

OFFERING CIRCULAR



scarborough
building society

(Incorporated in England under the Building Societies Act 1986 and registered with the Central Office of the Registry of Friendly Societies with registered number 500B)

£50,000,000 **6.875 per cent. Permanent Interest Bearing Shares**

Issue Price: 99.239 per cent.

Scarborough Building Society (the **Issuer** or the **Society**) will issue £50,000,000 6.875 per cent. Permanent Interest Bearing Shares (the **PIBS**) comprising 50,000 PIBS of £1,000 each at an issue price of 99.239 per cent. of their principal amount.

This Offering Circular is issued in compliance with the listing rules made under Section 73A of the Financial Services and Markets Act 2000 (the **FSMA**) by the Financial Services Authority (the **FSA**) in its capacity as competent authority (the **UK Listing Authority**). Application has been made to the UK Listing Authority under the FSMA for the PIBS to be admitted to the official list of the UK Listing Authority (the **Official List**) and to the London Stock Exchange plc (the **London Stock Exchange**) for the PIBS to be admitted to trading on the London Stock Exchange's Professional Securities Market (the **Market**). References in this Offering Circular to the PIBS being **listed** (and all related references) shall mean that such PIBS have been admitted to the Official List and have been admitted to trading on the Market.

Attention is drawn to the description in "*Certain Provisions of the Act and Requirements of the Supervisory Authority*" of the ways in which a building society can, without the consent of holders of permanent interest bearing shares, amalgamate with or transfer its rights and obligations to another building society or a company pursuant to the relevant legislation.

It is anticipated that the PIBS will be issued in registered form on 13 April 2007 conditionally upon the PIBS being admitted to the Official List and to trading on the Market, which in each case is expected to occur on 13 April 2007.

The listing of the PIBS will be expressed as a percentage of their principal amount.

The PIBS will be deferred shares in the Society for the purposes of Section 119 of the Building Societies Act 1986, as amended (the Act), and will not be protected deposits for the purposes of the Financial Services Compensation Scheme established under FSMA.

The PIBS will not be withdrawable at the option of the PIBS holders and will be repayable only at the option of the Society on 13 April 2017 or any Interest Payment Date (as defined in "*Special Conditions of Issue of the PIBS – Interest*") thereafter or in certain limited circumstances, as described in "*Special Conditions of Issue of the PIBS – Repayment*", in each case subject to the consent of the FSA or any successor body performing for the time being the same or similar functions in relation to building societies (or, in the event that the Society transfers its business to a company under section 97 of the Act, companies of that nature) in the United Kingdom (the **Supervisory Authority**).

The PIBS are expected to be rated Baa3 by Moody's Investors Service Limited (**Moody's**). A credit rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

The information contained in this Offering Circular is intended for sophisticated investors capable of understanding the nature of the PIBS and the risks attaching to them. There are fundamental differences between the PIBS and ordinary share accounts and deposit products of building societies. A number of these differences significantly increase the risk element involved in investing in the PIBS. Accordingly, attention is drawn to certain characteristics of the PIBS as described in "*Risk Factors*".

Manager and Sole Structuring Adviser

The Royal Bank of Scotland

11 April 2007

This Offering Circular comprises listing particulars produced in compliance with the listing rules made under Section 73A of the FSMA by the UK Listing Authority for the purpose of giving information with regard to the Issuer and the PIBS. The Issuer accepts responsibility for the information contained in this Offering Circular. To the best of the knowledge and belief of the Issuer (which has taken all reasonable care to ensure that such is the case), the information contained in this Offering Circular is in accordance with the facts and does not omit anything likely to affect the import of such information.

This Offering Circular is to be read in conjunction with all documents which are deemed to be incorporated herein by reference (see *“Documents Incorporated by Reference”* below).

No person is or has been authorised to give any information or to make any representation other than those contained in this Offering Circular in connection with the issue or sale of the PIBS and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer or The Royal Bank of Scotland plc (the “Manager”). Neither the delivery of this Offering Circular nor any subscription, sale or purchase made in connection herewith shall, under any circumstances, constitute a representation or create any implication that there has been no change in the affairs of the Issuer since the date hereof or that there has been no adverse change in the financial position of the Issuer since the date hereof.

The distribution of this Offering Circular and the offering or sale of the PIBS in certain jurisdictions may be restricted by law. Persons into whose possession this Offering Circular comes are required by the Issuer and the Manager to inform themselves about and to observe any such restrictions. The PIBS have not been and will not be registered under the United States Securities Act of 1933, as amended (the “Securities Act”). Subject to certain exceptions, PIBS may not be offered, sold or delivered within the United States or to U.S. persons. For a description of certain restrictions on offers and sales of PIBS and on distribution of this Offering Circular, see *“Marketing Arrangements”*.

This Offering Circular does not constitute an offer of, or an invitation by or on behalf of the Issuer or the Manager to subscribe for, or purchase, any PIBS.

The Manager has not separately verified the information contained in this Offering Circular. The Manager does not make any representation, express or implied, or accept any responsibility, with respect to the accuracy or completeness of any of the information in this Offering Circular. Neither this Offering Circular nor any other financial statements are intended to provide the basis of any credit or other evaluation and should not be considered as a recommendation by either the Issuer or the Manager that any recipient of this Offering Circular or any other financial statements should purchase the PIBS. Each potential purchaser of PIBS should determine for itself the relevance of the information contained in this Offering Circular and its purchase of PIBS should be based upon such investigation as it deems necessary. The Manager does not undertake to review the financial condition or affairs of the Issuer during the life of the arrangements contemplated by this Offering Circular nor to advise any investor or potential investor in the PIBS of any information coming to the attention of the Manager.

In connection with the issue of the PIBS, the Manager (or any person acting on its behalf) may over-allot PIBS (provided that the aggregate principal amount of PIBS allotted does not exceed 105 per cent. of the aggregate principal amount of the PIBS) or effect transactions with a view to supporting the market price of the PIBS at a level higher than that which might otherwise prevail. However, there is no assurance that the Manager (or any person acting on its behalf) will undertake stabilisation action. Any stabilisation action may begin on or after the date on which adequate public disclosure of the final terms of the offer of the PIBS is made and, if begun, may be ended at any time, but it must end no later than the earlier of 30 days after the issue date of the PIBS and 60 days after the date of the allotment of the PIBS.

In this Offering Circular, unless otherwise specified or the context otherwise requires, references to “pounds”, “penny”, “sterling”, and “£” are to the currency of the United Kingdom, references to “Euro” are to the single currency of those member states of the European Union participating in the Third Stage of European Economic and Monetary Union from time to time and references to the “Act” are to the Building Societies Act 1986, which expression shall include, where applicable, any statutory modification or re-enactment thereof or any statutory instrument, order or regulation made thereunder or under any such statutory modification or re-enactment. Terms used in this Offering Circular shall, unless otherwise defined, or as the context otherwise requires, have the same meanings as are given to them in the Act or, as the case may be, the Rules of the Society (the “Rules”) or the Memorandum of the Society (the “Memorandum”).

DOCUMENTS INCORPORATED BY REFERENCE

This Offering Circular should be read and construed in conjunction with the audited consolidated annual financial statements of the Issuer for the financial years ended 30 April 2005 and 30 April 2006 (together in each case with the audit report thereon and the annual business statement and the directors' report in respect of each such year), which have been previously published and which have been approved by the FSA or filed with it. Such documents shall be deemed to be incorporated in, and form part of, this Offering Circular, save that (i) any statement contained in a document which is deemed to be incorporated by reference herein shall be deemed to be modified or superseded for the purpose of this Offering Circular to the extent that a statement contained herein modifies or supersedes such earlier statement (whether expressly, by implication or otherwise) and (ii) any documents which are incorporated by reference therein shall not constitute a part of this Offering Circular. Any statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Offering Circular.

