Financial strength

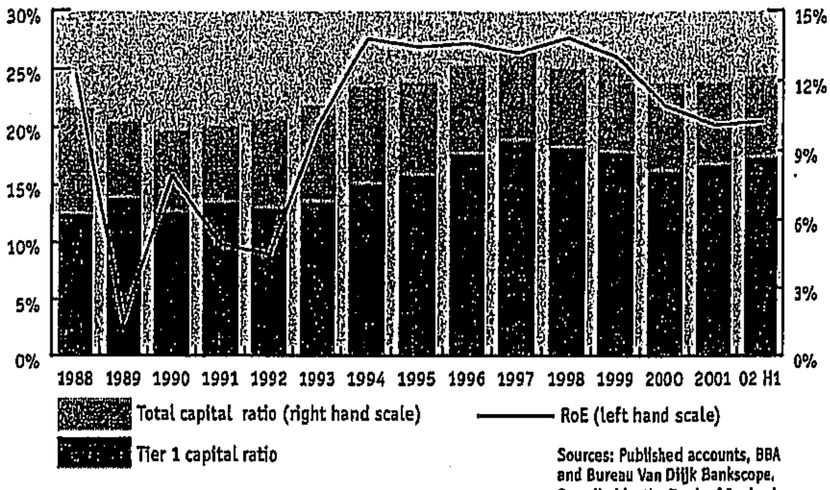
Capital

On the whole, UK banks are strongly capitalised. In 2001, 99% of UK-incorporated banks and building societies had an overall solvency ratio of over 10%. Overall solvency ratios (as well as Tier 1 ratios) for the major UK banks rose slightly in the six months to September 2002.

Some banking groups have been affected by the weakened financial position of the UK insurance industry. A number of banks have had to inject capital into their insurance subsidiaries and some may need to make additional capital injections in future, particularly if there are further falls in equity prices. At the consolidated level, elements of some groups' Tier 1 capital relates to value within insurance subsidiaries. The value of this capital can depend on the performance of the insurance business so it may not be as permanent as the shareholders' equity within the parent bank.

Capital levels within the building society sector have fallen from a solvency ratio of 14.3% in mid-1995 to 12.5% at the end of 2001. This largely reflects the 'mutualist' strategy of narrowing margins among the remaining societies that decided against converting into a public company. Profits have been returned to members, principally in the form of lower borrowing rates. Competitive pressures have however increased, and it might be difficult to restore higher margins in future, even if this is desirable to increase capital levels or offset higher loan loss provisions.

Chart 5: Major UK-owned banks' profitability and capitalisation



Sources: Published accounts, BBA and Bureau Van Dijk Bankscope. Compiled by the Bank of England

In terms of access to new capital, in addition to internal profit generation, building societies have some ability to raise debt capital. At present only 13% of building societies' capital is Tier 2, leaving scope for additional subordinated debt issues if required, especially by the larger societies. Building societies can also issue permanent interest bearing shares (PIBS) if they require additional Tier 1 capital. Smaller societies have fewer potential investors for debt capital issues, but generally have higher Tier 1 and overall capital ratios.

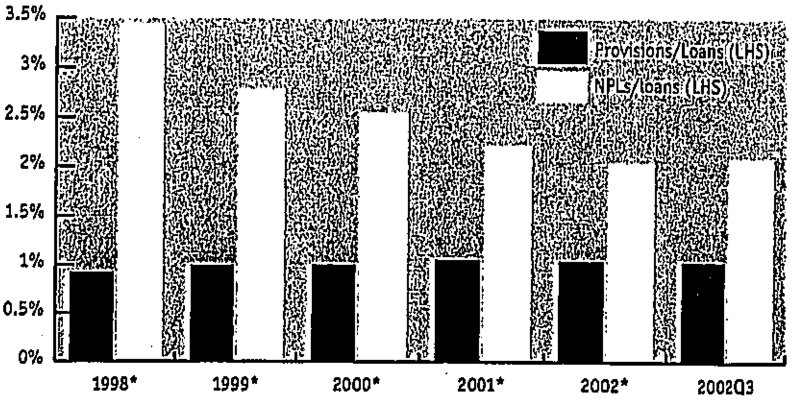
Profitability

The profitability of the major UK banks remains strong, although it has declined slightly from the peak levels of 1999-2000. The main factor behind this has been an increase in provisions and write-offs against corporate and emerging market exposures. The prospect of deteriorating credit conditions, particularly within the UK retail sector, may lead to further erosion of profitability over the medium term.

Although full year results for 2002 have not yet been published, it is clear that conditions have become more difficult for UK banks than in the recent past. Trading statements for the third quarter of 2002 revealed higher provisions in the second half of the year and weaker revenue growth. Provisioning ratios have not however risen as lending has also continued to grow strongly (see Chart 6, opposite). Profits have been generally towards the lower end of analysts' estimates, although firms with a purely UK retail business have been better able to maintain their profitability. Where reported earnings have fallen, this has largely been as a result of provisions made against losses in Latin America, actual or expected losses in the energy and telecoms sectors and private equity investments.

The capacity for building societies to manage margins has been eroded by the greater prevalence of fixed or capped rate mortgage products, which now account for around a third of loans. Interest rate risk management as a whole has become less straightforward as product offerings have become more varied and complex. Retail mortgage products now commonly include features such as caps, base rate tracking and fixed-rate periods. Borrowers may also choose to redeem these mortgages early (sometimes with no penalty), which introduces an element of optionality into firms' interest rate risk calculations.

Chart 6: Major UK-owned banks' provisions and non-performing loans (NPLs)



* Year to March

Source: FSA

Potential credit risk lendings

Potential credit risk lendings (PCRL's) comprise non-performing loans (NPL's) and potential problem loans (PPL's). NPL's are loans where the customers have failed to meet their commitments, either in part or in whole. PPL's are loans which are current as to payment of principal and interest, but where there exists serious doubt as to the ability of the borrowers to comply with repayment terms in the near future.

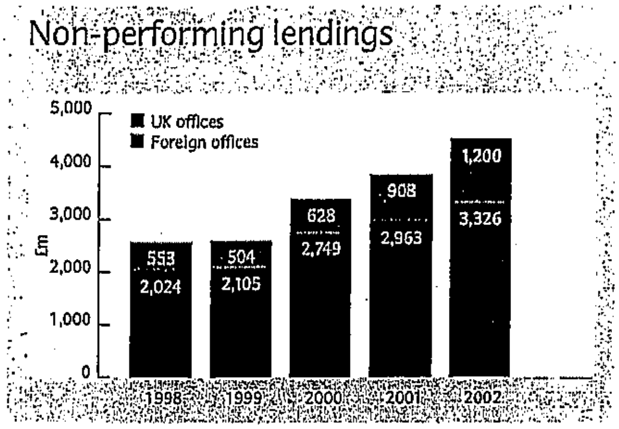
The tables and charts that follow present an analysis of potential credit risk lendings consistent in total with UK guidelines and practice, although more detail is provided to meet SEC guidelines. Further disclosure is made to record loans where interest is accrued but is being suspended or where specific provisions have been raised. Normal US banking practice would be to place such loans on non-accrual status. The amounts are stated before deduction of the value of security held, the specific provisions carried or interest suspended, all of which might reduce the impact of an eventual default, should it occur. The geographical presentation is based on the location of the office recording the transaction.

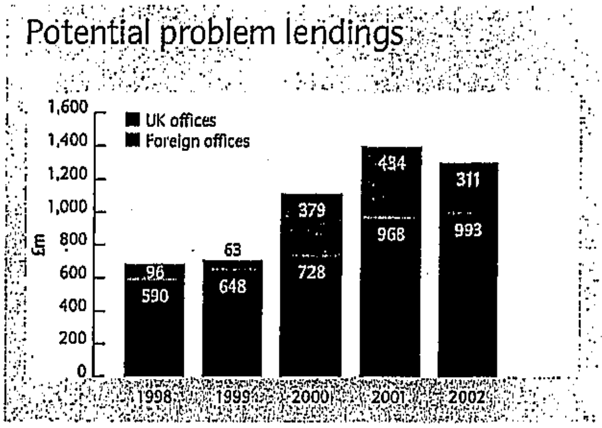
Non-performing loans

	2002 £m	2001 restated £m	2000 restated £m	1999 £m	1998 £m
Non-accrual lendings:					
UK	1,557	1,292	1,223	1,007	985
Other European Union	108	90	96	122	208
United States	744	306	119	47	38
Rest of the World	133	235	101	75	36
Accruing lendings where interest is being suspended:					
UK	472	386	351	326	266
Other European Union	44	30	36	19	26
United States	–	–	–	–	–
Rest of the World	95	145	109	91	92
Other accruing lendings against which provisions have been made:					
UK	606	660	474	423	457
Other European Union	27	20	71	42	74
United States	–	11	2	38	10
Rest of the World	44	43	76	50	50
Subtotals:					
UK	2,635	2,338	2,048	1,756	1,708
Other European Union	179	140	203	183	308
United States	744	317	121	85	48
Rest of the World	272	423	286	216	178
Accruing lendings 90 days overdue, against which no provisions have been made:					
UK	687	621	695	343	309
Other European Union	3	–	1	–	2
United States	–	–	–	–	–
Rest of the World	–	27	17	18	17
Reduced rate lendings:					
UK	4	4	6	6	7
Other European Union	–	–	–	–	–
United States	–	–	–	–	–
Rest of the World	2	1	–	2	–
Total non-performing loans:					
UK	3,326	2,963	2,749	2,105	2,024
Other European Union	182	140	204	183	310
United States	744	317	121	85	48
Rest of the World	274	451	303	236	195
Total	4,526	3,871	3,377	2,609	2,577

Potential problem loans

	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
UK	993	968	728	648	590
Other European Union	2	2	2	23	24
United States	241	369	313	5	4
Rest of the World	68	63	64	35	68
Total	1,304	1,402	1,107	711	686





UK non-performing loans increased by £363m to £3,326m primarily reflecting increases in the large corporate sector. These included loans to foreign borrowers made in the UK and were spread across a number of sectors, with telecommunications and energy being prominent. There were also additions from UK middle market business customers.

