



Standard Life Bank plc

**Pillar 3 Disclosures
For The Year Ended 31 December 2008**

Registered in Scotland Number SC173685

Standard Life Bank plc

Pillar 3 Disclosures

Contents

| | |
|----------------------------------|-----------|
| Introduction | 3 |
| Scope of permission | 4 |
| Risk management structure | 5 |
| Risk definition | 9 |
| Retail credit risk | 10 |
| Non retail credit risk | 15 |
| Market risk | 18 |
| Liquidity risk | 20 |
| Operational risk | 21 |
| Derivatives | 22 |
| Capital adequacy | 24 |
| Securitisation | 28 |

Standard Life Bank plc Pillar 3 Disclosures

1. Introduction

On the 1 January 2007 the European Union introduced a new legislative framework, the Capital Requirements Directive (“CRD”), commonly referred to as Basel 2. The CRD governs how much capital banks and building societies must hold to ensure that they adequately protect the interests of their depositors, members and shareholders. Within the UK the CRD has been implemented by the Financial Services Authority (“FSA”).

The disclosure requirements (Pillar 3) of the CRD complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The disclosure requirements aim to promote market discipline allowing market participants to assess the key risk exposures and risk management processes of the reporting firm.

In 2006 Standard Life Bank plc (“SLB”) was subject to the FSA capital regulations contained within the Interim Prudential Sourcebook for Banks. From 2007 SLB is regulated under the FSA Handbook which consists of the General Prudential Sourcebook (“GENPRU”) effective 1 January 2007 and the Prudential Sourcebook for Banks, Building Societies and Investment firms (“BIPRU”) effective 1 July 2007 as a result of SLB obtaining a waiver to apply the Internal Ratings Based (“IRB”) approach to the calculation of capital resource requirements for retail mortgage loans.

During the first half of 2007 SLB received approval from the FSA for its Basel 2 waiver application to apply the Internal Ratings Based (“IRB”) approach to retail lending. It also completed its Pillar 2 review and was issued with Individual Capital Guidance (“ICG”) by the FSA. During 2008 SLB received an updated ICG from the FSA.

Basis of disclosures

This document sets out the Pillar 3 disclosures for SLB prepared in accordance with the rules laid out in BIPRU Chapter 11. The information contained in this document is correct as at 31 December 2008 unless stated otherwise. Comparative figures have been provided where appropriate.

Frequency of disclosures

This report will be made on an annual basis as at the relevant accounting reference date (i.e. 31 December) and will be published as soon as practical within 6 months of this date.

Media and location of disclosures

The report will be published on the Standard Life Group (“SLG”) investors website at <http://www.standardlife.com/investor/index.html>.

Verification of disclosures

Disclosures will only be externally verified if they are deemed equivalent to those made under accounting or listing requirements. Internal verification of all figures disclosed within this document has been conducted.

These disclosures have been prepared solely to give information on the basis of calculating Basel 2 capital requirements and on the management of risks faced by SLB. As such they do not constitute any part of the SLB financial statements and cannot be relied upon in making judgements on SLB.

Standard Life Bank plc Pillar 3 Disclosures

2. Scope of permission

SLB is a subsidiary of Standard Life Assurance Limited (“SLAL”).

SLB’s FSA reference number is 187878.

High level Scope of IRB Permissions

The FSA granted approval for use of the IRB approach for the categories of retail mortgage assets identified in the table below from 1st July 2007.

| IRB exposure classes | Sub class | Geographies |
|--------------------------------|-----------------------------|-------------|
| Retail - Residential Mortgages | Prime residential mortgages | UK only |
| Retail - Residential Mortgages | Buy to let mortgages | UK only |

Portfolios permanently exempted from the IRB approach for application of the standardised approach

The FSA has granted approval for permanent exemptions from the IRB approach for the categories of assets identified in the table below from 1st July 2007.

| Category | Exposure class | Portfolio | Description |
|---|-----------------|--|--|
| Permanent exemptions for sovereigns, churches, religious communities, and institutions (As referred to in BIPRU 4.1.23 R (1), BIPRU 4.2.26 R (2) and BIPRU 4.2.26 R (3)) | Treasury assets | Banking book treasury assets | Liquidity portfolio and derivatives used for hedging purposes |
| Non-significant business units and immaterial exposure classes (As referred to in BIPRU 4.1.23 R (1) and BIPRU 4.2.26 R (4)) | Mortgages | 1. Irish self directed pension lending 2. Lifetime mortgage loans | 1. Loan facilities to Standard Life Investment Funds Limited for the purchase of residential buy-to-let properties in the UK to be held in Irish self directed pension schemes 2. Lifetime mortgage loans (non credit obligations) which are repayable on the ultimate sale of the mortgaged property |
| Other (As referred to in BIPRU 4.1.23 R (1) and BIPRU 4.2.26 R (5)-(10)) | None | None | None |

Scope of application

SLB is a UK bank regulated by the FSA. The Pillar 3 disclosures within this document are on a consolidated basis and include all of SLB’s subsidiary undertakings unless otherwise stated. For regulatory purposes capital adequacy is reported on an unconsolidated (i.e. SLB company only) and a consolidated regulatory basis. The difference between the unconsolidated and consolidated position is not material.

The only operational subsidiary of SLB is Standard Life Funding BV (SLFB) which raises funding for SLB through issuance of commercial paper and medium terms notes. SLB has setup a number of special purpose entities (“SPEs”) as part of its Lothian master trust securitisation and covered bond programme. SLB does not hold any of the share capital of these companies.

Apart from the ability of SLFB to pay dividends to SLB (which is restricted by minimum capital requirements within its country of domicile) there are no material current or foreseen impediments to the prompt transfer of capital resources or repayment of liabilities when due between SLB and its subsidiaries.

3. Risk management structure

SLB is a subsidiary of SLAL and forms part of the SLG UK Financial Services (“UKFS”) division. The SLB Board is responsible for discharging the key statutory and regulatory obligations in relation to SLB. The SLAL Board has a number of responsibilities in relation to SLB including management of Strategic Risk and approval of risk policies.

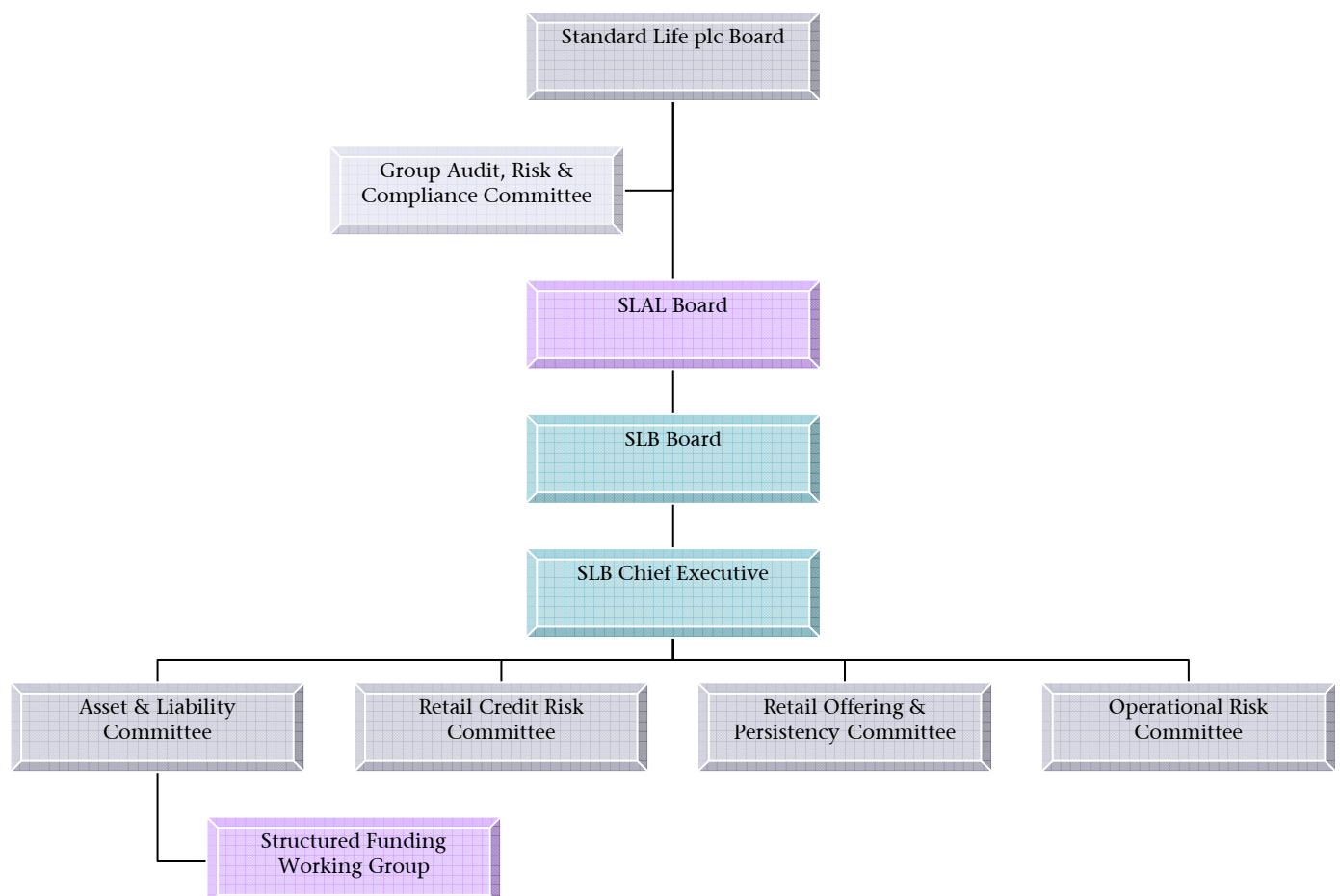
The management and control of risk is fundamental to the effective operation of SLB and the role it plays in the achievement by UKFS of its business strategy. SLB manages risks through its risk management framework, which allows for the identification, assessment, control and monitoring of risks across its operations. Day to day risk management is delegated from the SLB Board to the SLB Chief Executive and, through a system of delegated authorities and limits, to business managers. Risk oversight is provided by established risk management committees which are described below. These risk management committees are supported by specialist risk management and compliance functions.