Copies of documents deemed to be incorporated by reference in this Offering Circular can be viewed on the website of the Regulatory News Service operated by the London Stock Exchange at <http://www.londonstockexchange.com/en-gb/pricesnews/marketnews/> and may be obtained free of charge from the registered office of the Issuer.

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OVERVIEW OF THE PIBS

The following overview is qualified in its entirety by the remainder of this Offering Circular.

Issuer:	Scarborough Building Society.
Description of issue:	<p>£50,000,000 6.875 per cent. PIBS, comprising 50,000 PIBS of £1,000 each.</p> <p>The PIBS will be deferred shares in the Society for the purposes of Section 119 of the Act and will not be protected deposits for the purposes of the Financial Services Compensation Scheme established under the FSMA.</p>
Registrar:	Lloyds TSB Registrars.
Issue Price:	99.239 per cent. of the principal amount of the PIBS.
Form and Denomination:	The PIBS are in registered form and are available and transferable in accordance with the Rules in amounts and integral multiples of £1,000.
Interest:	<p>The PIBS bear interest from and including 13 April 2007 to but excluding the Reset Date (as defined in “<i>Special Conditions of Issues of the PIBS-Interest</i>” (the Conditions)) at the rate of 6.875 per cent. per annum payable, subject as set out in Condition 4, in arrear on 13 October and 13 April in each year, commencing on 13 October 2007. Thereafter the PIBS bear interest at the rate equal to 3 month sterling LIBOR plus 2.56 per cent. per annum as more fully described in Condition 4, payable, subject as set out in Condition 4, in arrear on 13 July, 13 October, 13 January and 13 April in each year, commencing on 13 July 2017, each such date subject to adjustment in accordance with the business day convention specified in Condition 4. Except as provided in Conditions 4(3)(b) to 4(3)(f), interest on the PIBS is non-cumulative.</p>
Repayment:	<p>The PIBS constitute permanent non-withdrawable deferred shares (as defined in the Act) in the Society and have no specified final maturity.</p> <p>The Society may elect to repay all, but not some only, of the PIBS on the Reset Date or on any Interest Payment Date thereafter at their principal amount together, subject to Conditions 4(3)(a) and 4(3)(b), with any interest accrued to but excluding the date of repayment.</p>
Payments:	Payments in respect of the PIBS will be made by sterling cheque drawn on a bank or building society in the United Kingdom, posted on the business day immediately preceding the relevant due date and made payable to the PIBS holders (or in the case of a joint holding of PIBS, the Representative Joint Shareholder) appearing in the PIBS Register in respect of the PIBS of which he is the holder at the close of business on the fifteenth day before the relevant due date (the Record Date) at the addresses shown in the PIBS Register on the Record Date.
Rating:	The PIBS are expected to be rated Baa3 by Moody’s. A rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

Withholding Tax:	<p>All payments in respect of the PIBS shall be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or governmental charges of whatever nature (Taxes) imposed or levied by or on behalf of the United Kingdom or any political subdivision or any authority thereof or therein having power to tax, unless the withholding or deduction of the Taxes is required by law.</p> <p>For a description of applicable United Kingdom taxation considerations see “<i>United Kingdom Taxation</i>”.</p>
Successions and Transfers:	<p>Upon an amalgamation by the Society with another building society under Section 93 of and Schedule 16 to the Act or a transfer of its engagements to any extent to another building society under Section 94 of and Schedule 16 to the Act, the PIBS shall become deferred shares in the amalgamated or transferee building society (as appropriate) without any alteration in their terms.</p>
Further Issues:	<p>The Society shall be at liberty from time to time without the consent of the PIBS holders to create and issue further permanent interest bearing shares as more fully described in Condition 11.</p>
Governing Law:	<p>English.</p>
Listing:	<p>Application has been made to the UK Listing Authority for the PIBS to be admitted to the Official List and to the London Stock Exchange for the PIBS to be admitted to trading on the Market.</p>
Selling Restrictions:	<p>There are restrictions on the sale of PIBS and the distribution of offering material as set out in “<i>Marketing Arrangements</i>”.</p>
Overview of Certain Provisions of the Rules of the Society and the Act relating to the PIBS:	<p>See “<i>Overview of Certain Provisions of the Rules of the Society and the Act relating to the PIBS</i>” for an overview of the key provisions of the Rules and certain provisions of the Act insofar as they might affect the rights of the PIBS holders.</p>
Certain Provisions of the Act and Requirements of the Supervisory Authority:	<p>See “<i>Certain Provisions of the Act and Requirements of the Supervisory Authority</i>” for a description of certain provisions of the Act and the requirements of the FSA in its role as the Supervisory Authority.</p>

RISK FACTORS

Investors should understand the risks of investing in the PIBS before they make their investment decision. They should make their own independent decision to invest in the PIBS and decide whether an investment in such PIBS is appropriate or proper based upon their own judgement and upon advice from such advisors as they consider necessary.

Factors which are material for the purpose of assessing the risks associated with the PIBS

Investors should be aware that the PIBS are undated and subordinated and that the terms of the PIBS vary considerably from the terms of ordinary share accounts and deposit products of building societies. They should particularly note the following characteristics of the PIBS:

(a) Permanence

The PIBS will not be withdrawable at the option of the PIBS holders and will be repayable only at the option of the Society on the Reset Date or any Interest Payment Date (as defined in “*Special Conditions of Issue of the PIBS – Interest*”) thereafter or in certain limited circumstances, as described in “*Special Conditions of Issue of the PIBS – Repayment*”, in each case subject to the permission of the Supervisory Authority. The Society is under no obligation to any investor to seek the Supervisory Authority’s permission to repay the PIBS and the Supervisory Authority has complete discretion as to whether to give such permission. There is no right to, or expectation of, repayment unlike normal investment accounts where the Society must return the capital investment (plus any accrued interest) to the investor as and when demanded (subject to the stated period of notice and other terms applicable to that particular account).

(b) Liquidity

In order to realise its capital investment in the PIBS, an investor must either go to an established secondary market or look to make a private sale. **There is no guarantee that the investor will be able to liquidate its investment in the PIBS** for cash because the future liquidity of the secondary market is not guaranteed and/or as the investor may be unable to find any potential private purchasers. Therefore, there is a risk that an investor may not be able to realise its investment in the PIBS when it wishes to do so.

(c) Capital value of investment

As the capital value of the PIBS will vary with market interest rates, the market perception of the value of the Society and the availability of purchasers, there is a real chance that the investor may make a capital loss when it comes to sell its PIBS.

(d) Subordination

The PIBS are subordinated to all other liabilities of the Society other than liabilities in respect of other deferred Shares (as defined in the Rules). The PIBS and other deferred Shares rank *pari passu* without any preference among themselves. In a winding-up or dissolution of the Society, the claims of the PIBS holders will rank behind all other creditors of the Society and the claims of Members holding Shares (other than deferred Shares, as so defined) as to principal and interest. If there are insufficient assets to repay all Members the amount paid up on their Shares, no repayments shall be made in respect of the deferred Shares until after all other Members have been repaid in full. In addition, in the event of a winding-up or dissolution of the Society, following payment in full of the Society’s creditors and repayment to Members (including PIBS holders) of the amount of their Shares according to their priority under their respective terms, the Society has determined that the PIBS holders will not be entitled to any share in any final surplus.

