Company Number: SC 001111

CLYDESDALE BANK PLC

ANNUAL REPORT AND CONSOLIDATED FINANCIAL STATEMENTS

30 SEPTEMBER 2006

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CLYDESDALE BANK PLC
Officers and Professional Advisers

Directors	**Executive:**	Lynne Peacock (Chief Executive Officer) # Gavin Slater # David Thorburn
	Non-executive:	Jonathan Dawson* Sir David Fell KCB* Richard Gregory OBE * # Roy Nicolson * # Malcolm Williamson (Chairman) # Peter Wood*
		* Member of the European Board Audit Committee # Member of the European Board Risk Committee
Secretary		Michael Webber
Registered Office		30 St Vincent Place Glasgow G1 2HL
Bankers		National Australia Bank Limited
Auditor		Ernst & Young LLP Registered Auditor

The Directors of Clydesdale Bank PLC (the "Bank") with its subsidiary undertakings (which together comprise the "Group") submit their report and consolidated financial statements for the year ended 30 September 2006.

Activities

The Bank is an "authorised person" under the Financial Services and Markets Act 2000 and is regulated by The Financial Services Authority (FSA).

The Bank and its subsidiaries offer access to a comprehensive range of banking and other related financial services through 343 branches in Scotland, England and Guernsey. Developments in the Group's existing business and future prospects are discussed below.

Profits and appropriations

The profit attributable to the shareholders for the year ended 30 September 2006 amounted to £326m (2005 £124m). No dividend was paid during the year (2005: £Nil). The Directors do not recommend the payment of a final dividend in respect of this financial year (2005: £Nil).

Review of developments

The Group is the United Kingdom (UK) arm of the National Australia Bank Limited ("NAB") that provides financial solutions to its 2.65 million customers in the UK.

The results demonstrate the continued recovery in the business. Income has increased, efficiency has improved with a reducing cost/income ratio and the strategic agenda outlined last year continues on track.

The Group continues to operate under the 2 brands of "Clydesdale Bank" and "Yorkshire Bank" and the key business developments over the last 12 months are as follows:

- There are now 74 Financial Solutions Centres within the UK, 36 in the South and 38 in the North. There has been continued expansion in the South, with 4 new centres opened, and a continued programme of relocations and refurbishments in the North where 5 centres have been relocated to new premises and a further 7 centres upgraded.

- The third party distribution channel now has 450 broker relationships and £1.6 billion mortgage advances were completed over the year. Over 16,000 customers have now been introduced to the Bank through this channel.

- In retail distribution, there are 343 branches, in addition to the 74 Financial Solutions Centres. The re-alignment of the high street branch presence was completed by the end of March 2006, 6 months ahead of schedule.

- The branch network continued to show improved performance in a number of areas with good growth in deposits, improvement in cross sales and mortgage sales up over the previous year (with 20% fewer branches).

- The 3 major investment programmes - branch, customer-facing and back office systems - are on track. The new Branch Teller system was successfully deployed in over half of Yorkshire Bank branches, with the remainder on schedule for completion by the end of November 2006. In addition the preparatory work to converge the back office systems of Clydesdale and Yorkshire onto one platform is well advanced.

- In September 2006 the transfer was announced of Account Management Services based in Aberdeen to Clydebank. This is a further step in the rationalisation of back office processing centres.

- The Bank's contact centre in Glasgow has been named "Best Contact Centre of the Year 2006" in the prestigious Contact Centre World Awards for the European, Middle East and Africa Regions. The contact centre beat competition from more than 400 entrants, and moved on to the World Contact Centre Awards in November 2006 where the team won the "Best Contact Centre in the World" award.

- In July 2006, the Group opened an international offshore branch in Guernsey, initially providing a 30-day notice account and fixed rate deposit products with plans to expand the range of services offered over the coming year.

Review of developments (continued)

- During the year the Bank launched a medium term note programme under the NAB Group US$30 billion Global MTN Programme. Since launch, a number of issuances under the programme have been made resulting in a total of £1,400 million of Floating Rate Notes being issued. In addition, in February 2006, the Bank launched its first stand-alone subordinated debt transaction.

- The agreement by staff members and trustees to reforms to the Group's pension schemes resulted in a one off credit to the profit and loss account of £145 million which has been recognised as income after Group Operating Profit. From 1 April 2006, the defined benefit schemes moved to a structure known as 'career average'. A one off contribution of £92 million was also made across the 2 defined benefit schemes during the 2006 financial year.

- Restructuring continues with the reconfiguration of the distribution networks and streamlining of operations. To date 99% of the headcount reduction has been achieved, exceeding the target for the current financial year, and £86m million of annualised cost savings have been delivered, broadly in line with expectations. As at 30 September 2006 £75m (74%) of the £102 million provision originally raised had been utilised. The remaining provision is anticipated to be utilised by September 2007.

In addition the Group has continued to demonstrate its commitment to the community in the following areas:

- The Group's sponsorship of the successful Scottish Commonwealth Games team was an opportunity for our staff, our customers and the communities in which we operate to share in the excitement and inspiration of the 2006 Commonwealth Games. The sponsorship programme was awarded 'most effective sponsorship campaign' at the recent UK Financial Services Forum awards for Marketing Effectiveness 2006.

- Following the success of the partnership, the Group has demonstrated its long term commitment to the Scotland team by announcing continued support through to the 2008 Youth Games and 2010 Commonwealth Games in New Delhi. In addition, the Group has become the first corporate supporter of the bid to bring the 2014 Commonwealth Games to Glasgow.

- Both Yorkshire and Clydesdale Bank brands were awarded the 'Special Achievement for a New Corporate Partner' accolade from the British Heart Foundation at a special 'Heart of Business' awards ceremony. To date in excess of £300,000 has been raised with staff and customers.

Financial instruments

The Group's risk management objectives and policies are discussed in the Risk Overview on pages 86 to 89.

Directors and Directors' interests

The current Directors are shown on page 2. Directors who are not full-time employees of the Bank or a related body corporate are appointed in accordance with the Articles of Association and may be eligible for reappointment thereafter. No Director was eligible for reappointment during the year.

<u>Appointments</u>

Peter Wood was appointed as a Non-Executive Director of the Bank on 28 October 2005.
Jonathan Dawson was appointed as a Non-Executive Director of the Bank on 9 December 2005.
Michael Webber was appointed as Secretary of the Bank on 1 March 2006.

<u>Resignations</u>

Karl Daniels resigned as a Non-Executive Director of the Bank on 30 November 2005.
Eugene Greene resigned as a Non-Executive Director of the Bank on 31 December 2005.
Myshele Shaw resigned as Secretary of the Bank on 28 February 2006.

Directors and Directors' interests (continued)

Directors' interests

No Director had any interest in the shares of the Bank or its subsidiaries at any time during the year. As the Bank is a wholly-owned subsidiary of NAB, which is incorporated in Australia, any interest which the Directors may have in NAB does not need to be notified to the Bank, so is not disclosed in this report.

Directors' liabilities

During the year the NAB Group paid a premium for a contract insuring the directors and officers of National Australia Bank Limited, its subsidiaries and controlled entities against personal liabilities which may arise in the course of the performance of their duties, as well as protecting the Group itself to the extent that it is obligated to indemnify directors and officers for such liability.

Employee involvement

The Group carries out an information programme to keep staff informed of business objectives and results. This is achieved through regular meetings, circulars, bulletins and specially commissioned videos as well as training courses for staff.

Under the UK National Share Incentive Plan, employees are entitled to purchase up to £1,500 worth of NAB shares each year through the National Partnership Share Plan. Participants contribute each month and the trustee uses the contributions to purchase shares on market which are then held in trust for the participants. Participants are entitled to receive dividends and exercise voting rights in respect of these shares and there is no risk of forfeiture. In addition, up to £3,000 of free shares per employee may be gifted per annum through the plan.

Under the UK National Share Incentive Plan, the National EVA ® Share Offer gifted ordinary shares of AUD1,000 to eligible employees based on Group performance during 2004 - 2005. Participants are entitled to receive dividends and exercise voting rights in respect of these shares whilst they are members of the plan.

Employment of disabled persons

It is the policy of the Group to promote equality of employment opportunities by giving full and fair consideration to applications from disabled people. If existing employees become disabled, every effort is made to retain them within the workforce wherever reasonable and practicable. The Group also endeavours to provide equal opportunities in the training, promotion and general career development of disabled employees.

The Group has recently become authorised to become a "two tick" symbol user by Jobcentre Plus. The disability symbol is a recognition given by Jobcentre Plus to employers who have agreed to take action to meet five commitments regarding the employment, retention, training and career development of disabled employees. Employers who wish to become a symbol user have to evidence they can achieve those commitments in their application.

Charitable and political donations

The total amount given for charitable purposes by the Group during the year ended 30 September 2006 was £221,000 (2005 £358,000). No political donations were made during the year (2005 £Nil).

Corporate governance

It is the Bank's policy not to include all of the disclosures in respect of voluntary corporate governance Codes of Practice as it is a wholly owned subsidiary of NAB. The NAB Group's Annual Financial Report details the Corporate Governance framework applicable to the Bank and its subsidiaries. These disclosures are made after consideration of authoritative pronouncements on audit committees and associated disclosures in Australia, the USA, and the United Kingdom.

Share capital

During the year the authorised share capital was increased by £50,000,000 by the creation of 50,000,000 ordinary shares of £1 each.

In May 2006, 26,753,864 ordinary shares of £1 each were issued at £8.41 per share, for general banking purposes, resulting in an increase of £26,753,864 to the allotted, called up and fully paid share capital, and an increase of £198,246,136 to the share premium account.

Accounting developments

In July 2002, the Financial Reporting Council in Australia formally announced that Australian reporting entities would be required to comply with Australian accounting standards equivalent to International Financial Reporting Standards ("IFRS") and other pronouncements set by the International Accounting Standards Board ("IASB") for financial years commencing on or after 1 January 2005.

Thus, the ultimate parent company NAB was required to adopt these standards for the financial year commencing 1 October 2005. The adoption of the standards was first reflected in NAB Group's financial statements for the half year ending 31 March 2006. In addition, comparative financial information prepared in compliance with IFRS is required for the year commencing 1 October 2004 for disclosure in the financial statements for the year to 30 September 2006.

As a result of this requirement on the NAB Group as a whole, Clydesdale Bank has adopted IFRS in accordance with the timelines above, including full adoption of IAS 32 and IAS 39 with effect from 1 October 2005. The adoption of these standards has a material effect on the Group's reported financial performance and financial position. The key differences for the Group are summarised in note 40 to these financial statements, which includes a description of the key differences and a summary of the impact on transition to profit and loss and retained earnings. Comparative figures for the year ended 30 September 2005 have been restated in compliance with IFRS in these financial statements, excluding IAS 32 and 39.

Events after the balance sheet date

No information has been identified since the balance sheet date about conditions existing at the balance sheet date which requires to be disclosed in these Financial Statements.

Auditors

In accordance with section 385 of the Companies Act 1985, a resolution to reappoint Ernst & Young LLP, and to authorise the Directors to fix their remuneration, will be proposed at the next Annual General Meeting.

Directors' statement as to disclosure of information to auditors

The Directors who were members of the board at the time of approving the Report of the Directors are listed on page 2. Having made enquiries of fellow Directors and of the company's auditors, each of these Directors confirms that:

- to the best of each Director's knowledge and belief, there is no information relevant to the preparation of their report of which the company's auditors are unaware; and

- each Director has taken all the steps a Director might reasonably be expected to have taken to be aware of relevant audit information and to establish that the company's auditors are aware of that information.

By order of the Board

Michael Webber
Secretary
16 November 2006

CLYDESDALE BANK PLC
Statement of Directors' Responsibilities

The Directors are responsible for preparing the Annual Report and the Financial Statements in accordance with applicable United Kingdom law and IFRS as adopted by the European Union.

Company Law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Bank and Group and of the profit or loss for that financial year. In preparing the Financial Statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;

- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;

- provide additional disclosures when compliance with the specific requirements of IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and

- state that the company has complied with IFRS, subject to any material departures disclosed and explained in the financial statements.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Bank and of the Group and which enable them to ensure that the financial statements comply with the Companies Act 1985 and Article 4 of the International Accounting Standards regulation. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Report of the Independent Auditor to the members of Clydesdale Bank PLC

We have audited the Group's Financial Statements for the year ended 30 September 2006 which comprise the Consolidated Income Statement, Consolidated and Bank Statements of Recognised Income and Expense, Consolidated and Bank Balance Sheets, Consolidated and Bank Cash Flow Statements, and the related notes 1 to 40. These Financial Statements have been prepared on the basis of the accounting policies set out therein.

This report is made solely to the Bank’s members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Bank’s members those matters we are required to state to them in an auditor’s report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank’s members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and Auditors

As described in the Statement of Directors' Responsibilities the Bank's Directors are responsible for the preparation of the Annual Report and Financial Statements in accordance with applicable United Kingdom law and International Financial Reporting Standards as adopted by the European Union.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the Financial Statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you if, in our opinion, the Report of the Directors is not consistent with the Financial Statements, if the Bank has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors’ remuneration and transactions with the Group is not disclosed.

We read the Report of the Directors and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Financial Statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Financial Statements, and of whether the accounting policies are appropriate to the Group’s circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Financial Statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Financial Statements.

Opinion

In our opinion:

- the Group Financial Statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs at 30 September 2006 and of its profit for the year then ended;

- the Bank Financial Statements give a true and fair view, in accordance with IFRS adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the Bank's affairs as at 30 September 2006;

- the Financial Statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and

- the information given in the Directors' report is consistent with the Financial Statements.

Ernst & Young LLP
Registered Auditor
London

16 November 2006

CLYDESDALE BANK PLC
Consolidated Income Statement
for the year ended 30 September 2006

	Note	**2006 £m**	2005 £m
Interest receivable and similar income		**1,475**	1,144
Interest expense and similar charges		**(693)**	(540)
Net interest income		**782**	604
Gains less losses on financial instruments at fair value		**38**	-
Other operating income		**296**	334
Non interest income	4	**334**	334
Total operating income		**1,116**	938
Personnel expenses		**(207)**	(201)
Depreciation expense		**(46)**	(49)
Other operating expenses		**(423)**	(348)
Total operating expenses	5	**(676)**	(598)
Operating profit before impairment losses		**440**	340
Impairment losses on credit exposures	14	**(129)**	(86)
Group operating profit		**311**	254
Pension scheme reforms benefit	22	**145**	-
Profit on sale of land and buildings		**10**	21
Reorganisation costs		**-**	(88)
Profit on ordinary activities before tax		**466**	187
Tax expense	6	**(140)**	(63)
Retained profit for the financial year	26	**326**	124

All material items dealt with in arriving at the profit on ordinary activities before tax for 2006 and 2005 relate to continuing activities.

CLYDESDALE BANK PLC
Statement of Recognised Income and Expense
for the year ended 30 September 2006

		Group		Bank	
	Note	**2006**	2005	**2006**	2005
		£m	£m	**£m**	£m
Income and expense recognised directly in equity					
Increase in share options granted	26	**9**	11	**9**	11
Revaluation of land and buildings	26	**3**	1	**3**	1
Net change in cash flow hedge reserve	26	**(19)**	-	**(19)**	-
Actuarial gains on defined benefit pension plans	22	**19**	9	**19**	9
Total changes in items recognised directly in equity		**12**	21	**12**	21
Tax on items recognised directly in equity	6	**8**	(3)	**8**	(3)
Net change in items recognised directly in equity		**20**	18	**20**	18
Profit for the year		**326**	124	**309**	139
Total recognised income and expense for the year		**346**	142	**329**	157
Attributable to:					
Ordinary shareholders		**346**	142	**329**	157

Effects of changes in accounting policy at 1 October 2005

Cash flow hedge reserve	26	11	-	11	-
Retained earnings	26	(54)	-	(60)	-
		(43)	-	(49)	-

CLYDESDALE BANK PLC
Balance Sheet
at 30 September 2006

		Group		Bank	
		2006	2005	**2006**	2005
	Note	**£m**	£m	**£m**	£m
Assets					
Cash and balances with central banks	8	**2,013**	1,107	**2,216**	1,107
Loans and advances to other banks	9	**495**	383	**490**	383
Derivative financial assets	10	**13**	-	**13**	-
Financial assets at fair value through profit and loss	11	**2,141**	-	**2,141**	-
Available for sale investments	12	**204**	2	**3**	2
Loans and advances to customers	13	**21,781**	19,118	**18,037**	16,513
Due from customers on acceptances		**5**	-	**5**	-
Investments in controlled entities and associates	15	**2**	2	**35**	33
Property, plant and equipment	16	**281**	361	**193**	187
Deferred tax assets	17	**147**	190	**145**	184
Due from related entities	34	**1,229**	890	**4,733**	3,574
Other assets	18	**671**	362	**631**	364
Total assets	31	**28,982**	22,415	**28,642**	22,347
Liabilities					
Due to other banks	19	**1,392**	733	**1,392**	733
Derivative financial liabilities	10	**32**	-	**32**	-
Financial liabilities at fair value through profit and loss	11	**142**	-	**142**	-
Due to customers	20	**17,081**	13,591	**16,674**	13,591
Liabilities on acceptances		**5**	-	**5**	-
Current taxes		**34**	61	**-**	28
Deferred tax liabilities	17	**16**	33	**1**	6
Provisions	21	**35**	79	**35**	79
Defined benefit pension liabilities	22	**112**	382	**112**	382
Bonds and notes	23	**1,652**	-	**1,652**	-
Due to related entities	34	**5,224**	4,912	**5,535**	4,966
Other liabilities	24	**1,574**	1,536	**1,535**	1,540
		27,299	21,327	**27,115**	21,325
Shareholders' equity					
Share capital	25	**232**	205	**232**	205
Share premium account	26	**243**	45	**243**	45
Share option reserve	26	**22**	11	**22**	11
Asset revaluation reserve	26	**17**	15	**17**	15
Merger reserve	26	**338**	338	**338**	338
Cash flow hedge reserve	26	**(2)**	-	**(2)**	-
Retained earnings	26	**766**	474	**677**	408
Total shareholders' equity		**1,616**	1,088	**1,527**	1,022
Minority interests	26	**67**	-	-	-
Total liabilities and shareholders' equity	31	**28,982**	22,415	**28,642**	22,347

These financial statements were approved by the Board of Directors on 16 November 2006 and were signed on its behalf by:

Gavin Slater
Director

Lynne Peacock
Chief Executive Officer

CLYDESDALE BANK PLC
Cash Flow Statement
for the year ended 30 September 2006

		Group		Bank	
		2006	2005	**2006**	2005
	Note	**£m**	£m	**£m**	£m
Cash flows from operating activities					
Cash used in operating activities	33	**(1,510)**	(750)	**(571)**	(1,377)
Interest received		**1,545**	1,137	**1,354**	1,020
Interest paid		**(535)**	(299)	**(514)**	(181)
Cash contribution to defined benefit pension schemes		**(92)**	-	**(92)**	-
Tax paid		**(118)**	(65)	**(86)**	(75)
Net cash used in operating activities		**(710)**	23	**91**	(613)
Cash flows from investing activities					
Purchase of property, plant and equipment		**(49)**	(58)	**(42)**	(29)
Proceeds from sale of property, plant and equipment		**97**	32	**32**	32
Sale of investments in controlled entities and associates		**-**	-	**(35)**	151
Net cash provided by/(used in) investing activities		**48**	(26)	**(45)**	154
Cash flows from financing activities					
Interest paid		**(220)**	(230)	**(94)**	(241)
Proceeds from share issues	25	**225**	-	**225**	-
Net proceeds from other debt issued		**1,652**	-	**1,652**	-
Net (increase)/decrease in amount due from related entities		**(340)**	638	**(1,160)**	1,050
Net increase in amount due to related entities		**290**	332	**479**	387
Net cash provided by financing activities		**1,607**	740	**1,102**	1,196
Net increase in cash and cash equivalents		**945**	737	**1,148**	737
Cash and cash equivalents at beginning of the year		**1,029**	292	**1,029**	292
Cash and cash equivalents at end of the year	33	**1,974**	1,029	**2,177**	1,029

1. Authorisation of financial statements and statement of compliance with IFRS

In these financial statements Clydesdale Bank PLC is referred to as the "Bank". The "Group" consists of the Bank and its controlled entities. The principal controlled entities are listed in note 15. The consolidated financial statements comprise the financial statements of the Group.

The consolidated Financial Statements of Clydesdale Bank PLC for the year ended 30 September 2006 were authorised for issue by the board of directors on 16 November 2006 and the balance sheets were signed on the Board's behalf by Gavin Slater and Lynne Peacock.

Clydesdale Bank PLC is incorporated in the UK and registered in Scotland.

Copies of the Annual Report and Consolidated Financial Statements prepared in respect of the Bank may be obtained from the Corporate Affairs Department, Clydesdale Bank PLC, 30 St. Vincent Place, Glasgow, G1 2HL.