Verification of the adequacy and effectiveness of the internal risk and control management systems is provided by the SLG Audit, Risk and Compliance Committee. This is a Committee of the Board of the SLG holding company, Standard Life plc, and is supported by the Group Internal Audit (“GIA”) function.

The SLAL Board annually approves a separate risk policy for all main categories of risk affecting SLB. Each such policy specifies the procedures to be followed across SLB to identify, assess, control and monitor the relevant risk.

The SLB Finance Director, the SLG Chief Risk Officer and the SLG Group Risk Director are the FSA Approved Persons charged with reporting on the setting and control of risk exposures of SLB.

Responsibility for the governance and implementation of day-to-day processes to manage risk within SLB is as follows.



3. Risk management structure (continued)

Governance Committees

SLAL Board

The SLAL Board is responsible for setting and monitoring strategic risk for SLB. The SLAL Board meets at least 8 times annually.

SLB Board

The SLB Board is responsible for the discharge of statutory and regulatory obligations in relation to SLB including approval of the SLB annual report and accounts. The SLB Board meets at least twice annually.

SLG Audit, Risk & Compliance Committee

This Committee (of the Board of the SLG holding company, Standard Life plc) reviews reports on the operation of internal controls and monitors significant control issues across SLG. It is also responsible for the review and assessment of the SLG internal audit programme and oversees the relationship with the external auditor. The Committee meets at least quarterly.

Risk Committees (and Sub-Committees)

Each risk committee is constituted, and operates in accordance with, terms of reference that are approved by the SLB Chief Executive. Committee membership comprises appropriate personnel in terms of expertise and seniority. All committees operate within parameters set by the risk policies which are formally approved by the SLAL Board.

Asset and Liability Committee (“ALCO”)

The ALCO has responsibility for the management of market risk, liquidity risk and credit risk in relation to non retail lending. The ALCO is also responsible for interest margin and capital management. The ALCO normally meets monthly.

Structured Funding Working Group (“SFWG”)

The SFWG is a sub-committee of the ALCO and has responsibility for all aspects of securitisation, covered bonds and other structured funding activity including risk monitoring, deal management, regulatory compliance and investor reporting. The SFWG normally meets monthly.

Retail Credit Risk Committee (“RCRC”)

The RCRC is responsible for managing credit risk on loans and advances to retail customers. The RCRC also approves and validates the IRB credit risk models used within the business together with the deployment of the lending policy and underwriting criteria applied to all lending applications. The RCRC normally meets monthly.

Retail Offering and Pricing Committee (“ROPC”)

The ROPC is responsible for the management of pricing and durational risk as well as customer engagement across all SLB products. The ROPC normally meets monthly.

Operational Risk Committee (“ORC”)

The ORC is responsible for monitoring and reporting of operational risk within SLB to the Group Operational Risk Committee. The ORC exists to focus and co-ordinate operational risk management activities and oversee SLB's risk profile. Senior management are responsible for the detailed management of operational risks in their area. Each business area undertakes risk self-assessment activities to identify and assess the key risks in its area, including the adequacy of controls to manage risk, using a consistent SLG methodology. The ORC normally meets monthly.

3. Risk management structure (continued)

Risk Management Functions

SLB Financial Risk

SLB has an established financial risk management function whose role is to support the SLB Board, the Directors and the risk committees in meeting their risk management responsibilities in relation to market risk, non retail credit risk and liquidity risk.

SLB Credit Risk

SLB has an established credit risk management function whose role is to support the SLB Board, the Directors and the risk committees in meeting their risk management responsibilities in relation to retail credit risk.

SLG Operational Risk

SLG has an established operational risk management function which includes specific SLB expertise and whose role is to both support the SLB Board, the Directors and the risk committees in meeting their risk management responsibilities in relation to operational risk.

SLG Compliance

SLG has an established compliance function which includes specific SLB expertise and whose role is to both support and monitor the achievement by SLB of high standards of compliance with existing and proposed regulation.

SLG Internal Audit

GIA is responsible for the independent review of risk management and the control environment within SLB. GIA agrees an audit plan on an annual basis which targets areas for audit using a risk based approach with high risk areas being reviewed annually. GIA issues audit reports and associated findings once each audit is complete. GIA reports quarterly to the SLG Audit, Risk and Compliance Committee on the adequacy of control processes and progress in addressing any audit issues raised. In certain circumstances GIA will outsource specialist or technical reviews if the relevant experience is not available within the team.

SLI Money Markets & FX (“MMFX”)

Day to day deal execution, money market funding and liquidity management is undertaken on behalf of SLB by Standard Life Investments (“SLI”) MMFX department.

SLG Treasury

The SLG Treasury function is responsible for overseeing wholesale funding and capital markets activity, deal structuring and programme management for SLG as a whole. The function provides expertise which assists ALCO and SLB Financial Risk in risk management and reporting in relation to non-retail credit risk, market risk and liquidity risk.

3. Risk management structure (continued)

Key Reports

The following key reports are produced in order to assist senior management and risk committees in the monitoring and management of risk.

Internal Capital Adequacy Assessment Process Report (“ICAAPR”)

On an annual basis, SLB self assesses capital requirements in relation to the risk definitions in section 4. This process includes identification of all risks faced by SLB, quantification of the potential impact of these risks on an economic capital basis and a review of controls that are in place to mitigate these risks. This capital assessment is conducted by the appropriate specialist risk teams and co-ordinated by the SLB Financial Risk team and involves senior management across SLB. The capital assessment is presented in the ICAAPR which is subject to challenge by each of SLB’s risk committees and is ultimately approved by the SLB Board and noted by the SLAL Board. The results of this assessment feed into SLB’s regular strategic planning and risk reporting processes in order to ensure that risk assessment, risk capital quantification and risk capital goals are fully embedded into the running of the business.

Enterprise Wide Risk Report (“EWRR”)

On a quarterly basis, the SLB Financial Risk team prepare the EWRR, which takes a holistic view of risk across the business. Each risk committee provides a quarterly risk information report which is then used to prepare the EWRR. This report is noted by the General Purposes Committee of the SLAL Board and also feeds into the SLG Risk Management reporting processes.

ALCO Report

The ALCO Report is the key market, liquidity and non retail credit risk reporting and monitoring document and is prepared by SLB Financial Risk. It is presented to the ALCO on a monthly basis and includes detailed information on all substantive SLB related non-retail credit, market and liquidity risk factors.

Asset Quality Report (“AQR”)

The AQR is the key retail credit risk reporting and monitoring document and is prepared by SLB Credit Risk. It is presented to the RCRC on a monthly basis and includes detailed information on all substantive SLB retail credit risk factors.

Operational Risk Report (“ORR”)

SLG Operational Risk prepares monthly divisional risk scorecards for SLB which are collated into a SLB wide ORR highlighting the top 10 operational risks to the business. It is presented to the ORC on a monthly basis and includes detailed information on the top 10 risks identified by management.

4. Risk Definition

SLB's strategy is to accept retail deposits from customers at fixed and floating interest rates and raise wholesale funding in the money and capital markets. SLB then seeks to earn an interest margin by investing these funds in high quality assets – predominantly prime residential mortgage assets. SLB seeks to manage interest margins by consolidating short term funds and lending for longer periods at higher rates whilst maintaining sufficient liquidity to meet all claims which might fall due. The management of the business and the execution of SLB's strategy is subject to a number of risks. SLB takes and manages risks in order to achieve its corporate, financial and regulatory objectives. The types of risk inherent in the pursuit of these objectives and the extent of exposure to these risks form the SLB risk profile. SLB defines the key risks it faces into the main categories described below.

Credit Risk

SLB is exposed to credit risk, which is the risk that a counterparty will cause a financial loss by failing to discharge an obligation. Credit risk is a key risk for the SLB business; management therefore carefully manages its exposure to credit risk. Credit exposures arise principally in retail lending activities (loans and advances to customers) with all loans secured by a first charge on the underlying property. Retail credit risk is managed by the RCRC. Credit risk also arises in relation to non retail lending activities, primarily liquidity book assets (loans and advances to banks and assets at fair value through profit or loss) and derivatives. Non retail credit risk is managed by the ALCO.

