

Except where indicated (#) this information is an integral part of the audited financial statements.

Capital management

The Group's capital management approach is driven by its desire to maintain a strong capital base to support the development of its business, to meet regulatory capital requirements at all times and to maintain good credit ratings.

Strategic business and capital plans are drawn up annually covering a three year horizon and approved by the Board. The plan ensures that adequate levels of capital and an optimum mix of the different components of capital are maintained by the Group to support the strategy. This is integrated with the Group's annual planning process that takes into consideration business growth assumptions across products and geographies and the related impact on capital resources.

The capital plan takes the following into account:

- regulatory capital requirements;
- forecast demand for capital to maintain the credit ratings;
- increases in demand for capital due to business growth, market shocks or stresses;
- available supply of capital and capital raising options; and
- internal controls and governance for managing the Group's risk, performance and capital.

The Group uses a capital model to assess the capital demand for material risks, and to support its internal capital adequacy assessment. Each material risk is assessed, relevant mitigants considered, and appropriate levels of capital determined. The capital model is a key part of the Group's management disciplines and formed the basis of the Group's submission to the FSA of its Internal Capital Adequacy Assessment Process ('ICAAP') for Basel II.

A strong governance culture and framework is embedded in the capital planning and assessment methodology. Overall responsibility for the effective management of risk rests with the Group's Board. The ARC reviews specific risk areas and reviews the issues discussed at the key capital management committees. The GALCO has set internal triggers and target ranges for capital management, and oversees adherence with these.

Current compliance with Basel I and the FSA Handbook

The Group's supervisor is the FSA. The capital that the Group is required to hold by the FSA is determined by its balance sheet, off-balance sheet and market risk positions weighted according to the type of counterparty instrument and collateral held. Further detail on counterparty and market risk positions is included in the Risk Review section on pages 56 to 57.

Local capital is maintained on the basis of host regulator's requirements. Processes are in place to ensure compliance with local regulatory ratios in all entities. The Group has put in place processes and controls to monitor and manage capital adequacy, and no breaches were reported during the year.

The table on page 61 summarises the capital position of the Group. The principal forms of capital are included in the following balances on the consolidated balance sheet: share capital and reserves (called-up ordinary share capital and preference shares, and eligible reserves), subordinated liabilities (innovative Tier 1 securities and qualifying subordinated liabilities), and loans to banks and customers (portfolio impairment provision).

Movement in capital

Total capital has increased by \$6,902 million to \$28,727 million compared to 2006. The increase has been primarily driven by increased ordinary and preference share capital, up by \$1,144 million largely from a \$750 million preference share issue during the year, increased eligible reserves, up by \$2,445 million largely due to increased retained earnings, and an increase in qualifying subordinated liabilities, net of amortisation, of \$2,884 million following issues of £300 million Lower Tier 2 Step-Up Dated Subordinated Notes, and €700 million and \$1 billion of subordinated debt.

Basel II

The Basel Committee on Banking Supervision published a framework for International Convergence of Capital Measurement and Capital Standards ('Basel II'), which replaces the 1988 Basel Accord. Basel II is structured around three 'pillars':

- Pillar 1 sets out minimum regulatory capital requirements – the minimum amount of capital banks must hold against risks;
- Pillar 2 sets out the key principles for supervisory review of an institution's risk management framework and, ultimately, its capital adequacy. It sets out specific oversight responsibilities for the Board and senior management, thus reinforcing principles of internal control and other corporate governance practices; and
- Pillar 3 aims to bolster market discipline through enhanced disclosure by banks.

Basel II provides three approaches of increasing sophistication to the calculation of credit risk capital; the Standardised Approach, the Internal Ratings Based Foundation Approach and the Internal Ratings Based Advanced Approach. Basel II also introduces capital requirements for operational risk for the first time.

The EU Capital Requirements Directive ('CRD') is the means by which Basel II is being implemented in the EU. EU Member States were required to bring implementing provisions into force by 1 January 2007. In the case of the provisions relating to advanced approaches for credit risk and operational risk, implementation becomes available from 1 January 2008. In the UK the CRD is implemented by the FSA through the General Prudential Sourcebook ('GENPRU') and BIPRU.

Transitional provisions mean that, unless firms notify the FSA to the contrary, they continue to apply existing capital calculations until 1 January 2008.

From 1 January 2008 the Group will use Advanced Internal Ratings Based Approach for the measurement of credit risk capital. This approach builds on the Group's risk management practices and is the result of a significant investment in data warehouse and risk models.

The Group applies a VaR model for the measurement of market risk capital in accordance with the scope of the permission to use such a model granted by the FSA. Where the Group's market risk exposures are not approved for inclusion in its VaR model, capital requirements are based on standard rules provided by the regulator which are less risk sensitive.

Capital continued

For the first time the Group will also be required to calculate a new capital charge to cover operational risk. The Group will apply the Standardised Approach for determining the capital requirements for operational risk.

During the transition period, Basel II capital requirements must not be less than 90 per cent of Basel I capital requirements in 2008 reducing to 80 per cent in 2009.

	2007 \$million	2006* \$million
Tier 1 capital:		
Called-up ordinary share capital and preference shares	8,915	7,771
Eligible reserves	11,382	8,937
Minority interests	271	209*
Innovative Tier 1 securities	2,338	2,262
Less: Restriction on innovative Tier 1 securities	–	(355)*
Goodwill and other intangible assets	(6,380)	(6,247)*
Unconsolidated associated companies	283	229
Other regulatory adjustments	(19)	(94)
Total Tier 1 capital	16,790	12,712
Tier 2 capital:		
Eligible revaluation reserves	927	509
Portfolio impairment provision	536	543*
Qualifying subordinated liabilities:		
Perpetual subordinated debt	3,394	3,368
Other eligible subordinated debt	8,764	5,387
Less: Amortisation of qualifying subordinated liabilities	(1,037)	(518)
Restricted innovative Tier 1 securities	–	355*
Total Tier 2 capital	12,584	9,644
Investments in other banks	(136)	(211)
Other deductions	(511)	(320)
Total capital base	28,727	21,825
Banking book:		
Risk weighted assets [#]	132,942	120,018*
Risk weighted contingents [#]	22,531	21,106
	155,473	141,124
Trading book:		
Market risks [#]	8,396	5,834
Counterparty/settlement risks [#]	7,964	6,475
Total risk weighted assets and contingents[#]	171,833	153,433
Capital ratios – Basel I		
Tier 1 capital [#]	9.8%	8.3%*
Total capital [#]	16.7%	14.2%*
Total capital ratio – Basel II[#]	15.2%	N/A

* Amounts have been restated as explained in note 51 on page 154.