The ultimate parent undertaking, and ultimate controlling party is National Australia Bank Limited (NAB), a company incorporated in the State of Victoria, Australia. This company also heads the largest group in which the results of the Group are consolidated. The smallest group in which the results of the Group are consolidated is that headed by National Australia Group Europe Limited ("NAGE") which is incorporated and registered in England and Wales. National Europe Holdings (GB) Limited, a company incorporated and registered in England and Wales, is the immediate holding company for the Bank.

The Group's Financial Statements have been prepared in accordance with IFRS. The Bank's Financial Statements have been prepared in accordance with IFRS as adopted for use in the European Union and as applied in accordance with the provisions of the Companies Act 1985. The principal accounting policies adopted by the Group are set out in note 2, and the impact of the transition to IFRS is set out in note 40.

2. Accounting policies

Basis of preparation

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosed amount of contingent liabilities. Assumptions made at each balance sheet date are based on best estimates at that date. Although the Group has internal control systems in place to ensure that estimates can be reliably measured, actual amounts may differ from those estimates. It is not anticipated that such differences would be material.

The financial statements have been prepared under the historical cost convention, as modified by the application of fair value measurements.

As permitted by section 230 of the Companies Act 1985, no Income Statement is presented for the Bank.

Statement of compliance and comparative amounts

The Group's accounting policies have changed as a result of the adoption of IFRS and the comparatives for the year ended 30 September 2005 have been restated accordingly. The Group has applied IFRS retrospectively to all periods covered by these financial statements and to the opening balance sheet as at 1 October 2004. However, the Group has chosen to take advantage of the exemption available within IFRS 1 "First-Time Adoption of International Financial Reporting Standards" and has not restated comparatives in respect of the application of IAS 39 "Financial Instruments: Recognition and Measurement", IAS 32 "Financial Statements: Disclosure and Presentation" or IFRS 4 "Insurance Contracts". Comparison of current and prior period results and financial position should be made in conjunction with the notes detailing the major impact of the transition to IFRS.

In accordance with IFRS 1 the Group has applied exemptions relating to the following areas on transition to IFRS:

- Business combinations undertaken prior to 1 October 2004 have not been restated;
- No adjustment for share based payments granted on or before 7 November 2002 has been reflected in the financial statements; and
- Certain previously recognised financial instruments have been designated on transition as financial assets or financial liabilities at fair value through profit or loss ("FVTPL").

2. Accounting policies (continued)

Early adoptions

The Group has elected to adopt the amendments made to IAS 19 "Employee Benefits" (issued in December 2004) for the year ended 30 September 2006. Comparatives have also been adjusted in accordance with IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors".

The Group has also adopted the amendment to IAS 39 "The Fair Value Option" issued by the IASB in June 2005. In accordance with the approach to adoption of IAS 39 outlined above, comparatives have not been restated.

Currency of presentation

All amounts are expressed in pounds sterling and all values are rounded to the nearest million pounds unless otherwise stated.

Principles of consolidation

Controlled entities
The consolidated financial statements comprise the financial statements of the Bank and its controlled entities. Controlled entities are all entities over which the Bank has the power to govern the financial and operating policies so as to obtain economic benefits from their activities.

Controlled entities are consolidated from the date on which control is transferred to the Bank. They are deconsolidated from the date that control ceases. The purchase method of accounting is used to account for the acquisition of controlled entities.

The effects of transactions between entities within the economic entity are eliminated in full upon consolidation.

Outside interests in the equity and results of the entities that are controlled by the Bank are shown as a separate item, "minority interest", in the consolidated financial statements.

On 1 December 2004 the entire business and undertaking of Yorkshire Bank PLC was transferred to Clydesdale Bank PLC. As both entities were under common control both before and after the business combination took place, this transfer is excluded from the scope of IFRS 3 and thus it has been accounted for by the use of merger accounting. The transfer has been given the effective date of 1 October 2004 and thus Clydesdale Bank PLC is treated as having acquired the assets, liabilities and reserves of Yorkshire Bank PLC with effect from that date. As no consideration was paid in relation to the transfer the only impact arising is the crystallisation of the Yorkshire Bank PLC Share Capital and Share Premium into a Merger Reserve in the combined entity.

Associates
Associates are undertakings over which the Bank exerts significant influence but not control. Investments in material associates are accounted for using the equity method. The attributable share of profit and reserves of the associated undertaking is based on the management accounts as at 30 September.

Foreign currency translation

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as qualifying cash flow hedges and qualifying net investment hedges. Translation differences on non-monetary items, such as equity securities held at fair value through profit or loss, are reported as part of the fair value gain or loss.

2. Accounting policies (continued)

Segment reporting

A business segment is defined as a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments.

A geographical segment is defined as a group of assets and operations engaged in providing products or services within a particular economic environment that are subject to risks and returns that are different from those of segments operating in other economic environments.

Fair value measurement

Fair value is defined as the amount for which an asset could be exchanged or a liability settled, between willing parties in an arms length transaction.

Where the classification of a financial asset or liability requires it to be stated at fair value, the fair value is determined by reference to the quoted bid or offer price in the most advantageous active market to which the Group entity has immediate access, wherever possible. An adjustment for credit risk is also incorporated into the fair value.

Fair value for a net open position in a financial liability that is quoted in an active market is the current offer price, and for a financial asset the bid price, multiplied by the number of units of the instrument held or issued.

Where no such active market exists for the particular asset or liability, the Group uses a valuation technique to arrive at the fair value, including the use of transaction prices obtained in recent arms length transactions, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. In doing so, fair value is estimated using a valuation technique that makes maximum use of market inputs and places minimal reliance upon entity-specific inputs.

The best evidence of the fair value of a derivative at initial recognition is the transaction price (i.e., the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group recognises profits on day one.

Primary difference in comparative financial periods
Under previous UK GAAP, financial instruments were typically valued at mid-market prices.

Assets

Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, including: cash and liquid assets, amounts due from other banks (to the extent less than 90 days) and short-term government securities.

Cash and cash equivalents are brought to account at the face value or the gross value of the outstanding balance where appropriate.

Due from other banks

Due from other banks includes certain loans, reverse repurchase agreements, nostro balances, and settlement account balances due from other financial institutions.

2. Accounting policies (continued)

Items classified as fair value through profit and loss

Upon initial recognition financial assets may be designated as FVTPL. This classification can only be used in the following circumstances:

- Designating instruments will eliminate or significantly reduce measurement or recognition inconsistencies (eliminate an accounting mismatch) that would otherwise arise from measuring assets or liabilities on a different basis.

  Under this criterion the Group has elected to designate certain individually hedged customer loans and their underlying derivatives at FVTPL on transition to IFRS. Derivatives at FVTPL are predominantly fixed interest rate swaps hedging fixed interest rate loans. The fair value of derivatives at FVTPL is based on the current active market rates. Significant terms and conditions affecting the timing and future cash flow of the loans are the principal amount, term, repayment frequency, and fluctuations in interest rates. Designating the loans at fair value minimises future volatility within the income statement as movement caused by interest rate fluctuations are largely offset by an equal and opposite movement in the underlying derivative financial instruments.

- If an embedded derivative is required to be separated from the host contract but cannot be reliably fair valued.

- Assets and liabilities are both arranged and their performance is evaluated on a fair value basis, in accordance with documented risk management and investment strategies.

Once a financial instrument has been designated as FVTPL it is not possible subsequently to change the designation.

Primary difference in comparative financial periods
These loans were previously accrual accounted under UK GAAP.

Derivative financial instruments and hedge accounting

All derivatives are recognised in the balance sheet at fair value on trade date and are classified as trading except where they are designated as part of an effective hedge relationship. The carrying value of a derivative is measured at fair value throughout the life of the contract. Derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative.

The method of recognising the resulting fair value gain or loss on a derivative depends on whether the derivative is designated as a hedging instrument and, if so, the nature of the item being hedged. The Group designates certain derivatives as either hedges of the fair value of recognised assets or liabilities or firm commitments (fair value hedge); or hedges of highly probable future cash flows attributable to a recognised asset or liability, or a highly probable forecast transaction (cash flow hedge). Hedge accounting is used for derivatives designated in this way provided certain criteria are met.

The Group documents, at the inception of a transaction, the relationship between hedging instruments and the hedged items, and the Group's risk management objective and strategy for undertaking these hedge transactions. The Group documents how effectiveness will be measured throughout the life of the hedge relationship and its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

Fair value hedge
The carrying value of the hedged item on initial designation is adjusted for the fair value attributable to the hedged risk. Subsequent to initial designation, changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. The movement in fair value of the hedged item attributable to the hedged risk is made as an adjustment to the carrying value of the hedged asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item is amortised to the income statement on an effective yield basis over the remaining period of the original hedge relationship.

2. Accounting policies (continued)

Derivative financial instruments and hedge accounting (continued)

Cash flow hedge
The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised in equity, while the gain or loss relating to the ineffective portion is recognised immediately in the income statement. The carrying value of the hedged item is not adjusted.

Amounts accumulated in equity are transferred to the income statement in the period in which the hedged item will affect profit or loss.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction ultimately affects profit or loss. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Derivatives that do not qualify for hedge accounting
Certain derivative instruments do not qualify for hedge accounting. This could occur for two reasons:-
- The Group has classified the derivative as a trading item; or
- The derivative does not meet the criteria for hedge accounting.

In both these cases the derivative is classified as a trading derivative. Changes in the fair value of trading derivatives are recognised immediately in the income statement.

Primary difference in comparative financial periods
In the comparative period, derivatives (other than foreign currency) that were held or issued for purposes other than trading were not recorded on balance sheet at fair value. If derivatives used to manage interest rate exposure were terminated early, any resulting gain or loss was deferred within 'other assets' or 'other liabilities' and amortised to the income statement over the remaining period originally covered by the terminated contract. If the underlying interest rate exposure position ceased to exist, any deferred gain or loss was recognised immediately in the income statement.

Interest accruals, premiums and realised settlement accounts arising on derivatives used to hedge exposures arising from anticipated future transactions, were deferred within other assets or other liabilities until such time as the accounting impact of the anticipated transaction was recognised in the financial statements. Such amounts only qualified for deferral where there was a high probability of the future transaction materialising. If it became apparent that the future transaction would not materialise, any deferred amounts were recognised immediately in the income statement.

Purchases and sales of financial assets classified within fair value through profit and loss were recognised on trade date, being the date that the Group was committed to purchase or sell an asset.

Available for sale investments

Available for sale investments are non-derivative financial assets that are designated as available for sale and are not categorised into any of the categories of (i) fair value through profit and loss (ii) loans and receivables or (iii) held to maturity. Available for sale investments primarily comprise debt and equity securities.

Available for sale investments are initially recognised at fair value including direct and incremental transaction costs. They are subsequently held at fair value. Gains and losses arising from changes in fair value are included as a separate component of equity until sale when the cumulative gain or loss is transferred to the income statement.

Interest income is determined using the effective interest method. Impairment losses and translation differences on monetary items are recognised in the income statement within the period in which they arise. Available for sale investments are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all the risks and rewards of ownership.

Consistent with financial assets the Group applies trade date accounting to purchases and sales of available for sale investments.

2. Accounting policies (continued)

Available for sale investments (continued)

Primary difference in comparative financial periods
Whilst the Group classified financial assets as available for sale, they were recorded at the lower of aggregate cost and fair value. Cost was adjusted for the amortisation of premiums and accretion of discounts to maturity. Unrealised losses in respect of market value adjustments and realised profits and losses on available for sale securities were recognised in the income statement.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and which are not classified as 'available for sale' or designated at fair value through profit and loss. They arise when the Group provides money or services directly to a customer with no intention of trading the loan. Loans and receivables include overdrafts, credit card lending, market rate advances, bill financing, housing loans, lease finance and term lending.

Loans and receivables are recorded at amortised cost, using the effective interest method, adjusted for impairment losses and unearned income. They are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all the risks and rewards of ownership.

As noted above, in certain limited circumstances the Group applies the fair value measurement option to financial assets. This option is applied to loans and advances where there is an embedded derivative within the loan contract and the Group has entered into a derivative to offset the risk introduced by the embedded derivative. The loan is designated as being carried at fair value through profit and loss to offset the movements in the fair value of the derivative within the income statement.

Primary difference in comparative financial periods
Loans and receivables were carried at recoverable amount represented by the gross value of the outstanding balance adjusted for a provision for doubtful debts and unearned income. Interest was recognised as revenue when it was earned.

Repurchase and reverse repurchase agreements

Securities sold subject to repurchase agreements ("repos") are valued at amortised cost and reclassified in the financial statements as pledged assets when the transferee has the right by contract or custom to sell or repledge the collateral. The counterparty liability is included in amounts due to other banks, deposits from banks, other deposits or deposits due to customers as appropriate, based upon the counterparty to the transaction.

Securities purchased under agreements to resell ("reverse repos") are valued at amortised cost and accounted for as collateralised loans. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method. Securities lent to counterparties are also retained in the financial statements.

Impairment of financial assets

The Group assesses at each balance sheet date whether there is evidence that a financial asset or a portfolio of financial assets is impaired. A financial asset or portfolio of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more loss events that occurred after the initial recognition of the asset and prior to the balance sheet date ('a loss event'), and that loss event or events has had an impact on the estimated future cash flows of the financial asset or the portfolio that can be reliably estimated.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

2. Accounting policies (continued)

Impairment of financial assets (continued)

For loans and receivables and held to maturity investments, the amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The amount of the loss is recognised using an allowance account and the amount of the loss is included in the income statement.

Financial assets at fair value through the profit and loss are not assessed for impairment as their fair value reflects the credit quality of the instrument and changes in fair value are recognised in the income statement.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar risk characteristics, taking into account asset type, industry, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the counterparty's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not currently exist. In addition, the Group uses its experienced judgement to estimate the amount of an impairment loss. This incorporates amounts calculated to overcome model deficiencies and systemic risks where appropriate and supported by historic loss experience data. The use of such judgements and reasonable estimates is considered by management to be an essential part of the process and does not impact reliability.

The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Following impairment, interest income is recognised using the original effective rate of interest which was used to discount the future cash flows for the purpose of measuring the impairment loss.

When a loan is uncollectible, it is written off against the related provision. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the provision for loan impairment in the balance sheet.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement.

In the case of equity instruments classified as available for sale, the Group seeks evidence of a significant or prolonged decline in the fair value of the security below its cost to determine whether impairment exists. Where such evidence exists, the cumulative net loss that has been previously recognised directly in equity is removed from equity and recognised in the income statement. In the case of debt instruments classified as available for sale, impairment is assessed based on the same criteria as all other financial assets. Reversals of impairment of debt securities classified as available for sale are recognised in the income statement. Reversals of impairment of equity shares classified as available for sale are not recognised in the income statement. Increases in the fair value of equity shares classified as available for sale after impairment are recognised directly in equity.

2. Accounting policies (continued)

Impairment of financial assets (continued)

Primary differences in comparative financial periods
The Group adopted a statistically based provisioning method for its provision for doubtful debts. Under this method, the Group estimated the level of losses inherent, but not specifically identified, in its existing credit portfolios at balance date. This approach considered latent risks inherent in the portfolio over the full life of the loan. The statistical provisioning method was applied to existing credit portfolios, including loans and advances drawn down in the current year.

Property, plant and equipment

All freehold and long-term leasehold land and buildings are revalued annually on an existing use basis by the Directors to reflect current market values, based on advice received from independent valuers. In addition, full independent valuations are carried out on a three year cycle on an existing use basis, including directly attributable acquisition costs but without deducting expected selling costs. For properties that are vacant, valuations are carried out on an open market basis. Revaluation increments are credited to the asset revaluation reserve, unless these reverse deficits on revaluations charged to the income statement in prior years. To the extent that they reverse previous revaluation gains, revaluation losses are charged against the asset revaluation reserve. This policy is applied to assets individually. Revaluation increases and decreases are not offset, even within a class of assets, unless they relate to the same asset.

All other items of property, plant and equipment are carried at cost, less accumulated depreciation and impairment losses. Historical cost includes expenditure that is directly attributable to acquisition.

Property, plant and equipment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. The recoverable amount is the higher of (i) the asset's fair value less costs to sell and (ii) the asset's value in use.

Where a group of assets working together supports the generation of cash inflows largely independent of cash inflows from other assets or groups of assets, recoverable amount is assessed in relation to that group of assets (cash-generating unit).

With the exception of land, all items of property, plant and equipment are depreciated using the straight-line method, at rates appropriate to their estimated useful lives to the Group. Buildings and leasehold properties with more than thirty years to the expiry of the lease, are depreciated over thirty years. Leasehold properties with less than thirty years to the expiry of the lease are depreciated over ten years or the period of the lease, whichever is the shorter. Motor vehicles, fixtures and equipment are depreciated over their estimated useful lives, which range from three to ten years. Residual values are determined on the dates of acquisition and revaluation of assets, based on estimated realisable values, net of any realisation costs.

Gains or losses on the disposal of property, plant and equipment, which is determined as the difference between the net sale proceeds and the carrying amount at the time of sale are included in the income statement.

Any realised amounts in the asset revaluation reserve are transferred directly to retained earnings.

Leases

As lessee
The leases entered into by the Group as lessee are primarily operating leases. Operating lease rentals are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

2. Accounting policies (continued)

Leases (continued)

As lessor
Leases entered into by the Group as lessor, where the Group transfers substantially all the risks and rewards of ownership to the lessee, are classified as finance leases. The net investment in the lease, which is comprised of the present value of the lease payments including any guaranteed residual value and initial direct costs, is recognised as a receivable. The difference between the gross receivable and the present value of the receivable is unearned income. Income is recognised over the term of the lease using the net investment method (before tax) reflecting a constant periodic rate of return.

Assets under operating leases are included within property, plant and equipment at cost and depreciated over the useful life of the lease after taking into account anticipated residual values. Operating lease rental income is recognised within 'Other operating income' in the income statement on a straight line basis over the life of the lease. Depreciation is recognised within 'Depreciation expense' in the income statement consistent with the nature of the asset (refer to note 16, Property plant and equipment).

Liabilities

Financial liabilities

Financial liabilities comprise items such as due to other banks, due to customers, liabilities on acceptances, trading liabilities and deposits and other borrowings.

Financial liabilities may be held at fair value through profit and loss or at amortised cost. Items held at fair value through profit and loss comprise both items held for trading and items specifically designated as fair value through profit and loss at initial recognition.

Financial liabilities held at fair value through profit and loss are initially recognised at fair value with transaction costs being recognised immediately in the income statement. Subsequently they are measured at fair value and any gains and losses are recognised in the income statement as they arise.

Liabilities may be designated as fair value through profit and loss if they meet the following criteria:

- If a host contract contains one or more embedded derivative the Group may designate the entire contract as being held at fair value; or

- Designating instruments will eliminate or significantly reduce measurement or recognition inconsistencies (eliminate an accounting mismatch) that would otherwise arise from measuring assets or liabilities on a different basis; or

- Assets and liabilities are both arranged and their performance evaluated on a fair value basis in accordance with documented risk management and investment strategies.

A financial liability is classified as held-for-trading if it is incurred principally for the purpose of selling in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking, or it is a derivative (not in a qualifying hedge relationship).

All other financial liabilities are measured at amortised cost using the effective interest method. A financial liability is derecognised from the balance sheet when the Group has discharged its obligation, the contract is cancelled or expires.

Primary difference in comparative financial periods
There was no equivalent classification for liabilities designated at fair value through profit and loss in comparative reporting periods. Financial liabilities were brought to account at the gross value of the outstanding balance. Interest expense on financial liabilities was recognised as an expense as it was incurred.

Financial liabilities were previously derecognised where the Group had constructively extinguished its obligations under the liability.

2. Accounting policies (continued)

Provisions

Provisions are recognised when a legal or constructive obligation exists as a result of past events and it is probable that an outflow of economic benefit will be necessary to settle the obligation, and it can be reliably estimated. Provisions are not discounted to the present value of their expected net future cash flows except where the time value of money is considered material.

Contingent liabilities are possible obligations whose existence will be confirmed only by uncertain future events or present obligations where the transfer of economic benefit is uncertain or cannot be reliably measured. Contingent liabilities are not recognised in the balance sheet but are disclosed unless they are remote.

Non-lending losses

Provision for non-lending losses is raised for losses to be incurred by the Group, which do not relate directly to amounts in respect of principal and interest outstanding for loans and advances.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation as at the reporting date, taking into account the risks and uncertainties that surround the events and circumstances that affect the provision.

Restructuring costs

Provisions for restructuring costs include provisions for expenses incurred but not yet paid and future expenses that will arise as a direct consequence of decisions already made. A provision for restructuring costs is only made where the Group has made a commitment and entered into an obligation such that it has no realistic alternative but to carry out the restructure and make future payments to settle the obligation. Provision for restructuring costs is only recognised when a detailed plan has been approved and the restructuring has either commenced or has been publicly announced. This includes the cost of staff termination benefits and surplus leased space. Costs related to ongoing activities are not provided for.