Investors should be aware that this subordination is a primary factor behind the higher interest rate that is paid on the PIBS when compared to other investment products. The higher interest rate reflects the fact that there is a higher risk involved with this investment.

(e) Investor protection

Unlike normal building society investment products, the PIBS are not protected deposits for the purposes of the Financial Services Compensation Scheme established under the FSMA.

- (f) Payments of interest may be missed or may not be paid in cash or at all

Interest in respect of the PIBS will not be payable where, or to the extent that, payment would result in the Society's capital falling below prescribed levels, as more fully explained in Condition 4(3)(a) in "*Special Conditions of Issue of the PIBS – Interest*". In such circumstances, interest which is not paid will be cancelled and each PIBS holder shall cease to have any right to that interest.

Interest in respect of the PIBS will not be payable in cash where the board of directors of the Society (the **Board**) passes a resolution cancelling or requiring a reduction in the interest payable for any reason other than to avoid bringing the Society's capital below prescribed levels, as more fully explained in Condition 4(3)(b) in "*Special Conditions of Issue of the PIBS*". In such circumstances, the interest payment will, prior to a Demutualisation Event (as defined in the Conditions), be made by delivery to the PIBS holder of such number of further PIBS (Payment PIBS, as defined in the Conditions) to which each PIBS holder shall, in the opinion of an independent investment bank, be entitled, based on the market value of the PIBS at such time. The Board may pass any such resolution at any time and in the event that it does pass any such resolution, PIBS holders will not be entitled to any compensation in respect of payments not made in cash.

Investors should be aware that the liquidity and market price for any series of Payment PIBS may not be the same as the PIBS, as any series of Payment PIBS will not be fungible with the PIBS and is likely to be significantly smaller in principal amount than the PIBS outstanding from time to time. Investors should also be aware that the aggregate amount of Payment PIBS which can be delivered in this manner is subject to a cap of 15 per cent. of the initial aggregate principal amount of the PIBS, and therefore that the return on any PIBS held by them may be reduced accordingly.

Investors are also advised that, following a Demutualisation Event, the Successor Entity (as defined in the Conditions) may, following the exercise of the Board's discretion referred to above, satisfy the interest not paid in cash by way of an "Alternative Interest Satisfaction Mechanism" (or **AISM**), which is also subject to a cap (of 15 per cent. of the initial aggregate principal amount of the PIBS) and which may therefore also negatively affect the return on PIBS held by investors. In accordance with Condition 8, following a Demutualisation Event, the Successor Entity will undertake to use all reasonable endeavours to obtain and maintain the corporate authorisations required for the operation of the AISM. However, if, at any time when the Arrears of Interest (as defined in the Conditions) are to be satisfied by means of the AISM, the Successor Entity does not have available and/or the board of directors of the Successor Entity does not have the necessary authority under English law to allot to, or to the order of, the Independent Investment Bank (as defined in the Conditions) a sufficient number of authorised but unissued ordinary shares (free from any pre-emption right) to satisfy the relevant AISM Payment (as defined in the Conditions), then the Successor Entity will not be able to operate the AISM. See Condition 4(3) in "*Special Conditions of Issue of the PIBS- Interest*") for further details.

- (g) Rights

The rights of the PIBS holders are markedly different from those of shareholders in a company, e.g. as to voting rights and protection of minorities. For example, as indicated in "*Overview of Certain Provisions of the Rules of the Society and the Act relating to the PIBS – Meetings*", each PIBS holder only has one vote at a general meeting of the Society, irrespective of the number of PIBS it holds, whereas shareholders at a general meeting of a company would normally have one vote on a poll for each ordinary share held.

- (h) Amalgamation of the Society and transfer of its engagements

If the Society amalgamates with, or transfers all or part of its engagements to, another building society, the PIBS will not become repayable as a consequence thereof, but will become deferred shares in that other society.

If the Society transfers the whole of its engagement to any other body, the transfer will incorporate arrangements to secure that the PIBS are effectively converted into perpetual subordinated debt of that body, and do not become repayable other than at the option of that body on the Reset Date or any Interest Payment Date (as defined in "*Special Conditions of Issue of the PIBS – Interest*") thereafter or in certain limited circumstances, as described in "*Special Conditions of Issue of the PIBS – Repayment*", in each case subject to the permission of the Supervisory Authority.

(i) Credit ratings may not reflect all risks

The credit rating assigned to the PIBS by Moody's may not reflect the potential impact of all risks related to structure, market, additional factors discussed above and other factors that may affect the value of the PIBS. A credit rating is not a recommendation to buy, sell or hold securities and may be revised or withdrawn by the relevant rating agency at any time.

(j) Taxation of interest

The PIBS will be listed on a recognised stock exchange (within the meaning of Section 841 of the Income and Corporation Taxes Act 1988) and therefore under current law, interest may be paid without withholding or deduction for tax. Nevertheless, tax may be withheld or deducted if there is a change of law or if the PIBS cease to be listed on a recognised stock exchange.

(k) No limitation on issuing debt or senior or *pari passu* securities

There is no restriction on the amount of debt which the Society may issue which ranks senior to the PIBS or on the amount of securities which the Society may issue which rank senior to, or *pari passu* with, the PIBS. The issue of any such debt or securities may reduce the amount recoverable by PIBS holders in the event of a winding-up of the Society and/or may increase the likelihood of a cancellation of payments under the PIBS.

(l) Legal investment considerations may restrict certain investments

The investment activities of certain investors are subject to legal investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisors to determine whether and to what extent (1) PIBS are legal investments for it, (2) PIBS can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of any PIBS. Financial institutions should consult their legal advisors or the appropriate regulators to determine the appropriate treatment of PIBS under any applicable risk-based capital or similar rules.

(m) Change of law

The conditions of the PIBS are based on English law in effect as at the date of this Offering Circular. No assurance can be given as to the impact of any possible judicial decision or change to English law or administrative practice after the date of this document.

Factors that may affect the Society's ability to fulfil its obligations under the PIBS

Investors' attention is also drawn to the following factors that may affect the Society's ability to fulfil its obligations under the PIBS. Most of these factors are contingencies which may or may not occur and the Society is not in a position to express a view on the likelihood of any such contingency occurring. The Society does not represent that the statements below are exhaustive. Prospective investors should also read the detailed information set out elsewhere in this Offering Circular and reach their own views prior to making any investment decision:

(a) **United Kingdom housing market**

One of the Society's primary activities is mortgage lending in the United Kingdom with loans secured against residential property. A downturn in the United Kingdom economy could have a negative effect on the housing market, particularly if this results in an increased level of unemployment or significantly higher interest rates. Residential property prices may fall and could result in losses being incurred by lenders on loans that have defaulted. In the Society's case, this risk is mitigated by the level of equity held in the property (the value of which acts as a security for the loan) and the existence of a mortgage indemnity guarantee policy for amounts lent in excess of 80% loan to value ratio.

A fall in the United Kingdom residential property prices could have consequences for the Society's funding costs and credit ratings if there were deemed to be a material deterioration in the quality of the mortgage portfolio.

The residential mortgage lending market in the United Kingdom is competitive, and developments in this market, and increased competition, could have an adverse effect on the Society's position in this market, and therefore on the Society's financial position.

(b) **United Kingdom Personal Financial Services Market**

The United Kingdom financial services market for products such as savings and regulated investments (where the Society acts as distributor for third parties) is competitive. Developments in this market and increased competition could have an adverse effect on the Society's position in this market and therefore on its financial position.