Market Risk

Market risk is the risk of current or prospective changes to the value of SLB or its income or costs, arising from the use of financial instruments. Market risk arises primarily due to changes in interest rates, exchange rates, equities or other market prices or conditions. The most significant elements of market risk for SLB are interest rate risk and currency risk. Exposures to market risk are subject to hedging activity with derivative financial instruments in order to minimise (interest rate risk) or eliminate (currency and equity risk) any exposure. Market risk is managed by the ALCO.

Liquidity Risk

Liquidity risk is the risk that the SLB is not able to meet its financial obligations as they fall due or can do so only at an excessive cost. Liquidity risk arises from the mismatch in the cash flows generated from assets, liabilities and derivatives. Liquidity risk is managed by the ALCO.

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people or systems or from external events and is managed by the ORC. Operational risk also includes legal, reputational and business risk but excludes Strategic Risk. Strategic Risk is managed by the UKFS Leadership Team.

Persistency Risk

SLB is exposed to persistency risk which is the risk that a financial loss is suffered as a result of mortgage balances being repaid by customers earlier than assumed within product pricing. Persistency risk is managed by the ROPC which monitors durational experience and pricing assumptions on a regular basis and assesses the impact of changes in prepayment behaviour on the business.

Concentration Risk

SLB is exposed to the risk associated with concentration of retail credit risk in one segment of the mortgage market (e.g. geographical region) or in terms of non retail credit risk, with one counterparty. SLB may then be overly exposed to the event that such a market sector, or counterparty, suffers poor credit experience. Retail concentration risk is managed by the RCRC and non retail concentration risk by the ALCO.

Other Risks

Although not currently material to the running of the business, SLB also considers other risks as part of its risk assessment process. These include expense risk, cyclicity risk, group risk, settlement risk, pension obligation risk and residual risk.

5. Retail credit risk

The operational management of retail credit risk exposure is primarily the responsibility of the RCRC. To enable the RCRC to fulfil this objective, the committee considers a broad array of management information. This information is available to the committee members on varying frequencies including daily, monthly and ad-hoc as appropriate. The management information covers all aspects of the business which may impact SLB's exposure to retail credit risk including new lending activities and changes in the composition of the existing mortgage portfolio. As part of this suite of management information, the committee reviews performance in relation to key Board approved portfolio limits.

IRB models

To ensure the optimum level of retail credit risk control, SLB has developed a detailed Retail Credit Risk Rating System ("RCRRS"). The models within this system promote a comprehensive understanding of the risks that SLB is currently exposed to and appraisal of the impact arising from any potential changes in risk profile.

The RCRRS operates by segmenting the mortgage book into ten individual risk grades (with grades 1 to 7 potentially containing cases up to 1 monthly payment in arrears), as follows:

| Grade | Description |
|-------|---|
| 1-6 | Performing risk grades; scorecard model - based on credit score & other related factors |
| 7 | Performing risk grade with previous SLB arrears |
| 8-10 | All impaired at differing levels 8: >1 up to 3 payments in arrears 9: >3 up to 6 payments in arrears 10: In default > 6 payments in arrears or "evidence of unlikelihood to pay" |

These risk grades reflect the current status of each exposure and as such an exposure may migrate between risk grades if the risk associated with that exposure changes. For each risk grade, SLB models an appropriate Probability of Default ("PD"), Exposure at Default ("EAD") and Loss Given Default ("LGD"). Using these components and the IRB formula, SLB calculates the Risk Weighted Exposure amounts (the value of assets based on their credit risk for inclusion in regulatory capital calculations) and associated regulatory capital requirements for retail assets.

PD

PD is the probability of an exposure defaulting within the next 12 month period. A mortgage exposure is considered to be in default when it is more than 180 days (6 payments) in arrears or where there is objective evidence of unlikelihood to pay. For the calculation of capital and expected loss, the PD percentage reflects the long run average for each ratings grade.

EAD

The EAD represents an adjustment to the current exposure value to reflect the likely change in the exposure before the point of default. This estimates the value of interest accrued due to arrears and the potential risk of further lending being granted prior to default. The EAD component is adjusted to reflect the value in a 'downturn' economic environment.

LGD

The LGD is expressed as the percentage of balance at default that estimates the future value of cash flows subsequent to a default. The LGD component takes account of the timescales and costs of obtaining possession of the collateral and the subsequent realisation of this collateral. The LGD component is also based on the outcome in a 'downturn' economic environment.

PD, EAD and LGD figures are disclosed in the table below. SLB does not currently map its internal rating grades against external ratings as it considers that there is no appropriate comparable credit risk data produced by external credit assessment institutions ("ECAI").

5. Retail credit risk (continued)

Retail mortgage loans by IRB exposure grade

The distribution of SLB's mortgage book by internal risk grading is given below rated from 1 (least risky) to 10 (in default). Lifetime mortgages are subject to the standardised approach.

| SLB risk grade | 31 December 2008 | | | | | |
|---------------------------|------------------|-------------------------------|-------------------------------|---------|----------|-----------------|
| | Mortgages £m | Risk Weighted assets £m | Impairment provision £m | PD % | LGD % | EAD £m |
| 1 | 474.3 | 5.5 | - | 0.003 | 0.157 | 567.2 |
| 2 | 2,655.4 | 29.6 | - | 0.026 | 7.297 | 3,024.7 |
| 3 | 966.2 | 12.5 | - | 0.036 | 5.615 | 1,109.5 |
| 4 | 2,822.5 | 124.4 | 0.1 | 0.052 | 26.511 | 3,099.7 |
| 5 | 1,450.7 | 192.1 | 0.3 | 0.138 | 37.743 | 1,580.7 |
| 6 | 1,014.0 | 338.9 | 0.6 | 0.485 | 37.972 | 1,103.5 |
| 7 | 84.2 | 39.6 | 0.1 | 2.758 | 17.325 | 91.5 |
| 8 | 69.8 | 99.4 | 0.4 | 22.370 | 22.266 | 73.5 |
| 9 | 34.2 | 14.4 | 0.7 | 87.750 | 25.780 | 35.8 |
| 10 – In default | 28.5 | 82.1 | 2.8 | 100.000 | 25.672 | 30.8 |
| Total IRB exposure | 9,599.8 | 938.5 | 5.0 | | | 10,716.9 |
| Lifetime mortgages | 11.3 | 4.0 | - | | | |
| Total mortgages | 9,611.1 | 942.5 | 5.0 | | | 10,716.9 |

| SLB risk grade | 31 December 2007 | | | | | |
|---------------------------|------------------|-------------------------------|-------------------------------|---------|----------|-----------------|
| | Mortgages £m | Risk Weighted assets £m | Impairment provision £m | PD % | LGD % | EAD £m |
| 1 | 686.3 | 8.0 | - | 0.003 | 0.229 | 815.1 |
| 2 | 3,362.6 | 37.3 | - | 0.026 | 5.472 | 3,817.3 |
| 3 | 1,514.7 | 19.5 | - | 0.036 | 6.428 | 1,728.1 |
| 4 | 3,007.1 | 107.5 | 0.1 | 0.052 | 21.338 | 3,327.0 |
| 5 | 1,421.2 | 161.4 | 0.1 | 0.138 | 32.025 | 1,565.8 |
| 6 | 956.1 | 263.7 | 0.2 | 0.485 | 31.035 | 1,050.7 |
| 7 | 85.7 | 23.6 | - | 2.758 | 9.678 | 93.8 |
| 8 | 37.7 | 40.6 | 0.1 | 22.370 | 16.736 | 39.9 |
| 9 | 16.8 | 3.9 | 0.1 | 87.750 | 14.206 | 17.6 |
| 10 – In default | 14.8 | 24.8 | 0.6 | 100.000 | 13.874 | 15.4 |
| Total IRB exposure | 11,103.0 | 690.3 | 1.2 | | | 12,470.7 |
| Lifetime mortgages | 10.4 | 3.6 | - | | | |
| Total mortgages | 11,113.4 | 693.9 | 1.2 | | | 12,470.7 |

Controls over the ratings system

The RCRRS was developed internally using detailed statistical analysis of both SLB and external data. The models are subject to regular review and validation and any amendments are subject to approval by the RCRC. On a monthly basis the RCRC examines a number of reports on the functioning of the model including the output of the Pillar 1 capital requirement calculation, risk grade segmentation, segment migration and new business tracking. On an annual basis, the RCRC reviews, challenges and approves the validation process for the models. The models are also subject to periodic review by GIA and the FSA.

As at 31 Dec 2007 the IRB model showed an overall PD of 0.343%. Actual default experience during 2008 was 0.319% which demonstrates that the model is performing well and predictions are within acceptable limits.

5. Retail credit risk (continued)

Approaches and methods adopted for determining provisions

As at each balance sheet date the mortgage portfolio is assessed for objective evidence of impairment. For those assets where evidence exists, the value of the impairment loss is individually assessed as the difference between the assets carrying amount and the present value of the estimated future cash flows. For assets where objective evidence of impairment does not exist, a collective assessment is made to establish the value of the impairment loss as a result of a loss event having occurred but for which no objective evidence is currently available.