Surplus leased space

Surplus lease space is an onerous contract and a provision is recognised when the expected benefits to be derived from the contract are less than the costs that are unavoidable under the contract. This arises where premises are currently leased under non-cancellable operating leases and either the premises are not occupied, or are being sub-leased for lower rentals than the Group pays, or there are no substantive benefits beyond a known future date. The provision is determined on the basis of the present value of net future cash flows.

Financial guarantees

The Group provides guarantees in the normal course of business on behalf of its customers. Guarantees written are conditional commitments issued by the Group to guarantee the performance of a customer to a third party. Guarantees are primarily issued to support direct financial obligations such as commercial bills or other debt instruments issued by a counterparty. It is the rating of the Group as a guarantee provider that enhances the marketability of the paper issued by the counterparty in these circumstances.

Financial guarantees are recognised at the greater of the unearned revenue or any provision that arises when a claim obligation is probable.

2. Accounting policies (continued)

Pension and post retirement costs

Employees of the Group are entitled to benefits on retirement, disability or death from the Group's superannuation plans. The Group operates both defined benefit and defined contribution pension schemes.

The defined contribution scheme receives fixed contributions from Group companies and the Group's obligation for contributions to these plans are recognised as an expense in the income statement as incurred. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payment is available.

The defined benefit schemes provide defined benefits based on years of service and career averaged earnings. A liability or asset in respect of defined benefit superannuation plans is recognised in the balance sheet and is measured as the present value of the defined benefit obligation at the reporting date less the fair value of the superannuation fund's assets at that date and any unrecognised past service cost.

The present value of the defined benefit obligations for each scheme is discounted by the AA corporate bond rates for bonds that have maturity dates approximating to the terms of the Group's obligations.

The Group does not offset pension assets and liabilities arising from different defined benefit plans.

Pension expense attributable to the Group's defined benefit plans comprises current service cost, interest cost, expected return on plan assets, curtailment gains and past service cost. The Group's policy where actuarial gains and losses arise as a result of actual experience is to fully recognise such amounts directly into retained earnings.

Primary difference in comparable financial periods
Previously under UK GAAP the deficit on defined benefit plans was disclosed in the financial statements but not recognised on the balance sheet. Contributions to the pensions schemes were recognised in the income statement over the expected working lives of employees.

Income tax

Income tax expense or revenue is the tax payable (or receivable) on the current period's taxable income based on the applicable tax rate adjusted by changes in deferred tax assets and liabilities.

Deferred tax assets and liabilities are recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates and laws that have been enacted or substantially enacted by the balance sheet date are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled. A deferred tax asset or liability is not recognised if it arises from initial recognition of an asset or liability (in a transaction other than a business combination) that at the time of the transaction affects neither accounting profit nor taxable profit or loss.

Deferred tax assets are only recognised for temporary differences, unused tax losses and unused tax credits if it is probable that future taxable amounts will arise to utilise those temporary differences and losses.

Deferred liabilities are not recognised for temporary differences arising from investments in subsidiaries and associates where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future. Deferred tax assets are not recognised for temporary differences arising from investments in subsidiaries and associates where it is probable that the difference will not reverse in the foreseeable future, and it is not probable that taxable profit will be available against which the temporary difference can be utilised.

The effects of income taxes arising from asset revaluation adjustments are recognised directly in the asset revaluation reserve where relevant.

Deferred tax assets and liabilities related to fair value re-measurement of cash flow hedges, which are charged or credited directly to equity, are also credited or charged directly to equity. The tax associated with these transactions will be recognised in the income statement at the same time as the underlying transaction.

2. Accounting policies (continued)

Income tax (continued)

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it is related to items recognised in equity, in which case the tax is also recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Subordinated debt and related entity balances

Subordinated debt and related entity balances are recorded at amortised cost.

Debt issues

Debt issues are short and long term debt issued by the Group including commercial paper, notes, term loans and medium term notes. Debt issues are typically recorded at amortised cost using the effective interest method. Premiums, discounts and associated issue expenses are recognised using the effective interest method through the income statement from the date of issue to accrete the carrying value of securities to redemption values by maturity date. Interest is charged to the income statement using the effective interest method. Embedded derivatives within debt instruments must also be separately accounted for where not closely related to the terms of the host debt instrument. These embedded derivative instruments are recorded at fair value with gains and losses on the embedded derivative recorded in the income statement.

Where debt issues are classified as held at fair value through profit and loss they are initially recognised at fair value with transaction costs being recognised immediately in the income statement. Subsequently they are measured at fair value and any gains and losses are recognised in the income statement as they arise.

Primary difference in comparative financial periods
Under UK GAAP the embedded derivative liability was not separately accounted for, nor was there an option available to classify the debt issue as being carried at fair value through profit and loss.

Revenue and expense recognition

Net interest income

Interest income is reflected in the income statement using the effective interest method.

The effective interest method is a method of calculating amortisation using the effective interest rate of a financial asset or financial liability. The effective interest rate is the rate that exactly discounts the estimated stream of future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or liability.

When calculating the effective interest rate, the cash flows are estimated considering all contractual terms of the financial instrument (e.g. prepayment, call and similar options) excluding future credit losses.

The calculation of the effective interest rate includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. Where it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments) are used.

Loan origination fees are recognised as revenue over the life of the loan as an adjustment of yield. Commitment fees are deferred, and recognised over the life of the loan as an adjustment of yield, or if unexercised, recognised as revenue upon expiration of the commitment. Where commitment fees are retrospectively determined and nominal in relation to market interest rates on related loans, commitment fees are recognised as revenue when charged. Where the likelihood of exercise of the commitment is remote, commitment fees are recognised as revenue over the commitment period. Loan related administration and service fees are recognised as revenue over the period of service.

2. Accounting policies (continued)

Net interest income (continued)

Direct loan origination costs are netted against loan origination fees and the net amount recognised as revenue over the life of the loan as an adjustment of yield. All other loan related costs are expensed as incurred.

Primary difference in comparative financial periods
Under UK GAAP, loan origination and other fee revenue was either recognised immediately in the income statement or deferred in the balance sheet and amortised as an adjustment to yield over the expected life of the loan.

Fees and commissions

Unless included in the effective interest calculation, fees and commissions are recognised on an accruals basis when the service has been provided. Fees and commissions not integral to the effective interest rate arising from services provided to customers and third parties are recognised once the service has been provided.

Commitment fees, together with related direct costs, for loan facilities where draw down is probable are deferred and recognised as an adjustment to the effective yield on the loan once drawn. Commitment fees in relation to facilities where draw down is not probable are recognised over the term of the commitment.

Gains less losses on financial instruments at fair value through profit and loss

Gains less losses on financial instruments at fair value through profit and loss comprises fair value gains and losses from three distinct activities:

- trading financial instruments;
- hedging assets, liabilities and derivatives designated in hedge relationships; and
- financial assets and liabilities designated at fair value through profit and loss.

Trading financial instruments recognises fair value movements on all trading financial instruments. For trading derivatives a full fair value is determined inclusive of interest income and expense arising on those derivatives. Interest income and expense on trading securities is reported within interest income and not included in the fair value movement on these instruments.

Hedging assets, liabilities and derivatives designated in hedge relationships recognises fair value movements on both the hedged item and hedging derivative in a fair value hedge relationship, and hedge ineffectiveness for both fair value and cash flow hedge relationships.

Financial instruments designated at fair value through profit and loss recognises fair value movements (excluding interest) on those items designated as fair value through profit and loss at inception.

Interest income and interest expense on hedging assets, liabilities and derivatives and financial assets and liabilities designated as fair value through profit and loss at initial recognition are recognised in net interest income.

Primary difference in comparative financial periods
There was no direct equivalent accounting policy under previous UK GAAP.

Net revenue or expense on derivatives used to manage interest rate risk was recognised in net interest income on an accruals basis.

2. Accounting policies (continued)

Equity based compensation

The Group engages in share-based payment transactions in respect of services received from certain of its employees. The fair value of the services received is measured by reference to the fair value of the shares or share options of NAB granted, on the date of the grant. The cost of the employee service received is measured by reference to the fair value of the shares or share options of NAB granted, on the date of the grant. The cost of the employee service received in respect of the shares or share options granted is recognised in the income statement over the period that the services are received by the Group, which is the vesting period, with a consequent increase in equity. The increase in share option reserve is reduced on repayment to the ultimate parent company.

The fair value of the options granted is determined using option pricing models, which take into account the exercise price of the option, the current share price, the risk free interest rate, the expected volatility of the NAB share price over the life of the option and other relevant factors. In the absence of market prices, the fair value of the instruments at the date of the grant is estimated using an appropriate valuation technique.

Except for those which include terms related to market conditions, vesting conditions included in the terms of the grant are not taken into account in estimating fair value.

Non market vesting conditions are taken into account by adjusting the number of share or share options included in the measurement of the cost of employee services so that ultimately, the amount recognised in the income statement reflects the number of vested shares or share options. Where vesting conditions are related to market conditions, the charges for the services received are recognised regardless of whether or not the market related vesting condition is met, provided that the non market vesting conditions are met.

Primary difference in comparative financial periods
No cost was recognised in respect of share based payment transactions under UK GAAP.

Accounting developments

During the year the IASB and International Financial Reporting Interpretations Committee issued the following standards and interpretations with an effective date after the date of these financial statements:

International Accounting Standards (IAS/IFRS)		***Effective Date: Annual periods beginning on or after***
IFRS 4	Insurance Contracts (Amendment to IAS 39 and IFRS 4 - Financial Guarantee Contracts)	1 January 2006
IFRS 7	Financial Instruments: Disclosures	1 January 2007
IAS 1	Amendment - Presentation of Financial Statements: Capital Disclosures	1 January 2007
IAS 19	Amendment - Actuarial Gains and Losses, Group Plans and Disclosures	1 January 2006
IAS 39	Fair Value Option	1 January 2006
IAS 39	Amendments to IAS 39 - Transition and Initial Recognition of Financial Assets and Financial Liabilities (Day 1 profits)	1 January 2006
IAS 39	Cash Flow Hedge Accounting	1 January 2006
IAS 39	Amendment to IAS 39 and IFRS 4 - Financial Guarantee Contracts	1 January 2006

2. Accounting policies (continued)

Accounting developments (continued)

International Financial Reporting Interpretations Committee

IFRIC 4	Determining whether an arrangement contains a lease	1 January 2006
IFRIC 8	Scope of IFRS 2	1 May 2006
IFRIC 9	Reassessment of embedded derivatives	1 January 2006
IFRIC 10	Interim Financial Reporting and Impairment	1 November 2006

As described above the Group has decided to early adopt the amendments to IAS 19 and IAS 39. The Group is reviewing the other standards and interpretations listed above to determine their effect on its financial reporting.

The directors do not anticipate that the adoption of these standards and interpretations will have a material impact on the Group's financial statements in the period of initial application.

Upon adoption of IFRS 7, the Group will have to disclose additional information about its financial instruments, their significance and the nature and extent of risks that they give rise to. More specifically the Group will need to disclose the fair value of its financial instruments and its risk exposure in greater detail. There will be no effect on reported income or net assets.

3. Nature of business and segmental reporting

For the purposes of this note a business segment is a distinguishable component of the entity that is engaged in providing groups of related products and services and that is subject to risks and returns that are different from those of other business segments. Separate financial information for each segment is reported to the UK Executive Committee for the purposes of evaluating performance.

The Group's business is organised into two main operating segments: Financial Services UK and nabCapital. Financial Services UK is the retailing arm of the Group, providing a full range of financial services to customers. nabCapital is responsible for the Group's relationships with large corporations and institutions.

Revenue and expenses directly associated with each business segment are included in determining their result. There are no material transactions between business segments. Segment revenue represents revenue directly attributable to a segment and a portion of the Group's revenue that can be allocated to a segment on a reasonable basis. Segment result represents segment revenue less segment expenses and impairment losses on credit exposures and after income taxes.

2006	**Financial Services UK £m**	**nabCapital £m**	**Total £m**
Net interest income	763	19	782
Non interest income	301	33	334
Income after operating profit	155	-	155
Segment revenue	1,219	52	1,271
Segment result	296	30	326
Total assets	26,732	2,250	28,982
Total liabilities	20,979	6,320	27,299
Other segment items			
Acquisition of property, plant & equipment	49	-	49
Depreciation of property plant & equipment	46	-	46
Impairment losses:			
Recognised in income statement	128	1	129
Amounts written off	154	-	154
Recoveries of amounts written off in previous years	42	-	42

3. Nature of business and segmental reporting (continued)

2005	**Financial Services UK £m**	**nabCapital £m**	**Total £m**
Net interest income	586	18	604
Non interest income	312	22	334
Income after operating profit	21	-	21
Segment revenue	919	40	959
Segment result	98	26	124
Total assets	19,994	2,421	22,415
Total liabilities	18,758	2,569	21,327
Other segment items			
Acquisition of property, plant & equipment	34	-	34
Depreciation of property plant & equipment	49	-	49
Impairment losses:			
Recognised in income statement	87	(1)	86
Amounts written off	135	-	135
Recoveries of amounts written off in previous years	45	-	45

Geographical segments

The Group has no material segments outwith the UK and thus no secondary geographical segment information is presented.

4. Non interest income

	2006	2005
	£m	£m
Gains less losses on financial instruments at fair value		
Foreign exchange derivatives	**15**	-
Interest rate derivatives	**1**	-
Other derivatives	**(1)**	-
Movement in fair value of assets	**22**	-
Ineffectiveness arising from hedging relationships	**1**	-
	38	-
Other operating income		
Fee and commission income	**224**	255
Operating lease income	**33**	35
Profit on sale of fixed assets	**2**	3
Other income	**37**	41
	296	334
Total non interest income	**334**	334

5. Operating expenses

	2006	2005
	£m	£m
Personnel expenses		
Salaries, wages and non cash benefits	**164**	147
Related personnel expenses	**14**	12
Defined contribution pension expense	**2**	1
Defined benefit pension expense	**10**	25
Employee share compensation	**9**	8
Other personnel expenses	**8**	8
	207	201
Depreciation expense		
Depreciation of property, plant & equipment (note 16)	**46**	49
Other operating expenses		
Operating lease rental	**31**	23
Other occupancy expenses	**36**	40
Related entity recharges	**250**	257
Other operating expenses	**106**	28
	423	348
Total operating expenses	**676**	598

Auditors' remuneration included within other operating expenses (including irrecoverable VAT):

	2006	2005
	£'000	£'000
Audit		
Audit services	**916**	487
Further assurance services	**111**	275
	1,027	762

6. Income tax expense

a) Analysis of charge in the period

Tax charged in the income statement

The charge for taxation comprises:	**2006 £m**	2005 £m
Current tax		
United Kingdom corporation tax at 30% (2005 30%)	**86**	66
Deferred tax		
Origination and reversal of temporary differences		
- current year	**61**	(3)
- prior year	**(7)**	-
Total deferred income tax	**54**	(3)
Income tax expense reported in income statement	**140**	63

Tax relating to items charged or credited to equity

	2006 £m	2005 £m
Current tax		
Release of pension restructuring provision	**(6)**	-
Deferred tax asset		
Actuarial gains and losses on pension schemes	**6**	3
Employee share compensation	**(2)**	-
Deferred tax liability		
Net gain on revaluation of cash flow hedges	**(6)**	-
Tax (credit)/charge in the statement of recognised income and expense	**(8)**	3

b) Factors affecting tax charge for the period

The tax assessed for the period reflects the standard rate of corporation tax in the UK (30%). The factors are explained below:

	2006 £m	2005 £m
Profit on ordinary activities before tax	**466**	187
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 30% (2005 30%)	**140**	56
Effects of:		
Expenses not deductible for tax purposes	**7**	7
Adjustments to tax charge in respect of previous periods	**(7)**	-
Total income tax charge for period	**140**	63

7. Profit dealt with in the financial statements of the Bank

The profit on ordinary activities after tax of the Bank for the year is £309m (2005: £139m).

8. Cash and balances with central banks

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Cash assets	**1,986**	1,085	**2,189**	1,085
Balances with central banks	**27**	22	**27**	22
	2,013	1,107	**2,216**	1,107

Balances with central banks are mandatory deposits which are not available for use in the Group's day to day business.

9. Loans and advances to other banks

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Transaction balances with other banks	**14**	347	**9**	347
Placements with other banks	**481**	36	**481**	36
	495	383	**490**	383

10. Derivative financial instruments

Use of derivatives

The Group uses derivatives to hedge its own balance sheet position. The Group's principal objective in holding or issuing derivatives is asset and liability management.

The operations of the Group are subject to the risk of interest rate fluctuations, to the extent that there is a difference between the amount of the interest-earning assets and the amount of interest-bearing liabilities that mature or reprice in specified periods. The principal objectives of asset and liability management are to protect levels of net interest income, while maintaining acceptable levels of interest rate liquidity risk and to facilitate the funding needs of the Group.

To achieve these objectives, the Group uses a combination of derivative financial instruments, including foreign exchange forward rate agreements, swaps, options, caps, floors, and other contingent contracts. These hedge transactions within the Group are entered into with NAB. Provided IAS 39 cash flow hedging criteria are met, the fair value changes on the related hedging instruments are deferred in the cash flow reserve and transferred to the income statement at the time the hedged item affects income. Hedge effectiveness is monitored, and any hedge ineffectiveness is recognised in the income statement immediately.

The Group does not trade in any financial instruments including derivatives and therefore does not have a trading book. However, certain historical derivatives within the Group do not meet the IAS 39 hedging criteria. These derivatives are designated as trading derivatives and their movement in fair value will directly impact income. The majority of these derivatives matured during the year ending 30 September 2006.

Derivatives

A derivative financial instrument is a contract or agreement whose value is related to the value of an underlying instrument, reference rate or index. Derivatives are usually separated into three generic classes: forward and futures contracts, options, and swaps, although individual products may combine the features of more than one class. The principal features of each of these classes, for derivatives that the Group enters into, are summarised below.

Forward and futures contracts
Forward and futures contracts are contracts for delayed delivery of a specific underlying asset in which the seller agrees to settle at a specified future date at a specified price or yield. A forward rate agreement is a confirmed agreement between two parties to exchange an interest rate differential on a notional principal amount at a given future date.

10. Derivative financial instruments (continued)

Options

Options are contracts that allow the holder of the option the right, but not the obligation, to purchase or sell a financial instrument at a specified price and within a specified period. Interest rate caps and floors are option contracts and are included as such in the disclosures below. They require the seller to pay the purchaser at specified future dates the amount, if any, by which a specified market interest rate exceeds the fixed cap rate or falls below the fixed floor rate, applied to the notional principal amount.

Swaps

Interest rate swap transactions generally involve the exchange of fixed and floating interest payment obligations without the exchange of the underlying notional principal amount. A cross currency swap takes the form of an agreement to exchange one currency for another and to re-exchange the currencies at the maturity of the swap, using the same exchange rate, with the exchange of interest payments throughout the swap period.

Other financial instruments

In addition to derivatives, various financial instruments, for example loans and advances, deposits, debt securities, trade debtors and creditors and accruals, arise directly from the Group's operations. Where the fair value of these differ from the book value details are given in the appropriate note to the financial statements. The disclosures in these notes include all short-term debtors and creditors.

Risk Management

The Group's management of certain risk factors that may impact the future results is discussed in the "Risk Overview" section on pages 86 to 89. The factors discussed should not be considered to be the complete list of all potential risks.

Group and Bank

2006	**Contract Amount**	**Fair Value Assets**	**Fair Value Liabilities**
	£m	**£m**	**£m**
Total derivatives held			
Foreign exchange rate related contracts			
Spot, forwards and futures	2,829	33	31
Currency swaps	407	-	-
Options	391	4	4
Total foreign exchange rate related contracts	3,627	37	35
Interest rate related contracts			
Swaps	14,780	42	69
Options	4,113	15	35
Total interest rate related contracts	18,893	57	104
Commodity derivatives	50	3	3
Equity and other derivatives	27	-	-
	77	3	3
Total derivative contracts	**22,597**	**97**	**142**

Derivative contracts are disclosed as follows:

	Fair Value Assets	**Fair Value Liabilities**
	£m	**£m**
Derivative financial assets and liabilities	13	32
Other derivative financial liabilities at fair value through profit and loss (note 11)	84	61
Derivative financial liabilities at fair value - related entities (note 11)	-	49
	97	**142**

10. Derivative financial instruments (continued)

Cash flow hedges
Included in the above are the following cash flow hedge derivatives:

	Contract	Fair Value	
	Amount	Assets	Liabilities
	£m	£m	£m
Interest rate-related contracts	6,429	5	9

The cash flow hedge derivatives are taken out as Sterling interest rate related Swaps designed to mitigate the Group's tailored business loans exposure. These are a combination of fixed and floating rate deals and the Group's commitments have the following maturity profile:

Buy	£m
0 to 6 months	1,677
6 to 12 months	1,126
1 to 2 years	1,989
2 to 5 years	1,637
	6,429

The Group has hedged the following forecast cash flows, which primarily vary with interest rates. These cash flows are expected to impact the income statement in the following periods, excluding any hedge adjustments that may be applied:

2006	Forecast receivable cash flows	Forecast payable cash flows
	£m	£m
- within one year	34	149
- between one and two years	12	79
- between two and three years	14	31
- between three and four years	24	-
- between four and five years	10	-
	94	259

Fair value hedges
The Group has the following fair value hedges that are designated as sterling interest rate related swaps and are raised to cover subordinated debt issued.