US non-performing loans increased by £427m to £744m reflecting the continued difficult economic conditions faced by the telecommunications and energy sectors. US potential problem loans fell by £128m to £241m primarily due to the reclassification of balances into the non-performing categories.

Other European Union non-performing loans increased from £140m to £182m. In the Rest of the World they fell to £274m, a decrease of £177m, primarily reflecting the reorganisation of the Group's Caribbean business in October 2002.

Interest forgone on non-performing loans

The total interest income that would have been recognised under the original contractual terms of the non-performing loans in 2002 was £275m (2001: £279m) of which £209m (2001: £210m) related to domestic lending and £66m (2001: £69m) related to foreign loans.

Interest income of approximately £22m (2001: £50m) from such loans was included in profit, of which £21m (2001: £33m) related to domestic lending and the remainder to foreign lending.

Ratios of provisions to non-performing loans and PCRL's appear in the next section, following the discussion of provisions.

Provisions for bad and doubtful debts

Barclays policy is to provide for credit losses when it considers that recovery is doubtful. The provision is made up of two components, a specific provision and a general provision. Risk managers continuously review the quality of the exposures based on their knowledge of the customer or counterparty, and developments in the industry and country of operation.

During 2002, credit conditions were less favourable than for several years and some sectors experienced difficulties. These circumstances are reflected in the bad debt charge for the year as set out in the table below. The net charge rose by 29% to £1,484m, an increase of £335m. New and increased specific provisions were 19% higher at £1,719m. Releases and recoveries together decreased by 15% at £233m.

The greater part of this increase occurred in Barclays Capital (£231m) and in the South American Corporate Banking (£96m) portfolios. The increase in provisions at Barclays Capital reflected difficult economic conditions, mainly in the telecommunications and energy sectors, particularly in the US. The deterioration in the second half of 2002 was largely in existing non-performing loans. The increase in South American Corporate Banking mainly related to Argentina.

Business Banking sustained an 8% increase in its bad debt provision charge, broadly in line with expectations. The charge for Barclaycard was £402m, 7% higher reflecting the acquisition of Providian UK and organic growth in average extended credit balances of 9%. Within Personal Financial Services, the provision charge fell by 13%, reflecting in part improvements in risk management.

Analysis of provision charges for bad and doubtful debts

	As at 31st December				
	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
Net specific provision charge / (release)*					
UK	1,041	964	688	568	501
Other European Union	14	20	12	1	(4)
United States**	385	136	17	34	(10)
Rest of the World	46	45	60	32	5
Total net specific provision charge	1,486	1,165	777	635	492
General provision charge / (release)	(2)	(16)	40	(14)	–
	1,484	1,149	817	621	492

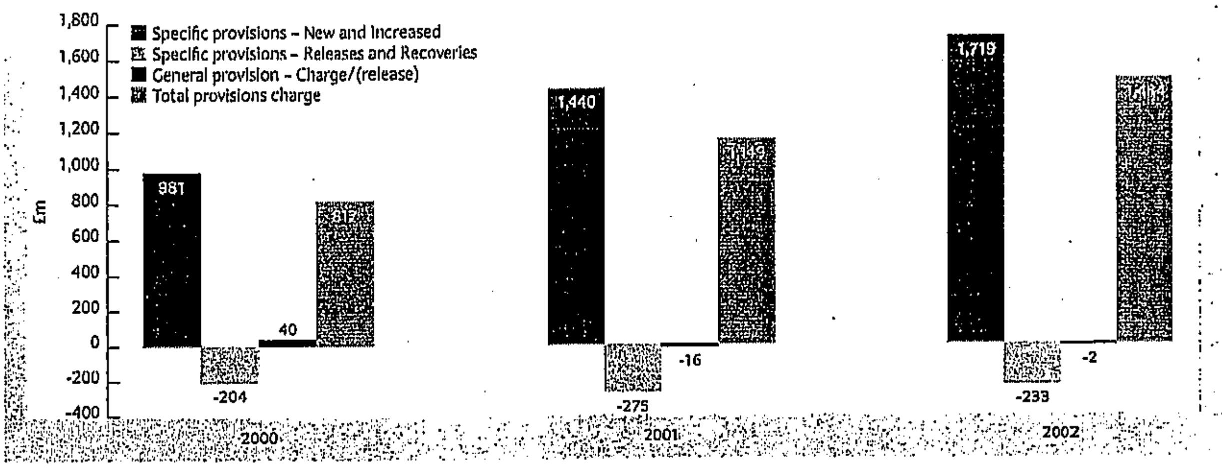
* The geographical analysis of provisions is based on the location of the office recording the transaction.
** The US charge includes provisions raised against Argentinean exposures booked in the US.

Analysis of provision balances for bad and doubtful debts

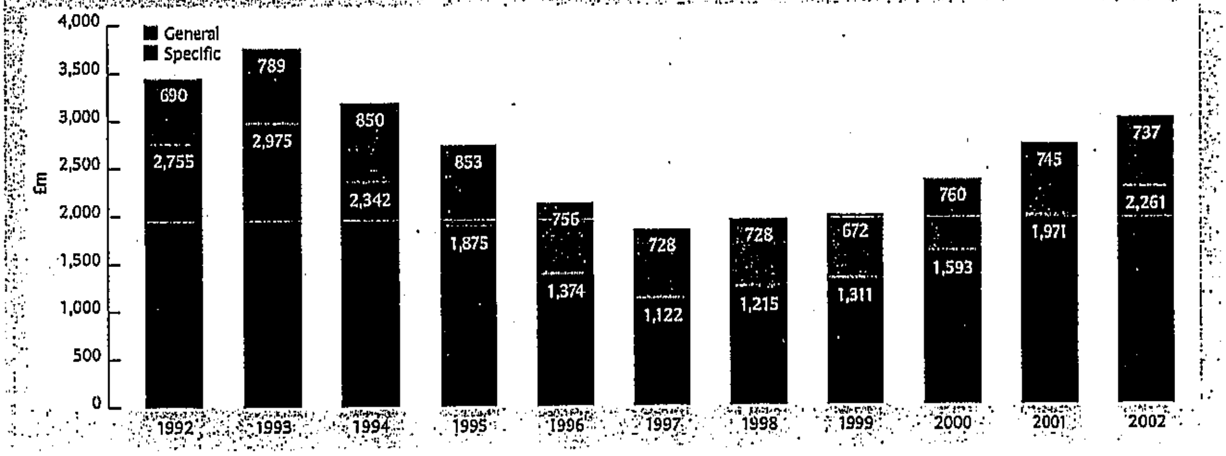
	As at 31st December				
	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
Specific provision*					
UK	1,790	1,605	1,343	1,083	937
Other European Union	84	89	112	131	220
United States**	257	89	20	23	23
Rest of the World	130	188	118	74	35
Total specific provision	2,261	1,971	1,593	1,311	1,215
General provision	737	745	760	672	728
	2,998	2,716	2,353	1,983	1,943
Average loans and advances for the year (excluding trading business)	174,764	157,904	122,333	106,488	101,338
(including trading business)	256,789	223,221	176,938	147,139	145,749

* The geographical analysis of provisions is based on the location of the office recording the transaction.
** The US balance includes provisions held against Argentinean exposures booked in the US.

Provision charge analysis



Provision balances



Provisioning approach

General provisions reflect losses that, although not specifically identified, are known from experience to be present in the lending portfolio at the balance sheet date.

These provisions are adjusted at least half yearly by an appropriate charge or release of general provisions based on statistical estimates. The general provisions take Risk Tendency (statistically expected losses) into account, based on models that are systematically updated to reflect evolving loss experience.

See Credit risk management on pages 57 to 58 for a fuller description of Risk Tendency.

Specific provisions are raised for:

» Individual counterparties when the Group considers that the creditworthiness of a borrower or counterparty has undergone deterioration such that the recovery of the whole or part of an outstanding advance is in serious doubt.

» Homogeneous portfolios comprised of large numbers of individually small lendings, where the characteristics of the portfolio permit statistical models to be used in estimating specific provisions. These statistical models are consistent with the Group's policy of raising provision when recovery is doubtful. These provisions are raised in parts of Personal Financial Services, Woolwich, Barclays Private Clients, Barclaycard and Business Banking.

Write-off occurs immediately to the extent that the whole or part of the debt is considered unrecoverable.

Treatment of interest on debts that have specific provisions
If the collection of interest is doubtful, it is credited to a suspense account and excluded from interest income in the profit and loss account. Although interest continues to be charged to the customer's account, the amount suspended is netted against the relevant loan. Loans on which interest is suspended are not reclassified as accruing interest until interest and principal payments are up-to-date and future payments are reasonably assured. If the collection of interest is considered remote, interest is no longer applied.

Treatment of collateral assets acquired in exchange for advances
Assets acquired in exchange for advances in order to achieve an orderly realisation continue to be reported as advances. The assets acquired are recorded at the carrying value of the original advance as at the date of the exchange. Any impairment is accounted for as a specific provision.