(c) **Regulation**

The Society is regulated by the FSA. The FSA regulates the sale of residential mortgages and general insurance products. The regulatory regime requires the Society to be compliant across many aspects of activity, including the training, authorisation and supervision of personnel, systems processes and documentation. If the Society fails to be compliant with relevant regulations, there is a risk of an adverse impact on the business due to sanctions, fines or other action imposed by the regulatory authorities.

The FSA and other bodies such as the Financial Ombudsman Service, could impose further regulations or obligations in relation to current and past dealing with retail customers. As a result, the Society may incur costs in complying with these regulations or obligations relating to its business, including potential compensation and costs relating to sales advice given to retail customers.

The Society has some exposure in terms of loans to Housing Associations. Changes in the United Kingdom housing benefit system could have an adverse effect on the ability of Housing Associations to service these loans.

(d) **Financial risks**

Control of financial risk is one of the most important risk factors for financial institutions. Financial risk includes credit, liquidity, operational and market risk. Failure to control these risks could result in material adverse effects on the Society's financial performance and reputation. The Society's risk management structure is the overall responsibility of the Board. Assisting the Board, the Board Audit and Compliance Committee (which comprise non-executive directors) and the Financial Risk Committees (which comprise executive directors and which report to the Board) consider all matters relating to regulatory, prudential and accounting requirements that may affect the Society and its subsidiaries. The Society has a formal structure for managing financial risks, including

established risk limits, reporting lines, governance committees, mandates and other control procedures.

Credit Risk

Credit Risk is the potential risk of financial loss arising from the failure of a customer or counterparty to settle their financial and/or contractual obligations as they fall due. The Society's retail credit exposures are managed in accordance with the Board approved lending policy. Wholesale counterparty exposures are managed through Board policy limits to individual counterparties, countries, terms of exposure and type of financial instrument.

Liquidity Risk

The Society's liquidity policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding, to retain full public confidence in the solvency of the Society and to be in a position to meet its financial obligations as they fall due. This is achieved through maintaining a prudent level of liquid assets, through wholesale funding facilities and through management of the growth of the business.

Operational Risk

Operational Risk is the potential risk of financial loss or impairment to reputation arising from failures in operational processes or the systems that support them. To minimise operational risk, the Society maintains a system of control based on best practice principles and regulatory considerations, which is commensurate with the characteristics of the business and the markets in which it operates. Other operational risk mitigants include insurances and continuity arrangements.

Market Risk

Market Risk is the risk from changes in interest rates, and the prices of financial securities. The Society offers numerous mortgage and savings products with varying interest rate features and maturities that create potential interest rate exposures. The Society manages this risk on a continuous basis, within limits set by the Board, using a combination of on and off balance sheet instruments. The Society raises funds through the sterling money markets, capital markets and retail savings market. The Society's policy is to ensure that there is no significant exposure to fluctuations in foreign currency interest rates.

(e) International Financial Reporting Standards

The Society has adopted International Financial Reporting Standards for reporting periods beginning on or after 1 May 2005. These standards are, in a number of ways different from previously existing generally accepted accounting principles in the United Kingdom and their implementation may have a significant effect on the presentation of the Society's financial statements.

(f) Basel Capital Requirements Directive

The Basel Committee has issued proposals for reform of the 1988 Capital Accord and has proposed a revised framework, which places enhanced emphasis on market discipline and sensitivity to risk. The Capital Requirements Directive is the EU Directive which implements the Revised Basel Framework. It will introduce a supervisory framework in the EU reflecting the Rules on capital measurement and capital standards set out in the Revised Basel Framework. The Society cannot predict the precise effects of the potential changes that might result from implementation of the proposals on its own financial performance. Prospective investors in the PIBS should consult their own advisors as to the consequences for them of the potential application of the Revised Basel Framework.

(f) European Monetary Union

If the United Kingdom joins the European Monetary Union there is no assurance that this would not adversely affect investors in the PIBS. It is possible that the United Kingdom may become a participating Member State and that the Euro may become the lawful currency of the United Kingdom. In that event (i) all amounts payable in respect of any PIBS denominated in sterling may become payable in Euro; (ii) the law may allow or require the PIBS to be re-denominated into Euro and additional measures to be taken in respect of such PIBS; and (iii) there may no longer be

available published or displayed rates for deposits in sterling used to determine the rates of interest on such PIBS or changes in the way those rates are calculated, quoted and published or displayed. The introduction of the Euro could also be accompanied by a volatile interest rate environment, which could adversely affect investors in the PIBS.

OVERVIEW OF CERTAIN PROVISIONS OF THE RULES OF THE SOCIETY AND THE ACT RELATING TO THE PIBS

The rights and restrictions attaching to the PIBS will be governed by the Rules, certain provisions of the Act and the “*Special Conditions of Issue of the PIBS*” herein. Set out below is an overview of the key provisions of the Rules and certain provisions of the Act insofar as they might affect the rights of the PIBS holders, together with certain explanatory notes which are italicised. Terms defined in the Rules will, unless the context otherwise requires, have the same meanings when used in this overview.

1. General

The Person whose name is entered in the PIBS Register (as defined below) as the holder of PIBS is a Shareholding Member of the Society.

Each PIBS holder (as defined in the Conditions), and all Persons claiming through him or on his behalf or under the Rules, shall be bound by the Rules and by the Memorandum and, where applicable, the Additional Rules (which are set out in the Rules).

2. Register

The Society shall maintain a register for the purposes of the PIBS (the **PIBS Register**), in which shall be entered the name and address of each PIBS holder. Each PIBS holder shall notify the Society immediately of any change of name or address and shall produce such evidence of such change as the Society may require.

Transfers and other documents or instructions relating to or affecting the title to any PIBS shall also be recorded in the PIBS Register. No charge shall be made in respect of any entry in the PIBS Register. The PIBS Register shall be maintained at the Principal Office, or at such other place as the Board considers appropriate.

The Society has appointed Lloyds TSB Registrars, The Causeway, Worthing, West Sussex BN99 6DA as its registrar for the PIBS issue.

3. PIBS Certificate

Each PIBS holder, within one month after becoming entered in the PIBS Register as the holder of PIBS, shall, if he shall make a written request to the Society at the time of applying to be so entered, be supplied by the Society with a duly executed share certificate issued under the seal of the Society in respect of PIBS (a **PIBS Certificate**) (which shall not be the property of the Society).

Each PIBS holder entered into the records of the Society who has not previously requested to be supplied by the Society with a PIBS Certificate shall within one month after making a written request to the Society be supplied by the Society with a PIBS Certificate.

Save as aforesaid, nothing in the Rules requires a PIBS to be evidenced by a PIBS Certificate or other written instrument. PIBS Certificates shall be made available at the offices of the Registrar.

Notwithstanding these provisions of the Rules regarding the issue of PIBS Certificates, the Society will procure that a PIBS Certificate is issued to all PIBS holders who hold their PIBS in certificated form, regardless of whether or not one is requested, within 14 days after the issue or lodgement of any instrument of transfer of PIBS. The PIBS will also be capable of being held in uncertificated form.

4. Replacement of a PIBS Certificate

A PIBS holder losing his PIBS Certificate shall immediately give notice in writing of such loss to the Society at its Principal Office and to the Registrar. If a PIBS Certificate is damaged or alleged to have been lost, stolen or destroyed, a new PIBS Certificate representing the same PIBS shall be issued to that PIBS holder upon request, subject to delivery up of the old PIBS Certificate or (if alleged to have been lost, stolen or destroyed) subject to compliance with such conditions as to evidence and indemnity as the Society and the Registrar may think fit and to payment of any exceptional expenses of the Society and the Registrar incidental to its investigation of the evidence of such alleged loss, theft or destruction. Where a holder of a certificated PIBS has sold part of his holding he will be entitled to a PIBS Certificate for the balance without charge.