Buy	£m
0 to 6 months	200
2 to 5 years	500
over 5 years	120
	820

In addition the Group has a cross currency related swap, designated as a fair value hedge, which was taken out to mitigate the Euro exposure created on the issue of medium term notes on 15 September 2006 (note 23).

Buy		£m
2 to 5 years	Exchange rate £/Euro = 1.473	407

10. Derivative financial instruments (continued)

In accordance with the requirements of IFRS 1 "First Time Adoption of International Financial Reporting Standards" the following derivative tables for 2005 are disclosed as previously reported under UK GAAP.

Summary of outstanding derivative contracts

2005	Contract	Fair Value	
Group	Amount	Positive	Negative
	£m	£m	£m
Non trading derivatives			
Foreign exchange derivatives			
Forward foreign exchange	2,329	27	19
Other foreign exchange	220	1	1
Total	2,549	28	20
Equity derivatives			
Options	46	1	-
Commodity derivatives			
Options	8	-	-
Interest rate derivatives			
Swaps	9,744	55	112
Forward rate agreements	45	-	-
Options	2,558	23	21
Total	12,347	78	133
Total non trading derivatives	14,950	107	153

Counterparty

An analysis of the contract amount and positive fair value of investments entered into with third parties by the counterparty type is set out below:

	Contract amount 2005 £m	Fair value 2005 £m
Ultimate parent company and fellow subsidiary undertakings	11,858	62
Other OECD Banks	23	1
Other	3,069	44
Total	**14,950**	**107**

10. Derivative financial instruments (continued)

Unrecognised gains/(losses) on instruments used for hedging

2005	**Gains £m**	**Losses £m**	**Total net gains/(losses) £m**
At 1 October 2004 (as restated)	84	175	(91)
Gains and losses arising in previous years that were recognised in year ended 30 September 2004	33	83	50
Gains and losses arising before 1 October 2004 that were not recognised in year ended 30 September 2005	51	92	(41)
Gains and losses arising after 1 October 2004 that were not recognised in year ended 30 September 2005	56	(61)	(5)
At 30 September 2005	**107**	**153**	**(46)**
Of which gains and losses expected to be recognised in the year ended:			
30 September 2006	32	25	7
30 September 2007 or after	75	128	(53)

11. Financial assets and liabilities at fair value through profit and loss

Group and Bank	**2006 £m**	2005 £m
Financial assets at fair value		
Loans designated at fair value through profit and loss	**2,141**	-
Financial liabilities at fair value		
Derivative financial liabilities at fair value - related entities	**49**	-
Deposits at fair value through profit and loss	**116**	-
Other net derivative financial liabilities designated at fair value through profit and loss	**(23)**	-
	142	-

12. Available for sale investments

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Other securities				
- Listed	**204**	2	**3**	2

13. Loans and advances to customers

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Overdrafts	**3,380**	3,217	**3,580**	3,222
Credit cards	**614**	657	**614**	659
Lease finance	**1,445**	876	**734**	943
Housing loans	**9,569**	7,302	**6,425**	4,565
Other wholesale placements	**116**	-	**-**	-
Other term lending	**7,200**	7,598	**7,200**	7,648
Other lending	**3**	2	**3**	2
Gross loans and advances to customers	**22,327**	19,652	**18,556**	17,039
Unearned income	**(257)**	(334)	**(243)**	(334)
Deferred and unamortised fee income	**(39)**	-	**(35)**	-
Impairment losses on credit exposures (note 14)	**(250)**	(200)	**(241)**	(192)
	21,781	19,118	**18,037**	16,513

Lease Finance
The Group provides leasing facilities to industry, commerce and private individuals.

The costs of assets acquired by the Group during the year for the purpose of letting under finance leases and hire purchase contracts amounted to £88m (2005 £113m) and £776m (2005 £941m) respectively. The total closing balances of finance leases and hire purchase contracts were £171m (2005 £190m) and £1,150m (2005 £1,001m) respectively.

Loans and advances to customers include finance lease receivables, which may be analysed as follows:

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Gross investment in finance lease receivables:				
Due within one year	**565**	640	**317**	362
Due within one to five years	**848**	954	**397**	450
Due after more than five years	**32**	56	**20**	23
Total gross investment in lease finance receivables	**1,445**	1,650	**734**	835
Deduct: Unearned future finance income on lease receivables	**(97)**	(168)	**(84)**	(152)
Net investment in lease finance	**1,348**	1,482	**650**	683

13. Loans and advances to customers (continued)

Concentration of exposure	**Group**		**Bank**	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Commercial and industrial	**2,977**	3,020	**2,977**	3,020
Agriculture, forestry, fishing and mining	**627**	633	**627**	633
Manufacturing	**517**	615	**517**	615
Construction	**647**	662	**647**	662
Financial, investment and insurance	**18**	293	**18**	293
Property	**3,501**	2,692	**3,501**	2,692
Other lease finance	**1,445**	876	**734**	943
Personal - mortgages	**9,569**	7,304	**6,425**	4,565
Personal - other	**2,956**	2,663	**2,956**	2,724
Other	**70**	894	**154**	892
	22,327	19,652	**18,556**	17,039

14. Impairment losses on credit exposures

	Specific 2006 £m	**Collective 2006 £m**	**Total 2006 £m**	Specific 2005 £m	Collective 2005 £m	Total 2005 £m
Group						
Opening balance	**37**	**163**	**200**	45	159	204
Effect of implementing IAS 32/39 (note 40)	**(24)**	**57**	**33**	-	-	-
Restated opening balance	**13**	**220**	**233**	45	159	204
Charge for the year	**109**	**20**	**129**	82	4	86
Amounts written off	**(154)**	**-**	**(154)**	(135)	-	(135)
Recoveries of amounts written off in previous years	**42**	**-**	**42**	45	-	45
Closing balance	**10**	**240**	**250**	37	163	200
Bank						
Opening balance	**36**	**156**	**192**	43	152	195
Effect of implementing IAS 32/39 (note 40)	**(23)**	**56**	**33**	-	-	-
Restated opening balance	**13**	**212**	**225**	43	152	195
Charge for the year	**107**	**20**	**127**	80	3	83
Amounts written off	**(153)**	**-**	**(153)**	(131)	-	(131)
Reclassifications	**-**	**-**	**-**	(1)	1	-
Recoveries of amounts written off in previous years	**42**	**-**	**42**	45	-	45
Closing balance	**9**	**232**	**241**	36	156	192

14. Impairment losses on credit exposures (continued)

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Amounts included in				
Loans and advances to customers (note 13)	**250**	200	**241**	192
Non accrual loans				
Loans and advances to customers	**67**	42	**65**	21
Provisions	**(10)**	(14)	**(9)**	(13)
Total	**57**	28	**56**	8

15. Investments in controlled entities and associates

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
At 30 September	**2**	2	**35**	33

Principal controlled entities at 30 September 2006	**Nature of business**	**Country of incorporation and principal operations**
Clydesdale Bank Asset Finance Limited	Leasing and hire purchase	Scotland
Clydesdale Group Investments Limited	Group finance company	England
Yorkshire Bank Home Loans Limited	Mortgage finance	England
Yorkshire Bank Investments Limited	Investment holding	England

All the principal subsidiary undertakings are wholly owned by the Bank. Details of all subsidiary undertakings will be annexed to the next Annual Return of the Bank.

All of the above subsidiaries have a 30 September financial year end. Where a subsidiary has a financial year end other than 30 September, the consolidated financial statements include interim management accounts prepared to 30 September.

The associated undertaking is The Scottish Agricultural Securities Corporation PLC, its country of registration and operations being Scotland. The associated undertaking's principal activity is in the provision of finance and the Group's interest of 33.33% in the issued equity capital of £2,000,000 is held by the Bank. The associated undertaking has a 31 March year end. The investment is equity accounted.

16. Property, plant and equipment

Movements on property, plant and equipment

Group	Freehold land and buildings £m	Leases of 50 years and over unexpired £m	Leases of under 50 years unexpired £m	Motor vehicles, fixtures and equipment £m	Operating lease assets £m	Total £m
Cost or valuation						
At 1 October 2005	104	13	67	232	222	638
Additions	15	1	15	11	7	49
Reclassifications	-	(5)	-	5	-	-
Disposals	(17)	-	(8)	(57)	(84)	(166)
At 30 September 2006	**102**	**9**	**74**	**191**	**145**	**521**
Accumulated depreciation						
At 1 October 2005	-	-	35	194	48	277
Charge for the year	3	-	6	11	26	46
Reclassifications	-	-	1	(1)	-	-
Disposals	-	-	(6)	(57)	(17)	(80)
Released on revaluation	(3)	-	-	-	-	(3)
At 30 September 2006	**-**	**-**	**36**	**147**	**57**	**240**
Net book value						
At 30 September 2006	**102**	**9**	**38**	**44**	**88**	**281**
At 30 September 2005	104	13	32	38	174	361

Bank	Freehold land and buildings £m	Leases of 50 years and over unexpired £m	Leases of under 50 years unexpired £m	Motor vehicles, fixtures and equipment £m	Total £m
Cost or valuation					
At 1 October 2005	104	13	67	232	416
Additions	15	1	15	11	42
Reclassifications	-	(5)	-	5	-
Disposals	(17)	-	(8)	(57)	(82)
At 30 September 2006	**102**	**9**	**74**	**191**	**376**
Accumulated depreciation					
At 1 October 2005	-	-	35	194	229
Charge for the year	3	-	6	11	20
Reclassifications	-	-	1	(1)	-
Disposals	-	-	(6)	(57)	(63)
Released on revaluation	(3)	-	-	-	(3)
At 30 September 2006	**-**	**-**	**36**	**147**	**183**
Net book value					
At 30 September 2006	**102**	**9**	**38**	**44**	**193**
At 30 September 2005	104	13	32	38	187

16. Property, plant and equipment (continued)

Assets held under finance leases and hire purchase contracts

The net book value of motor vehicles, fixtures and equipment includes assets held under finance leases and hire purchase contracts of £Nil (2005: £5.4m), net of accumulated depreciation of £Nil (2005: £3.2m).

Valuations

Cost or valuation of freehold and leasehold land and buildings at 30 September comprises:

	2006	2005
	£m	£m
At current year valuation	**118**	115
At cost	**67**	69
	185	184

On the historical cost basis, freehold and leasehold land and buildings would have been included as follows:

	2006	2005
	£m	£m
Cost	**210**	211
Accumulated depreciation	**(94)**	(90)
Net book value	**116**	121

Land and buildings occupied for own activities

	2006	2005
	£m	£m
Net book value	**116**	117

17. Deferred tax

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Deferred tax asset				
Opening balance	**190**	60	**184**	54
Effect of implementing IFRS non IAS 32/39 (note 40)	**-**	117	**-**	117
Effect of implementing IAS32/39 (note 40)	**20**	-	**22**	-
Restated opening balance	**210**	177	**206**	171
Tax (credit)/expense recognised in income statement	**(64)**	16	**(64)**	16
Deferred taxation recognised in equity	**(4)**	(3)	**(4)**	(3)
Other	**5**	-	**7**	-
Closing balance	**147**	190	**145**	184

The deferred tax asset is attributable to the following items:

Defined benefit pension liability	**50**	108	**50**	108
Impairment reserve on credit exposures	**65**	50	**63**	44
Other	**32**	32	**32**	32
	147	190	**145**	184

Deferred tax liability				
Opening balance	**33**	18	**6**	-
Effect of implementing IFRS non IAS 32/39 (note 40)	**-**	2	**-**	4
Effect of implementing IAS32/39 (note 40)	**5**	-	**5**	-
Restated opening balance	**38**	20	**11**	4
Tax (credit)/expense recognised in income statement	**(10)**	13	**(4)**	2
Deferred taxation recognised in equity	**(6)**	-	**(6)**	-
Disposals	**(4)**	-	-	-
Other	**(2)**	-	-	-
Closing balance	**16**	33	**1**	6

The deferred tax liability is attributable to the following items:

Accumulated depreciation	**13**	29	**(2)**	2
Net gain on revaluation of properties	**4**	4	**4**	4
Cash flow hedge reserve	**(1)**	-	**(1)**	-
	16	33	**1**	6

18. Other assets

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Prepayments and accrued income	**244**	204	**207**	208
Other	**427**	158	**424**	156
	671	362	**631**	364

19. Due to other banks

Group and Bank	2006 £m	2005 £m
Transaction balances with other banks	**22**	78
Securities sold under agreements to repurchase	**505**	-
Deposits with other banks	**865**	655
	1,392	733

20. Due to customers

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Non interest bearing demand deposits	**1,477**	1,405	**1,436**	1,405
Interest bearing demand deposits	**11,747**	9,379	**11,789**	9,379
Term deposits	**2,509**	1,996	**2,101**	1,996
Other wholesale deposits	**1,348**	811	**1,348**	811
	17,081	13,591	**16,674**	13,591

21. Provisions

	Reorganisation £m	Other £m	Total £m
Group and Bank			
At 1 October 2005	70	9	79
Charge to income statement	-	2	2
Provisions utilised	(36)	(3)	(39)
Other	(7)	-	(7)
At 30 September 2006	**27**	**8**	**35**

Reorganisation
Following a review of operations a reorganisation provision was recognised during the year ended 30 September 2005. The provision covered the costs associated with the streamlining of operations, reductions in staffing levels and the reconfiguration of distribution networks. The programme in relation to these activities continues to run and the provision is expected to be fully utilised by 30 September 2007.

Other
This category includes:
- Provision for post-retirement health care under a defined benefit scheme for pensioners and their dependent relatives. This is a closed scheme and the provision will be utilised over the life of the remaining scheme members.
- Provision for costs associated with claims for mis-sold endowment policies. If a customer believes that an endowment policy may have been mis-sold by the Bank, they are able to have the basis of the advice examined, subject to certain time limits. The provision recognised is the best estimate of future costs given current claims experience.
- Provision for costs arising in respect of a number of legal actions and claims arising in the ordinary course of the Bank's business.

22. Retirement benefit obligations

The Group is a sponsoring employer in two funded defined benefit pension schemes, the Clydesdale Bank Pension Scheme and the Yorkshire Bank Pension Fund (the "Schemes"). The assets of the Schemes are held in separate trustee administered funds. In addition, the ultimate parent company of the Group is the sponsoring employer of a further defined benefit pensions scheme in which certain Group employees participate (the National Australia Bank UK Retirement Benefits Plan).

The Group closed the defined benefit schemes to new members in 2004, with the terms for existing staff remaining unchanged. Since that time the principal scheme available to new members is the defined contribution scheme, "Total Pension". The scheme is funded by contributions from employees and the Group, with Group contributions in the range of 3% to 11%. Following a review of arrangements in April 2006, the benefits to members have been enhanced with contributions now in the range of between 5% and 10%. In relation to this scheme, the pension charge for the year for the Group is disclosed in note 5.

In April 2006, the Group implemented a number of reforms in relation to the Schemes. Defined benefits accruing after April 2006 are determined on a "career average revalued earnings" basis. Benefits for active members which have built up to April 2006 revalue in the future in line with price inflation. Pensions in payment which built up after April 2006 increase in line with price inflation subject to a maximum annual increase of 2.5%. In relation to the Clydesdale Bank Pension Scheme, the previous position was that pre-April 1997 pensions in payment would increase each year on a discretionary basis. Such annual increases will now be guaranteed in line with price inflation, subject to a maximum of 2.5%. The impact of these changes has been incorporated in the income statement as an adjustment to past service cost. In conjunction with the reforms the Group made a special contribution of £57m to the Clydesdale Bank Scheme and £35m to the Yorkshire Bank Fund in order to reduce the deficits.

The Bank also provides post-retirement health care under a defined benefit scheme for pensioners and their dependant relatives for which provision has been made (note 21). A one percentage point change in the assumed rate of increase in healthcare costs would change the defined benefit pension obligation by £0.3m (2005: £0.3m) and would have no material impact upon service costs and interest costs.

The latest full valuations of the Schemes were carried out at 30 September 2004 and have been updated to 30 September 2006 by qualified independent actuaries.

The principal financial assumptions used in the Schemes' valuations at 30 September 2006 were as follows:

	2006	2005
	% p.a.	% p.a.
Inflation	**2.90**	2.80
Rate of increase in salaries	**N/A**	3.80
Rate of increase for pensions in payment:		
pre April 1997 (Clydesdale Bank Pension Scheme)	**2.20**	2.80
pre April 1997 (Yorkshire Bank Pension Fund)	**2.90**	2.80
post April 1997 (both Schemes)	**2.20**	N/A
Rate of increase for pensions in deferment	**2.90**	2.80
Discount rate	**5.05**	5.00
Post-retirement mortality:		
Current pensioners at 60 - male	**25 years**	25 years
Current pensioners at 60 - female	**28 years**	28 years
Future pensioners at 60 - male	**26 years**	26 years
Future pensioners at 60 - female	**29 years**	29 years

Of the total contributions made to the Schemes of £136m (2005: £49m), £14m (2005: £13m) were made by fellow group undertakings in respect of employees originally employed by the Group and entitled to continue as members of the Schemes.

The total contributions to the Schemes in 2007 are expected to be £35m.

22. Defined benefit pension liabilities (continued)

The fair value of the Schemes' assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of the Schemes' liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, were:

Clydesdale Bank Pension Scheme

	2006		2005		2004	
	£m	**% of fair value of scheme assets**	£m	% of fair value of scheme assets	£m	% of fair value of scheme assets
Assets						
Equities	**570**	**64.12**	531	69.96	505	80.54
Property	**33**	**3.71**	19	2.50	-	0.00
Government bonds	**177**	**19.91**	154	20.29	76	12.12
Corporate bonds	**59**	**6.64**	51	6.72	39	6.22
Cash	**50**	**5.62**	4	0.53	7	1.12
Total market value of scheme assets	**889**	**100.00**	759	100.00	627	100.00
Present value of scheme liabilities	**(978)**		(1,030)		(880)	
Net pension liability	**(89)**		(271)		(253)	

Yorkshire Bank Pension Fund

	2006		2005		2004	
	£m	**% of fair value of scheme assets**	£m	% of fair value of scheme assets	£m	% of fair value of scheme assets
Assets						
Equities	**523**	**64.17**	499	69.99	475	80.51
Property	**31**	**3.80**	18	2.52	-	0.00
Government bonds	**162**	**19.88**	144	20.20	71	12.03
Corporate bonds	**54**	**6.63**	48	6.73	37	6.27
Cash	**45**	**5.52**	4	0.56	7	1.19
Total market value of scheme assets	**815**	**100.00**	713	100.00	590	100.00
Present value of scheme liabilities	**(838)**		(824)		(729)	
Net pension liability	**(23)**		(111)		(139)	

The Schemes have not invested in any of the Group's own financial instruments nor in properties or other assets used by the Group.