A mortgage exposure is deemed to be past due if it is between 1 and 30 days (one payment) in arrears.

A mortgage asset is determined to be impaired where the account is more than 30 days (one payment) in arrears. In addition, other forms of objective evidence are considered where available, such as:

- The borrower is subject to bankruptcy proceedings;
- The borrower is seeking protection from creditors through bankruptcy, IVA or similar processes; and
- The voluntary surrender of collateral by the borrower.

The value of the impairment provision is calculated using SLB's internal ratings system. However, there are differences from the methodology used for evaluation of expected loss and regulatory capital. This is necessary to comply with the differing requirements of Basel 2 (enacted by the FSA through BIPRU) and International Financial Reporting Standards ("IFRS"). The collective assessment of impairment is based on historical experience, statistical models and experienced judgement but does not incorporate the effects of historical conditions that do not currently exist.

Retail mortgage provisions

Provisions made against retail mortgage assets are given below. Further information is available within the SLB Annual Report and Accounts which are available on the SLG investors website.

| Provisions | 31 December 2008 | | |
|-------------------------------------|------------------|---------------|----------|
| | Individual £m | Collective £m | Total £m |
| Opening balance at 1 January 2008 | (0.7) | (0.5) | (1.2) |
| Charge to income statement | (3.8) | (0.7) | (4.5) |
| Amounts written off during the year | 1.1 | - | 1.1 |
| Amounts recovered during the year | (0.4) | - | (0.4) |
| Closing balance at 31 December 2008 | (3.8) | (1.2) | (5.0) |

| Provisions | 31 December 2007 | | |
|--|------------------|---------------|----------|
| | Individual £m | Collective £m | Total £m |
| Opening balance at 1 January 2007 | (1.1) | (0.4) | (1.5) |
| Credit / (charge) for year to income statement | 0.2 | (0.1) | 0.1 |
| Amounts written off during the year | 0.2 | - | 0.2 |
| Closing balance at 31 December 2007 | (0.7) | (0.5) | (1.2) |

5. Retail credit risk (continued)

Analysis of retail mortgages exposures performance

| Mortgage status | 31 December 2008 | 31 December 2007 |
|-------------------------------|------------------|------------------|
| | £m | £m |
| Neither past due nor impaired | 9,299.4 | 10,972.0 |
| Past due but not impaired | 91.7 | 66.6 |
| Impaired | 130.5 | 68.0 |
| Impairment allowance | (5.0) | (1.2) |
| Fair value hedge adjustment* | 94.5 | 8.0 |
| Total | 9,611.1 | 11,113.4 |

* The fair value hedge adjustment relates to IFRS hedge accounting of fixed rate mortgages. Further details are available in the SLB Annual Report and Accounts.

Retail mortgages concentration risk by UK region

| Region | 31 December 2008 | | | |
|---------------------|------------------|--------------|----------------|--------------|
| | Number | % of Total | Value £m | % of Total |
| East | 9,491 | 11.5 | 1,115.6 | 11.6 |
| East Midlands | 4,557 | 5.5 | 443.3 | 4.6 |
| London | 7,477 | 9.1 | 1,391.7 | 14.5 |
| North East | 2,352 | 2.9 | 211.7 | 2.2 |
| Scotland | 8,742 | 10.6 | 762.8 | 7.9 |
| North West | 7,385 | 9.0 | 729.1 | 7.6 |
| South East | 16,042 | 19.5 | 2,194.3 | 22.8 |
| South West | 9,591 | 11.7 | 1,048.0 | 10.9 |
| Wales | 2,435 | 3.0 | 240.6 | 2.5 |
| West Midlands | 5,751 | 7.0 | 602.6 | 6.3 |
| Yorkshire | 4,943 | 6.0 | 441.8 | 4.6 |
| Northern Ireland | 3,263 | 4.0 | 305.3 | 3.2 |
| Region not assigned | 127 | 0.2 | 124.3 | 1.3 |
| Total | 82,156 | 100.0 | 9,611.1 | 100.0 |

| Region | 31 December 2007 | | | |
|---------------------|------------------|--------------|-----------------|--------------|
| | Number | % of Total | Value £m | % of Total |
| East | 10,939 | 11.5 | 1,317.1 | 11.9 |
| East Midlands | 5,234 | 5.5 | 510.1 | 4.6 |
| London | 8,332 | 8.8 | 1,558.6 | 14.0 |
| North East | 2,673 | 2.8 | 245.3 | 2.2 |
| Scotland | 9,873 | 10.4 | 863.6 | 7.8 |
| North West | 8,336 | 8.8 | 825.5 | 7.4 |
| South East | 18,621 | 19.7 | 2,577.7 | 23.2 |
| South West | 11,291 | 11.9 | 1,246.3 | 11.2 |
| Wales | 2,743 | 2.9 | 271.5 | 2.4 |
| West Midlands | 6,647 | 7.0 | 698.1 | 6.3 |
| Yorkshire | 5,694 | 6.0 | 520.6 | 4.7 |
| Northern Ireland | 3,639 | 3.9 | 330.3 | 3.0 |
| Region not assigned | 788 | 0.8 | 148.7 | 1.3 |
| Total | 94,810 | 100.0 | 11,113.4 | 100.0 |

Retail mortgages concentration risk by product type

| Product type | 31 December 2008 | 31 December 2007 |
|----------------------|------------------|------------------|
| | £m | £m |
| Residential mortgage | 8,761.5 | 10,255.2 |
| Buy to let mortgage | 838.3 | 847.8 |
| Lifetime mortgages | 11.3 | 10.4 |
| Total | 9,611.1 | 11,113.4 |

5. Retail credit risk (continued)

Average retail mortgage exposure during the year

| Period | 31 December 2008 |
|----------------|------------------|
| | £m |
| Year end 2008 | 9,611.1 |
| Year end 2007 | 11,113.4 |
| Average | 10,362.3 |

| Period | 31 December 2007 |
|----------------|------------------|
| | £m |
| Year end 2007 | 11,113.4 |
| Year end 2006 | 10,088.7 |
| Average | 10,601.1 |

Residual maturity of mortgage exposures

| Residual maturity | 31 December 2008 | 31 December 2007 |
|-------------------|------------------|------------------|
| | £m | £m |
| Within 3 months | 43.4 | 19.6 |
| 3 – 6 months | 45.0 | 3.0 |
| 6 – 12 months | 94.2 | 7.9 |
| 1 – 5 years | 934.6 | 289.2 |
| After 5 years | 8,493.9 | 10,793.7 |
| Total | 9,611.1 | 11,113.4 |

Undrawn retail mortgage exposure

Total undrawn mortgage loan facilities at 31 December 2008 were £2,156.3m (2007: £2,231.5m). Potential drawdown of these facilities is included in the EAD calculation within the IRB models.

Credit risk mitigation

SLB mitigates its exposure to retail credit risk by accepting collateral in the form of a first ranking charge over residential properties situated in the jurisdictions of England, Wales, Scotland and Northern Ireland. All properties are individually assessed for suitability as collateral, including by reference to their title, tenure and market value.

SLB requires that all applications for mortgage funding are supported by a written valuation report on the relevant property. This report must be provided by an independent valuer who is a qualified and practising member of the Royal Institution of Chartered Surveyors (RICS) holding an appropriate level of professional indemnity insurance cover. The valuation report may be based on a physical internal and external inspection of the property by the independent valuer or on the results provided by an Automated Valuation Model (AVM) where the independent valuer considers it appropriate to rely on information provided by an AVM.

SLB does not net retail customer exposures with associated retail savings deposits although SLB may have a right of set off in the event of default. SLB offers flexible mortgages where customers can overpay on their mortgage and subsequently draw the overpayment down at a later date. Any drawdown of overpayments is taken into account in the EAD calculation within the RCRRS. SLB retains liquidity to fund draw downs and can limit the level of draw downs available in the event of house price declines or where specific customers experience arrears.

SLB does not employ credit derivatives to mitigate risk on retail mortgage assets.

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6. Non retail credit risk

The purpose of the non-retail credit risk management policy is to minimise credit risk whilst maintaining appropriate levels of liquidity and obtaining the best possible return. SLB maintains a policy of investing in government securities, debt programmes or with counterparties which are rated as investment grade by the following ECAI:

- Standard and Poors (S&P)
- Moody's

ALCO manages concentrations of credit risk within the non retail asset portfolio by setting maximum exposure limits to individual counterparties. These limits are agreed based on external ratings, credit default swap data and internal credit research and are monitored on a daily basis.

SLI MMFX manages credit exposures and the mapping of ECAI credit ratings to positions in the banking book using the treasury dealing system. These mappings are reviewed by SLB Finance and produce standardised risk weightings based on the prescribed credit quality assessment scales provided by the FSA.