5. Transfers

A PIBS holder may transfer his PIBS to any Person and no fee shall be charged in respect of a transfer. No transfer of PIBS shall be valid unless made in a form approved by the Board and until registered in the PIBS Register, but such transferee shall be entitled to have his name entered in the PIBS Register following notice by him to the Society of such a transfer, such notice to be made or given in the form endorsed on the PIBS Certificate or in such other manner as the Board in its absolute discretion may permit.

The registration of transfers of the PIBS may be suspended at such times and for such periods as the Board may determine, but not for more than 30 days in the year, and notice of such suspension shall be given by advertisement in at least one national daily newspaper.

A fully paid PIBS shall be free from all liens in respect of liabilities to the Society.

Two or more Persons may jointly hold a PIBS. No PIBS shall be issued to the holders, or be held by them at any time, as tenants in common.

The Society may decline to issue any PIBS, or register any transfer of PIBS, to more than four Persons jointly. Joint PIBS holders shall be entitled to choose the order in which they are named in the records of the Society.

6. Meetings

As Members of the Society, the PIBS holders will, subject to the provisions of the Rules, be entitled to receive notice of, propose resolutions at, attend, be counted in a quorum and vote, or appoint a proxy, at general meetings of the Society.

A PIBS holder is entitled to vote on a resolution (whether an Ordinary Resolution or Special Resolution or a Shareholding Members' Resolution, but not a Borrowing Members' Resolution) if:

- (a) being an Individual, he is not a minor on the voting date or, where he is voting by proxy, on the date of the meeting at which the resolution is intended to be moved;
- (b) in the case of a joint Shareholding, he is the Representative Joint Shareholder;
- (c) he was entered in the PIBS Register as the holder of PIBS:
 - (i) at the end of the last Financial Year before the voting date; or
 - (ii) if the voting falls during that part of the Financial Year which follows the conclusion of the Annual General Meeting commenced in that year, at the beginning of the period of 56 days immediately preceding the voting date for Members voting in person at a special general meeting or a postal ballot,as the case may be; and
- (d) he has not ceased to be a PIBS holder at any time between the time referred to in (c)(i) and (ii) above (as applicable) and the voting date.

At a general meeting of the Society, each PIBS holder will have one vote regardless of the principal amount of PIBS held by that PIBS holder or whether the PIBS holder is otherwise a Member of the Society.

7. Winding-up and dissolution

Upon the winding-up of the Society, or upon it being dissolved by consent, if there are insufficient assets to repay all Members the amounts paid up on their Shares, no repayments shall be made in respect of any deferred Share (including the PIBS) until after all other Members have been repaid in full.

Upon the winding-up of the Society, or upon it being dissolved by consent, any surplus remaining after payment in full of the Society's creditors and repayment to Members (including PIBS holders) of the amount of their Shares (together with interest due thereon) according to their priority under their respective terms and conditions of issue, shall be applied as follows:

- (a) up to 20 per cent. to holders of all or some of the deferred Shares in the Society (including the PIBS). The proportion (if any) of such 20 per cent. to which any particular issue of deferred Shares (including the PIBS) is entitled shall be set forth in the terms and conditions of issue of

that issue of deferred Shares (*see note below which describes the way in which the Society has determined the exercise of this discretion*); and

- (b) the remainder among qualifying Members (other than holders of deferred Shares (including the PIBS)) in proportion to the value of their Shareholdings.

For the purposes of these provisions of the Rules, **qualifying Members** means Persons who hold on the date of commencement of the dissolution or winding-up, and have held throughout the period of two years up to that date, Shares to the value of not less than £100.

The Society has determined that, in exercising its discretion regarding the distribution of any surplus on a winding-up or dissolution of the Society referred to in sub-paragraph 7(a) above, no proportion of any final surplus will be paid to the holders of PIBS.

8. Disputes and legal proceedings

Subject to the provisions of Section 1 of the Courts and Legal Services Act 1990, Section 85 of and Schedule 14 to the Act provide that no court other than the High Court of Justice in England shall have jurisdiction to hear and determine disputes between a building society and a member or a representative of a member in that capacity in respect of any rights or obligations arising from the rules of a building society or the Act. Pursuant to Section 1 of the Courts and Legal Services Act 1990, the High Court and County Courts Jurisdiction Order 1991 No. 724 has been made which empowers the High Court to transfer cases over which it has jurisdiction to the County Court.

9. Unclaimed interest

In certain circumstances set out in the Rules, the Society shall be entitled to sell for the best price reasonably obtainable any PIBS in respect of which no interest has been claimed during a period of 12 years. The Society must first give written notice to the UK Listing Authority of its intention to sell the PIBS. The Society shall be obliged to account (as debtor and not as trustee) to the PIBS holder or any other Person entitled to the PIBS for the net proceeds of sale of the PIBS.

SPECIAL CONDITIONS OF ISSUE OF THE PIBS

The following are the special conditions of issue of the PIBS in the form in which, subject to the removal of the wording in italics which does not form part of the special conditions, they will appear on the reverse of each PIBS Certificate:

The PIBS holders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of the Rules (as defined below) of the Society (as defined below). The PIBS (as defined below) are also issued subject to, and with the benefit of, these special conditions of issue (the **Conditions** and each a **Condition**). In the event of inconsistency between the Rules and these Conditions, the Rules will prevail (unless otherwise provided in the Rules).

1 General

- (1) Terms defined in the Rules of the Society for the time being (the **Rules**) will, unless the context otherwise requires, have the same meanings when used in these Conditions.
- (2) The PIBS:
 - (a) are deferred Shares for the purposes of Section 119 of the Building Societies Act 1986, as amended (the **Act**);
 - (b) are not protected deposits for the purpose of the Financial Services Compensation Scheme established under the Financial Services and Markets Act 2000 (the **FSMA**);
 - (c) are not withdrawable; and
 - (d) are permanent interest bearing shares for the purposes of the Rules.
- (3) Upon a transfer of PIBS by a PIBS holder the Society will procure that the new PIBS holder is issued with a PIBS Certificate within 14 days after the lodgement of the instrument of transfer if it holds its PIBS in certificated form. The PIBS Certificate will be made available at the offices of the Registrar.
- (4) The PIBS may be held jointly by up to four Persons.
- (5) Rights to Conversion Benefits to which a PIBS holder may become entitled by reason of its holding of PIBS shall not be required to be assigned to a charity nominated by the Society pursuant to any scheme for charitable assignment established by the Society for the time being. In the event that a PIBS holder is a Member of the Society other than by reason of its holding of PIBS and has made a declaration to assign any Conversion Benefits to a charity, that assignment declaration shall not apply to Conversion Benefits derived from its holding of PIBS. If there is a conflict between these Conditions and any other provisions for the assignment of Conversion Benefits to which a Member is subject, then these Conditions shall prevail in relation to Conversion Benefits derived from PIBS held by any PIBS holder, whenever the assignment of Conversion Benefits is made. For these purposes, **Conversion Benefits** shall mean any benefits which a person has a right to receive as a shareholding member of the Society under the terms of any future transfer of the Society's business to a company and, if the Society merges with any other building society, **Society** shall, after the date of such merger, extend to such other society.

2 Form and denomination

The PIBS are in registered form and are available and transferable in accordance with the Rules in amounts and integral multiples of £1,000.

In the case of PIBS in certificated form, no legal transfer of a PIBS shall be valid unless made in the form endorsed on the PIBS Certificate or in such other form as the Board may agree, which form shall be presented to the Registrar. Legal title to the PIBS will pass upon registration of such transfer in the PIBS Register and the Registrar shall, on behalf of the Society, issue a PIBS Certificate in respect of such holding (which will be made available at the offices of the Registrar).