22. Defined benefit pension liabilities (continued)

Expected rate of return on plan assets

The expected rate of return on plan assets is based on the actual split of the Schemes' assets, and the following expected rates of return of each asset type:

	Clydesdale Bank			**Yorkshire Bank**		
	2006	2005	2004	**2006**	2005	2004
	% p.a.	% p.a.	% p.a.	**% p.a.**	% p.a.	% p.a.
Equities	**8.20**	8.10	8.70	**8.20**	8.10	8.70
Property	**6.60**	6.55	7.10	**6.60**	6.55	7.10
Government bonds	**4.40**	4.30	4.90	**4.40**	4.30	4.90
Corporate bonds	**5.05**	5.00	5.50	**5.05**	5.00	5.50
Cash	**4.75**	4.50	4.75	**4.75**	4.50	4.75

Reconciliation of fair value of scheme assets

	Clydesdale Bank		**Yorkshire Bank**		**Total**	
	2006	2005	**2006**	2005	**2006**	2005
	£m	£m	**£m**	£m	**£m**	£m
Fair value of scheme assets at 1 October	**759**	627	**713**	590	**1,472**	1,217
Actual return on scheme assets	**78**	134	**72**	124	**150**	258
Employer contributions	**84**	27	**52**	21	**136**	48
Benefits paid	**(32)**	(29)	**(22)**	(22)	**(54)**	(51)
Fair value of scheme assets at 30 September	**889**	759	**815**	713	**1,704**	1,472

Reconciliation of defined benefit obligation

	Clydesdale Bank		**Yorkshire Bank**		**Total**	
	2006	2005	**2006**	2005	**2006**	2005
	£m	£m	**£m**	£m	**£m**	£m
Defined benefit obligation at 1 October	**1,030**	880	**824**	729	**1,854**	1,609
Interest cost	**48**	49	**40**	41	**88**	90
Service cost	**21**	25	**19**	26	**40**	51
Curtailment gains	**-**	(1)	**-**	(2)	**-**	(3)
Past service costs	**(108)**	2	**(37)**	4	**(145)**	6
Benefits paid	**(32)**	(29)	**(22)**	(22)	**(54)**	(51)
Actuarial loss	**16**	104	**11**	48	**27**	152
Transition of restructuring reserves	**3**	-	**3**	-	**6**	-
Defined benefit obligation at 30 September	**978**	1,030	**838**	824	**1,816**	1,854

22. Defined benefit pension liabilities (continued)

Reconciliation of balance sheet liability

	Clydesdale Bank		Yorkshire Bank		Total	
	2006	2005	**2006**	2005	**2006**	2005
	£m	£m	**£m**	£m	**£m**	£m
Balance sheet liability at 1 October	**(271)**	(253)	**(111)**	(139)	**(382)**	(392)
Employer contributions	**84**	27	**52**	21	**136**	48
Total pension expense	**93**	(25)	**28**	(22)	**121**	(47)
Statement of recognised income and expense	**8**	(20)	**11**	29	**19**	9
Transition of restructuring reserves	**(3)**	-	**(3)**	-	**(6)**	-
Balance sheet liability at 30 September	**(89)**	(271)	**(23)**	(111)	**(112)**	(382)

Pension expense for the year

	Clydesdale Bank		Yorkshire Bank		Total	
	2006	2005	**2006**	2005	**2006**	2005
	£m	£m	**£m**	£m	**£m**	£m
Current service cost	**21**	25	**19**	26	**40**	51
Past service costs	**(108)**	2	**(37)**	4	**(145)**	6
Interest cost	**48**	49	**40**	41	**88**	90
Expected return on assets	**(54)**	(50)	**(50)**	(47)	**(104)**	(97)
Curtailment gains	**-**	(1)	**-**	(2)	**-**	(3)
Total pension expense	**(93)**	25	**(28)**	22	**(121)**	47

Statement of recognised income and expense

	Clydesdale Bank		Yorkshire Bank		Total	
	2006	2005	**2006**	2005	**2006**	2005
	£m	£m	**£m**	£m	**£m**	£m
Gain on scheme assets	**24**	84	**22**	77	**46**	161
Experience losses on scheme liabilities	**-**	(1)	**-**	(8)	**-**	(9)
Loss from change in actuarial assumptions	**(16)**	(103)	**(11)**	(40)	**(27)**	(143)
Total amount recognised in SORIE	**8**	(20)	**11**	29	**19**	9
Cumulative amount recognised in SORIE	**(12)**	(20)	**40**	29	**28**	9

22. Defined benefit pension liabilities (continued)

History of experience gains and losses
Clydesdale Bank

	2006	2005
Difference between the expected and actual return on scheme assets		
Amount (£m)	**(24)**	(84)
Percentage of scheme assets	**2.70%**	11.07%
Experience gains and losses on scheme liabilities		
Amount (£m)	**-**	(1)
Percentage of the present value of the scheme liabilities	**0.00%**	0.10%
Total amount recognised in statement of recognised income and expense		
Amount (£m)	**8**	(20)
Percentage of the present value of the scheme liabilities	**0.82%**	1.94%

History of experience gains and losses
Yorkshire Bank

	2006	2005
Difference between the expected and actual return on scheme assets		
Amount (£m)	**22**	(77)
Percentage of scheme assets	**2.70%**	10.80%
Experience gains and losses on scheme liabilities		
Amount (£m)	**-**	(8)
Percentage of the present value of the scheme liabilities	**0.00%**	0.97%
Total amount recognised in statement of recognised income and expense		
Amount (£m)	**11**	29
Percentage of the present value of the scheme liabilities	**1.31%**	3.52%

23. Bonds and notes

Group and Bank	**2006 £m**	2005 £m
Medium term notes	**1,408**	-
Subordinated medium term notes	**245**	-
Total bonds, notes and subordinated debt	**1,653**	-
Net premiums/(discounts)	**(1)**	
	1,652	-
Total bonds and notes were recorded as:		
At amortised cost	**1,000**	-
Designated as fair value hedges	**652**	-
	1,652	-

Details of the terms and conditions of medium term notes issued by Clydesdale Bank PLC as at 30 September 2006 were as follows:

Issue date	**Issue currency**	**Fair Value £m**	**Coupon rate %**	**Maturity date**
Medium term notes				
22 December 2005	GBP	450	5.12625%	22 December 2008
31 March 2006	GBP	200	4.81375%	31 March 2008
29 June 2006	GBP	350	4.95375%	29 June 2011
15 September 2006	EUR	407	3.39600%	15 September 2009
Subordinated medium term notes				
16 February 2006	GBP	245	4.87500%	17 February 2016

24. Other liabilities

	Group		**Bank**	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Accruals and deferred income	**57**	49	**53**	47
Notes in circulation	**1,101**	962	**1,101**	962
Accrued interest payable	**227**	165	**227**	165
Other liabilities	**189**	360	**154**	366
	1,574	1,536	**1,535**	1,540

25. Called up share capital

	2006 Number	2005 Number
Authorised		
Ordinary shares of £1 each - equity	**254,785,000**	204,785,000
Allotted, called up and fully paid	**£m**	£m
Ordinary shares of £1 each - equity		
At 1 October	**205**	205
Issued during the year	**27**	-
At 30 September	**232**	205

During the year the authorised share capital was increased by £50,000,000 by the creation of 50,000,000 ordinary shares of £1 each.

On 23 May 2006, 26,753,864 ordinary shares of £1 each were issued at £8.41 per share, resulting in an increase of £26,753,864 to the allotted, called up and fully paid share capital, and an increase of £198,246,136 to the share premium account (note 26).

26. Reserves

	Group		Bank	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Share premium account	**243**	45	**243**	45
Share option reserve	**22**	11	**22**	11
Asset revaluation reserve	**17**	15	**17**	15
Merger reserve	**338**	338	**338**	338
Cash flow hedge reserve	**(2)**	-	**(2)**	-
Retained earnings	**766**	474	**677**	408
	1,384	883	**1,295**	817

Share option reserve
The share option reserve records the value of equity benefits provided to employees and directors as part of their remuneration.

Asset revaluation reserve
The asset revaluation reserve includes the gross revaluation increments and decrements arising from the revaluation of land and buildings.

Merger reserve
The merger reserve arises as a result of the transfer of the entire business and undertakings of Yorkshire Bank PLC to Clydesdale Bank PLC on 1 December 2004.

Cash flow hedge reserve
The cash flow hedge reserve records fair value revaluations of derivatives designated as cash flow hedging instruments.

Minority interests
Minority interests represent the share of subsidiary equity controlled by parties outside of the Group. At the balance sheet date, whilst a share of net equity was attributable to the minority interests, no profit was attributable in respect of these interests.

26. Reserves (continued)

Movements in reserves **Group**	**Share premium account £m**	**Share option reserve £m**	**Asset revaluation reserve £m**	**Cash flow hedge reserve £m**	**Retained earnings £m**
At 30 September 2005	45	11	15	-	474
Effect of implementing IAS 32/39 (note 40)	-	-	-	11	(54)
At 1 October 2005	45	11	15	11	420
Premium on issue of shares	198	-	-	-	-
Profit for the year	-	-	-	-	326
Actuarial gains on defined benefit pension schemes	-	-	-	-	19
Increase in share options granted	-	9	-	-	-
Revaluation of land and buildings	-	-	3	-	-
Net change in cash flow hedge reserve	-	-	-	(19)	-
Transfers from/to:					
Asset revaluation reserve	-	-	(1)	-	1
Tax on items recognised directly in equity	-	2	-	6	-
At 30 September 2006	**243**	**22**	**17**	**(2)**	**766**

Bank	**Share premium account £m**	**Share option reserve £m**	**Asset revaluation reserve £m**	**Cash flow hedge reserve £m**	**Retained earnings £m**
At 30 September 2005	45	11	15	-	408
Effect of implementing IAS 32/39 (note 40)	-	-	-	11	(60)
At 1 October 2005	45	11	15	11	348
Premium on issue of shares	198	-	-	-	-
Profit for the year	-	-	-	-	309
Actuarial gains on defined benefit pension schemes	-	-	-	-	19
Increase in share options granted	-	9	-	-	-
Revaluation of land and buildings	-	-	3		
Net change in cash flow hedge reserve	-	-	-	(19)	-
Transfers from/to:					
Asset revaluation reserve	-	-	(1)	-	1
Tax on items recognised directly in equity	-	2	-	6	-
At 30 September 2006	**243**	**22**	**17**	**(2)**	**677**

27. Memorandum items

	Contract amount 2006 £m	Risk weighted amount 2006 £m	Contract amount 2005 £m	Risk weighted amount 2005 £m
Contingent liabilities				
Group and Bank				
Acceptance and endorsements	**-**	**-**	6	6
Guarantees and assets pledged as collateral security				
- guarantees and irrevocable letters of credit	**374**	**137**	516	295
Other contingent liabilities	**1**	**1**	13	13
	375	**138**	535	314
Commitments				
Group				
Sale and option to resell transactions	**500**	**-**	-	-
Other commitments				
- undrawn formal standby facilities, credit lines and other commitments to lend				
- 1 year or less	**1,061**	**298**	888	249
- over 1 year	**10,548**	**-**	9,807	-
	11,609	**298**	10,695	249
Bank				
- undrawn formal standby facilities, credit lines and other commitments to lend				
- 1 year or less	**1,061**	**298**	888	249
- over 1 year	**10,720**	**-**	9,807	-
	11,781	**298**	10,695	249

The tables above give the contract amounts and risk-weighted amounts of off balance sheet transactions for the Group and Bank. The contract amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts at risk. The risk weighted amounts have been calculated in accordance with the FSA guidelines.

Contingent liabilities and commitments are credit-related instruments which include acceptances, letters of credit, guarantees and commitments to extend credit. The contractual amounts represent the amounts at risk should the contract be fully drawn upon and the client default. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

28. Capital commitments

The Group and Bank had future capital expenditure which had been contracted for but not provided for in the financial statements of £2m (2005: £9m) at 30 September 2006.

29. Lease commitments

Group and Bank **Operating lease commitments**	**Land and buildings 2006 £m**	Land and buildings 2005 £m
Payments committed to be made during the next year under non-cancellable operating leases which expire:		
- within 1 year	**1**	1
- between 1 and 5 years	**5**	3
- over 5 years	**23**	21
	29	25
Where the Group is the lessee the future minimum lease payments under non-cancellable operating leases are:		
- within 1 year	**29**	25
- within 1 and 5 years	**106**	95
- over 5 years	**270**	243
	405	363

30. Other contingent liabilities

The Bank is named in and is defending a number of legal actions arising in the ordinary course of business. No material adverse impact on the financial position of the Group or the Bank is expected to arise from the ultimate resolution of these legal actions.

31. Assets and liabilities denominated in foreign currency

	Group		**Bank**	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Assets				
Sterling	**25,155**	21,555	**24,790**	21,862
Currencies other than sterling	**3,827**	860	**3,852**	485
Total assets	**28,982**	22,415	**28,642**	22,347
Liabilities				
Sterling	**25,141**	21,555	**24,790**	21,862
Currencies other than sterling	**3,841**	860	**3,852**	485
Total liabilities and shareholders' funds	**28,982**	22,415	**28,642**	22,347

The above table cannot be considered to reflect exposure to foreign exchange risk as it does not take into account off balance sheet items.

32. Employees

The average number of full time equivalent employees of the Group during the year was made up as follows:

	2006 Number	2005 Number
Managers	**1,342**	1,198
Clerical staff	**4,384**	4,978
	5,726	6,176

All staff are contracted employees of NAGE. The numbers above disclose the staff remunerated directly by the Group but exclude employees working within other NAGE subsidiaries who provide support services to the Group.

33. Notes to the statement of cash flows

Reconciliation of operating profit to net cash flows from operating activities

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Profit on ordinary activities before tax	**466**	187	**426**	183
Adjustments for:				
Interest receivable	**(1,475)**	(1,144)	**(1,293)**	(1,032)
Interest payable	**693**	540	**546**	438
Depreciation (note 5)	**46**	49	**20**	18
Difference between pension contributions paid and amounts recognised in the income statement	**(159)**	(4)	**(159)**	(4)
Profit on sale of property, plant & equipment	**(12)**	(24)	**(12)**	(24)
Impairment losses on credit exposures (note 14)	**129**	86	**127**	83
Share based payments expense	**11**	8	**11**	8
Cash flows from operating activities before changes in operating assets and liabilities	**(301)**	(302)	**(334)**	(330)
Changes in operating assets and liabilities				
Net (increase)/decrease in:				
Balances with supervisory central banks	**(5)**	(3)	**(5)**	(3)
Loans and advances to other banks	**(409)**	(82)	**(404)**	(82)
Derivative financial assets	**39**	-	**38**	-
Financial assets at fair value through profit and loss	**(425)**	-	**(425)**	-
Loans and advances to customers	**(4,479)**	(3,137)	**(3,333)**	(3,546)
Available for sale investments	**(202)**	250	**(1)**	250
Due from customers on acceptances	**2**	-	**2**	-
Other assets	**52**	(74)	**124**	(73)
Net increase/(decrease) in:				
Due to other banks	**723**	656	**723**	656
Derivative financial liabilities	**(11)**	-	**(11)**	-
Financial liabilities at fair value through profit and loss	**(74)**	-	**(74)**	-
Due to customers	**3,586**	1,653	**3,180**	1,450
Liabilities on acceptances	**(2)**		**(2)**	
Provisions	**(44)**	38	**(44)**	38
Other liabilities	**40**	251	**(5)**	263
Net cash used in operating activities	**(1,510)**	(750)	**(571)**	(1,377)

Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprises the following balances with less than three months maturity from the date of acquisition.

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Cash assets (excluding balances with central banks)	**1,986**	1,085	**2,189**	1,085
Loans and advances to other banks	**-**	297	**-**	297
Other assets	**439**	14	**439**	14
Due to other banks	**(16)**	(80)	**(16)**	(80)
Due to related entities	**(375)**	(286)	**(375)**	(286)
Other liabilities	**(60)**	(1)	**(60)**	(1)
	1,974	1,029	**2,177**	1,029

34. Related party transactions

The Bank is a wholly owned controlled entity of NAGE. The ultimate parent entity of the Bank is NAB.

During the year there have been transactions between the Bank, its ultimate parent, controlled entities of the ultimate parent, controlled entities of the Bank, and other related parties.

The Bank provides a range of services to related parties, including the provision of banking facilities and standby financing arrangements. Other dealings include granting loans and accepting deposits, and the provision of finance, forward exchange and interest cover. Those transactions are normally subject to commercial terms and conditions.

The Bank and Group receives a range of services from the parent and related parties, including loans and deposits, forward exchange and interest rate cover and various administrative services. Fees may be charged for these services.

Amounts due from related entities	**Group**		**Bank**	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Loans				
Ultimate parent	**1,202**	628	**1,202**	628
Controlled entities of the ultimate parent	**-**	227	**-**	227
Controlled entities of Bank	**-**	-	**3,498**	2,684
	1,202	855	**4,700**	3,539
Other receivables				
Controlled entities of the ultimate parent	**27**	35	**33**	35
Total amounts due from related entities	**1,229**	890	**4,733**	3,574
Interest income on the above amounts was as follows:				
Ultimate parent	**35**	43	**35**	43
Controlled entities of the ultimate parent	**8**	8	**8**	8
Controlled entities of Bank	**-**	-	**127**	123
Total interest income on amounts due from related entities	**43**	51	**170**	174

34. Related party transactions (continued)

Amounts due to related entities	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Deposits				
Ultimate parent	**4,127**	3,650	**4,127**	3,650
Controlled entities of the ultimate parent	**384**	599	**384**	599
Controlled entities of Bank	**-**	-	**284**	54
	4,511	4,249	**4,795**	4,303
Subordinated liabilities				
Controlled entities of the ultimate parent	**622**	572	**622**	572
Other payables				
Ultimate parent	**44**	15	**64**	15
Controlled entities of the ultimate parent	**47**	76	**54**	76
	91	91	**118**	91
Total amounts due to related parties	**5,224**	4,912	**5,535**	4,966
Interest expense on the above amounts was as follows:				
Ultimate parent	**169**	168	**169**	191
Controlled entities of the ultimate parent	**60**	61	**60**	10
Controlled entities of Bank	**-**	-	**24**	33
Total interest expense on amounts due to related entities	**229**	229	**253**	234

Subordinated liabilities

Subordinated liabilities comprise entirely of undated loan capital which is provided to the Bank by NAGE. Interest on the loans is payable at rates related to the London Interbank Offered Rate ("LIBOR"). The loans are subject to five years and one day's notice of redemption by the lenders and are repayable at par. Early repayment is at the option of the borrower, subject to the prior consent of the FSA. The loans are subordinated to the claims of other creditors and are unsecured. The loans are employed in the general business of the Bank.

Details of subordinated liabilities in excess of 10% of the total balance are disclosed below.

	2006	2005
	£m	£m
5.44375% (2005: 5.1688%) Undated subordinated notes	**65**	65
5.19188% (2005: 5.19188%) Undated subordinated notes	**100**	100
	165	165
Other undated subordinated notes	**457**	407
Total subordinated debt	**622**	572

The rates of interest stated above apply at 30 September 2006.

34. Related party transactions (continued)

Other transactions with related entities

	Group		Bank	
	2006	2005	**2006**	2005
	£m	£m	**£m**	£m
Non interest income received				
Controlled entities of the ultimate parent	**24**	29	**24**	28
Controlled entities of Bank	**-**	-	**-**	1
	24	29	**24**	29
Administrative expenses				
Ultimate parent	**4**	3	**4**	3
Controlled entities of the ultimate parent	**272**	264	**272**	264
	276	267	**276**	267

Other related party transactions

Compensation of key management personnel (including directors)

	Group	
	2006	2005
	£m	£m
Salaries and other short-term benefits	10	7
Share based payments	1	1
	11	8

Transactions with key management personnel

For the purposes of IAS24 "Related Party Disclosures" key management personnel comprise members of the Board and the Company Secretary, the UK Executive Committee, the Board Audit Committee and the Risk Management Committee.

Key management and their close family members have undertaken the following transactions with the Group in the normal course of business. The transactions were made on the same terms and conditions as applicable to other Group employees, or on normal commercial terms.

	2006	2005
	£m	£m
Loans and advances	**5**	4
Deposits	**12**	-

No provisions have been recognised in respect of loans provided to key management personnel. There were no debts written off or forgiven during the year ended 30 September 2006 (2005: £Nil).

Included in the above are 13 (2005:11) loans totalling £4m (2005: £4m) made to directors, key management personnel and their close family members.

34. Related party transactions (continued)

Other related party transactions
The Group incurred costs in relation to pension scheme administration. These costs, which amounted to £0.6m in the year ended 30 September 2006 (2005: £0.6m) were charged to the two Group sponsored Schemes and to the National Australia Bank UK Retirement Benefits Plan. The Group has deposits of £4.7m (2005 £4.3m) at the year end placed by the Schemes at market rates.

The following payments were made to superannuation funds sponsored by the Bank:

	Bank	
	2006	2005
	£m	£m
Clydesdale Bank Pension Fund	**70**	15
Yorkshire Bank Pension Fund	**46**	12
	116	27

Payments of £1m (2005: £1m) were also made to the National Australia Bank UK Retirement Plan.

35. Share based payments

Share incentive plans, share offers, performance options and performance rights in NAB, the Group's ultimate parent company, are used to provide short-term and long-term incentives to employees. These incentives are an integral part of the Group's remuneration strategy in rewarding employees' current and future contribution to the Group's performance.

The plans described below involve the provision of shares in NAB to employees of the Group and to directors of the Company, and performance options and performance rights to senior employees of the Group. The Group reimburses NAB for the cost of these shares and the value of the performance options and performance rights.

UK National Share Incentive Plan
Under the UK National Share Incentive Plan, employees are entitled to purchase up to £1,500 worth of NAB shares each year through the National Partnership Share Plan. Participants contribute each month and the trustee uses the contributions to purchase shares on market which are then held in trust for the participants. Participants are entitled to receive dividends and exercise voting rights in respect of these shares and there is no risk of forfeiture. In addition, up to £3,000 of free shares per employee may be gifted per annum through the plan.