Bad debt provisions charge ratios

	Year ended 31st December				
	2002 %	2001 %	2000 %	1999 %	1998 %
Provisions charge as a percentage of average loans and advances for the year (excluding trading business):					
Specific provisions	0.85	0.74	0.64	0.60	0.49
General provisions	–	(0.01)	0.03	(0.02)	–
	0.85	0.73	0.67	0.58	0.49
Amounts written off (net of recoveries)	0.64	0.53	0.47	0.52	0.40
Provisions charge as a percentage of average loans and advances for the year (including trading business):					
Specific provisions	0.58	0.52	0.44	0.43	0.34
General provisions	–	–	0.02	(0.01)	–
	0.58	0.52	0.46	0.42	0.34
Amounts written off (net of recoveries)	0.43	0.37	0.32	0.38	0.28

Provisions balance ratios

	As at 31st December				
	2002 %	2001 %	2000 %	1999 %	1998 %
Provisions balance at end of year as a percentage of loans and advances at end of year (excluding trading business):					
Specific provision	1.29	1.22	1.06	1.19	1.17
General provision	0.42	0.46	0.51	0.61	0.70
	1.71	1.68	1.57	1.80	1.87
Provisions balance at end of year as a percentage of loans and advances at end of year (including trading business):					
Specific provision	0.86	0.85	0.79	0.83	0.90
General provision	0.28	0.32	0.38	0.42	0.54
	1.14	1.17	1.17	1.25	1.44

Movements in provisions for bad and doubtful debts

	Year ended 31st December				
	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
Provisions balance at beginning of year	2,716	2,353	1,983	1,943	1,850
Acquisitions and disposals	(11)	46	119	(10)	–
Exchange and other adjustments	(77)	(1)	4	(13)	6
Amounts written off:					
UK	(950)	(814)	(595)	(546)	(520)
Other European Union	(31)	(36)	(45)	(44)	(45)
United States	(215)	(94)	(26)	(40)	(7)
Rest of the World	(24)	(29)	(17)	(21)	(9)
	(1,220)	(973)	(683)	(651)	(581)
Recoveries (analysed below)	106	142	113	93	176
Subtotal	1,514	1,567	1,536	1,362	1,451
Provisions charged against profit					
New and increased specific provisions:					
UK	1,210	1,157	843	768	753
Other European Union	33	35	35	27	32
United States	404	173	27	45	11
Rest of the World	72	75	76	47	23
	1,719	1,440	981	887	819
Releases of specific provisions:					
UK	(81)	(87)	(55)	(115)	(96)
Other European Union	(12)	(10)	(17)	(22)	(32)
United States	(10)	(10)	(6)	(7)	(8)
Rest of the World	(24)	(26)	(13)	(15)	(15)
	(127)	(133)	(91)	(159)	(151)
Recoveries:					
UK	(88)	(106)	(100)	(85)	(156)
Other European Union	(7)	(5)	(6)	(4)	(4)
United States	(9)	(27)	(4)	(4)	(13)
Rest of the World	(2)	(4)	(3)	–	(3)
	(106)	(142)	(113)	(93)	(176)
Net specific provisions charge	1,486	1,165	777	635	492
General provision charge/(release)*	(2)	(16)	40	(14)	–
Net charge to profit	1,484	1,149	817	621	492
Provisions balance at end of year	2,998	2,716	2,353	1,983	1,943

* An analysis of the movement in general provisions is shown in note 17 to the accounts.

Provisions charge for bad and doubtful debts by industry

	Net specific provision for the year					Specific provisions at 31st December				
	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
UK:										
Banks and other financial institutions	1	(2)	7	10	11	1	5	7	9	14
Agriculture, forestry and fishing	(1)	6	6	4	(5)	7	13	11	7	4
Manufacturing	80	62	8	4	15	98	49	43	48	41
Construction	41	12	7	4	(7)	35	6	8	7	10
Property	8	3	1	(5)	(20)	9	8	8	8	12
Energy and water	22	1	8	–	–	28	10	8	2	2
Wholesale and retail distribution and leisure	37	44	21	34	(10)	54	60	42	42	18
Transport	7	6	2	4	(1)	7	6	4	4	2
Communications	16	1	–	–	1	15	1	1	1	1
Business and other services	62	75	27	14	(7)	92	77	40	34	43
Home loans	4	8	10	5	(4)	53	60	61	39	35
Other personal	748	782	577	504	376	1,343	1,252	1,041	830	664
Overseas customers (a)	13	(34)	6	(22)	152	39	52	58	41	88
Finance lease receivables	3	–	8	12	–	9	6	11	11	3
	1,041	964	688	568	501	1,790	1,605	1,343	1,083	937
Foreign	445	201	89	67	(9)	471	366	250	228	278
	1,486	1,165	777	635	492	2,261	1,971	1,593	1,311	1,215

Analysis of amounts written off and recovered by industry

	Amounts written off for the year					Recoveries of amounts previously written off				
	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
UK:										
Banks and other financial institutions	2	3	13	14	16	–	3	4	2	12
Agriculture, forestry and fishing	4	7	6	6	2	2	2	2	3	7
Manufacturing	72	65	30	20	28	22	11	16	12	12
Construction	15	16	8	12	12	3	2	2	3	5
Property	10	5	5	9	17	2	1	3	7	22
Energy and water	4	1	2	–	–	1	–	–	–	–
Wholesale and retail distribution and leisure	53	35	34	35	25	11	9	12	17	45
Transport	7	4	3	4	2	1	–	1	1	1
Communications	2	–	–	1	–	–	–	–	–	–
Business and other services	65	57	33	43	36	13	9	11	12	27
Home loans	11	14	15	3	8	1	4	3	2	4
Other personal	692	599	435	363	254	31	29	28	24	21
Overseas customers (a)	9	2	7	31	120	–	35	17	1	–
Finance lease receivables	4	6	4	5	–	1	1	1	1	–
	950	814	595	546	520	88	106	100	85	156
Foreign	270	159	88	105	61	18	36	13	8	20
	1,220	973	683	651	581	106	142	113	93	176

Note
(a) Includes amounts in 1998 in respect of Russian counterparties recorded in the UK.

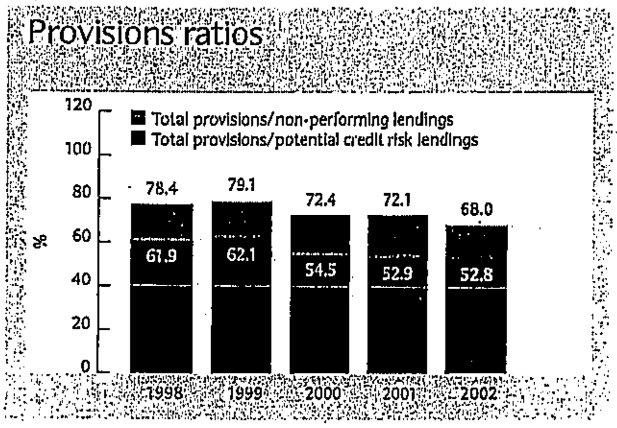
Total provision coverage of total non-performing loans

	2002 %	2001 %	2000 %	1999 %	1998 %
UK	73.5	74.9	72.9	81.1	78.4
Other European Union	71.4	78.6	72.1	94.5	95.2
United States	43.7	61.8	81.0	74.1	104.2
Rest of the World	65.0	59.2	64.7	50.4	45.1
Total	68.0	72.1	72.4	79.1	78.4

Total provision coverage of total potential credit risk lendings (NPL's and PPL's)

	2002 %	2001 %	2000 %	1999 %	1998 %
UK	56.6	56.4	57.7	62.0	60.7
Other European Union	70.7	77.5	71.4	84.0	88.3
United States	33.0	28.6	22.6	70.0	96.2
Rest of the World	52.0	51.9	53.4	43.9	33.5
Total	52.8	52.9	54.5	62.1	61.9

Geographically, the specific provision is allocated according to the location of the office recording the transaction. Similarly, the general provision is allocated according to the characteristics of the loans in each geographic area.



Another useful way of assessing provision balances is to recognise that specific provisions are created to cover non-performing loans, whereas general provisions relate to as yet unidentified losses on performing lendings. The following table provides an analysis of provision balances on this basis.

Ratios of general and specific provision balances

	2002 %	2001 %	2000 %	1999 %	1998 %
Specific provisions coverage of non-performing loans					
Specific provisions/Non-performing loans	50.0	50.9	47.2	50.2	47.1
General provisions coverage of performing loans					
General provisions/Performing loans	0.28	0.33	0.38	0.43	0.55

The ratio of general provisions to performing loans declined in 2001 with the acquisition of Woolwich plc, a portfolio consisting predominantly of secured residential mortgage loans needing comparatively low general provisions. These ratios include both trading and banking books. Performing loans comprise gross loans and advances to banks and customers (banking and trading) less non-performing loans.

Potential credit risk lendings

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Non-performing loans

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			(£ millions)		
Non-accrual lendings:					
UK	**1,557**	1,292	1,223	1,007	985
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Other European Union	**3**	—	1	—	2
United States	**—**	—	—	—	—
Rest of the World	**—**	27	17	18	17
Reduced rate lendings:					
UK	**4**	4	6	6	7
Other European Union	**—**	—	—	—	—
United States	**—**	—	—	—	—
Rest of the World	**2**	1	—	2	—
Total non-performing loans:					
UK	**3,326**	2,963	2,749	2,105	2,024
Other European Union	**182**	140	204	183	310
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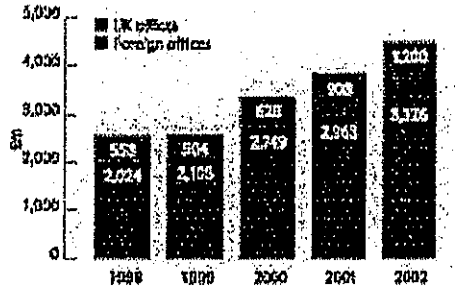
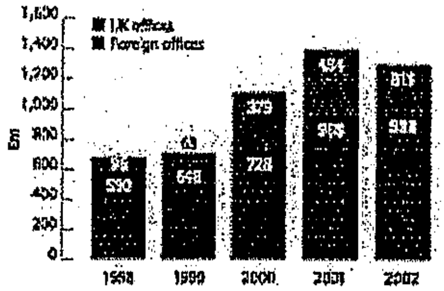
Non-performing lendings



Potential problem lendings



UK non-performing loans increased by £363m to £3,326m primarily reflecting increases in the large corporate sector. These included loans to foreign borrowers made in the UK and were spread across a number of sectors, with telecommunications and energy being prominent. There were also additions from UK middle market business customers.

US non-performing loans increased by £427m to £744m reflecting the continued difficult economic conditions faced by the telecommunications and energy sectors. US potential problem loans fell by £128m to £241m primarily due to the reclassification of balances into the non-performing categories.

Other European Union non-performing loans increased from £140m to £182m. In the Rest of the World they fell to £274m, a decrease of £177m, primarily reflecting the reorganisation of the Group's Caribbean business in October 2002.