Analysis of non-retail credit exposures by ECAI (S&P) designation

| Credit quality step | 31 December 2008 | | | | | | | Total £m |
|---------------------|-----------------------------------|-----------------------------|----------------|-------------------------|---------------------|--------------|----------------|-------------|
| | Balances with the Bank of England | Loans and advances to banks | Treasury Bills | Certificates of deposit | Floating rate notes | Derivatives | | |
| | £m | £m | £m | £m | £m | £m | | |
| 1 | 505.6 | 202.9 | 59.9 | 286.5 | 39.5 | 214.7 | 1,309.1 | |
| 2 | - | 117.4 | - | 175.1 | 19.9 | 82.2 | 394.6 | |
| Unrated by S&P * | - | - | - | 122.2 | - | - | 122.2 | |
| Total | 505.6 | 320.3 | 59.9 | 583.8 | 59.4 | 296.9 | 1,825.9 | |

| Credit quality step | 31 December 2007 | | | | | | | Total £m |
|---------------------|-----------------------------------|-----------------------------|----------------|-------------------------|---------------------|--------------|----------------|-------------|
| | Balances with the Bank of England | Loans and advances to banks | Treasury Bills | Certificates of deposit | Floating rate notes | Derivatives | | |
| | £m | £m | £m | £m | £m | £m | | |
| 1 | 212.5 | 935.5 | 158.5 | 43.9 | 49.9 | 132.7 | 1,533.0 | |
| 2 | - | 289.4 | - | 71.5 | 59.8 | - | 420.7 | |
| Unrated by S&P * | - | 105.4 | - | - | - | - | 105.4 | |
| Total | 212.5 | 1,330.3 | 158.5 | 115.4 | 109.7 | 132.7 | 2,059.1 | |

* Exposures unrated by S&P are all rated credit quality step 2 by Moody's.

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6. Non retail credit risk (continued)

Analysis of non-retail credit exposures by domicile of counterparty

| 31 December 2008 | | | | | | | |
|-------------------|---|-----------------------------------|----------------------|-------------------------------|---------------------------|-------------------|----------------|
| Geographic Region | Balances with the Bank of England £m | Loans and advances to banks £m | Treasury Bills £m | Certificates of deposit £m | Floating rate notes £m | Derivatives £m | Total £m |
| UK | 505.6 | 202.9 | 59.9 | 505.4 | 9.9 | 269.4 | 1,553.1 |
| Europe | - | 117.4 | - | 78.4 | 10.0 | 25.7 | 231.5 |
| North America | - | - | - | - | 10.0 | 1.8 | 11.8 |
| Other | - | - | - | - | 29.5 | - | 29.5 |
| Total | 505.6 | 320.3 | 59.9 | 583.8 | 59.4 | 296.9 | 1,825.9 |

| 31 December 2007 | | | | | | | |
|-------------------|---|-----------------------------------|----------------------|-------------------------------|---------------------------|-------------------|----------------|
| Geographic Region | Balances with the Bank of England £m | Loans and advances to banks £m | Treasury Bills £m | Certificates of deposit £m | Floating rate notes £m | Derivatives £m | Total £m |
| UK | 212.5 | 473.7 | 158.5 | 71.5 | 39.8 | 92.4 | 1,048.4 |
| Europe | - | 833.6 | - | 43.9 | 20.0 | 36.5 | 934.0 |
| North America | - | 23.0 | - | - | 10.0 | 3.8 | 36.8 |
| Other | - | - | - | - | 39.9 | - | 39.9 |
| Total | 212.5 | 1,330.3 | 158.5 | 115.4 | 109.7 | 132.7 | 2,059.1 |

Analysis of average non-retail credit exposures during the period

| 31 December 2008 | | | | | | | |
|------------------|---|-----------------------------------|----------------------|-------------------------------|---------------------------|-------------------|----------------|
| Period | Balances with the Bank of England £m | Loans and advances to banks £m | Treasury Bills £m | Certificates of deposit £m | Floating rate notes £m | Derivatives £m | Total £m |
| Year end 2008 | 505.6 | 320.3 | 59.9 | 583.8 | 59.4 | 296.9 | 1,825.9 |
| Year end 2007 | 212.5 | 1,330.3 | 158.5 | 115.4 | 109.7 | 132.7 | 2,059.1 |
| Average | 359.1 | 825.3 | 109.2 | 349.6 | 84.6 | 214.8 | 1,942.5 |

| 31 December 2007 | | | | | | | |
|------------------|---|-----------------------------------|----------------------|-------------------------------|---------------------------|-------------------|----------------|
| Period | Balances with the Bank of England £m | Loans and advances to banks £m | Treasury Bills £m | Certificates of deposit £m | Floating rate notes £m | Derivatives £m | Total £m |
| Year end 2007 | 212.5 | 1,330.3 | 158.5 | 115.4 | 109.7 | 132.7 | 2,059.1 |
| Year end 2006 | 190.3 | 819.2 | 157.3 | 530.5 | 186.6 | 38.6 | 1,922.5 |
| Average | 201.4 | 1,074.8 | 157.9 | 323.0 | 148.2 | 85.7 | 1,990.8 |

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6. Non retail credit risk (continued)

Analysis of residual maturity of non retail credit exposures

| Residual maturity | 31 December 2008 | | | | | | | Total £m |
|-------------------|-----------------------------------|-----------------------------|----------------|-------------------------|---------------------|--------------|----------------|-------------|
| | Balances with the Bank of England | Loans and advances to banks | Treasury Bills | Certificates of deposit | Floating rate notes | Derivatives | | |
| | £m | £m | £m | £m | £m | £m | | |
| Within 3 months | 499.7 | 320.3 | 59.9 | 583.8 | 19.9 | 14.4 | 1,498.0 | |
| 3 – 6 months | - | - | - | - | 10.0 | 31.2 | 41.2 | |
| 6 – 12 months | - | - | - | - | 5.0 | 0.2 | 5.2 | |
| 1 – 5 years | - | - | - | - | 24.5 | 200.1 | 224.6 | |
| After 5 years | 5.9 | - | - | - | - | 51.0 | 56.9 | |
| Total | 505.6 | 320.3 | 59.9 | 583.8 | 59.4 | 296.9 | 1,825.9 | |

| Residual maturity | 31 December 2007 | | | | | | | Total £m |
|-------------------|-----------------------------------|-----------------------------|----------------|-------------------------|---------------------|--------------|----------------|-------------|
| | Balances with the Bank of England | Loans and advances to banks | Treasury Bills | Certificates of deposit | Floating rate notes | Derivatives | | |
| | £m | £m | £m | £m | £m | £m | | |
| Within 3 months | 204.3 | 1,330.3 | 138.8 | 89.5 | 15.0 | 21.2 | 1,799.1 | |
| 3 – 6 months | - | - | 19.7 | 25.9 | - | 2.5 | 48.1 | |
| 6 – 12 months | - | - | - | - | 34.9 | 27.3 | 62.2 | |
| 1 – 5 years | - | - | - | - | 59.8 | 79.1 | 138.9 | |
| After 5 years | 8.2 | - | - | - | - | 2.6 | 10.8 | |
| Total | 212.5 | 1,330.3 | 158.5 | 115.4 | 109.7 | 132.7 | 2,059.1 | |

Approaches and methods adopted for determining provisions

All non retail credit risk exposures are subject to monthly review by ALCO who recommend any provisions required by reference to credit analysis supplied by SLI MMFX, which primarily considers counterparty credit rating actions and outlooks. Current provisions against non retail exposures are nil (2007: nil).

Undrawn non retail exposures

There were no undrawn non retail exposures at 31 December 2008 (2007: nil).

Credit risk mitigation

Collateral agreements are in place with all derivative counterparties to mitigate counterparty risk in the event of default of derivative assets. Collateral in relation to derivatives is not currently recognised as credit risk mitigation within the Pillar 1 capital calculations.

SLB does not net non retail credit exposures and liabilities with the same counterparties when calculating total credit exposures.

SLB does not employ credit derivatives to mitigate risk on non retail credit exposures.

Settlement risk

Settlement risk also arises in relation to non retail credit which is the risk arising in any situation where a payment in cash or securities is made in the expectation of a corresponding receipt in cash or securities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from SLB's market transactions on any single day.

7. Market risk

SLB is exposed to market risk, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk arises from open positions in interest rates, foreign exchange rates and equity indices, which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices such as interest rates or credit spreads.

All exposures to market risk relate to non-trading portfolios within the banking book which arise primarily from the interest rate management of retail banking assets and associated funding liabilities.

An assessment of specific market risk is required before inception of the risk. ALCO periodically reviews the methods and processes employed to identify market risk when making investment decisions and in particular, any material changes to the methods and processes.

Interest rate risk

SLB offers mortgage products with fixed interest rates, variable rates linked to SLB's standard variable rate (set by SLB in response to prevailing market conditions) and variable rates related to Bank of England base rate. Mortgage assets are funded by customer deposits which can have fixed rates, variable rates set by SLB or variable rates related to Bank of England base rate. Residual mortgage balances not funded by savings are primarily funded by Libor related wholesale borrowings. Interest rate risk arises as a result of timing differences on the re-pricing of assets and liabilities (repricing risk), unexpected changes in the slope and shape of yield curves (yield curve risk), by changes in correlation of interest rates between different financial instruments (basis risk) and by prepayment options embedded in loans and advances to customers (optionality risk).

Basis risk refers to the relationship between interest rates and net interest income and estimated asset/liability market value mismatches resulting from the re-pricing of assets and liabilities on different interest rate bases. Where interest rates on assets are determined on a different basis from those on the related funding liability and these bases are not perfectly correlated, basis risk arises. SLB manages basis risk through the use of derivatives.