Mid Year and Year End Share Offers
Under the UK National Share Incentive Plan, the National EVA ® Share Offer gifts up to AUD1,000 of ordinary shares to each employee when the Group's performance is on target.

In 2005, two employee share offers (each valued at approximately AUD500 per employee) were made, based on the Group's achievements at mid year and year end as measured against a scorecard of objectives for the Group. Shares under the mid-year offer were allocated on 19 September 2005, and those under the year end offer were allocated on 15 December 2005. These shares are held by the trustees for three years, or until the employee ceases their 'relevant employment', i.e. ceases employment with either a company in the Group or a company that was in the Group when the shares were allocated to the employee.

The shares are registered in the name of the trustee who holds them on behalf of the participating employee for the duration of the restriction period. Participating employees receive dividends and may exercise, through the trustee, voting rights (which are the equivalent to those for other ordinary NAB shares) in respect of the shares, but otherwise cannot deal with the shares until the restriction period concludes. If a participating employee leaves the Group prior to the end of the three year restriction period due to voluntary resignation the share may be transferred to the employee or sold. If employment is terminated during the restriction period for a reason justifying dismissal the shares are forfeited.

35. Share based payments (continued)

Executive Share Option Plan and Performance Rights Plan
The Group operates a long term incentive programme primarily targeted at key executive positions, delivering performance options and performance rights, linked to the share price of NAB.

The plans provide for the Board of NAB to grant performance options and performance rights to executives of the Group to subscribe for fully paid ordinary shares in NAB. Each performance option and performance right entitles the holder to subscribe for one fully paid ordinary share in NAB. The performance options and performance rights cannot be transferred and are not quoted on a recognised stock market. No payment is required from executives at the time of the grant. There are no voting rights or dividends associated with the performance options or performance rights.

The exercise price per performance option is the market price of NAB fully paid ordinary shares as at the date the performance option was granted or such other relevant date determined by the Board of NAB.

The holder of performance rights must pay a nominal exercise price in order to exercise those rights. The total exercise price payable on the exercise of any performance rights on a particular day is AUD1, irrespective of the number of rights exercised that day.

The fair value of the options granted is determined using option pricing models, which take into account the exercise price of the option, the current share price, the risk free interest rate, the expected volatility of the NAB share price over the life of the option and other relevant factors. In the absence of market prices, the fair value of the instruments at the date the grant is estimated using an appropriate valuation technique.

Except for those which include terms related to market conditions, vesting conditions included in the terms of the grant are not taken into account in estimating fair value.

The following significant assumptions were adopted to determine the fair value of options and performance rights at each issue date:

Grant date	31-Jul-06	03-May-06	03-May-06	06-Feb-06	06-Feb-06
Risk-free interest rate (per annum)	5.90%	5.70%	5.70%	5.20%	5.20%
Life of options	5.5 years	5.5 years	5.5 years	5.5 years	5 years
Volatility of share price	15.50%	15.00%	15.00%	15.00%	15.00%
Dividend rate (per annum)	5.00%	5.00%	5.00%	5.30%	5.30%
Exercise price of options	AUD35.50	AUD37.55	AUD34.53	AUD34.53	AUD34.53
Fair value of performance options	AUD3.98	AUD3.75	AUD4.65	AUD3.39	AUD3.23
Fair value of performance rights	AUD20.11	AUD19.51	AUD19.51	AUD18.23	-

Grant date	19-Dec-05	08-Jul-05	22-Feb-05	07-Feb-05
Risk-free interest rate (per annum)	5.20%	5.10%	5.40%	5.30%
Life of options	5 years	5 years	5 years	5 years
Volatility of share price	15.00%	16.00%	16.00%	16.00%
Dividend rate (per annum)	5.30%	5.80%	5.80%	5.80%
Exercise price of options	AUD31.78	AUD29.93	AUD30.41	AUD29.93
Fair value of performance options	AUD2.74	AUD2.80	AUD1.54	AUD2.80
Fair value of performance rights	AUD17.11	AUD18.31	AUD7.37	AUD17.15

35. Share based payments (continued)

The movement in share options and performance rights granted since March 2003 and exercised during the year was as follows:

Share options	**2006 Number**	**2006 Weighted Average Exercise Price AUD**	2005 Number	2005 Weighted Average Exercise Price AUD
Outstanding at 1 October	**3,467,444**	**30.23**	1,566,839	30.31
Granted during the year	**1,324,426**	**34.53**	1,900,605	30.16
Outstanding at 30 September	**4,791,870**	**31.42**	3,467,444	30.23
Exercisable at 30 September	**-**		-	

No share options were exercised during the year (2005: AUD Nil). For share options outstanding at 30 September 2006, the weighted average remaining contractual life is 3.17 years (2005: 3.24 years). The range of exercise prices for options outstanding at the end of the year was AUD26.59 to AUD35.50 (2005: AUD26.59 to AUD30.98).

Performance rights	**2006 Number**	**2006 Weighted Average Exercise Price AUD**	2005 Number	2005 Weighted Average Exercise Price AUD
Outstanding at 1 October	**849,402**	**1.00**	389,225	1.00
Granted during the year	**331,229**	**1.00**	460,177	1.00
Outstanding at 30 September	**1,180,631**	**1.00**	849,402	1.00
Exercisable at 30 September	**-**		-	

No performance rights were exercised during the year (2005: AUD Nil). For performance rights outstanding at 30 September 2006, the weighted average remaining contractual life is 3.22 years (2005: 3.25 years). The exercise price for outstanding options is AUD1.00 for the total rights exercised by an individual on the same day.

36. Directors' emoluments

	2006 £m	2005 £m
Aggregate emoluments	**3**	2

No Directors (2005: Nil) exercised share options in the year and three Directors (2005 three) became entitled to receive shares under long-term incentive schemes operated by the Bank's ultimate parent undertaking. No Directors (2005: Nil) accrued retirement benefits under a money purchase pension scheme.

The aggregate emoluments of the highest paid Director in respect of those duties relevant to the Bank were £1.1m (2005: £0.6m). The Bank's pension contributions amounted to £Nil (2005: £Nil). The Director exercised no share options in the year (2005: Nil) and was entitled to receive shares under the long term incentive scheme.

37. Fair values of financial instruments

Financial instruments include both financial assets and financial liabilities and also derivatives. The fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. For the purposes of this note, carrying value refers to amounts reflected in the Consolidated Balance Sheet.

Group	Footnote	**Carrying Value 2006 £m**	**Fair value 2006 £m**	Carrying Value 2005 £m	Fair value 2005 £m
Financial assets					
Cash and balances with supervisory central banks	(a)	**2,013**	**2,013**	1,107	1,107
Loans and advances to other banks	(b)	**495**	**495**	383	383
Derivative financial assets (on balance sheet)	(c)	**13**	**13**	28	28
Financial assets at fair value through profit and loss	(d)	**2,141**	**2,141**	-	-
Available for sale investments	(e)	**204**	**204**	2	2
Loans and advances to customers	(b)	**21,781**	**21,781**	19,118	19,118
Due from customers on acceptances	(a)	**5**	**5**	-	6
Due from related entities	(f)	**1,229**	**1,229**	890	890
Other assets	(g)	**231**	**231**	164	164
Financial liabilities					
Due to other banks	(a)	**1,392**	**1,392**	733	733
Derivative financial liabilities (on balance sheet)	(c)	**32**	**32**	20	20
Financial liabilities at fair value through profit and loss	(d)	**142**	**142**	-	-
Due to customers	(a)	**17,081**	**17,081**	13,591	13,591
Liabilities on acceptances	(a)	**5**	**5**	-	6
Bonds and notes	(h)	**1,652**	**1,652**	-	-
Due to related entities	(f)	**5,224**	**5,224**	4,912	4,912
Other liabilities	(i)	**227**	**227**	165	165

37. Fair values of financial instruments (continued)

The fair value estimates are based on the following methodologies and assumptions:

(a) The carrying amounts of these financial assets and financial liabilities approximate their fair value.

(b) The carrying value of loans and advances is net of allowance for impairment losses and unearned income. The fair values of loans and advances equate to the carrying value at 30 September.

(c) The fair value of derivatives, including foreign exchange contracts, interest rate swaps, interest rate and currency option contracts, and currency swaps, are obtained from quoted closing market prices as at balance sheet date, discounted cash flow models or option pricing models as appropriate.

(d) The fair value of assets and liabilities designated as being carried at fair value through profit and loss are based on quoted market prices and data or valuation techniques based upon observable market data as appropriate to the nature and type of the underlying instrument.

(e) Available for sale investments are carried at the lower of cost or net realisable value. Fair value is based on market values, where available.

(f) The carrying amount of amounts due from and due to related entities is considered to approximate fair value.

(g) Other financial assets include accrued interest receivable.

(h) The carrying value of bonds and notes reflects their fair value. This is based on quoted closing market prices as at balance sheet date where available, otherwise an appropriate discounted cash flow model is used.

(i) Other financial liabilities include accrued interest payable.

38. Maturity profile

Group 2006	Call £m	3 months or less £m	3 to 12 months £m	1 to 5 years £m	Over 5 years £m	No specified maturity £m	Total £m
Assets							
Cash and balances with central banks	2,013	-	-	-	-	-	2,013
Loans and advances to other banks	14	481	-	-	-	-	495
Derivative financial assets	12	-	-	1	-	-	13
Financial assets at fair value through profit and loss	-	7	50	820	1,262	2	2,141
Available for sale investments	1	-	-	201	2	-	204
Loans and advances to customers	3,397	299	7,973	3,803	6,634	(325)	21,781
Due from customers on acceptances	-	5	-	-	-	-	5
Due from related entities	3	1,175	17	9	17	8	1,229
All other assets	-	-	-	-	-	1,101	1,101
Total assets	5,440	1,967	8,040	4,834	7,915	786	28,982
Liabilities							
Due to other banks	24	790	54	19	505	-	1,392
Derivative financial liabilities	16	-	-	16	-	-	32
Financial liabilities at fair value through profit and loss	-	(15)	(8)	19	116	30	142
Due to customers	11,468	3,539	1,534	367	148	25	17,081
Liabilities on acceptances	-	5	-	-	-	-	5
Bonds and notes	(1)	-	-	-	1,653	-	1,652
Due to related entities	5	231	852	2,192	1,887	57	5,224
All other liabilities	-	-	-	-	-	1,771	1,771
Total liabilities	11,512	4,550	2,432	2,613	4,309	1,883	27,299

38. Maturity profile (continued)

Group 2005	Call £m	3 months or less £m	3 to 12 months £m	1 to 5 years £m	Over 5 years £m	No specified maturity £m	Total £m
Assets							
Cash and balances with central banks	1,107	-	-	-	-	-	1,107
Loans and advances to other banks	71	-	-	-	25	287	383
Available for sale investments	-	-	1	-	-	1	2
Loans and advances to customers	4,040	1,224	1,828	4,170	8,056	(200)	19,118
Due from related entities	184	575	77	19	-	35	890
All other assets	-	-	-	-	-	915	915
Total assets	5,402	1,799	1,906	4,189	8,081	1,038	22,415
Liabilities							
Due to other banks	46	683	30	-	-	(26)	733
Due to customers	9,361	3,047	846	335	2	-	13,591
Due to related entities	808	747	430	1,968	198	761	4,912
All other liabilities	-	-	-	-	-	2,091	2,091
Total liabilities	10,215	4,477	1,306	2,303	200	2,826	21,327

38. Maturity profile (continued)

Bank 2006	Call £m	3 months or less £m	3 to 12 months £m	1 to 5 years £m	Over 5 years £m	No specified maturity £m	Total £m
Assets							
Cash and balances with central banks	2,216	-	-	-	-	-	2,216
Loans and advances to other banks	490	-	-	-	-	-	490
Derivative financial assets	12	-	-	1	-	-	13
Financial assets at fair value through profit and loss	-	7	50	820	1,262	2	2,141
Available for sale investments	1	-	-	-	2	-	3
Loans and advances to customers	3,396	246	7,849	3,115	3,672	(241)	18,037
Due from customers on acceptances	-	5	-	-	-	-	5
Due from related entities	1,850	1,430	16	9	18	1,410	4,733
All other assets	-	-	-	-	-	1,004	1,004
Total assets	7,965	1,688	7,915	3,945	4,954	2,175	28,642
Liabilities							
Due to other banks	24	790	54	19	505	-	1,392
Derivative financial liabilities	16	-	-	16	-	-	32
Financial liabilities at fair value through profit and loss	-	(15)	(8)	19	116	30	142
Due to customers	12,409	2,626	1,103	363	148	25	16,674
Liabilities on acceptances	-	5	-	-	-	-	5
Bonds and notes	(1)	-	-	1,407	246	-	1,652
Due to related entities	1,863	678	2,141	-	-	853	5,535
All other liabilities	-	-	-	-	-	1,683	1,683
Total liabilities	14,311	4,084	3,290	1,824	1,015	2,591	27,115

38. Maturity profile (continued)

Bank 2005	**Call £m**	**3 months or less £m**	**3 to 12 months £m**	**1 to 5 years £m**	**Over 5 years £m**	**No specified maturity £m**	**Total £m**
Assets							
Cash and balances with central banks	1,107	-	-	-	-	-	1,107
Loans and advances to other banks	71	-	-	-	25	287	383
Available for sale investments	-	-	1	-	-	1	2
Loans and advances to customers	4,196	1,217	1,757	3,672	5,863	(192)	16,513
Due from related parties	2,868	575	77	19	-	35	3,574
All other assets	-	-	-	-	-	768	768
Total assets	8,242	1,792	1,835	3,691	5,888	899	22,347
Liabilities							
Due to other banks	46	683	30	-	-	(26)	733
Due to customers	9,361	3,047	846	335	2	-	13,591
Due to related entities	808	801	430	1,968	198	761	4,966
All other liabilities	-	-	-	-	-	2,035	2,035
Total liabilities	10,215	4,531	1,306	2,303	200	2,770	21,325

39. Financial risk management

Strategy in using financial instruments

By their nature, the Group's activities are principally related to the use of financial instruments including derivatives. The Group accepts deposits from customers at both fixed and floating rates for various periods, and seeks to earn above-average interest margins by investing these funds in high-quality assets. The Group seeks to increase these margins by consolidating short-term funds and lending for longer periods at higher rates, while maintaining sufficient liquidity to meet all claims that might fall due.

The Group also seeks to raise its interest margins by obtaining above-average margins, net of allowances, through lending to commercial and retail borrowers with a range of credit standing. Such exposures involve not just on-balance sheet loans and advances, but the Group also enters into guarantees and other commitments such as letters of credit and performance, and other bonds.

Fair value hedges
The Group hedges part of its existing interest rate and foreign currency risk resulting from any potential decrease in the fair value of fixed rate assets or increase in fair value of fixed rate liabilities attributable to both interest rate and foreign currency risk denominated both in local and foreign currencies using interest rate, cross currency interest rate and cross currency swaps.

Cash flow hedges
The Group hedges a portion of the variability in future cash flows attributable to interest rate risk of variable interest rate assets and liabilities.

There were no transactions for which cash flow hedge accounting had to be ceased in 2006 as a result of the highly probable cash flows no longer expected to occur. The fair value of derivatives entered into is disclosed in note 11. The fair value of derivatives deferred within the cash flow hedge reserve to hedge forecast future cash flows is disclosed in note 26.

Credit risk

The Group takes on exposure to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due. Impairment provisions are provided for losses that have been incurred at the balance sheet date. Significant changes in the economy, or in the health of a particular industry segment that represents a concentration in the Group's portfolio, could result in losses that are different from those provided for at the balance sheet date. Management therefore carefully manages its exposure to credit risk.

The Group structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or groups of borrowers, and to geographical and industry segments. Such risks are monitored on a revolving basis and subject to an annual or more frequent review. Limits on the level of credit risk by product, industry sector and by country are approved quarterly by the Board.

The exposure to any one borrower including banks and brokers is further restricted by sub-limits covering on and off balance sheet exposures, and daily delivery risk limits in relation to trading items such as forward foreign exchange contracts. Actual exposures against limits are monitored daily.

Exposure to credit risk is managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and capital repayment obligations and by changing these lending limits where appropriate. Exposure to credit risk is also managed in part by obtaining collateral and corporate and personal guarantees, but a significant portion is personal lending where no such facilities can be obtained.

Derivatives
The Group maintains strict control limits on net open derivative positions (i.e. the difference between purchase and sale contracts), by both amount and term. At any one time, the amount subject to credit risk is limited to the current fair value of instruments that are favourable to the Group (i.e. assets where their fair value is positive), which in relation to derivatives is only a small fraction of the contract, or notional values used to express the volume of instruments outstanding. This credit risk exposure is managed as part of the overall lending limits with customers, together with potential exposures from market movements. Collateral or other security is not usually obtained for credit risk exposures on these instruments, except where the Group requires margin deposits from counterparties.

39. Financial risk management (continued)

Credit-related commitments
The primary purpose of these instruments is to ensure that funds are available to a customer as required. Guarantees and standby letters of credit, which represent irrevocable assurances that the Group will make payments in the event that a customer cannot meet its obligations to third parties, carry the same credit risk as loans. Documentary and commercial letters of credit, which are written undertakings by the Group on behalf of a customer authorising a third party to draw drafts on the Group up to a stipulated amount under specific terms and conditions, are collateralised by the underlying shipments of goods to which they relate and therefore carry less risk than a direct borrowing.

Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. With respect to credit risk on commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most commitments to extend credit are contingent upon customers maintaining specific credit standards. The Group monitors the term to maturity of credit commitments because longer-term commitments generally have a greater degree of credit risk than shorter-term commitments.

Market risk

The Group takes on exposure to market risks. Market risk arise from open positions in interest rate, currency and equity products, all of which are exposed to general and specific market movements. The Group applies a "value at risk" methodology to estimate the market risk of positions held and the maximum losses expected, based upon a number of assumptions for various changes in market conditions. The Board sets limits on the value at risk that may be accepted, which is monitored on a daily basis.

Market risk of derivative financial instruments held or issued is the risk that the value of derivatives will be adversely affected by changes in the market value of the underlying instrument, reference rate or index. The residual market exposures are managed within established limits approved by the Board. An independent unit monitors compliance within delegated limits on a daily basis.

39. Financial risk management (continued)

Interest rate sensitivity gap analysis

Part of the Group's return on financial instruments is obtained from controlled mismatching of the dates on which interest receivable on assets and interest payable on liabilities are next reset to market rates or, if earlier, the dates on which the instruments mature. The tables below summarise these repricing mismatches on the Group's non-trading book as at 30 September 2006 and 30 September 2005. Items are allocated to time bands by reference to the earlier of the next contractual interest rate repricing date or the maturity date.

Group 2006	Weighted average effective interest rate %	0 to 3 months £m	3 to 12 months £m	1 to 2 years £m	2 to 3 years £m	3 to 4 years £m	4 to 5 years £m	Over 5 years £m	Non interest bearing £m	Total £m
Assets										
Cash assets	4.56	1,986	-	-	-	-	-	-	-	1,986
Balances with supervisory central banks	2.84	27	-	-	-	-	-	-	-	27
Loans and advances to other banks	2.84	495	-	-	-	-	-	-	-	495
Derivative financial assets		-	-	-	-	-	-	-	13	13
Financial assets at fair value through profit and loss	6.32	206	76	119	113	193	311	1,123	-	2,141
Available for sale investments	5.93	203	-	-	-	-	-	-	1	204
Loans and advances to customers	6.44	16,434	1,922	1,624	672	324	533	387	(115)	21,781
Due from customers on acceptances		-	-	-	-	-	-	-	5	5
Due from related entities		1,178	24	-	-	-	-	-	27	1,229
All other assets		-	-	-	-	-	-	-	1,101	1,101
Total assets		20,529	2,022	1,743	785	517	844	1,510	1,032	28,982
Liabilities										
Due to other banks	4.90	1,311	72	-	-	-	-	-	9	1,392
Derivative financial liabilities		-	-	-	-	-	-	-	32	32
Financial liabilities at fair value through profit and loss	5.06	-	1	3	3	5	6	90	34	142
Due to customers	2.79	14,190	1,235	103	72	-	4	-	1,477	17,081
Liabilities on acceptances		-	-	-	-	-	-	-	5	5
Bonds and notes	5.07	1,402	-	-	-	-	250	-	-	1,652
Due to related entities		236	4,897	-	-	-	-	-	91	5,224
All other liabilities		-	-	-	-	-	-	-	1,771	1,771
Shareholders' equity		-	-	-	-	-	-	-	1,683	1,683
Total liabilities and shareholders' equity		17,139	6,205	106	75	5	260	90	5,102	28,982
Off balance sheet items		(1,607)	1,002	516	1,383	(352)	111	(1,053)	-	-
Interest rate sensitivity gap		1,783	(3,181)	2,153	2,093	160	695	367	(4,070)	-
Cumulative gap		1,783	(1,398)	755	2,848	3,008	3,703	4,070	-	

39. Financial risk management (continued)

Interest rate sensitivity gap analysis (continued)

Group 2005	**Weighted average effective interest rate %**	**0 to 3 months £m**	**3 to 12 months £m**	**1 to 2 years £m**	**2 to 3 years £m**	**3 to 4 years £m**	**4 to 5 years £m**	**Over 5 years £m**	**Non interest bearing £m**	**Total £m**
Assets										
Cash assets		1,085	-	-	-	-	-	-	-	1,085
Balances with supervisory central banks	1.97	22	-	-	-	-	-	-	-	22
Loans and advances to other banks		-	-	-	-	-	-	-	383	383
Available for sale investments		1	-	-	-	-	-	-	1	2
Loans and advances to customers	6.43	13,396	1,569	1,817	753	284	465	1,061	(227)	19,118
Due from related entities		759	96	-	-	-	-	-	35	890
All other assets		-	-	-	-	-	-	-	915	915
Total assets		15,263	1,665	1,817	753	284	465	1,061	1,107	22,415
Liabilities										
Due to other banks	4.79	654	79	-	-	-	-	-	-	733
Due to customers	2.44	11,555	542	180	16	-	-	1	1,297	13,591
Due to related entities		1,555	3,266	-	-	-	-	-	91	4,912
All other liabilities		-	-	-	-	-	-	-	2,091	2,091
Shareholders' equity		-	-	-	-	-	-	-	1,088	1,088
Total liabilities and shareholders' equity		13,764	3,887	180	16	-	-	1	4,567	22,415
Off balance sheet items		(2,069)	1,391	906	1,070	(168)	(300)	(830)	-	-
Interest rate sensitivity gap		(570)	(831)	2,543	1,807	116	165	230	(3,460)	-
Cumulative gap		(570)	(1,401)	1,142	2,949	3,065	3,230	3,460	-	

A negative interest rate sensitivity gap exists when more liabilities than assets reprice during a given period. Although a negative gap position tends to benefit net interest income in a declining interest rate environment, the actual effect will depend on a number of factors, including the extent to which repayments are made earlier or later than the contracted date and variations in interest rate sensitivity within repricing periods and among currencies.