Interest forgone on non-performing loans

The total interest income that would have been recognised under the original contractual terms of the non-performing loans in 2002 was £275m (2001: £279m) of which £209m (2001: £210m) related to domestic lending and £66m (2001: £69m) related to foreign loans.

Interest income of approximately £22m (2001: £50m) from such loans was included in profit, of which £21m (2001: £33m) related to domestic lending and the remainder to foreign lending.

Ratios of provisions to non-performing loans and PCRL's appear in the next section, following the discussion of provisions.

Provisions for bad and doubtful debts

Barclays policy is to provide for credit losses when it considers that recovery is doubtful. The provision is made up of two components, a specific provision and a general provision. Risk managers continuously review the quality of the exposures based on their knowledge of the customer or counterparty, and developments in the industry and country of operation.

During 2002, credit conditions were less favourable than for several years and some sectors experienced difficulties. These circumstances are reflected in the bad debt charge for the year as set out in the table below. The net charge rose by 29% to £1,484m, an increase of £335m. New and increased specific provisions were 19% higher at £1,719m. Releases and recoveries together decreased by 15% at £233m.

The greater part of this increase occurred in Barclays Capital (£231m) and in the South American Corporate Banking (£96m) portfolios. The increase in provisions at Barclays Capital reflected difficult economic conditions, mainly in the telecommunications and energy sectors, particularly in the US. The deterioration in the second half of 2002 was largely in existing non-performing loans. The increase in South American Corporate Banking mainly related to Argentina.

Business Banking sustained an 8% increase in its bad debt provision charge, broadly in line with expectations. The charge for Barclaycard was £402m, 7% higher reflecting the acquisition of Providian UK and organic growth in average extended credit balances of 9%. Within Personal Financial Services, the provision charge fell by 13%, reflecting in part improvements in risk management.

Analysis of provision charges for bad and doubtful debts

	As at 31st December				
	2002	2001	2000	1999	1998
			(£ millions)		
Net specific provision charge/(release)*					
UK	**1,041**	964	688	568	501
Other European Union	**14**	20	12	1	(4)
United States**	**385**	136	17	34	(10)
Rest of the World	**46**	45	60	32	5
Total net specific provision charge	**1,486**	1,165	777	635	492
General provision charge/(release)	**(2)**	(16)	40	(14)	—
	1,484	1,149	817	621	492

* The geographical analysis of provisions is based on the location of the office recording the transaction.

** The US charge includes provisions raised against Argentinean exposures booked in the US.

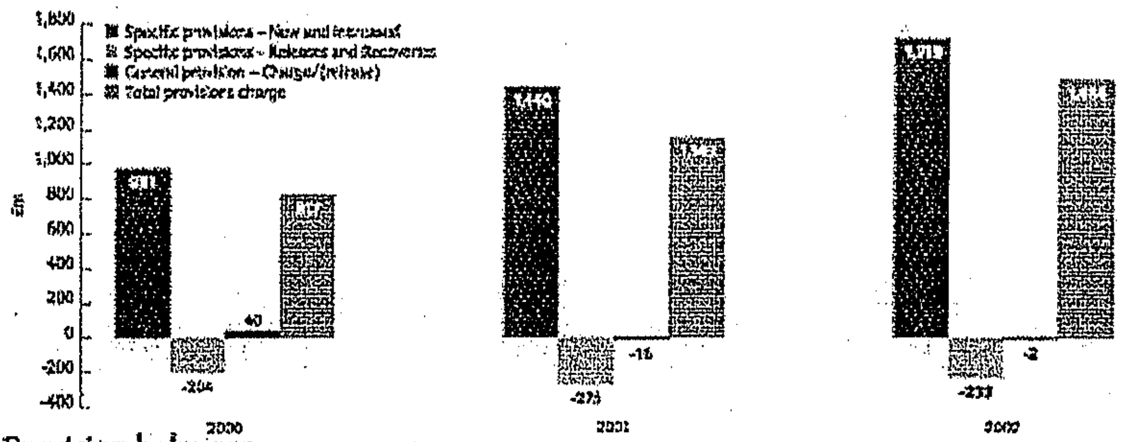
Analysis of provision balances for bad and doubtful debts

	As at 31st December				
	2002	2001	2000	1999	1998
			(£ millions)		
Specific provision*					
UK	**1,790**	1,605	1,343	1,083	937
Other European Union	**84**	89	112	131	220
United States**	**257**	89	20	23	23
Rest of the World	**130**	188	118	74	35
Total specific provision	**2,261**	1,971	1,593	1,311	1,215
General provision	**737**	745	760	672	728
	2,998	2,716	2,353	1,983	1,943
Average loans and advances for the year					
(excluding trading business)	**174,764**	157,904	122,333	106,488	101,338
(including trading business)	**256,789**	223,221	176,938	147,139	145,749

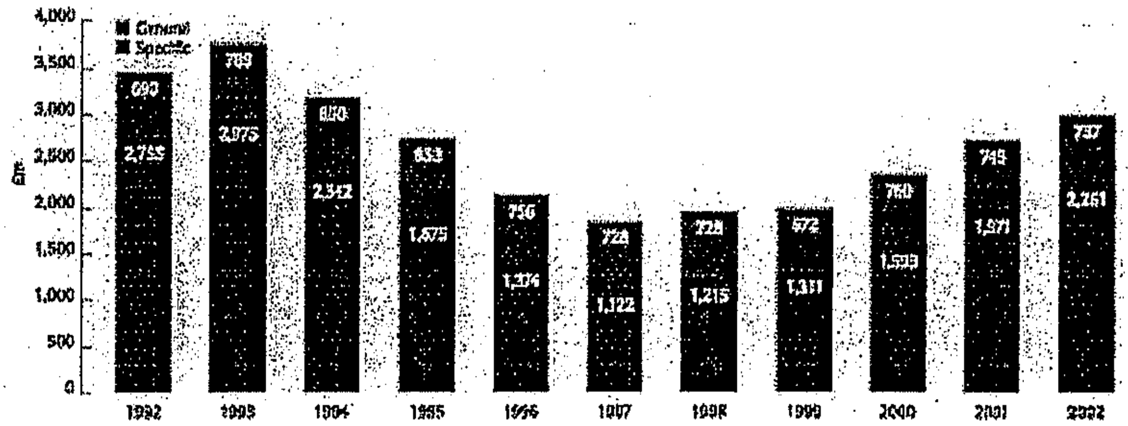
* The geographical analysis of provisions is based on the location of the office recording the transaction.

** The US balance includes provisions held against Argentinean exposures booked in the US.

Provision charge analysis



Provision balances



Provisioning approach

General provisions reflect losses that, although not specifically identified, are known from experience to be present in the lending portfolio at the balance sheet date.

These provisions are adjusted at least half yearly by an appropriate charge or release of general provisions based on statistical estimates. The general provisions take Risk Tendency (statistically expected losses) into account, based on models that are systematically updated to reflect evolving loss experience.

See Credit risk management on pages 27 to 28 for a fuller description of Risk Tendency.

Specific provisions are raised for:

- Individual counterparties when the Group considers that the creditworthiness of a borrower or counterparty has undergone deterioration such that the recovery of the whole or part of an outstanding advance is in serious doubt.

- Homogeneous portfolios comprised of large numbers of individually small lendings, where the characteristics of the portfolio permit statistical models to be used in estimating specific provisions. These statistical models are consistent with the Group's policy of raising provision when recovery is doubtful. These provisions are raised in parts of Personal Financial Services, Woolwich, Barclays Private Clients, Barclaycard and Business Banking.

Write-off occurs immediately to the extent that the whole or part of the debt is considered unrecoverable.

Treatment of interest on debts that have specific provisions

If the collection of interest is doubtful, it is credited to a suspense account and excluded from interest income in the profit and loss account. Although interest continues to be charged to the customer's account, the amount suspended is netted against the relevant loan. Loans on which interest is suspended are not reclassified as accruing interest until interest and principal payments are up-to-date and future payments are reasonably assured. If the collection of interest is considered remote, interest is no longer applied.

Treatment of collateral assets acquired in exchange for advances

Assets acquired in exchange for advances in order to achieve an orderly realisation continue to be reported as advances. The assets acquired are recorded at the carrying value of the original advance as at the date of the exchange. Any impairment is accounted for as a specific provision.

Bad debt provisions charge ratios

	Year ended 31st December				
	2002	2001	2000	1999	1998
			(£ millions)		
Provisions charge as a percentage of average loans and advances for the year (excluding trading business):					
Specific provisions	**0.85**	0.74	0.64	0.60	0.49
General provisions	**—**	(0.01)	0.03	(0.02)	—
	0.85	0.73	0.67	0.58	0.49
Amounts written off (net of recoveries)	**0.64**	0.53	0.47	0.52	0.40
Provisions charge as a percentage of average loans and advances for the year (including trading business):					
Specific provisions	**0.58**	0.52	0.44	0.43	0.34
General provisions	**—**	—	0.02	(0.01)	—
	0.58	0.52	0.46	0.42	0.34
Amounts written off (net of recoveries)	**0.43**	0.37	0.32	0.38	0.28

Provisions balance ratios

	As at 31st December				
	2002	2001	2000	1999	1998
			(%)		
Provisions balance at end of year as a percentage of loans and advances at end of year (excluding trading business):					
Specific provision	**1.29**	1.22	1.06	1.19	1.17
General provision	**0.42**	0.46	0.51	0.61	0.70
	1.71	1.68	1.57	1.80	1.87
Provisions balance at end of year as a percentage of loans and advances at end of year (including trading business):					
Specific provision	**0.86**	0.85	0.79	0.83	0.90
General provision	**0.28**	0.32	0.38	0.42	0.54
	1.14	1.17	1.17	1.25	1.44