3 PIBS Register

- (1) The Society has appointed the Registrar to act as registrar in respect of the PIBS under the terms of a Registrar's Agreement dated 26 April 2000 and made between the Society and Lloyds TSB Registrars, as Registrar. PIBS holders are deemed to have notice of all the provisions of the Registrar's Agreement applicable to them.
- (2) Pursuant to the Registrar's Agreement, the Society shall procure that the Registrar maintains the PIBS Register, in which shall be entered the name and address of each PIBS holder. Each PIBS holder shall notify the Registrar immediately of any change of name or address and shall produce such evidence of change of name or address as the Registrar may reasonably require.
- (3) A PIBS holder must provide the Registrar with a written order containing such instructions and other information as the Society and the Registrar may require to complete, execute and deliver a PIBS Certificate to such PIBS holder. On receipt of such documents, the Society shall instruct the Registrar to arrange for the authentication of, and the Registrar to deliver to, or to the order of, the person or persons named in such written order of a PIBS Certificate, registered in the name or names requested by such person or persons.
- (4) Transfers and other documents or instructions relating to, or affecting the title of, any PIBS shall be recorded in the PIBS Register. No charge shall be made in respect of any entry in the PIBS Register. The PIBS Register shall be maintained at the principal office of the Registrar or at such other place as the Society and the Registrar shall agree.
- (5) The Society shall procure that the Registrar shall, on behalf of the Society, issue a PIBS Certificate in respect of each holding of all PIBS held by each PIBS holder (or, in the case of a joint holding of PIBS, the Representative Joint Shareholder) within 14 days after one is requested.
- (6) No person shall have any right to enforce any term or condition of the PIBS under the Contracts (Rights of Third Parties) Act 1999.

4 Interest

- (1) The PIBS bear interest from and including 13 April 2007 (the **Issue Date**) to but excluding the Reset Date at the rate of 6.875 per cent. per annum payable, subject as set out below, in arrear on 13 October and 13 April in each year (each a **Fixed Interest Payment Date**), commencing on 13 October 2007. Thereafter the PIBS bear interest at a rate calculated in accordance with paragraph (2) below (each a **Rate of Interest**) payable, subject as set out below, in arrear by quarterly instalments 13 July, 13 October, 13 January and 13 April in each year, commencing on 13 July 2017 (each a **Floating Interest Payment Date** and together with the Fixed Interest Payment Date, each an **Interest Payment Date**). The period from and including the Issue Date to but excluding the first Interest Payment Date and each successive period from and including one Interest Payment Date to but excluding the next succeeding Interest Payment Date is called an **Interest Period**. If any Interest Payment Date falling after the Reset Date would otherwise fall on a date which is not a Business Day, it will be postponed to the next Business Day. Except as provided in Conditions 4(3)(b) to 4(3)(f), interest on the PIBS is non-cumulative.

From and including the Issue Date to but excluding the Reset Date, where it is necessary to calculate an amount of interest in respect of any PIBS for a period which is not an Interest Period, such interest shall be calculated on the basis of the actual number of days in the period from (and including) the most recent Interest Payment Date (or, if none, the Issue Date) to (but excluding) the date on which the relevant interest is payable, divided by the product of (a) the actual number of days in the period from (and including) such Interest Payment Date (or, if none, the Issue Date) to (but excluding) the next (or first) scheduled Interest Payment Date and (b) two.

- (2) (a) The Rate of Interest payable in respect of the PIBS from and including the Reset Date will be the Screen Rate (as defined below) plus the Margin (the **Floating Rate of Interest**) as determined by such leading bank or investment banking firm in London as shall be appointed by the Society (the **Agent Bank**). If, on any Interest Determination Date (as defined below), the Screen Rate is unavailable, the Agent Bank will request the Reference Banks to provide it with the rate at which deposits in sterling are offered by

each of them to prime banks in the London interbank market for three months at approximately 11.00 a.m. (London time) on the Interest Determination Date in question.

- (b) If, on any Interest Determination Date, the Screen Rate is unavailable and at least two of the Reference Banks provide such rates to the Agent Bank, the Floating Rate of Interest for the relevant Interest Period shall be the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards) as established by the Agent Bank of such rates, plus the Margin.
 - (c) If on any Interest Determination Date the Screen Rate is unavailable and fewer than two rates are provided to the Agent Bank as requested, the Floating Rate of Interest for the relevant Interest Period will be the arithmetic mean of the rates quoted by major banks in the London interbank market selected by the Agent Bank, at approximately 11.00 a.m., London time, on the Interest Determination Date in question for loans in sterling to leading European banks for a period of three months commencing on the first day of such Interest Period, plus the Margin. If the Floating Rate of Interest cannot be determined in accordance with the above provisions, the Floating Rate of Interest shall be the Floating Rate of Interest determined as at the last preceding Interest Determination Date.
 - (d) After the Reset Date, whenever it is necessary to compute an amount of interest in respect of any PIBS for a period other than an Interest Period, such interest shall be calculated on the basis of the actual number of days in such period divided by 365 or, in the case of Interest Payment Date falling in a leap year, 366.
 - (e) As soon as practicable after 11.00 a.m. (London time) on each Interest Determination Date, the Agent Bank shall determine the Floating Rate of Interest for the relevant Interest Period and calculate the amount of interest payable on each £1,000 principal amount of PIBS on each Interest Payment Date (the **Floating Interest Amount**). The Floating Interest Amount shall be determined by applying the Floating Rate of Interest to each £1,000 principal amount of PIBS, multiplying the sum by the actual number of days in the Interest Period concerned divided by 365 or, in the case of an Interest Payment Date falling in a leap year, 366 and rounding the resultant figure to the nearest penny (half a penny being rounded upwards). The Society shall cause the Floating Rate of Interest and the Floating Interest Amount for each Interest Period and the relevant Interest Payment Date to be notified to the Registrar as soon as practicable after their determination and calculation and shall procure that the Registrar gives notice thereof to the PIBS holders.
 - (f) The Society may from time to time appoint any leading bank or investment banking firm in London (as determined by the Society) as the Agent Bank in substitution for any existing Agent Bank. In the event of the appointed office of the Agent Bank being unable or unwilling to continue to act as the Agent Bank, the Society shall forthwith appoint the London office of such other leading bank or investment banking firm in London to act as such in its place. The Agent Bank may not resign its duties or be removed without a successor having been appointed as aforesaid.
 - (g) All notifications, opinions, advice, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of this Condition 4(2) by the Agent Bank shall (in the absence of wilful default, bad faith or manifest error) be binding on the Society, the Agent Bank, the Registrar and all PIBS holders and (in the absence as aforesaid) no liability shall attach to the Agent Bank in connection with the exercise or non-exercise of its powers, duties and discretions.
- (3) (a) If, on any day within the 30 days preceding a scheduled Interest Payment Date, the Board:
- (i) after consultation with the Supervisory Authority (as defined below) and having taken appropriate legal advice, is of the opinion that on the relevant date, the Society is, or payment of the relevant interest payment would result in the Society being, or there is a reasonable likelihood that payment of the relevant interest payment would in the foreseeable future result in the Society being, in non-compliance with its Applicable Regulatory Capital Requirements; and

- (ii) passes a resolution cancelling or, as the case may require, reducing the interest to such extent as may be necessary to secure that, in the opinion of the Board (after consultation with the Supervisory Authority and having taken appropriate legal advice), such payment would not cause or contribute to any non-compliance with its Applicable Regulatory Capital Requirements,

then the Society shall, as soon as practicable, give notice to all PIBS holders of such resolution in accordance with Condition 12, and such interest payment or part thereof, as the case may be, shall not be made. On the passing of a resolution cancelling or reducing an interest payment, each PIBS holder shall cease to have any right to the interest for that period so cancelled or, as the case may be, any interest other than the reduced amount payable in accordance with that resolution.

