residential owner-occupied properties.

The Group has investments in a range of debt securities issued by government bodies, banks and building societies, and in asset-backed securities, in both the UK and overseas. UK government securities, bank and supranational securities and bank certificates of deposit comprise 61% (2006: 55%) of debt securities held. 68% (2006: 67%) of the asset-backed securities are UK invested.

Customer accounts comprise investment and savings accounts held by customers. 20% of these (2006: 20%) were opened through direct channels and 11% (2006: 15%) through Bradford & Bingley International Ltd, the Group's deposit taker on the Isle of Man. Debt securities in issue represent bonds, medium term notes and other debt securities issued in a range of countries and currencies with no significant investment by any individual counterparty.