Movements in provisions for bad and doubtful debts

	2002	2001	2000	1999	1998
	Year ended 31st December (£ millions)				
Provisions balance at beginning of year	2,716	2,353	1,983	1,943	1,850
Acquisitions and disposals	(11)	46	119	(10)	—
Exchange and other adjustments	(77)	(1)	4	(13)	6
Amounts written off:					
UK	(950)	(814)	(595)	(546)	(520)
Other European Union	(31)	(36)	(45)	(44)	(45)
United States	(215)	(94)	(26)	(40)	(7)
Rest of the World	(24)	(29)	(17)	(21)	(9)
	(1,220)	(973)	(683)	(651)	(581)
Recoveries (analysed below)	106	142	113	93	176
Subtotal	1,514	1,567	1,536	1,362	1,451
Provisions charged against profit					
New and increased specific provisions:					
UK	1,210	1,157	843	768	753
Other European Union	33	35	35	27	32
United States	404	173	27	45	11
Rest of the World	72	75	76	47	23
	1,719	1,440	981	887	819
Releases of specific provisions:					
UK	(81)	(87)	(55)	(115)	(96)
Other European Union	(12)	(10)	(17)	(22)	(32)
United States	(10)	(10)	(6)	(7)	(8)
Rest of the World	(24)	(26)	(13)	(15)	(15)
	(127)	(133)	(91)	(159)	(151)
Recoveries:					
UK	(88)	(106)	(100)	(85)	(156)
Other European Union	(7)	(5)	(6)	(4)	(4)
United States	(9)	(27)	(4)	(4)	(13)
Rest of the World	(2)	(4)	(3)	—	(3)
	(106)	(142)	(113)	(93)	(176)
Net specific provisions charge	1,486	1,165	777	635	492
General provision charge/(release)*	(2)	(16)	40	(14)	—
Net charge to profit	1,484	1,149	817	621	492
Provisions balance at end of year	2,998	2,716	2,353	1,983	1,943

* An analysis of the movement in general provisions is shown in note 17 to the accounts.

Provisions charge for bad and doubtful debts by industry

	Net specific provision for the year					Specific provisions at 31st December				
	2002	2001	2000	1999	1998	2002	2001	2000	1999	1998
					(£ millions)					
UK:										
Banks and other financial institutions	1	(2)	7	10	11	1	5	7	9	14
Agriculture, forestry and fishing	(1)	6	6	4	(5)	7	13	11	7	4
Manufacturing	80	62	8	4	15	98	49	43	48	41
Construction	41	12	7	4	(7)	35	6	8	7	10
Property	8	3	1	(5)	(20)	9	8	8	8	12
Energy and water	22	1	8	—	—	28	10	8	2	2
Wholesale and retail distribution and leisure	37	44	21	34	(10)	54	60	42	42	18
Transport	7	6	2	4	(1)	7	6	4	4	2
Communications	16	1	—	—	1	15	1	1	1	1
Business and other services	62	75	27	14	(7)	92	77	40	34	43
Home loans	4	8	10	5	(4)	53	60	61	39	35
Other personal	748	782	577	504	376	1,343	1,252	1,041	830	664
Overseas customers (a)	13	(34)	6	(22)	152	39	52	58	41	88
Finance lease receivables	3	—	8	12	—	9	6	11	11	3
	1,041	964	688	568	501	1,790	1,605	1,343	1,083	937
Foreign	445	201	89	67	(9)	471	366	250	228	278
	1,486	1,165	777	635	492	2,261	1,971	1,593	1,311	1,215

Analysis of amounts written off and recovered by industry

	Amounts written off for the year					Recoveries of amounts previously written off				
	2002	2001	2000	1999	1998	2002	2001	2000	1999	1998
					(£ millions)					
UK:										
Banks and other financial institutions	2	3	13	14	16	—	3	4	2	12
Agriculture, forestry and fishing	4	7	6	6	2	2	2	2	3	7
Manufacturing	72	65	30	20	28	22	11	16	12	12
Construction	15	16	8	12	12	3	2	2	3	5
Property	10	5	5	9	17	2	1	3	7	22
Energy and water	4	1	2	—	—	1	—	—	—	—
Wholesale and retail distribution and leisure	53	35	34	35	25	11	9	12	17	45
Transport	7	4	3	4	2	1	—	1	1	1
Communications	2	—	—	1	—	—	—	—	—	—
Business and other services	65	57	33	43	36	13	9	11	12	27
Home loans	11	14	15	3	8	1	4	3	2	4
Other personal	692	599	435	363	254	31	29	28	24	21
Overseas customers (a)	9	2	7	31	120	—	35	17	1	—
Finance lease receivables	4	6	4	5	—	1	1	1	1	—
	950	814	595	546	520	88	106	100	85	156
Foreign	270	159	88	105	61	18	36	13	8	20
	1,220	973	683	651	581	106	142	113	93	176

Note

(a) Includes amounts in 1998 in respect of Russian counterparties recorded in the UK.

Total provision coverage of total non-performing loans

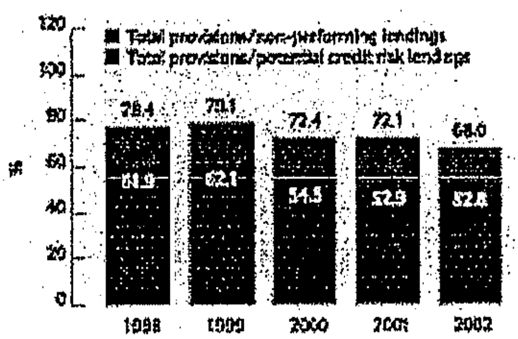
	2002	2001	2000	1999	1998
			(%)		
UK	73.5	74.9	72.9	81.1	78.4
Other European Union	71.4	78.6	72.1	94.5	95.2
United States	43.7	61.8	81.0	74.1	104.2
Rest of the World	65.0	59.2	64.7	50.4	45.1
Total	68.0	72.1	72.4	79.1	78.4

Total provision coverage of total potential credit risk lendings (NPL's and PPL's)

	2002	2001	2000	1999	1998
			(%)		
UK	56.6	56.4	57.7	62.0	60.7
Other European Union	70.7	77.5	71.4	84.0	88.3
United States	33.0	28.6	22.6	70.0	96.2
Rest of the World	52.0	51.9	53.4	43.9	33.5
Total	52.8	52.9	54.5	62.1	61.9

Geographically, the specific provision is allocated according to the location of the office recording the transaction. Similarly, the general provision is allocated according to the characteristics of the loans in each geographic area.

Provisions ratios



Another useful way of assessing provision balances is to recognise that specific provisions are created to cover non-performing loans, whereas general provisions relate to as yet unidentified losses on performing lendings. The following table provides an analysis of provision balances on this basis.

Ratios of general and specific provision balances

	2002	2001	2000	1999	1998
			(%)		
Specific provisions coverage of non-performing loans					
Specific provisions/Non-performing loans	50.0	50.9	47.2	50.2	47.1
General provisions coverage of performing loans					
General provisions/Performing loans	0.28	0.33	0.38	0.43	0.55

The ratio of general provisions to performing loans declined in 2001 with the acquisition of Woolwich plc, a portfolio consisting predominantly of secured residential mortgage loans needing comparatively low general provisions. These ratios include both trading and banking books. Performing loans comprise gross loans and advances to banks and customers (banking and trading) less non-performing loans.

Five Year Summary

For the years ended 31 December

	2002 £m	2001* £m	2000 £m	1999* £m	1998* £m
Profit and Loss Account					
Net operating income ⊘	**7,546**	6,507	[illegible]	5,666	5,313
Operating expenses ⊘	**3,609**	3,331	2,868	2,531	2,384
Provisions for bad and doubtful debts	**832**	608	47	440	364
Underlying profit before tax ⊘	**3,062**	[illegible]	[illegible]	2,719	2,565
Balance Sheet					
Total assets	**355,080**	312,071	266,143	233,891	204,370
Total assets (excluding long-term assurance assets attributable to policyholders)	**317,749**	274,470	235,085	209,656	185,238
Subordinated liabilities	**9,127**	7,923	5,985	5,140	3,626
Share capital	**1,346**	1,292	1,278	1,162	1,197
Reserves	**12,423**	10,121	9,260	8,492	8,923
	%	%	%	%	%
Performance Ratios					
Post-tax return on mean equity ⊘	**16.3**	15.1	19.5	19.1	17.5
Cost:income ratio †	**45.2**	49.2	43.3	44.4	44.9
Net interest margin††	**1.71**	1.74	1.95	2.17	2.32
			per ordinary share		
	pence	pence	pence	pence	pence
Shareholder Information					
Dividends	**29.4**	26.0	22.4	20.2	17.3
Underlying earnings excluding exceptional items and goodwill amortisation	**56.1**	47.7	55.6	51.5	45.2

* 2001 numbers are restated to reflect the use of unsmoothed asset values for the purposes of determining the income from long-term assurance business, the implementation of FRS19 'Deferred Tax' and UITF33 'Obligations in capital instruments'.

* The HBOS Group figures for 1998 and 1999 are an aggregate of, or calculation based on, the Halifax Group accounts for the year ended 31 December, and Bank of Scotland Group accounts for the year ended 28 February following.

⊘ Excluding exceptional items.

† The cost:income ratio is calculated excluding exceptional items, goodwill amortisation and after netting operating lease depreciation, amounts written off fixed asset investments and general insurance claims against operating income.

†† The net interest margin excluding trading assets was 1.86% in 2002 (2001 1.87%).

Financial Review and Risk Management

Mike Ellis,
Group Finance Director

Overview of Results

Group profit before tax increased by £547m to £3,062m before charging exceptional costs of £153m, as shown below:

	2002 £m	2001 [illegible] [illegible]
Group profit before tax	2,909	[illegible]
Add back:		
– Merger costs		76
– Merger integration costs	153	[illegible]
– Other		15
Group profit before tax and exceptional items	**3,062**	2,515

Divisional financial performance is aggregated within the following table:

Year ended 31 December 2002	Retail Banking £m	Insurance & Investment £m	Business Banking £m	Corporate Banking £m	Treasury £m	Bank West £m	Group Items £m	Total £m
Net interest income	3,007	50	628	737	200	148		4,770
Non-interest income	721	831	576	445	125	78		2,776
Net Operating income	3,728	881	1,204	1,182	325	226		7,546
Operating expenses*	(1,956)	(196)	(789)	(194)	(89)	(138)	(247)	(3,609)
General insurance claims		(79)						(79)
Amounts written off fixed asset investments		(4)	(6)	(13)	(1)			(24)
Operating profit before provisions*	1,772	602	409	975	235	88	(247)	3,834
Provisions for bad & doubtful debts								
Specific	(360)		(135)	(285)	(4)	(11)		(795)
General	(13)		(12)	(10)		(2)		(37)
Share of profits of associates and joint ventures	27	(13)	20	1				35
Profit on disposal of business			25					25
Profit before tax*	1,426	589	307	681	231	75	(247)	3,062
2001 Profit before tax*	1,305	472	306	523	169	80	(240)	2,515

* Excluding exceptional items.