ALCO manages interest rate risk on behalf of SLB, closely monitoring interest rate movements, future expectations of interest rates, the interest rate and re-pricing maturity structure of its interest bearing assets and liabilities and the level of non-interest bearing assets and liabilities.

Interest rate exposures are impacted by changes in interest rates and so the quantification of SLB's exposures is reported to ALCO on a regular basis. ALCO reviews three key measures in order to monitor and control interest rate risk:

- Interest rate sensitivity analysis – assesses the impact on estimated asset and liability market values under a range of deterministic shocks to the interest rate curve. Dedicated quantitative risk management models and software are used to implement these measures for internal management purposes;
- Interest margin analysis – based on actual net interest margin against plan, with variances analysed in terms of assets and liabilities linked to administered, fixed or market rates; and
- Interest rate gap analysis – assesses the difference in carrying value between assets and liabilities repricing in various gap periods. Part of the return on financial instruments is obtained from the controlled mismatching of the dates on which interest is receivable on assets and payable on liabilities.

7. Market risk (continued)

Exposure to interest rate risk in the banking book

The effect of scenarios of possible changes in interest rates, both parallel and non-parallel, is measured against the base market value scenarios using internal models. Total interest rate exposure, including derivative positions, must remain within pre-agreed limits.

Market value is calculated for interest rate risk management purposes as the present value of future cash flows using discount factors generated from current, market and interest rate curves. All interest rate exposures are in GBP.

The variation in the total economic market value of SLB arising from interest rate risk is set out below. These movements were within the internal limits set by SLB.

| Interest Rate Shock | 31 December 2008 | 31 December 2007 |
|--------------------------------------|------------------|------------------|
| | £m | £m |
| Parallel shift up 200 basis points | (31.8) | (38.3) |
| Parallel shift down 200 basis points | 70.8 | 42.3 |

Note that the 2008 down shift produces a more pronounced market value movement than the up shift in comparison to 2007. This is due to the impact of the low levels of interest rates at 2008 year end on the internal model outputs.

The sensitivity analysis represents the impact on market value at the balance sheet date that the specified changes in assumptions would have if they persist going forward. The sensitivity will vary with time, both due to changes in market conditions and the changes in the actual balance sheet mix, this mix being actively managed. This sensitivity analysis is non linear and larger or smaller impacts should not be derived from these results. SLB considers this to be representative of risk exposure during the reporting period; however these sensitivities are hypothetical and should not be considered to be predictive of future performance.

Currency risk

Currency risk is the risk that the sterling value of, or net income from, assets or liabilities that are denominated in a foreign currency change as a consequence of changes in foreign exchange rates. It arises as a result of SLB having assets, liabilities and derivatives that are denominated in currencies other than sterling as a result of normal banking activities, primarily wholesale funding.

SLB is not exposed to material currency risk since the majority of its operations are based in the UK. SLB does however raise funds via non sterling bank deposits and the issuance of non sterling denominated commercial paper, certificates of deposit, medium-term notes and securitised notes. SLB's policy is to fully mitigate all exchange rate exposures by using cross currency swaps and forward foreign exchange contracts, or to match liability exposures with assets denominated in the same currency. As such no sensitivity analysis for currency risk is presented. SLB's foreign exchange risk is managed by SLI MMFX and is reviewed by ALCO on a monthly basis.

Equity risk

All exposure to equity index risk through the issue of retail equity bonds to customers is fully hedged via the use of equity swaps. As a result of this hedging SLB has no exposure to equity risk so no sensitivity analysis to equity risk is presented.

8. Liquidity risk

Liquidity risk is the risk that SLB is not able to meet its financial obligations as they fall due or can do so only at an excessive cost. Liquidity risk arises from the mismatch in the cash flows generated from assets, liabilities and derivatives. SLB maintains a policy of ensuring funds are available at all times to meet financial obligations as they fall due. SLB ensures it can meet its financial obligations by managing the size of its mortgage book and by maintaining a portfolio of high quality liquid assets, diversified sources of funding and a balanced maturity profile of liquid assets, wholesale and retail funds.

During 2008 SLB acted to further diversify its funding sources with the launch of its 5bn Euro covered bond programme on 9 July 2008. SLB has completed two debt issues to date from this programme, of £1.5bn and £0.6bn (on 9 July 2008 and 28 November 2008 respectively) which it has retained on its own balance sheet to be used as collateral for secured financing transactions.

On 13 October 2008 the UK Government announced the details of the 2008 Credit Guarantee Scheme for UK incorporated banks and building societies debt issuance (the "Scheme"). The Scheme forms part of the Government's measures to ensure the stability of the financial system. The Scheme provides for HM Treasury to guarantee specific bank and building society debt instruments issued during the period beginning from the announcement of the Scheme and ending on 31 December 2009. Debt instruments which are guaranteed under the Scheme are required to have a maturity not exceeding three years. SLB has applied and become an eligible institution under the Scheme. On 11 February 2009 SLB launched its Euro Medium Term Note programme under which it can issue debt, including debt covered by the Scheme. On 18 February 2009 the Group issued £500m of debt under the scheme, maturing on 25 February 2011.

As a result, in addition to retail funding sources, wholesale funding can be raised by taking deposits from banks and other institutions, issuance of certificates of deposit, entering into repo agreements of eligible assets, securitisation of mortgage assets, issuance of covered bonds and the issuance of commercial paper and medium term notes.

SLB's liquidity management process, managed on a day to day basis on behalf of ALCO by SLI MMFX with support and oversight by SLB Finance & SLG Treasury, includes:

- Day-to-day management of funding requirements by monitoring future cash flows to ensure that requirements can be met, including replenishment of funds as they mature or are borrowed by customers;
- Maintenance of diverse sources of funding, including committed standby facilities, and an active presence in global money markets to enable funding to be raised;
- Maintaining a portfolio of highly marketable assets that can easily be liquidated as protection against any unforeseen interruption to cash flow;
- Monitoring market conditions for early signs of liquidity stress and taking corrective action as appropriate;
- Monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- Managing the concentration and maturity profile of wholesale and retail assets and liabilities;
- Stress testing SLB's liquidity position to ensure it can withstand various stress scenarios; and
- Contingency planning for unexpected events to ensure continued access to liquidity in the event of market disruption or specific events impacting SLB (e.g. a ratings downgrade).

Monitoring and reporting take the form of cash flow measurement and projections for the next day, week, month and year respectively, as these are all key periods for liquidity management. The starting point for these projections is an analysis of the current contractual maturity profile of wholesale financial liabilities and the expected collection date of wholesale financial assets. Expected retail inflows and outflows are then considered to assess the overall liquidity position in the event that funding can and cannot be raised and any actions taken appropriately. Sources of liquidity are regularly reviewed by ALCO to maintain a wide diversification by currency, geography, provider, product and term.

Longer term funding requirements arising from SLB's medium term note, securitisation and covered bond programmes are considered by ALCO to ensure sufficient liquidity is available to refinance or repay maturing debt as appropriate.

9. Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people or systems or from external events and is managed by the ORC. Operational risk also includes legal, reputational and business risk but excludes strategic risk which is owned by the UKFS Leadership Team. The ORC exists to focus and co-ordinate operational risk management activities and oversees SLB's risk profile. Senior management are responsible for the detailed management of operational risks in their area. Each business area undertakes risk self-assessment activities to identify and assess the key risks in its area including the adequacy of controls to manage the risks using a consistent SLG wide methodology.

Operational risk pillar 1 capital charge

SLB uses the standardised approach to operational risk which involves applying a fixed percentage, dependent on the business line being considered, to the average income over the last 3 years.

For SLB, all business is retail banking related so a 12% factor is used. This factor is applied to the average total income per the income statement in the annual report and accounts to arrive at the Pillar 1 operational risk charge.

| Business Line | Total Income £m | | | | Beta | 2008 Capital Charge £m |
|----------------|-----------------|----------|----------|-----|------|------------------------|
| | 31/12/06 | 31/12/07 | 31/12/08 | | | |
| Retail Banking | 102.4 | 62.9 | 61.0 | 12% | | 9.1 |

| Business Line | Total Income £m | | | Beta | 2007 Capital Charge £m |
|----------------|-----------------|----------|----------|------|------------------------|
| | 31/12/05 | 31/12/06 | 31/12/07 | | |
| Retail Banking | 87.7 | 102.4 | 62.9 | 12% | 10.1 |

The adequacy of the operational risk capital amount is further considered as part of SLB's economic capital calculation performed as part of the ICAAP. This process involves review of all of SLB's operational risk returns which quantify potential operational risk losses by looking at the impact and likelihood of operational risk events along with mitigating controls. The ICAAP then determines whether the Pillar 1 charge is satisfactory or whether additional capital is required to cover SLB's operational risk exposure which is then included in the Pillar 2 capital charge.

10. Derivatives

In order to mitigate the interest rate, equity and currency risks inherent in the financial instruments used in day to day operations, the SLAL Board has authorised the use of derivative instruments for the purpose of supporting the strategic and operational business activities of SLB and reducing the risk of loss arising from changes in market rates. All use of derivative instruments within SLB is to hedge risk exposure within the banking book and no trading positions in derivatives are taken.