39. Financial risk management (continued)

Interest rate sensitivity gap analysis (continued)

Bank 2006	**Weighted average effective interest rate %**	**0 to 3 months £m**	**3 to 12 months £m**	**1 to 2 years £m**	**2 to 3 years £m**	**3 to 4 years £m**	**4 to 5 years £m**	**Over 5 years £m**	**Non interest bearing £m**	**Total £m**
Assets										
Cash assets	4.69	2,189	-	-	-	-	-	-	-	2,189
Balances with supervisory central banks	2.84	27	-	-	-	-	-	-	-	27
Loans and advances to other banks	2.84	490	-	-	-	-	-	-	-	490
Derivative financial assets		-	-	-	-	-	-	-	13	13
Financial assets at fair value through profit and loss	6.32	206	76	119	113	193	311	1,123	-	2,141
Available for sale investments	5.93	-	-	-	-	-	-	-	3	3
Loans and advances to customers	6.44	13,609	1,591	1,345	558	268	441	321	(96)	18,037
Due from customers on acceptances		-	-	-	-	-	-	-	5	5
Due from related entities		3,280	1,420	-	-	-	-	-	33	4,733
All other assets		-	-	-	-	-	-	-	1,004	1,004
Total assets		19,801	3,087	1,464	671	461	752	1,444	962	28,642
Liabilities										
Due to other banks	4.90	1,311	72	-	-	-	-	-	9	1,392
Derivative financial liabilities		-	-	-	-	-	-	-	32	32
Financial liabilities at fair value through profit and loss	5.06	-	1	3	3	5	6	90	34	142
Due to customers	2.79	13,852	1,205	101	70	-	4	-	1,442	16,674
Liabilities on acceptances		-	-	-	-	-	-	-	5	5
Bonds and notes	5.07	1,402	-	-	-	-	250	-	-	1,652
Due to related entities		2,541	2,876	-	-	-	-	-	118	5,535
All other liabilities		-	-	-	-	-	-	-	1,683	1,683
Shareholders' equity		-	-	-	-	-	-	-	1,527	1,527
Total liabilities and shareholders' equity		19,106	4,154	104	73	5	260	90	4,850	28,642
Off balance sheet items		(1,607)	1,002	516	1,383	(352)	111	(1,053)	-	
Interest rate sensitivity gap		(912)	(65)	1,876	1,981	104	603	301	(3,888)	-
Cumulative gap		(912)	(977)	899	2,880	2,984	3,587	3,888	-	-

39. Financial risk management (continued)

Interest rate sensitivity gap analysis (continued)

Bank 2005	**Weighted average effective interest rate %**	**0 to 3 months £m**	**3 to 12 months £m**	**1 to 2 years £m**	**2 to 3 years £m**	**3 to 4 years £m**	**4 to 5 years £m**	**Over 5 years £m**	**Non interest bearing £m**	**Total £m**
Assets										
Cash assets		1,085	-	-	-	-	-	-	-	1,085
Balances with supervisory central banks	1.97	22	-	-	-	-	-	-	-	22
Loans and advances to other banks		-	-	-	-	-	-	-	383	383
Available for sale investments		1	-	-	-	-	-	-	1	2
Loans and advances to customers	6.43	11,571	1,355	1,569	650	246	402	916	(196)	16,513
Due from related entities		3,443	96	-	-	-	-	-	35	3,574
All other assets		-	-	-	-	-	-	-	768	768
Total assets		16,122	1,451	1,569	650	246	402	916	991	22,347
Liabilities										
Due to other banks	4.79	654	79	-	-	-	-	-	-	733
Due to customers	2.44	11,555	542	180	16	-	-	1	1,297	13,591
Due to related entities		2,541	2,334	-	-	-	-	-	91	4,966
All other liabilities		-	-	-	-	-	-	-	2,035	2,035
Shareholders' equity		-	-	-	-	-	-	-	1,022	1,022
Total liabilities and shareholders' equity		14,750	2,955	180	16	-	-	1	4,445	22,347
Off balance sheet items		(2,069)	1,391	906	1,070	(168)	(300)	(830)	-	-
Interest rate sensitivity gap		(697)	(113)	2,295	1,704	78	102	85	(3,454)	-
Cumulative gap		(697)	(810)	1,485	3,189	3,267	3,369	3,454	-	

40. Transition to IFRS

The Group adopted IFRS with effect from 1 October 2005, and has restated its previously published UK GAAP financial statements for the year ended 30 September 2005.

The Group has chosen to take advantage of the exemption available within IFRS 1 "First-Time Adoption of International Financial Reporting Standards" and not restate comparatives in respect of the application of IAS 39 "Financial Instruments: Recognition and Measurement", IAS 32 "Financial Instruments: Presentation and Disclosure" or IFRS 4 "Insurance Contracts". These standards are applied with effect from 1 October 2005.

The following notes and reconciliations, along with the accounting policies detailed in note 2, provide an explanation of how the transition from UK GAAP to IFRS has affected the Group's financial statements.

The IFRS impacts contained in the following reconciliations have been shown as:

- those arising from required recognition and measurement adjustments to the financial statements to transition from UK GAAP to IFRS either at 1 October 2004 or 1 October 2005 (transitional adjustments);

- those arising during the year ended 30 September 2005 to adjust for measurement differences between UK GAAP and IFRS in the income statement or reserves (measurement adjustments); and

- those concerning presentation and disclosure of items in the financial statements (disclosure adjustments) at the relevant dates.

Recognition and measurement adjustments that arise as a result of the opening transition process affect balance sheet values and are recognised in either retained earnings or an appropriate equity reserve at the date of transition. These may arise at either 1 October 2004 or 1 October 2005.

Presentation and disclosure adjustments do not impact total equity or retained earnings, but reclassify items from one line to another.

The areas of most significant impact and the adjustments arising from application of IFRS are summarised below, in accordance with IFRS 1.

Transitional and measurement adjustments at 1 October 2004

(1) Defined benefit pension liabilities

The measurement principles under IFRS are similar to those previously disclosed under FRS 17. IAS 19 "Employee Benefits" requires that any asset or liability in respect of defined benefit pension schemes be recognised in the balance sheet and is measured as the present value of the defined benefit obligation at the reporting date less the fair value of the superannuation fund's assets at that date and any unrecognised past service cost. IAS 19 allows a number of spreading options to defer the immediate impact of actuarial movements to the balance sheet. However, the decision has been made by Group to adopt the most transparent approach under the standard whereby actuarial movements are recognised immediately.

The Group has decided that it would not be appropriate for balance sheet volatility to impact directly on the Income Statement. Instead, the main items creating such volatility (actuarial gains and losses) feed directly into an equity adjustment on the Balance Sheet via the Statement of Recognised Income and Expenditure.

In addition to the recognition of the IAS 19 pension deficit on transition, the treatment of the pension element of the restructure provision required review. Accepted historical practice under UK GAAP was to raise a restructure provision at the time of announcement to cover future cash payments to the scheme for pension augmentations. IAS 19 treats such augmentations as a past service cost, which should be added to the overall deficit when the liability is first established.

40. Transition to IFRS (continued)

(2) Share based payments

IFRS introduces the requirement for the Group to recognise an expense in respect of all share-based remuneration (performance options, performance rights and shares issued to employees) determined with reference to the fair value of the equity instruments issued. The fair value of the performance options and performance rights at grant date will be expensed over their vesting period on a straight-line basis. Similarly, the fair value of shares granted under the staff share schemes will be recognised as an expense over their vesting period on a straight-line basis.

Under the exemption provided in IFRS 1, the Group has not applied IFRS 2 "Share-based Payment" to equity instruments issued prior to 7 November 2002. The transitional adjustment at 1 October 2004 is therefore calculated in respect of performance options, performance rights and shares granted after 7 November 2002 that remain unvested at 1 January 2005.

(3) Property, plant & equipment

(a) Contract purchase motor vehicles

Under UK GAAP contract purchase motor vehicles were treated as finance lease assets on the Group balance sheet. Following transition to IFRS it was determined that the risks and rewards of ownership reside with the lessor (a fellow NAB controlled entity, Custom Fleet Limited) rather than the Group, and contract motor vehicles were derecognised from fixed assets and reclassified from finance to operating leases. Instead of accounting for a finance lease creditor for future lease payments, the lessee accounts for the contract lease payments as operating lease expenses.

(b) Asset finance leases

The adoption of IFRS requires changes to accounting in the Group's Asset Finance businesses, as lessor for both finance and operating leases.

IAS 17 requires that, when accounting for a finance lease as the lessor, income is recognised using the gross investment method, which is a before tax method. Previously, UK GAAP required income to be accounted for using the net cash investment method, which is an after-tax method. The total income recognised over the lease term is the same under both methods. However, if the effect of tax cash flows is significant, the net cash investment method would typically allow income to be recognised earlier in the lease.

IAS 17 specifies that operating leases where the company is lessor should be classified as Property, plant and equipment rather than Loans and Advances. Income statement items previously included in 'Net Interest Income' are now separated and shown in 'Other Operating Income' and 'Depreciation and Amortisation Expense'.

The calculation of depreciation on operating lease assets is also impacted by IFRS. IAS 16 "Property, Plant and Equipment" requires the depreciation method to reflect the pattern in which an asset's future economic benefits are expected to be consumed by the entity. A straight-line method of depreciation has been adopted to meet this requirement.

40. Transition to IFRS (continued)

(4) Taxation

IFRS requires the Group to adopt a balance sheet approach of determining deferred tax items, based upon a comparison of accounting carrying amounts of assets and liabilities with their tax base. This method identifies a broader range of differences than those that arise under UK GAAP, which used an income statement liability method to determining deferred tax amounts.

In adopting a balance sheet approach to tax effect accounting, IAS12 "Income Taxes" imposes an obligation to assign a tax base to every asset or liability on an entity's balance sheet. A capital gains tax liability is recognised as an adjustment to the Asset Revaluation Reserve.

Transitional adjustments at 1 October 2005

(5) Financial assets and liabilities at fair value through profit and loss

IAS 39 requires that derivatives and certain specific financial instruments are recognised at fair value on the balance sheet. The application of this requirement to the Group's financial assets and liabilities is summarised below.

(a) Cash flow hedging derivative financial instruments

Where cash flow hedge accounting criteria are met, the carrying value of the hedged item is not adjusted. The fair value changes on the related hedging instrument are deferred in a separate cash flow reserve (to the extent that the hedge is effective) and transferred to the income statement at the time the hedged item affects income. Hedge ineffectiveness is recognised in the income statement immediately.

(b) Trading derivative financial instruments

Certain historic derivatives within the Group are not able to be incorporated into a cash flow hedge relationship. This is because external deals were not always discrete transactions. Certain derivatives were historically bundled up into larger transactions, thus losing the link between the external deal and the internal hedged item. These derivatives are designated as trading derivatives and their movement in fair value will directly impact income. The majority of these derivatives matured during year ending September 2006.

IAS 39 also requires that bid or offer prices are applied to financial instruments which are transacted in active markets, rather than mid prices.

(c) Other financial instruments designated at fair value through profit and loss

IAS 39 allows financial assets to be designated at fair value through profit or loss on initial recognition or on the date of transition to IFRS. Once a financial instrument has been designated at fair value it is not possible to change the designation subsequently. The Group has designated certain individually hedged customer loans at fair value through profit and loss on transition to IFRS. Interest recognition on these loans and the derivative financial instruments which hedge them were accrual accounted under UK GAAP. Designating the loans at fair value will minimise future volatility in income as movement caused by interest rate fluctuations will be largely offset by an equal and opposite movement in the fair value of derivative financial instruments.

On transition to IFRS a credit to retained earnings is recognised on certain individually hedged loans, reflecting the present value of future earnings, after deducting an appropriate credit risk spread.

40. Transition to IFRS (continued)

(5) Financial assets and liabilities at fair value through profit and loss (continued)

(d) Acceptances

Financial assets and liabilities arising from acceptances are required to be recorded on the balance sheet at fair value on initial recognition and subsequently measured at amortised cost. Previously under UK GAAP acceptances were not recognised on the balance sheet but disclosed as a contingent liability.

(6) Loans and advances

(a) Effective interest rate and deferral of income

Under UK GAAP, loan origination fees are either recognised when received or deferred in the balance sheet and amortised as an adjustment to yield over the expected life of the loan. IAS 39 requires fees to be amortised using the effective interest rate on the related financial asset. The effective interest rate is the rate that exactly discounts the estimated stream of future cash payments or receipts over the expected life of the financial instrument.

The opening adjustment on transition to IFRS records the reversal of fees originally included in fee income, which are now being deferred and amortised. IAS 39 requires that all amortised net fee income is reported within net interest income, whereas under UK GAAP certain types of fees were recorded in other operating income.

(b) Provisions for impairment

IAS 39 only allows the recognition of loan impairment (previously referred to as provisions for doubtful debts) when objective evidence is available that a loss event has occurred. Reference is no longer made to General and Specific provisions but to Collective and Individually assessed provisions.

Loan impairment is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. Impairment must be assessed individually for financial assets that are considered individually significant, and may be assessed collectively for financial assets that are not individually significant. Under UK GAAP, provisions for doubtful debts were made so as to record impaired loans at their expected net realisable value.

(c) Re-recognition of financial liabilities

IAS 39 does not allow a financial liability to be removed from the balance sheet until it is extinguished, i.e. when the debtor discharges the liability by paying its customer, or if the debtor is legally released from the liability.

On transition to IFRS the Group re-recognised certain customer financial liabilities. This is accounted for as an adjustment to opening retained earnings, with no impact on the income statement.

Reclassifications made within the financial statements

In addition to the transitional and measurement adjustments detailed above, the adoption of IFRS introduces changes to the format of the income statement, balance sheet and other financial statement disclosures. Certain reclassifications of assets and liabilities and balances within equity reserves have occurred as a result of these changes.

40. Transition to IFRS (continued)

Consolidated Income Statement Reconciliation for the year ended 30 September 2005

	Note	UK GAAP £m	Effect of IFRS £m	IFRS £m
Interest receivable and similar income	(3b)	1,143	1	1,144
Interest expense and similar charges		(540)	-	(540)
Net interest income		603	1	604
Other operating income		334	-	334
Total operating income		937	1	938
Personnel expenses	(1) (2)	(190)	(11)	(201)
Depreciation and amortisation expense	(3a) (3b)	(47)	(2)	(49)
Other operating expenses		(348)	-	(348)
Total operating expenses		(585)	(13)	(598)
Operating profit before impairment losses		352	(12)	340
Impairment losses on loans and advances		(86)	-	(86)
Group operating profit		266	(12)	254
Profit on sale of land and buildings		21	-	21
Reorganisation costs	(1)	(102)	14	(88)
Profit on ordinary activities before tax		185	2	187
Tax expense	(4)	(61)	(2)	(63)
Retained profit for the financial year		124	-	124

Reconciliation of retained earnings at 1 October 2004

	Note	Group £m	Bank £m
UK GAAP retained earnings at 30 September 2004		629	544
IFRS adjustments applicable at 1 October 2004 :			
Defined benefit pension liabilities	(1)	(396)	(396)
Share based payments	(2)	(3)	(3)
Property, plant & equipment:			
Asset finance leases	(3b)	(5)	-
Taxation	(4)	118	117
		(286)	(282)
IFRS retained earnings at 1 October 2004		343	262

Note references are to the notes on pages 74 to 77.

40. Transition to IFRS (continued)

Reconciliation of retained earnings at 30 September 2005 and 1 October 2005

	Note	**Group £m**	**Bank £m**
UK GAAP retained earnings at 30 September 2005		754	684
IFRS adjustments applicable at 30 September 2005:			
Defined benefit pension liabilities	(1)	(377)	(377)
Share based payments	(2)	(11)	(11)
Property, plant & equipment:			
Contract purchase motor vehicles	(3a)	1	-
Asset finance leases	(3b)	(7)	-
Taxation	(4)	114	112
		(280)	(276)
IFRS retained earnings at 30 September 2005		474	408
IAS 32/39 adjustments applicable at 1 October 2005:			
Financial assets & liabilities at fair value through profit and loss			
Trading derivatives	(5b)	(15)	(15)
Bid and Offer Adjustment	(5b)	-	-
Financial assets at fair value	(5c)	27	27
Loans and advances			
Effective interest rate & deferral of income	(6a)	(33)	(29)
Impairment - collective provision	(6b)	(50)	(62)
Impairment - individually allocated provisions	(6b)	24	23
Re-recognition of financial liabilities	(6c)	(26)	(26)
Taxation	(4)	19	22
		(54)	(60)
IFRS retained earnings at 1 October 2005		420	348

Note references are to the notes on pages 74 to 77.

40. Transition to IFRS (continued)

Consolidated Balance Sheet Reconciliation at 1 October 2004

	Note	UK GAAP 30 Sept 04 £m	Effect of IFRS Reclassification £m	Effect of IFRS Measurement £m	IFRS 1 Oct 04 £m
Assets					
Cash and balances with central banks		127	19	-	146
Items in the course of collection		233	(233)	-	-
Loans and advances to banks		1,412	(1,170)	-	242
Available for sale investments		-	252	-	252
Loans and advances to customers	(3b)	16,189	(119)	(3)	16,067
Debt securities		251	(251)	-	-
Equity shares		1	(1)	-	-
Investments in controlled entities and associates		2	-	-	2
Operating lease assets		181	(181)	-	-
Property, plant and equipment	(3a) (3b)	187	181	(7)	361
Deferred tax assets	(4)	42	18	117	177
Other assets	(1)	148	152	(4)	296
Due from related parties		-	1,527	-	1,527
Prepayments and accrued income		176	(176)	-	-
Total assets		18,949	18	103	19,070
Liabilities					
Due to other banks		3,620	(3,553)	-	67
Items in the course of transmission		67	(67)	-	-
Due to customers		12,045	(107)	-	11,938
Debt securities in issue		3	(3)	-	-
Notes in circulation		824	(824)	-	-
Accruals and deferred income		119	(119)	-	-
Current taxes		-	76	-	76
Deferred tax liabilities	(4)	-	18	2	20
Provisions		44	(4)	-	40
Defined benefit pension liabilities	(1)	-	-	392	392
Bonds and notes		522	(522)	-	-
Due to related entities	(2)	-	4,325	-	4,325
Other liabilities	(3a)	469	798	(4)	1,263
		17,713	18	390	18,121
Shareholders' equity					
Share capital		205	-	-	205
Share premium account		45	-	-	45
Share option reserve		-	-	3	3
Asset revaluation reserve	(4)	19	-	(4)	15
Merger reserve		338	-	-	338
Retained earnings		629	-	(286)	343
Total shareholders' equity		1,236	-	(287)	949
Total liabilities and shareholders' equity		18,949	18	103	19,070

Note references are to the notes on pages 74 to 77.