Group operating profit before provisions and exceptional items at £3,834m is 24% higher than a year ago. Strong, asset led, net interest earnings and broadly stable margins as described in the Divisional Reviews, together with non-interest income, 18% higher than a year ago, and underlying operating expenses contained at 6% growth, all contribute to the strong result. Merger synergies contributed £209m of the increase.

Underlying earnings per share before exceptional items and goodwill amortisation rose 18% to 56.1p (2001 restated 47.7p) and the proposed final dividend is 19.6p, 5% higher than the previous financial year. The basic dividend cover is 1.7 times and 1.9 times on an underlying basis, up from 1.4 times and 1.7 times respectively in 2001. Our stated policy is to increase underlying dividend cover progressively to 2.5 times. If approved at the Annual General Meeting, the final dividend will be paid on 23 May 2003 to shareholders on the register at the close of business on 14 March 2003.

Ordinary shareholders are again being offered the choice of electing under the Share Dividend Plan to receive the whole of their dividends in new ordinary shares credited as fully paid instead of cash in respect of the proposed final dividend for the year ended 31 December 2002. Key dates in respect of the new shares to be allotted to shareholders who elect to join the Plan can be found on page 116.

Financial Review and Risk Management continued

Balance Sheet Analysis

As at 31 December 2002

	Retail Banking £bn	Insurance & Investment £bn	Business Banking £bn	Corporate Banking £bn	Treasury £bn	Bank West £bn	Total 2002 £bn	2001
Loans & Advances to Customers*	157.9		23.2	44.1	1.9	7.2	234.3	[illegible]
Bad Debt Provisions Including Interest in suspense								
Specific	0.9		0.2	0.3		0.1	1.5	[illegible]
General	0.3		0.2	0.2			0.7	[illegible]
Gross Loans & Advances to Customers*	159.1		23.6	44.6	1.9	7.3	236.5	[illegible]
Total Risk Weighted Assets	90.0	0.4	26.7	53.5	11.0	5.5	187.1	[illegible]
Total Customer Deposits	103.8		12.3	14.1	16.4	3.6	150.2	[illegible]

* Net of securitisation.

The mix of the Group's gross lending portfolio at the year end is summarised in the following table:

Classification of advances*

	2002 %	2001 %
Agriculture, forestry and fishing		1
Energy	1	1
Manufacturing industry	3	3
Construction & property	9	8
Hotels, restaurants and wholesale and retail trade	4	[illegible]
Transport, storage and communication	2	2
Financial	3	[illegible]
Other services	5	[illegible]
Individuals:		
Residential Mortgages	62	64
Other Personal	7	7
Overseas residents	4	3
Total	100	100

* After securitisation.

Loans and advances to customers increased by 18% to £234.3bn after securitisations of £3.5bn in the year. Within Retail Banking, net mortgage lending was £23bn. Credit cards and personal loans also grew strongly. Corporate advances grew 25% to £44.1bn whilst Business Banking achieved 23% growth to £23.2bn. As stated in the Divisional Reviews, this growth has been achieved without compromising on asset quality.

Customer deposits grew by 7% to £150.2bn and wholesale funding by 26% to £126.4bn.

Bad Debt Provisions & Non-Performing Assets

	Specific £m	General £m	Total £m
At 1 January 2002	1,102	667	1,769
Amounts written off during the year	(618)		(618)
Charge for the year	795	37	832
Recoveries of amounts previously written off	38		38
Exchange movements	4	(1)	3
At 31 December 2002	1,321	703	2,024

The total charge for bad and doubtful debts against Group profits was £832m (2001 £608m) and represents 0.38% of average customer lending (2001 0.33%). Within this the charge for specific provisions increased 43% to £795m (2001 £556m), representing 0.37% of average customer lending (2001 0.30%). The general provision charge amounted to £37m (2001 £52m).

Closing provisions as a percentage of period end customer advances are analysed in the following table:

	2002 £m	2002 As % of customer advances	2001 £m	2001 As % of customer advances
Specific Provisions	1,321	0.56	[illegible]	[illegible]
General Provisions	703	0.30	[illegible]	[illegible]
Total	2,024	0.86	[illegible]	[illegible]

Non-performing assets (NPAs) amounted to 1.80% of year end customer advances (2001 2.06%). NPAs in respect of UK residential mortgages amounted to 1.17% of year end advances (2001 1.47%) and NPAs in respect of other advances amounted to 2.81% (2001 3.09%). The amount of NPAs increased to £4,206m (2001 £4,072m) of which £1,697m (2001 £1,851m) were in respect of UK residential mortgages and £2,509m (2001 £2,221m) were in respect of other advances.

The cumulative provisions and interest in suspense, which are deducted from advances in the balance sheet, together with their percentage cover of NPAs are as follows:

	2002 £m	2002 As % of NPAs	2001 £m	2001 As % of NPAs
Specific Provisions	1,321	31	1,102	27
General Provisions	703	17	667	[illegible]
Interest in Suspense	141	3	[illegible]	[illegible]
Total	2,165	51	[illegible]	[illegible]
of which:				
UK residential mortgages	389	23	[illegible]	21
Other advances	1,776	71	1,512	[illegible]
Total	2,165	51	[illegible]	[illegible]

Share of Operating Profit/(Loss) in Associates and Joint Ventures

Included within the share of operating profit/(loss) in associates and joint ventures are the following items:

	2002 £m	2001 £m
Lex Vehicle Leasing*	13	[illegible]
Centrica Personal Finance	18	[illegible]
RFS	3	[illegible]
esure	(13)	[illegible]
Sainsbury's Bank	11	[illegible]
Other	3	[illegible]
Total	35	[illegible]

* After charging goodwill amortisation.

Taxation

The tax charge for the year of £835m (2001 £663m) represents 28.7% (2001 28.9%) of profit before tax compared with a UK corporation tax rate applicable to the year of 30% (2001 30%). The effective rate is lower than the UK corporation tax rate mainly due to the net effect of lower tax rates overseas and interest deductible on Innovative Tier 1 Securities.

Notes on the Accounts continued

18. Provisions for Bad and Doubtful Debts

	Group		
	Specific £ million	General £ million	Total £ million
At 1 January 2002	1,102	667	1,769
New provisions less releases	833	37	870
Amounts written off	(618)		(618)
Exchange movements	4	(1)	3
Cumulative provisions as at 31 December 2002	1,321	703	2,024
New provisions less releases	833	37	870
Recoveries of amounts previously written off	(38)		(38)
Net charge to profit and loss account	795	37	832

19. Debt Securities

	2002				2001			
	Issued by Public Bodies £ million	Issued by Others £ million	Total £ million	Market Value £ million	Issued by Public Bodies £ million	Issued by Others £ million	Total £ million	Market Value £ million
Group								
Investment securities								
Listed								
British Government Securities	521		521	524	378		378	384
Others	1,318	14,086	15,404	15,402	2,096	10,992	13,088	13,144
Unlisted								
Certificates of deposit issued by banks and building societies		1,962	1,962	1,963		5,138	5,138	5,152
Others	266	7,015	7,281	7,207	1,221	9,395	10,616	10,623
Total investment securities	2,105	23,063	25,168	25,096	3,695	25,525	29,220	29,303
Other securities								
Listed	486	1,826	2,312	2,312	1,454	397	1,851	1,851
Unlisted		16,844	16,844	16,844	229	11,149	11,378	11,378
	2,591	41,733	44,324	44,252	5,378	37,071	42,449	42,532
of which:-								
maturing within 1 year			21,426				22,189	
1 year and over			22,898				20,260	
			44,324				42,449	

The movement on debt securities held as investment securities is as follows:-

	Group		
	Amortised Cost £ million	Aggregate amount written off £ million	Book Value £ million
At 1 January 2002	29,243	(23)	29,220
Exchange translation	(379)		(379)
Additions	19,676		19,676
Amortisation	6		6
Disposals	(23,352)		(23,352)
Amount written off		(3)	(3)
At 31 December 2002	25,194	(26)	25,168
Aggregate unamortised premium at 31 December 2002	6		6

Debt securities include securities with a market value of £662 million (2001 – £1,077 million) for the Group sold subject to agreement to repurchase.

Summary consolidated profit and loss account for the year ended 31 December 2002

The profit and loss account set out below shows goodwill amortisation and integration costs separately. In the statutory profit and loss account on pages 96 and 97, these items are included in the captions prescribed by the Companies Act.