- (b) Notwithstanding the foregoing, the Society may, in circumstances other than as set out in Condition 4(3)(a) above, elect in its sole and absolute discretion to cancel, in whole or in part, the interest payable on any Interest Payment Date, as provided below. To do so, the Board must pass a resolution within 30 days prior to the scheduled Interest Payment Date cancelling, in whole or in part, the interest payable on such Interest Payment Date. The Society shall as soon as practicable after the passing of such resolution, and in any event by no later than the 10th day prior to the relevant Interest Payment Date, give notice thereof (the **Deferral Notice**) to all PIBS holders in accordance with Condition 12. The amount of interest so cancelled is referred to in these Conditions as **Arrears of Interest**.
- (c) The Society shall satisfy all Arrears of Interest (if any) as follows:
 - (A) if a Demutualisation Event has not occurred, the Society shall satisfy such Arrears of Interest within 30 days of the relevant Interest Payment Date by operation of the procedures set out in Condition 4(3)(d)(a) **PIK Payment**) or
 - (B) if a Demutualisation Event has occurred, the Successor Entity shall instead satisfy such Arrears of Interest within 30 days of the relevant Interest Payment Date by either (at the sole discretion of the Successor Entity) (i) a PIK Payment or (ii) by operation of the procedures described in Condition 4(3)(e) (an **AISM Payment**) in each case as more particularly provided in the terms and conditions of the Tier 1 Notes (as defined in Condition 8(2), and with such amendments to these Conditions as may be determined necessary by the independent investment bank appointed pursuant to Condition 8(2) to implement the same, except that if the PIK Cap or AISM Cap, as the case may be, has been or will be exceeded by making such PIK Payment or AISM Payment, as the case may be, the Successor Entity shall be required to satisfy such Arrears of Interest by whichever of the PIK Payment or AISM Payment as is not prohibited by the PIK Cap or AISM Cap, as the case may be.

The Deferral Notice shall (i) state that the relevant interest payment (or part of it, as the case may be) shall not be made in cash; and (ii) specify which of the procedures set out in (A) and (B) above shall instead apply.

- (d) If the Society elects to make a PIK Payment, it shall (i) appoint an Independent Investment Bank, contact details of which shall be included in the Deferral Notice, to determine, as at a date no later than 10 days preceding the Interest Payment Date or, where the Board passes the relevant resolution later than such date, on the day which is two Business Days following the passing of such resolution (the **PIK Determination Date**), the number of Payment PIBS required to be issued to satisfy the relevant Arrears of Interest as described in the following paragraph; and (ii) unless prevented for legal, regulatory or other reasons, make such interest payment by delivery in accordance with this Condition 4(3)(d) of the Payment PIBS to, or to the order of, the holders of the PIBS within 30 days of the relevant Interest Payment Date, in each case subject to the PIK Cap referred to below.

The number of Payment PIBS required to be issued in accordance with the above will be such number of PIBS as, in the determination of the Independent Investment Bank, will on the PIK Determination Date have an aggregate market value of as near as practicable to, but not less than, the relevant amount of interest which the Board has resolved will

not be paid in cash. The Independent Investment Bank shall owe no client duties to the holders of PIBS of Tier 1 Notes. To the extent that any PIBS holder's entitlement to Payment PIBS does not result in a round number of Payment PIBS, such holder's entitlement shall be rounded up to the nearest whole Payment PIBS.

Notwithstanding the foregoing, the Society shall not make a PIK Payment to the extent that the aggregate principal amount of Payment PIBS to be issued as a PIK Payment, together with the aggregate principal amount of Payment PIBS previously issued pursuant to this Condition 4(3)(b), would exceed in aggregate £7,500,000 (representing 15% of the initial aggregate principal amount of the PIBS) (the **PIK Cap**) and in such case, such amount of Arrears of Interest which exceeds the PIK Cap will be cancelled and PIBS holders shall have no claim in respect thereof.

Whilst Condition 4(3)(b) entitles the Society in its sole discretion to cancel, in whole or in part, any scheduled interest payment to be made in cash (as required by current applicable Capital Regulations) and instead to make such interest payment by the delivery of Payment PIBS pursuant to Condition 4(3)(d) (or, following a Demutualisation Event, by the Successor Entity making a PIK Payment or AISM Payment) it is the Society's intention not to cancel any part of a scheduled interest payment to be made in cash other than in the circumstances described under Condition 4(3)(a).

- (e) If the Successor Entity elects to make an AISM Payment, it shall (i) select a date within 30 days of the relevant Interest Payment Date on which the AISM Payment shall be made (the **AISM Payment Date**), details of which shall be included in the Deferral Notice; (ii) appoint an Independent Investment Bank, contact details of which shall also be included in the Deferral Notice to determine, as at a date no later than 10 days preceding the AISM Payment Date or, where the Board passes the relevant resolution later than such date, on the day which is two Business Days following the passing of such resolution (the **AISM Determination Date**), the number of ordinary shares in the Successor Entity (**Payment Ordinary Shares**) required to be issued to satisfy the relevant Arrears of Interest and (iii) on the AISM Determination Date, unless prevented for legal, regulatory, or other reasons, make such interest payment by the delivery in accordance with this Condition 4(3)(e) (as more particularly set out in the terms and conditions of the Tier 1 Notes) of the Payment Ordinary Shares to, or to the order of, the Independent Investment Bank, who will (I) use reasonable endeavours to procure purchasers for such Payment Ordinary Shares and (II) deliver such proceeds of the sale of the Payment Ordinary Shares to, or hold such proceeds of such sale to the order of, the trustee of the Tier 1 Notes (appointed under the trust deed referred to in Condition 8(4) or its agent). The proceeds of the sale of the Payment Ordinary Shares shall be paid by or on behalf of the trustee of the Tier 1 Notes to the holders of the Tier 1 Notes.

Notwithstanding the foregoing, the Successor Entity shall not make an AISM Payment to the extent that the aggregate amount of Payment Ordinary Shares to be issued as an AISM Payment, together with the aggregate amount of Payment Ordinary Shares previously issued pursuant to this Condition 4(3)(e) (as more particularly set out in the terms and conditions of the Tier 1 Notes) in the 12 month period prior to the relevant AISM Payment Date, would exceed in aggregate 2.0 per cent. of the Successor Entity's issued and outstanding ordinary share capital as at the relevant AISM Determination Date (the **AISM Cap**) and in such case, such amount of Arrears of Interest which exceeds the AISM Cap will be treated as an equivalent amount of principal subordinated in the manner set out in the terms and conditions of the Tier 1 Notes so as to rank on a winding-up of the Successor Entity equally with ordinary shares in the Successor Entity.

- (f) If (i) a Demutualisation Event has not occurred and the Society cannot make a PIK Payment (in whole or in part) due to the operation of the PIK Cap such Arrears of Interest shall be cancelled and each PIBS holder shall cease to have any right to payment of such Arrears of Interest; or (ii) a Demutualisation Event has occurred and the Successor Entity cannot make a PIK Payment or an AISM Payment, as the case may be, (in whole or in part) due to the operation of the PIK Cap and the AISM Cap, such amount of Arrears of Interest which exceeds the PIK Cap or the AISM Cap, as the case may be, will be treated as an equivalent amount of principal subordinated in the manner

set out in the terms and conditions of the Tier 1 Notes so as to rank on a winding-up of the Successor Entity equally with ordinary shares in the Successor Entity.