The objective, when using any derivative instrument, is to ensure that the risk reward profile of any transaction is optimised. The intention is to only use derivatives to create economically effective hedges. Due to the specific requirements of IAS 39 “Financial Instruments: Recognition and Measurement” in obtaining hedge accounting, not all economic hedges are designated as accounting hedges, either because natural accounting offsets are expected or because obtaining hedge accounting would be unduly onerous. The benefits of using derivative instruments are measured by examining the anticipated consequences of not hedging the perceived risk in terms of the market value of SLB and the impact on earnings.

The following table describes the significant activities undertaken by SLB, the risks associated with such activities and the types of derivatives which are typically used in managing such risks on an economic basis. Such risks may alternatively be managed using on balance sheet instruments as part of an integrated approach to risk management.

| Activity | Risk | Type of derivative instrument used |
|---------------------------------|--|---|
| Fixed rate mortgage lending | Sensitivity to changes in interest rates | Pay fixed rate interest rate swaps |
| Variable rate mortgage lending | Sensitivity to changes in interest rates | Interest basis rate swaps |
| Variable rate borrowing | Sensitivity to changes in interest rates | Interest basis rate swaps |
| Fixed rate borrowing | Sensitivity to changes in interest rates | Receive fixed rate interest rate swaps |
| Foreign currency borrowing | Sensitivity to changes in currency rates | Cross currency interest rate / forward foreign currency swaps |
| Equity linked customer deposits | Sensitivity to changes in equity indices | Equity swaps |

Counterparty credit risk (“CCR”)

ALCO is responsible for setting limits over the use of derivative products for managing exposure to interest rates, foreign exchange rates and equity indices. The ALCO approves the SLB non retail credit policy and regularly monitors credit exposures arising in respect of non retail exposures, including derivatives.

CCR in relation to derivatives is defined as the potential cost to replace the derivative contract if the counterparty fails to fulfil its obligations. This risk is monitored on an ongoing basis with reference to the current derivative fair value, a proportion of the notional amount of the contracts and the liquidity of the market. All transactions in derivative contracts are undertaken with appropriately rated financial banking institutions. Management has established credit limits for each individual banking counterparty, including an allowance for derivative exposures, which ensures that there is no disproportionate exposure to the risk of counterparty default. In addition, in order to further mitigate credit risk, credit exposures arising on derivative contracts are collateralised with cash deposits.

The ALCO regularly reviews the potential impact of a ratings downgrade on the activities of SLB and its structured funding programmes and takes actions accordingly. All derivative positions are collateralised so a ratings downgrade would not result in a material increase in the amount of collateral required.

10. Derivatives (continued)

Derivative exposures

SLB employ the CCR mark to market method to calculate capital requirements for derivatives. The tables below show the credit exposure to derivatives held on an unconsolidated basis.

| Type of derivative instrument | 31 December 2008 | | |
|-------------------------------|---------------------------|---------------------------------|-----------------------------|
| | Positive fair value £m | Potential credit exposure £m | Total credit exposure £m |
| Interest rate derivatives | 43.9 | 15.4 | 59.3 |
| Currency derivatives | 49.4 | 8.1 | 57.5 |
| Equity derivatives | 0.4 | 1.2 | 1.6 |
| Total | 93.7 | 24.7 | 118.4 |

| Type of derivative instrument | 31 December 2007 | | |
|-------------------------------|---------------------------|---------------------------------|-----------------------------|
| | Positive fair value £m | Potential credit exposure £m | Total credit exposure £m |
| Interest rate derivatives | 37.7 | 8.8 | 46.5 |
| Currency derivatives | 22.8 | 12.6 | 35.4 |
| Equity derivatives | 1.0 | 0.3 | 1.3 |
| Total | 61.5 | 21.7 | 83.2 |

11. Capital Adequacy

SLB's objectives when managing capital, which is a broader concept than the 'equity' on the face of the balance sheet, are:

- to comply with the capital requirements set by the regulators of the banking markets where SLB operates;
- to optimise tax and gearing efficiency;
- to safeguard the ability to continue as a going concern so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- to maintain a strong capital base to support the development of its business.

The amount and composition of SLB's capital requirements are determined by assessing the following:

- minimum capital requirements as calculated under Pillar 1;
- economic capital requirements calculated using internal methodologies;
- the impact of stress and scenario testing on economic and Pillar 1 capital;
- individual capital guidance issued by the FSA; and
- levels of capital consistent with the targeted senior debt rating of SLB.

Capital adequacy and the use of regulatory capital are monitored on a daily basis by management, employing techniques based on the guidelines developed by the Basel Committee and the European Community Directives, as implemented by the FSA for supervisory purposes. The required capital adequacy information is filed with the FSA quarterly on an unconsolidated basis.

Pillar 1 capital calculation

SLB has adopted the following approaches to risk under BIPRU for Pillar 1 capital calculation purposes:

| Exposure class | Capital calculation |
|---|---------------------------------------|
| Retail claims or contingent retail claims | Internal ratings based approach (IRB) |
| Claims or contingent claims on institutions | Standardised |
| Claims or contingent claims on central governments or central banks | Standardised |
| Own securitisation positions | Internal ratings based approach (IRB) |
| All other claims | Standardised |
| Operational risk | Standardised |

The FSA requires each UK bank to hold a minimum amount of capital resources as defined within the FSA Handbook BIPRU. Reference is made to the credit risk weighting of each asset class held by the bank and resulting operational risk requirements (Pillar 1 requirement), the banks own assessment of the additional risk it runs and capital required to cover these risks (Pillar 2) and individual capital guidance from the FSA as to the overall adequacy of regulatory capital resources.

SLB's regulatory capital is divided into two tiers:

- Tier 1 capital consisting of share capital, retained earnings and reserves created by appropriations of retained earnings as adjusted for the book value of intangible assets; and
- Tier 2 capital consisting of qualifying subordinated loan capital and collective impairment allowances

Expected losses and investments that are not material or qualifying holdings are deducted from Tier 1 and Tier 2 capital to arrive at total regulatory capital.

Expected losses are calculated by the capital model component of the IRB model using long run average PD's and downturn EAD's and LGD's.

11. Capital Adequacy (continued)

Composition of capital resources

| Capital resources on an unconsolidated basis as at 31 December 2008 | | £m |
|---|--|--------------|
| Tier 1 capital | | |
| Share capital | | 271.8 |
| Retained earnings | | 26.5 |
| Less: intangible assets | | (4.5) |
| Less: expected loss | | (4.3) |
| Less: investments that are not material holdings or qualifying holdings | | (0.7) |
| Total qualifying Tier 1 capital | | 288.8 |
| Tier 2 capital | | |
| Subordinated debt | | 265.0 |
| Less: expected loss | | (4.3) |
| Less: investments that are not material holdings or qualifying holdings | | (0.7) |
| Total qualifying Tier 2 capital 1 | | 260.0 |
| Total regulatory capital | | 548.8 |
| Capital resources on an unconsolidated basis as at 31 December 2007 | | £m |
| Tier 1 capital | | |
| Share capital | | 271.8 |
| Retained earnings | | 28.4 |
| Less: intangible assets | | (4.2) |
| Less: expected loss | | (2.0) |
| Less: investments that are not material holdings or qualifying holdings | | (0.7) |
| Total qualifying Tier 1 capital | | 293.3 |
| Tier 2 capital | | |
| Subordinated debt | | 265.0 |
| Less: expected loss | | (2.0) |
| Less: investments that are not material holdings or qualifying holdings | | (0.7) |
| Total qualifying Tier 2 capital 1 | | 262.3 |
| Total regulatory capital | | 555.6 |

Retained earnings

Retained earnings exclude gains or losses on cash flow hedges.

Intangible assets

Intangible assets relate to capitalised software.

Subordinated debt

The subordinated debt is undated and interest is payable at a fixed rate of 6.14% (which is then converted to floating rate via an interest rate swap). The rights and claims of all subordinated debt holders are subordinated to the claims of all senior creditors of SLB. The subordinated notes are redeemable at par at the option of the issuer on 29 June 2015 but if they are not redeemed on 29 June 2015, then interest rate payable will be reset to 2.80% over the gross redemption yield on the appropriate benchmark gilt on reset date. SLB has had no defaults of principal, interest or other breaches in respect of subordinated debt.

Investments that are not material holdings or qualifying holdings

This relates to SLB's investment in SLFB, a subsidiary funding company.

Expected loss

Expected loss deductions are made for mortgage assets on the IRB approach for the excess of expected losses over accounting provisions. This figure is shown net of tax.

11. Capital Adequacy (continued)

Pillar 1 risk weighted exposure amounts and capital floors

Pillar 1 risk-weighted assets are measured in accordance with the FSA handbook BIPRU with the standardised approach to credit risk applied to non retail assets (i.e. all assets apart from retail mortgage assets) and operational risk and the IRB approach applied to retail mortgage assets (apart from Lifetime mortgage loans and Irish self directed pension lending which fall under the standardised approach).