	2002 £m	2001* £m	2000* £m	Pro forma 2000* £m
Net interest income	7,849	6,846	5,286	5,929
Dividend income	58	54	44	46
Fees and commissions receivable	5,308	4,735	3,614	4,079
Fees and commissions payable	(965)	(930)	(706)	(804)
Dealing profits	1,462	1,426	933	1,131
Other operating income	1,209	1,052	874	998
	7,072	6,337	4,759	5,450
General insurance premium income – net	1,894	1,375	950	979
Non-interest income	8,966	7,712	5,709	6,429
Total income	16,815	14,558	10,995	12,358
Staff costs	3,942	3,461	3,019	3,440
Other operating expenses	3,727	3,380	2,815	3,174
Operating expenses	7,669	6,841	5,834	6,614
Profit before other operating charges	9,146	7,717	5,161	5,744
General insurance claims – net	1,350	948	673	698
Operating profit before provisions	7,796	6,769	4,488	5,046
Provisions for bad and doubtful debts	1,286	984	550	602
Amounts written off fixed asset investments	59	7	42	43
Profit before goodwill amortisation and integration costs	6,451	5,778	3,896	4,401
Goodwill amortisation	731	651	537	640
Integration costs	957	875	389	434
Profit before tax	4,763	4,252	2,970	3,327
Tax	1,556	1,537	1,054	1,177
Profit after tax	3,207	2,715	1,916	2,150
Minority interests (including non-equity)	133	90	50	54
Preference dividends – non-equity	305	358	294	328
	2,769	2,267	1,572	1,768
Additional Value Shares dividend – non-equity	798	399	—	—
Profit attributable to ordinary shareholders	1,971	1,868	1,572	1,768
Earnings per ordinary share	68.4p	67.6p	66.9p	66.5p
Additional Value Shares dividend	27.7p	14.5p	—	—
	96.1p	82.1p	66.9p	66.5p
Goodwill amortisation	24.2p	23.2p	22.4p	23.6p
Integration costs	23.8p	22.6p	11.9p	11.7p
Adjusted earnings per ordinary share	144.1p	127.9p	101.2p	101.8p

*restated (see page 10)

Profit RBS increased its profit before tax, goodwill amortisation and integration costs by 12%, or £673 million, from £5,778 million to £6,451 million.

After goodwill amortisation and integration costs, profit before tax was up 12%, from £4,252 million to £4,763 million. Integration costs relating to NatWest, the Mellon Regional Franchise and Medford Bancorp Inc. ("Medford") were £957 million against £875 million in 2001.

Total income RBS continued to achieve strong growth in income. Total income at £16,815 million was up by 16%, or £2,257 million. Excluding acquisitions, total income rose by 12%.

Citizens increased its income by 53% (15% underlying growth, excluding the effect of acquisitions and exchange rate fluctuations), Direct Line Group by 39% (34% excluding acquisitions) and Retail Direct by 16%.

Corporate Banking and Financial Markets income was up by 11%, notwithstanding Financial Markets' strong performance in 2001 when it benefited from market volatility and falling interest rates.

Retail Banking grew its income by 8% and Ulster Bank by 8%. Income in Wealth Management declined 3% as the effect of lower stock market values on activity levels and fees more than offset the benefit from increased customer numbers and volumes.

Net interest income Net interest income increased by 15%, or £1,003 million, to £7,849 million. Net interest income accounted for 47% of total income. Average interest-earning assets of the banking business increased by 14%.

Net interest margin The Group's net interest margin remained stable at 3.1%. Improved lending margins offset the downward pressure on deposit margins arising from lower interest rates.

Non-interest income Non-interest income increased by 16%, or £1,254 million, to £8,966 million. Non-interest income accounted for 53% of total income.

Fees and commissions receivable were up 12%, or £573 million. Volume driven increases in lending fees and continued strong growth in fee paying current accounts contributed to the increase. Dealing profits at £1,462 million were up £36 million, 3%, on the strong performance in 2001. The increase in dealing profits resulted from customer led business growth and higher revenues from trading in interest rate instruments. Other operating income was £157 million, 15% higher mainly due to the expansion of CBFM's operating lease business. General insurance premium income, after reinsurance, rose by 38%, or £519 million reflecting Direct Line Group's organic growth and acquisitions in Continental Europe.

Operating expenses Operating expenses, excluding goodwill amortisation and integration costs, rose by 12%, or £828 million, to £7,669 million. Excluding acquisitions, operating expenses were up 7%, £469 million in support of strong growth in business volumes.

Cost:income ratio Strong income growth coupled with tight cost management resulted in a further improvement in the Group's cost:income ratio, to 45.6% from 47.0%. Excluding the effect of acquisitions, the cost:income ratio improved to 45.0%.

Net insurance claims General insurance claims, after reinsurance, increased by 42%, or £402 million, to £1,350 million reflecting significant volume growth and acquisitions at Direct Line.

Provisions The profit and loss charge for provisions was £1,345 million compared with £991 million in 2001. The charge for the two halves of the year was consistent with the second half of 2001.

Bad debt provisions amounted to £1,286 million compared with £984 million in 2001. The charge reflects overall growth in lending and, as in the second half of 2001, is particularly influenced by provisions required against a number of specific corporate situations. Amounts written off fixed asset investments, largely in the first half of the year, were £59 million against £7 million in 2001.

Total balance sheet provisions for bad debts amounted to £3,927 million at 31 December 2002, up 8% from £3,653 million at 31 December 2001.

Integration costs

	2002 £m	[illegible]	[illegible]	[illegible]
Staff costs	530	598	255	286
Premises and equipment	127	64	27	27
Other administrative expenses	298	188	95	109
Depreciation of tangible fixed assets	2	25	12	12
Integration costs	957	875	389	434

The IT integrations of NatWest and the Mellon Regional Franchise were completed during the year, ahead of schedule in both cases.

Integration costs in relation to NatWest were £810 million compared with £847 million in 2001 and £345 million in 2000. Implementation has been faster which has resulted in revenue benefits and cost savings being achieved ahead of plan.

Expenditure of £134 million and £13 million was incurred in 2002 relating to the integration of Mellon Regional Franchise and Medford respectively compared with £28 million in respect of Mellon Regional Franchise in 2001. The transaction benefits are being delivered more quickly than was planned.

Provisions

	2002 £m	2001 £m	2000 £m	Pro forma 2000 £m
Gross new provisions	1,408	1,071	756	841
less: recoveries	(63)	(80)	(164)	(196)
Charge to profit and loss account	1,345	991	592	645
Comprising:				
Provisions for bad and doubtful debts	1,286	984	550	602
Amount written off fixed asset investments	59	7	42	43
Charge to profit and loss account	1,345	991	592	645

2002 compared with 2001

Gross new provisions were up 31%, £337 million to £1,408 million. The increase reflects growth in overall lending and as in the second half of 2001, provisions required in a number of specific corporate situations. Recoveries of amounts previously written off were down £17 million, 21%, to £63 million. Consequently the net charge to the profit and loss account was up £354 million, 36% to £1,345 million.

Bad debt provisions amounted to £1,286 million compared with £984 million in 2001. The charge reflects overall growth in lending and is particularly influenced by provisions required against a number of specific corporate situations. Amounts written off fixed asset investments, largely in the first half of the year, were £59 million against £7 million in 2001.

Total balance sheet provisions for bad and doubtful debts amounted to £3,927 million, up 8% from £3,653 million at 31 December 2001. Total provision coverage (the ratio of total balance sheet provisions to risk elements in lending) at 31 December 2002 was maintained at 81%.

2001 compared with 2000 and pro forma 2000

Gross new provisions were up 42% and 27% compared with 2000 and pro forma 2000 respectively, to £1,071 million. The increase reflected the growth in lending and the deterioration in the short-term economic outlook combined with the impact of a small number of specific customer situations. Recoveries of amounts previously written off were down £84 million and £116 million, compared with 2000 and pro forma 2000 respectively, to £80 million. Consequently the net charge to the profit and loss account increased to £991 million, up £399 million, 67% and £346 million, 54% on 2000 and pro forma 2000 respectively.

Total balance sheet provisions for bad and doubtful debts amounted to £3,653 million (2000 – £3,153 million) equivalent to 81% (2000 – 83%) of risk elements in lending.

Provisions for bad and doubtful debts For a discussion of the factors considered in determining the amount of the provisions, see 'Provisioning policy' on page 53. The following table shows the elements of provisions for bad and doubtful debts.

	2002 £m	[illegible] £m	[illegible] £m	[illegible] £m	[illegible] £m	[illegible] £m
Provisions at the beginning of the period						
Domestic	2,467	2,370	484	433	347	316
Foreign	1,186	783	332	304	286	143
	3,653	3,153	816	737	633	459
Currency translation and other adjustments						
Domestic	(4)	4	(1)	—	—	—
Foreign	(58)	13	43	2	10	(8)
	(62)	17	42	2	10	(8)
Acquisitions of businesses						
Domestic	11	83	1,871	2	—	—
Foreign	12	171	494	23	—	(11)
	23	254	2,365	25	—	(11)
Amounts written-off						
Domestic	(743)	(645)	(599)	(35)	(175)	(144)
Foreign	(293)	(190)	(185)	(5)	(51)	(26)
	(1,036)	(835)	(784)	(40)	(226)	(170)
Recoveries of amounts written-off in previous periods						
Domestic	37	54	142	10	44	20
Foreign	26	26	22	3	10	15
	63	80	164	13	54	35
Charged to profit and loss account						
Domestic	813	601	473	74	217	155
Foreign	473	383	77	5	49	173
	1,286	984	550	79	266	328
Provisions at the end of the period (1)						
Domestic	2,581	2,467	2,370	484	433	347
Foreign	1,346	1,186	783	332	304	286
	3,927	3,653	3,153	816	737	633
Gross loans and advances to customers						
Domestic	145,274	127,650	116,310	41,045	38,248	31,804
Foreign	81,970	66,487	54,905	13,892	11,829	9,846
	227,244	194,137	171,215	54,937	50,077	41,650
Closing customer provisions as a % of gross loans and advances to customers (2)						
Domestic	1.78%	1.93%	2.04%	1.18%	1.13%	1.09%
Foreign	1.63%	1.77%	1.40%	2.39%	2.57%	2.90%
Total	1.73%	1.88%	1.83%	1.49%	1.47%	1.52%
Customer charge against profit as a % of gross loans and advances to customers						
Domestic	0.56%	0.47%	0.41%	0.72%	0.57%	0.49%
Foreign	0.58%	0.58%	0.14%	0.14%	0.41%	1.76%
Total	0.57%	0.51%	0.32%	0.58%	0.53%	0.79%

Notes:

(1) Includes closing provisions against loans and advances to banks of £7 million (31 December 2001 – £8 million; 31 December 2000 – £14 million).

(2) Closing customer provisions exclude closing provisions against loans and advances to banks.

Provisions for bad and doubtful debts *(continued)* The following table presents additional information with respect to the provisions for bad and doubtful debts.