40. Transition to IFRS (continued)

Bank Balance Sheet Reconciliation at 1 October 2004

	Note	UK GAAP 30 Sept 04 £m	Effect of IFRS Reclassification £m	Effect of IFRS Measurement £m	IFRS 1 Oct 04 £m
Assets					
Cash and balances with central banks		127	19	-	146
Items in the course of collection		233	(233)	-	-
Loans and advances to banks		1,412	(1,170)	-	242
Available for sale investments		-	252	-	252
Loans and advances to customers		16,267	(3,215)	-	13,052
Debt securities		251	(251)	-	-
Equity shares		1	(1)	-	-
Investments in controlled entities and associates		183	-	-	183
Property, plant and equipment	(3a)	187	-	(5)	182
Deferred tax assets	(4)	54	-	117	171
Other assets	(1)	141	156	(4)	293
Due from related entities		-	4,624	-	4,624
Prepayments and accrued income		181	(181)	-	-
Total assets		19,037	-	108	19,145
Liabilities					
Due to other banks		3,620	(3,553)	-	67
Items in the course of transmission		67	(67)	-	-
Due to customers		12,248	(107)	-	12,141
Debt securities in issue		3	(3)	-	-
Notes in circulation		824	(824)	-	-
Accruals and deferred income		107	(107)	-	-
Current taxes		-	47	-	47
Deferred tax liabilities	(4)	-	-	4	4
Provisions		44	(4)	-	40
Defined benefit pension liabilities	(1)	-	-	392	392
Bonds and notes		522	(522)	-	-
Due to related entities	(2)	-	4,325	-	4,325
Other liabilities	(3a)	451	815	(5)	1,261
		17,886	-	391	18,277
Shareholders' equity					
Share capital		205	-	-	205
Share premium account		45	-	-	45
Share option reserve		-	-	3	3
Asset revaluation reserve	(4)	19	-	(4)	15
Merger reserve		338	-	-	338
Retained earnings		544	-	(282)	262
Total shareholders' equity		1,151	-	(283)	868
Total liabilities and shareholders' equity		19,037	-	108	19,145

Note references are to the notes on pages 74 to 77.

40. Transition to IFRS (continued)

Consolidated Balance Sheet Reconciliation at 30 September 2005

	Note	UK GAAP 30 Sept 05 £m	Effect of IFRS Reclassification £m	Measurement £m	IFRS 30 Sept 05 £m
Assets					
Cash and balances with central banks		1,085	22	-	1,107
Items in the course of collection		287	(287)	-	-
Loans and advances to banks		788	(405)	-	383
Available for sale investments		-	2	-	2
Loans and advances to customers	(3b)	19,304	(184)	(2)	19,118
Debt securities		1	(1)	-	-
Equity shares		1	(1)	-	-
Investments in controlled entities and associates		2	-	-	2
Operating lease assets		179	(179)	-	-
Property, plant and equipment	(3a) (3b)	192	179	(10)	361
Deferred tax assets	(4)	49	31	110	190
Due from related entities		-	890	-	890
Other assets	(1)	193	176	(7)	362
Prepayments and accrued income		212	(212)	-	-
Total assets		22,293	31	91	22,415
Liabilities					
Due to other banks		3,468	(2,735)	-	733
Items in the course of transmission		72	(72)	-	-
Due to customers		13,690	(99)	-	13,591
Debt securities in issue		1,342	(1,342)	-	-
Notes in circulation		962	(962)	-	-
Accruals and deferred income		140	(140)	-	-
Current taxes	(4)	-	63	(2)	61
Deferred tax liabilities	(4)	-	31	2	33
Provisions	(1)	102	(9)	(14)	79
Defined benefit pension liabilities	(1)	-	-	382	382
Bonds and notes		572	(572)	-	-
Due to related entities	(2)	-	4,912	-	4,912
Other liabilities	(3a)	584	956	(4)	1,536
		20,932	31	364	21,327
Shareholders' equity					
Share capital		205	-	-	205
Share premium account		45	-	-	45
Share option reserve		-	-	11	11
Asset revaluation reserve	(4)	19	-	(4)	15
Merger reserve		338	-	-	338
Retained earnings		754	-	(280)	474
Total shareholders' equity		1,361	-	(273)	1,088
Total liabilities and shareholders' equity		22,293	31	91	22,415

Note references are to the notes on pages 74 to 77.

40. Transition to IFRS (continued)

Bank Balance Sheet Reconciliation at 30 September 2005

	Note	UK GAAP 30 Sept 05 £m	Effect of IFRS Reclassification £m	Effect of IFRS Measurement £m	IFRS 30 Sept 05 £m
Assets					
Cash and balances with central banks		1,085	22	-	1,107
Items in the course of collection		287	(287)	-	-
Loans and advances to banks		788	(405)	-	383
Available for sale investments			2	-	2
Loans and advances to customers		19,382	(2,869)	-	16,513
Debt securities		1	(1)	-	-
Equity shares		1	(1)	-	-
Investments in controlled entities and associates		33	-	-	33
Property, plant and equipment	(3a)	192	-	(5)	187
Deferred tax assets	(4)	73	1	110	184
Due from related entities		-	3,574	-	3,574
Other assets	(1)	192	180	(8)	364
Prepayments and accrued income		216	(216)	-	-
Total assets		22,250	-	97	22,347
Liabilities					
Due to other banks		3,468	(2,735)	-	733
Items in the course of transmission		72	(72)	-	-
Other wholesale deposits		-	-	-	-
Due to customers		13,744	(153)	-	13,591
Debt securities in issue		1,342	(1,342)	-	-
Notes in circulation		962	(962)	-	-
Accruals and deferred income		139	(139)	-	-
Current taxes	(4)	-	31	(3)	28
Deferred tax liabilities	(4)	-	1	5	6
Provisions	(1)	102	(9)	(14)	79
Defined benefit pension liabilities	(1)	-		382	382
Bonds and notes		572	(572)	-	-
Due to related entities	(2)	-	4,966	-	4,966
Other liabilities	(3a)	558	986	(4)	1,540
		20,959	-	366	21,325
Shareholders' equity					
Share capital		205	-	-	205
Share premium account		45	-	-	45
Share option reserve		-	-	11	11
Asset revaluation reserve	(4)	19	-	(4)	15
Merger reserve		338	-	-	338
Retained earnings		684	-	(276)	408
Total shareholders' equity		1,291	-	(269)	1,022
Total liabilities and shareholders' equity		22,250	-	97	22,347

Note references are to the notes on pages 74 to 77.

40. Transition to IFRS (continued)

Consolidated Balance Sheet Reconciliation at 1 October 2005

	Note	**IFRS 30 Sept 05 £m**	**IAS 32 & 39 £m**	**IFRS 1 Oct 05 £m**
Assets				
Cash and balances with central banks		1,107	-	1,107
Loans and advances to banks		383	-	383
Derivative financial assets	(5b)	-	71	71
Financial assets at fair value through profit and loss	(5c)	-	1,716	1,716
Available for sale investments		2	-	2
Loans and advances to customers	(5c) (6a) (6b) (6c)	19,118	(1,688)	17,430
Due from customers on acceptances	(5d)	-	6	6
Investments in controlled entities and associates		2	-	2
Property, plant and equipment		361	-	361
Deferred tax assets	(4)	190	20	210
Due from related entities		890	-	890
Other assets		362	7	369
Total assets		22,415	132	22,547
Liabilities				
Due to other banks		733	-	733
Derivative financial instruments	(5b)	-	43	43
Financial liabilities at fair value through profit and loss	(5c)	-	216	216
Due to customers	(6c)	13,591	(98)	13,493
Liabilities on acceptances	(5d)	-	6	6
Current taxes		61	-	61
Deferred tax liabilities	(4)	33	5	38
Provisions		79	-	79
Defined benefit pension liabilities		382	-	382
Due to related entities		4,912	-	4,912
Other liabilities	(4) (6c)	1,536	3	1,539
		21,327	175	21,502
Shareholders' equity				
Share capital		205	-	205
Share premium account		45	-	45
Share option reserve		11	-	11
Asset revaluation reserve		15	-	15
Merger reserve		338	-	338
Cash flow hedge reserve	(5a)	-	11	11
Retained earnings		474	(54)	420
Total shareholders' equity		1,088	(43)	1,045
Total liabilities and shareholders' equity		22,415	132	22,547

Note references are to the notes on pages 74 to 77.

40. Transition to IFRS (continued)

Bank Balance Sheet Reconciliation at 1 October 2005

	Note	**IFRS 30 Sept 05 £m**	**IAS 32 & 39 £m**	**IFRS 1 Oct 05 £m**
Assets				
Cash assets		1,107	-	1,107
Loans and advances to banks		383	-	383
Derivative financial assets	(5b)	-	71	71
Financial assets at fair value through profit and loss	(5c)	-	1,716	1,716
Available for sale investments		2	-	2
Loans and advances to customers	(5c) (6a) (6b) (6c)	16,513	(1,683)	14,830
Due from customers on acceptances	(5d)	-	6	6
Investments in controlled entities and associates		33	-	33
Property, plant and equipment		187	-	187
Deferred tax assets	(4)	184	22	206
Due from related entities		3,574	-	3,574
Other assets		364	(6)	358
Total assets		22,347	126	22,473
Liabilities				
Due to other banks		733	-	733
Derivative financial liabilities	(5b)	-	43	43
Financial liabilities at fair value through profit and loss	(5c)	-	216	216
Due to customers	(6c)	13,591	(98)	13,493
Liabilities on acceptances	(5d)	-	6	6
Current taxes		28	-	28
Deferred tax liabilities	(4)	6	5	11
Provisions		79	-	79
Defined benefit pension liabilities		382	-	382
Due to related entities		4,966	-	4,966
Other liabilities	(4) (6c)	1,540	3	1,543
		21,325	175	21,500
Shareholders' equity				
Share capital		205	-	205
Share premium account		45	-	45
Share option reserve		11	-	11
Asset revaluation reserve		15	-	15
Merger reserve		338	-	338
Cash flow hedge reserve	(5a)	-	11	11
Retained earnings		408	(60)	348
Total shareholders' equity		1,022	(49)	973
Total liabilities and shareholders' equity		22,347	126	22,473

Note references are to the notes on pages 74 to 77.

Management of risk

Effective management of risk is a key capability for a successful financial services provider, and is fundamental to the Clydesdale Bank Group's ("CB Group") strategy, as well as that of its ultimate parent entity National Australia Bank Limited ("NAB Group"). A key component of the NAB Group's risk management strategy is the establishment by the Board of a formal 'risk appetite statement' for the NAB Group and all major subsidiaries.

This places an overall limit on the total amount of risk that the NAB Group is prepared to take. That position is set with respect to the returns that the NAB Group is seeking to provide to shareholders, the credit rating that the NAB Group is seeking to maintain, and the NAB Group's capital position and desired capital ratios.

This position informs the CB Group's risk, capital and business management limits and policies. It is periodically reviewed by the Boards as a part of the strategic planning process, or as the commercial circumstances of the CB Group change.

In line with the NAB Group Risk Charter, the CB Group's approach to risk management is based on an overriding principle that risk management capability must be embedded within the business' front-line teams to be effective. This overriding principle embodies the following concepts:

- all business decisions proactively consider risk;
- business managers use the risk management framework which assists in the appropriate balancing of both risk and reward components;
- all employees are responsible for risk management in their day-to-day activities; and
- risk management is a core competency area for all employees.

The CB Group manages risk within an established 'three lines of defence' framework. Control is exercised through clearly defined delegation of authority, with clear and rapid communication and escalation channels throughout the organisation. The first line of defence comprises the business units managing the risks associated with their activities. The second line encompasses dedicated risk functions who are accountable for independent monitoring and oversight. The third line of defence relates to Internal Audit independently reviewing, monitoring, and testing business unit compliance with risk policies and procedures, and regularly assessing the overall effectiveness of the risk management framework.

The NAB Group Risk Management Committee, chaired by the Managing Director and Group Chief Executive, serves as the principal risk strategy and policy decision making body within the NAB Group, and provides the Board with assurance in the performance of the overall risk management framework. This committee is supported by five sub-committees - NAB Group Credit Risk Committee, NAB Group Market Risk Committee, NAB Group Operational Risk and Compliance Committee, NAB Group Asset and Liability Committee, and NAB Group Economic Capital Committee - each with a specialised focus.

Within the UK there is also a regional Risk Management Committee comprised of senior regional executives, which serves to provide a leadership focus on key risk issues from a regional perspective.

In addition, the NAB Group has four regional risk management teams including one in the UK. The UK team independently monitors and systematically assesses the risk profile within the region against established risk appetite parameters. They also assist the front line businesses in the design and implementation of appropriate risk management policies/strategies, and work with the businesses to promote awareness of the need to manage risk. Together with the NAB Group Risk Management function, efforts continue to evolve the organisational culture and staff behaviours.

Operational risk and compliance

Operational risk is the risk of loss resulting from inadequate or failed processes, people or systems, or from external events. This includes risk relating to the management of ongoing activities, as well as to organisational changes such as project and change initiatives.

The NAB Group continues to place significant focus on improving its operational risk management processes and systems. One area of improvement has been the governance process supporting operational risk management, including in particular, revisions to the Group Operational Risk and Compliance Committee charter and structures and the reporting and escalation of risks and issues.

Operational risk and compliance (continued)

Various reports are produced at management, Board sub-committee and Board level to assist with their oversight and monitoring obligations. This incorporates regional reporting of risk profiles, key operational risk and events, as well as consideration of external events and their relevance to the NAB Group. This process generates visibility and understanding of the NAB Group's overall operational risk profile.

The Operational Risk Framework ("ORF") is based on a set of core principles and defines the NAB Group's standards for operational risk management and compliance. Its design recognises the importance of embedding operational risk and compliance into "business-as-usual" activities. It has particular focus on defining and implementing the right behaviours and incorporating risk considerations into the NAB Group's systems and processes.

The ORF is an essential element the business strategy, which underpins all operational risk management activities. It includes:
- an established governance structure that is used to ensure consistent application, management and reporting of the operational risk management process. This element also includes the establishment and communication of the NAB Group's operational risk appetite;
- a structured risk management process to facilitate the identification, quantification and management of risks.

The CB Group is committed to sound risk management and compliance and is investing significantly in improving its capabilities in these areas.

Credit risk

Credit risk is the potential that a borrower or a counterparty will fail to meet its obligations in accordance with agreed terms. The NAB Group's credit risk management infrastructure is framed to provide sound management principles and practices for the maintenance of appropriate asset quality across the NAB Group. These principles and practices are followed by the CB Group. Group Portfolio Management & Policy, a division of NAB Group Risk Management, is responsible for the development and maintenance of credit policies and key credit risk systems.

The management of credit risk within the CB Group is achieved through both the traditional focuses on approval and monitoring of individual transactions and asset quality, analysis of the performance of the various credit risk portfolios and the independent oversight of credit portfolios across the Group. Portfolio monitoring techniques cover such areas as industry or geographic concentrations and delinquency trends. Roles and responsibilities between NAB Group Portfolio Management & Policy and the regional Risk Management Teams are clearly defined.

Significant credit risk strategies and policies are approved, and reviewed annually, by the NAB Board, and the NAB Risk Committee. Through such policies the NAB Board establishes the NAB Group's tolerance for risk. These policies are delegated to, and disseminated under the guidance and control of, executive management within the UK.

The NAB Group's credit policies, which are subject to ongoing review, are documented and disseminated in a form that provides a consistent view of all major credit policies supporting the credit operations of the NAB Group.

For complex credit products and services, NAB Group Portfolio Management & Policy provides a policy framework that identifies and quantifies risks and establishes the means of mitigating such risks.

Single large exposure policies are in place within the CB Group. Overall composition and quality of credit portfolio exposures are monitored and periodically reported to the CB Board, and, where required, to the relevant regional supervisory authorities.

A key factor in the introduction of new products and services is the identification of credit risk inherent in such products and services. This is managed through a process requiring acceptance by all impacted areas of the business and approval by Risk Management Committees prior to implementation.

Non-traded market risk

Non-traded market risk includes liquidity and funding risk, structural interest rate risk and foreign exchange risk.

The primary objective for the management and oversight of non-traded market risk is to maintain the risk profile within approved risk appetite and limits, while implementing strategies that protect current and future earnings from the impact of market volatility.

Non-traded market risk (continued)

Policies, inclusive of risk appetite and limits, are approved by the NAB Board, with Group authority delegated to the NAB Group Asset and Liability Management Committee (Group ALCO) and CB Asset and Liability Management Committees (CB ALCOs) for their subsequent implementation and monitoring.

The management of interest rate risk in the UK resides with Group Treasury.

Risk oversight is the responsibility of the Group Non-Traded Market Risk team. This team was established in January 2005, to strengthen the risk governance framework via introducing standards of independence and control resilience consistent with traded market risk, with teams in place across the UK business.

CB Group ALCO meets monthly and reports to the CB Group Risk Management Committee and the CB Board Risk Committee.

Liquidity and funding risk

Liquidity risk is the risk that the Group is unable to meet its current and future financial obligations as they fall due at acceptable cost. These obligations include the repayment of deposits on-demand or at their contractual maturity dates, the repayment of borrowings and loan capital as they mature, the payment of operating expenses and tax, the payment of dividends and the ability to fund new and existing loan commitments.

Liquidity within the CB Group is managed in accordance with the regulatory requirements of the FSA and with policies approved by the NAB Board, with oversight from CB Group ALCO and NAB Group ALCO.

To meet the requirements of local regulatory authorities the liquidity of the regional bank is managed on a daily basis as a stand-alone undertaking. CB Group ALCO delegates daily management responsibilities to the regional treasury operating divisions.

NAB Group policies are applied over and above the requirements of local regulatory authorities, when these supplement local regulatory policy. The combination of regulatory and NAB Group policy requirements results in liquidity being managed through a combination of positive cash flow management, the maintenance of portfolios of high quality liquid assets, and diversification of the funding base. NAB Group Policy uses liquidity scenarios to monitor both 'going concern' and 'name crisis' events. Cash flow mismatch limits have been established to limit the CB Group's liquidity exposure. In addition, regional banks are required to hold liquid asset portfolios to meet any unexpected cash flow requirement.

A three-level contingency plan has also been established for management of an escalated liquidity requirement where the CB Group experiences either restricted access to wholesale funding, or a large increase in the withdrawal of funds. The plan identifies triggers on each level, details the action required, allocates the key tasks to individuals, provides a timeframe and defines a management committee to manage the action plan.

Structural interest rate risk

Structural interest rate risk comprises the sensitivity of the CB Group's current and future net interest income to movements in market interest rates.

These are three major contributors to interest rate risk:
- the investment of non-interest bearing deposits and equity into interest-bearing assets;
- the mismatch between repricing dates of interest-bearing assets and liabilities; and
- the inability of the pricing 'basis' for customer asset and liability products to be replicated in the financial markets.

Within the objective to secure stable and optimal net interest income over both a 12-month period and over the long term, mismatch risk can be minimised with the investment of equity and non-interest-bearing deposits targeting the stability of net interest income.

Interest rate risk is principally managed through the use of interest rate swaps and caps/floors. All products are used within approved mandates, with strategies subject to monthly reporting to NAB Group ALCO and CB Group ALCO.

Interest rate risk management across the NAB Group is directed by NAB Group Treasury, with execution on a UK business basis via CB Group Treasury. CB Group ALCO, via Risk Committee oversight, monitors risk to ensure it remains within approved policy and limits set by the NAB Board.

Structural interest rate risk (continued)

Basis risk is more difficult to manage, given limited market liquidity in basis risk products. To mitigate this risk, NAB Group Treasury and the NAB Group Non-Traded Market Risk team closely monitor pricing strategies, product innovation and marketing, since these play an important role in reducing the mismatch attributable to repricing characteristics of customer assets and liabilities.

As a further step in its commitment to strengthen the risk management and oversight framework, the NAB Group has introduced Value at Risk (VaR) as one of its principal measures for interest rate risk, along with an Earnings at Risk (EaR) measure that calculates the impact on future net interest income over the next 12 months. These limit measures are complemented by sensitivity and scenario analysis.

These improved risk measures and the independence of NAB Group Treasury and NAB Non-Traded Market Risk management structures have contributed to a more transparent interest rate risk management framework within NAB Board approved risk appetite and limits.

Foreign exchange risk

Real foreign exchange exposures arise independently of the accounting process. Such transaction exposures arise from the risk that future cash flows will be converted to Sterling at less favourable rates than at present. Such cash flows could result from the repatriation of profits or capital back to the Company. The policy of NAB Group is to fully hedge these exposures at the time of commitment, if they are of a material nature. Such hedging of transaction exposures is assessed on a case-by-case basis.

The transactional currency exposures principally arise from dealings with customers and the CB Group maintains a matched position through transactions with NAB Group.