The capital calculations presented below are based upon full implementation of Basel 2 requirements and also show the impact of transitional capital floors. SLB is subject to transitional provisions in relation to Basel 2 from 2007-2009. These provisions introduce floors on minimum capital requirements for firms implementing an IRB approach based on Basel 1 rules. The capital floor is essentially 8% of the risk weighted assets as calculated under Basel 1. This floor is compared to the Basel 2 capital charge (including the Pillar 2 element) and the higher is the capital requirement during the transitional period. The floors apply to SLB due to the significant reduction in mortgage risk weights from Basel 1 to Basel 2.

Risk weighted exposures and regulatory capital ratios

This analysis is prepared on an unconsolidated basis. Analysis on a consolidated basis is not materially different.

| Risk exposures | 31 December 2008 | |
|--|-------------------------|----------------------------|
| | Risk weighted assets £m | Pillar 1 capital charge £m |
| IRB exposure class credit risk | | |
| Residential mortgages | 938.5 | 75.1 |
| Standardised exposure class credit risk | | |
| Residential mortgages | 4.0 | 0.3 |
| Financial institutions | 193.6 | 15.5 |
| Sovereign and other items | 62.9 | 5.0 |
| Counterparty risk | 23.8 | 1.9 |
| Operational risk | 113.2 | 9.1 |
| Total pillar 1 | 1,336.0 | 106.9 |
| Impact of transitional capital floors | 3,133.4 | 250.7 |
| Total including transitional floors | 4,469.4 | 357.5 |
| Tier 1 Ratio – Basel 2 basis | | 21.6% |
| Tier 2 Ratio – Basel 2 basis | | 19.5% |
| Tier 1 Ratio – Including transitional floor | | 6.6% |
| Tier 2 Ratio – Including transitional floor | | 5.9% |

SLB's capital resources were higher than both the Basel 2 requirement and the transitional floor as at 31 December 2008 and 31 December 2007.

11. Capital Adequacy (continued)

Risk weighted exposures and regulatory capital ratios (continued)

| Risk exposures | 31 December 2007 | |
|--|-------------------------|----------------------------|
| | Risk weighted assets £m | Pillar 1 capital charge £m |
| IRB exposure class credit risk | | |
| Residential mortgages | 690.3 | 55.3 |
| Standardised exposure class credit risk | | |
| Residential mortgages | 3.6 | 0.3 |
| Financial institutions | 326.2 | 26.1 |
| Sovereign and other items | 49.3 | 3.9 |
| Counterparty risk | 20.0 | 1.6 |
| Operational risk | 126.5 | 10.1 |
| Total pillar 1 | 1,215.9 | 97.3 |
| Impact of transitional capital floors | 3,924.1 | 313.9 |
| Total including transitional floors | 5,140.0 | 411.2 |
| Tier 1 Ratio – Basel 2 basis | | 24.1% |
| Tier 2 Ratio – Basel 2 basis | | 21.5% |
| Tier 1 Ratio – Including transitional floor | | 5.7% |
| Tier 2 Ratio – Including transitional floor | | 5.1% |

Pillar 2 capital calculation - Internal capital adequacy assessment process (“ICAAP”)

SLB is obliged to self assess additional capital requirements for any risks which are not captured under Pillar 1. This assessment is subject to review and guidance by the FSA after which the total regulatory capital requirement is determined. As a result, in addition to daily calculation of Pillar 1 capital requirements, SLB conducts, at least annually, an assessment of the amount of internal capital it requires in order to support current and future business activities (Pillar 2 capital requirement).

This process includes identification of all of the risks faced by SLB, quantification of the potential impact of these risks on an economic capital basis and a review of controls that are in place to mitigate these risks. This capital assessment is conducted by SLB Financial Risk in conjunction with SLG Treasury with the involvement of senior management across SLB, is subject to challenge by each of SLB’s risk committees and is ultimately approved by the SLAL Board. The results of this assessment feed into SLB’s regular strategic planning and risk reporting processes in order to ensure that risk assessment, risk capital quantification and risk capital goals are fully embedded into the running of the business.

SLB’s ICAAP forms the basis of the FSA supervisory review and evaluation process in which the FSA provide individual guidance on the amount and quality of financial resources they consider appropriate to SLB. SLB first received ICG from the FSA during the first half of 2007 and received an updated ICG in 2008.

Capital monitoring and forecasting

Capital forecasts are prepared on a monthly basis based on the most up to date business plan and are provided to ALCO and for use within SLG risk reporting, in order to inform decisions in relation to capital. The business planning process includes sensitivity analysis to assess capital requirements under certain management defined scenarios. The business planning and ICAAP processes are aligned to ensure relevant capital stresses and scenarios are being considered and that SLB has sufficient capital to support current and future activities.

12. Securitisation

Issuance

SLB has securitised part of its residential mortgage portfolio in order to raise funding for its business activities. Under this arrangement, the beneficial interest in these mortgages is transferred to Lothian Trustees Limited (the "Trust"), a SPE. SLB continues to administer securitised mortgages as well as providing cash management services to the Trust and other Lothian SPEs and receives a fee for doing so. The issue of mortgage backed floating rate notes by the SPEs funds the purchase of the mortgages.

Although SLB does not directly or indirectly own any of the share capital of the SPEs, the nature of these entities, which are in substance controlled by SLB, means that SLB retains substantially all of the risks and rewards of the securitised mortgages. As such risk transfer is not considered significant and securitised mortgages continue to be recognised on balance sheet for regulatory and accounting purposes. As a result all mortgage exposures attract a risk weighting and a related capital requirement within SLB's Pillar 1 calculations. No capital deductions are however recognised for securitisation first losses retained by SLB.

SLB is not obliged to support any losses in respect of the loans and advances subject to securitisation, except as described below, nor does it intend to do so. This is clearly stated in the offering circular subscribed to by the note holders of the debt issued by the SPEs and in the legal agreements with the note holders. Losses are shared equally in accordance with the interests held in the Trust. SLB's interest in the Trust will only bear additional loss in limited exceptional circumstances set out in the offering circular (such as in the event of SLB becoming insolvent or the default and set-off by customers of SLB who are both mortgage and deposit holders).

SLB has made £8.2m (2007 – £43.8m) of subordinated loans to Lothian Funding Limited, repayments of interest and capital on which are subordinated to the claims of the note holders of the debt issued by the SPEs.

SLB has an option (but not an obligation) to sell further mortgage loans to the Trust where at the end of any trust determination period the rate of repayment of principal exceeds the level agreed at the date of sale of the loans. SLB has no right or obligation to repurchase the benefit of any securitised loan except to the extent that the loan breaches representations and warranties given at the date of sale. It does, however, have the option (but not the obligation) to repurchase loans from the Trust, on being offered the opportunity to do so, where the borrower requests a further advance or a product switch.

The SFWG is responsible for monitoring and controlling securitisation activity on behalf of ALCO. This includes monitoring of ratings downgrade triggers within the deal and holding discussions with ratings agencies as necessary in the event that any action is required.

Summary of securitisation issuance activity

| Securitisation entity | Date of securitisation | 31 December 2008 | | Carrying value of debt issued £m |
|--|------------------------|--------------------------------|----------------------|----------------------------------|
| | | Mortgage assets securitised £m | Gross debt issued £m | |
| Lothian Mortgages (No.1) Plc | 16 Apr 2003 | 1,367.0 | 1,000.0 | - |
| Lothian Mortgages (No.2) Plc | 23 Sep 2003 | 2,205.0 | 1,500.0 | - |
| Lothian Mortgages (No.3) Plc | 30 Jun 2004 | 1,041.0 | 1,250.0 | 730.2 |
| Lothian Mortgages (No.4) Plc | 24 Feb 2005 | 2,187.0 | 1,250.0 | 745.8 |
| Lothian Mortgages Master Issuer Plc 2006-1 | 10 May 2006 | 1,388.0 | 1,005.0 | 934.5 |
| Lothian Mortgages Master Issuer Plc 2007-1 | 6 Dec 2007 | 581.6 | 500.0 | - |
| | | 8,769.6 | 6,505.0 | 2410.5 |
| Movement in securitised mortgage assets | | (5,946.1) | - | - |
| | | <u>2,823.5</u> | <u>6,505.0</u> | <u>2,410.5</u> |

Securitised bonds issued by Lothian are rated by S&P and Moody's.

12. Securitisation (continued)

Summary of securitisation issuance activity (continued)

During the year Lothian Mortgages (No. 1) Plc (24 July 2008), Lothian Mortgages (No. 2) Plc (24 October 2008) and Lothian Mortgages Master Issuer Plc series 2007-01 (24 July 2008) called and fully repaid all tranches of outstanding securities still in issue. As a component of these repayment transactions SLB repurchased a total of £1.6bn mortgages from the Trust. At the same time the SPEs repaid the associated subordinated loans of £35.6m due to SLB.

Purchase

SLB does not hold any external asset backed securities within its liquidity portfolio. In 2007 SLB held the 2007-1 issuance from its Lothian securitisation programme which was subject to a sale and repurchase agreement in return for funding from an external party. During the year this tranche was called and fully repaid by Lothian Mortgages Master Issuer Plc series 2007-01 (24 July 2008).