	2002 £m	2001 £m	2000 £m		1998 £m
Loans and advances to customers (gross)	**227,244**	194,137	171,215	50,077	41,650
Provisions at end of period:					
Specific provisions – customers	**3,323**	3,031	2,571	567	454
Specific provisions – banks	**7**	8	14	—	—
General provision	**597**	614	568	170	179
	3,927	3,653	3,153	737	633
Customer provision at end of period as % of loans and advances to customers at end of period:					
Specific provisions	**1.47%**	1.56%	1.50%	1.13%	1.09%
General provision	**0.26%**	0.32%	0.33%	0.34%	0.43%
	1.73%	1.88%	1.83%	1.47%	1.52%
Average loans and advances to customers (gross)	**211,206**	181,584	142,288	45,807	39,456
As a % of average loans and advances to customers during the period:					
Total customer provisions charged to profit and loss	**0.61%**	0.54%	0.39%	0.58%	0.83%
Amounts written-off (net of recoveries) – customers	**0.46%**	0.42%	0.44%	0.38%	0.34%

Analysis of closing provisions for bad and doubtful debts The following table analyses customer provisions for bad and doubtful debts by geographical area and type of domestic customer.

	31 December						30 September			
	2002		2001		2000		1999		1998	
	Closing provision £m	% of loans to total loans %	Closing provision £m	% of loans to total loans %	Closing provision £m	% of loans to total loans %	Closing provision £m	% of loans to total loans %	Closing provision £m	% of loans to total loans %
Domestic										
Central and local government	—	**0.6**	—	0.4	—	1.1	—	0.3	—	0.3
Manufacturing	**205**	**3.2**	209	3.8	148	4.0	16	5.4	16	5.0
Construction	**65**	**1.5**	72	1.6	77	1.5	8	1.3	9	1.3
Finance	**71**	**5.5**	73	4.4	75	5.8	4	5.8	3	5.3
Service industries and business activities	**699**	**11.5**	627	12.9	665	12.2	124	16.1	95	16.7
Agriculture, forestry and fishing	**29**	**1.1**	31	1.2	33	1.4	3	1.4	2	1.5
Property	**40**	**7.0**	39	6.3	55	6.1	11	7.3	13	7.0
Individuals – home mortgages	**60**	**18.5**	53	19.1	35	19.0	22	19.1	17	20.0
– other	**855**	**9.8**	855	10.3	797	10.5	167	12.5	121	10.9
Finance leases and instalment credit	**208**	**5.2**	164	5.8	149	6.3	12	7.2	7	8.4
Total domestic	**2,232**	**63.9**	2,123	65.8	2,034	67.9	367	76.4	283	76.4
Foreign	**1,091**	**36.1**	908	34.2	537	32.1	200	23.6	171	23.6
Specific provisions	**3,323**	**100.0**	3,031	100.0	2,571	100.0	567	100.0	454	100.0
General provision	**597**		614		568		170		179	
Total provisions	**3,920**		3,645		3,139		737		633	

Risk elements in lending and potential problem loans The Group's loan control and review procedures do not include the classification of loans as non-accrual, accruing past due, restructured and potential problem loans, as defined by the SEC in the US. The following table shows the estimated amount of loans that would be reported using the SEC's classifications. The figures incorporate estimates and are stated before deducting the value of security held or related provisions.

	31 December 2002 £m	[illegible]	[illegible]	[illegible]	[illegible]
Loans accounted for on a non-accrual basis (3):					
Domestic	3,077	2,829	2,482	378	416
Foreign	1,098	737	344	170	148
Total	4,175	3,566	2,826	548	564
Accruing loans which are contractually overdue 90 days or more as to principal or interest (4):					
Domestic	363	643	662	322	311
Foreign	129	142	168	110	117
Total	492	785	830	432	428
Loans not included above which are classified as 'troubled debt restructurings' by the SEC:					
Domestic	144	26	43	13	15
Foreign	60	116	122	104	5
Total	204	142	165	117	20
Total risk elements in lending	4,871	4,493	3,821	1,097	1,012
Potential problem loans (5)					
Domestic	639	801	699	171	98
Foreign	544	279	73	75	45
	1,183	1,080	772	246	143
Closing provisions for bad and doubtful debts as a % of total risk elements in lending	81%	81%	83%	67%	63%
Risk elements in lending as a % of gross loans and advances to customers	2.14%	2.31%	2.23%	2.19%	2.43%

Notes:

(1) For the analysis above, 'Domestic' consists of the UK domestic transactions of the Group. 'Foreign' comprises the Group's transactions conducted through offices outside the UK and through those offices in the UK specifically organised to service international banking transactions.

(2) The classification of a loan as non-accrual, past due 90 days or troubled debt restructuring does not necessarily indicate that the principal of the loan is uncollectable in whole or in part. Collection depends in each case on the individual circumstances of the loan, including the adequacy of any collateral securing the loan and therefore classification of a loan as non-accrual, past due 90 days or troubled debt restructuring does not always require that a provision be made against such a loan. In accordance with the Group's provisioning policy for bad and doubtful debts, it is considered that adequate provisions for the above risk elements in lending have been made.

(3) The Group's UK banking subsidiary undertakings account for loans on a non-accrual basis from the point in time at which the collectability of interest is in significant doubt. Certain subsidiary undertakings of the Group, principally Citizens, generally account for loans on a non-accrual basis when interest or principal is past due 90 days.

(4) Overdrafts generally have no fixed repayment schedule and consequently are not included in this category.

(5) Loans that are current as to the payment of principal and interest but in respect of which management has serious doubts about the ability of the borrower to comply with contractual repayment terms. Substantial security is held in respect of these loans and appropriate provisions have already been made in accordance with the Group's provisioning policy for bad and doubtful debts.

	2002 £m	[illegible]	[illegible]	[illegible]	[illegible]
Gross income not recognised but which would have been recognised under the original terms of non-accrual and restructured loans					
Domestic	234	173	148	53	57
Foreign	73	60	48	32	20
	307	233	196	85	77
Interest on non-accrual and restructured loans included in net interest income					
Domestic	[illegible]	42	30	4	14
Foreign	[illegible]	14	8	13	7
	[illegible]	56	38	17	21

Credit quality Overall credit quality remains strong with no material change in the distribution by grade of the Group's total risk assets compared with the position at the previous year end.

Risk elements in lending amounted to £4,871 million at 31 December 2002, up 8% from £4,493 million at 31 December 2001, and up 2% from £4,791 million at 30 June 2002.

Total provision coverage (the ratio of total balance sheet provisions to risk elements in lending) at 31 December 2002 was maintained at 81%.

Risk elements in lending and potential problem loans in aggregate amounted to £6,054 million, an increase of 9% over 31 December 2001 and 1% over 30 June 2002.

Integration The Group successfully completed the conversion of NatWest IT systems on to the RBS technology platform in October 2002. This programme ran for 30 months and involved more than 4,000 staff, culminating in the migration of a customer base three times the size of the Royal Bank of Scotland on to a single technology platform. The scale and complexity of this project are without precedent.

Annualised revenue benefits of £805 million and annualised cost savings of £1,350 million were delivered by December 2002. In addition, by February 2003 all integration initiatives had been completed. As a result the full programme annualised benefits, comprising £890 million revenue benefits and £1,440 million cost savings, have been achieved less than three years after the acquisition of NatWest.

Cumulative combined revenue and cost benefits to the profits for the period 2000 to 2002 amounted to £3.6 billion, which is £1.1 billion ahead of the original plan.

In the US, Citizens completed the IT integration of the Mellon Regional Franchise in August 2002, earlier than planned. Benefits from this transaction have been delivered more quickly than was envisaged, and are on track to be delivered in full.

Earnings and dividends Earnings per ordinary share, adjusted for goodwill amortisation, integration costs and the dividend on Additional Value Shares ("AVS"), increased by 13% from 127.9p to 144.1p. Basic earnings per ordinary share increased by 1% from 67.6p to 68.4p, reflecting the increase in the AVS dividend paid during the year.

A second dividend of 30.0p per share was paid on 2 December 2002 to the holders of AVS issued in connection with the acquisition of NatWest. By the end of 2002, a total of 45.0p per AVS had been paid, in accordance with the original payment schedule. The third and final AVS dividend, if declared by the directors, of 55.0p per AVS will be paid on 1 December 2003.

A final dividend of 31.0p per ordinary share is recommended, resulting in a total ordinary dividend for the year of 43.7p per ordinary share, an increase of 15%. The total dividend is covered 3.3 times by earnings before goodwill amortisation, integration costs and the AVS dividend.

Balance sheet Total assets were £412 billion at 31 December 2002, 12% higher than total assets of £369 billion at 31 December 2001. Of the total assets, £311 billion (76%) related to banking business and £101 billion (24%) to trading business (31 December 2001: £285 billion (77%) banking business and £84 billion (23%) trading business).

Lending to customers excluding repurchase agreements and stock borrowing ("reverse repos") increased by 13%, £22 billion. Including reverse repos, loans and advances to customers were up 17%. Customer deposits increased by 10%, from £199 billion at 31 December 2001 to £219 billion at 31 December 2002. Excluding repurchase agreements and stock lending ("repos"), customer deposits grew by 7%, £13 billion.

Capital ratios at 31 December 2002 were 7.3% (tier 1) and 11.7% (total), against 7.1% (tier 1) and 11.5% (total) at 31 December 2001.

Profitability The adjusted after-tax return on ordinary equity was 17.6% compared with 16.8% for 2001. This is based on profit attributable to ordinary shareholders before integration costs, goodwill amortisation and the AVS dividend, and average ordinary equity.

Acquisitions In May 2002, Lombard, the leasing arm of CBFM, completed the acquisition of Dixon Motors PLC for a consideration of £118 million.

In July 2002, Citizens announced the acquisition of Medford Bancorp Inc., a Massachusetts savings bank for a cash consideration of US$273 million and in September 2002 announced the acquisition of Pennsylvania based commercial bank, Commonwealth Bancorp Inc for a cash consideration of US$450 million. These acquisitions were completed in October 2002 and January 2003 respectively.