- (g) If the Board passes a resolution cancelling or requiring a reduction in the interest payment on an Interest Payment Date pursuant to Condition 4(3)(b) and the Society is unable, whether for legal, regulatory or other reasons, to issue Payment PIBS on the relevant date specified in Condition 4(3)(b)(iii), then:
 - (i) the Society shall not pay any interest or dividend on any other class of deferred Shares (as defined in the Act) of the Society (other than any class of deferred Shares the terms of which do not provide for the Board to be able to cancel any interest or dividend payment at its discretion), for a period of 12 months following the passing of such resolution; and
 - (ii) the Society shall, as soon as reasonably practicable notify each stock exchange on which it has any securities (including the PIBS) for the time being listed, of the passing of the resolution by the Board (together with a list of the Board members and their titles) and the cancellation (in whole or in part) of the relevant interest payment.
- (4) Any amount representing principal of or interest on a PIBS in respect of which no cheque has been cashed and no payment claimed shall cease to be payable after 12 years from the due date and shall revert to the Society.

5 Repayment

- (1) The PIBS constitute permanent non-withdrawable deferred Shares (as defined in the Act) in the Society and have no specified final maturity.
- (2) The Society may, having obtained Relevant Supervisory Consent (as defined below) and having given not less than 30 nor more than 60 days' notice to the PIBS holders in accordance with the Conditions, which notice shall be irrevocable, elect to repay all, but not some only, of the PIBS on the Reset Date or on any Interest Payment Date thereafter at their principal amount together, subject to Conditions 4(3)(a) and 4(3)(b), with any interest accrued to but excluding the date of repayment.
- (3) The PIBS will become repayable on the date that an instrument or order is made or an effective resolution is passed for the winding-up or, otherwise than by virtue of Section 93(5), Section 94(10), Section 97(9) or Section 97(10) of the Act, dissolution of the Society but only if and subject to the condition that all sums due from the Society to Creditors claiming in the winding-up or dissolution have been paid in full.
- (4) The claims of the PIBS holders in a winding-up or dissolution of the Society will be for the principal amount of their PIBS together, subject to Condition 4, with interest accrued to but excluding the date of repayment after all sums due from the Society to Creditors have been paid in full. The PIBS holders will not be entitled to any share in any final surplus upon a winding-up or dissolution of the Society.
- (5) Up to the Reset Date if, as a result of any change in or proposed change in, or amendment to or proposed amendment to, the laws of the United Kingdom or any political subdivision or authority thereof having power to tax, or any change in or proposed change in the application of official or generally published interpretation of such laws, or any interpretation or pronouncement by any relevant tax authority that provides for a position with respect to such laws or regulations that differs from the previously generally accepted position in relation to similar transactions or which differs from any specific written confirmation given by a tax authority in respect of the PIBS, which change becomes, or would become, effective, or in the case of a change or proposed change in law if such change is enacted (or in the case of a proposed change, is expected to be enacted) by act of Parliament or made by statutory instrument, on or after 11 April 2007, the Society reasonably determines (and in making such determination the Society shall obtain an appropriate legal opinion, a copy of which it shall provide to the Registrar) that the Society will not obtain full relief for the purposes of United Kingdom corporation tax for interest payable in respect of the PIBS including, for the avoidance of doubt, where the payment of interest is to be satisfied by the issue of Payment PIBS pursuant to Condition 4 or, as a result of the PIBS being in issue, the Society may be

unable to claim or surrender losses as group relief, and such requirement or circumstance cannot be avoided by the Society taking such measures as it (acting in good faith) deems appropriate, then the Society may, subject to having obtained the Relevant Supervisory Consent (as defined above) and having given not less than 30 nor more than 60 days' notice to the PIBS holders in accordance with the Conditions, which notice shall be irrevocable, redeem at any time all, but not some only of the PIBS.

- (6) Up to the Reset Date if the Supervisory Authority determines that securities of the nature of, and including, the PIBS can no longer qualify as Tier 1 Capital as a result of a change in applicable regulations, then the Society may (subject to having obtained Relevant Supervisory Consent), having given not less than 30 nor more than 60 days' notice to the PIBS holders in accordance with the Conditions, which notice shall be irrevocable, redeem at any time all, but not some only, of the PIBS.
- (7) If the Society elects to redeem the PIBS pursuant to Condition 5(5) above, it shall redeem each PIBS at their principal amount, together, subject to Conditions 4(3) and 4(3)(b), with any interest accrued to but excluding the date of repayment. If the Society elects to redeem the PIBS pursuant to Condition 5(6) above, it shall redeem each PIBS at the higher of their principal amount and the Call Redemption Price, together, subject to Conditions 4(3) and 4(3)(b), with any interest accrued to but excluding the date of repayment.
- (8) The Society may, having obtained prior Relevant Supervisory Consent and, for so long as the PIBS are admitted to the official list maintained by the competent authority designated under Part VI of the FSMA (the **UK Listing Authority**, which expression shall include any body appointed to perform such functions under any successor legislation), and admitted to trading on the London Stock Exchange plc's Professional Securities Market (the **Market**), subject to and in accordance with the requirements from time to time of the UK Listing Authority and the London Stock Exchange plc, purchase any of the PIBS.
- (9) All PIBS repaid or purchased by the Society as aforesaid shall be cancelled forthwith and such PIBS may not be reissued or resold.

6 Payments

All payments in respect of the PIBS will be made by sterling cheque drawn on a bank or building society in the United Kingdom, posted on the Business Day immediately preceding the relevant due date and made payable to the PIBS holders (in the case of a joint holding of PIBS, the Representative Joint Shareholder) appearing in the PIBS Register in respect of the PIBS of which he is the holder at the close of business on the fifteenth day before the relevant due date (the **Record Date**) at the addresses shown in the PIBS Register on the Record Date. In relation to payments of interest only, upon application of any PIBS holder (or in the case of a joint holding of PIBS, the Representative Joint Shareholder) to the Society, in the form from time to time prescribed by the Society, not less than 10 days before the due date for any interest payment in respect of its PIBS, the interest payment may be made by transfer on the due date or, if the due date is not a Business Day, on the immediately following Business Day to a sterling account maintained or designated by the relevant PIBS holder with a bank or building society in the United Kingdom.

All payments in respect of the PIBS shall be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or governmental charges of whatever nature (**Taxes**) imposed or levied by or on behalf of the United Kingdom or any political subdivision or any authority thereof or therein having power to tax, unless the withholding or deduction of the Taxes is required by law.

For a description of applicable United Kingdom taxation considerations see "United Kingdom Taxation".

7 Replacement of PIBS Certificates

A PIBS holder who has lost a PIBS Certificate shall immediately give notice in writing of such loss to the Society at its Principal Office and to the Registrar at its specified office. If a PIBS Certificate is damaged or alleged to have been lost, stolen or destroyed, a new PIBS Certificate representing the same PIBS shall be issued by the Registrar, on behalf of the Society, to the PIBS holder upon request, subject to delivery up of the old PIBS Certificate or (if alleged to have been lost, stolen or destroyed) subject to compliance with such conditions as to evidence and indemnity as the Society

and the Registrar may think fit and to payment of any exceptional expenses of the Society and the Registrar incidental to its investigation of the evidence of such alleged loss, theft or destruction. The new PIBS Certificate will be made available at the offices of the Registrar.

8 Succession and transfers

- (1) Upon an amalgamation by the Society with another building society under Section 93 of and Schedule 16 to the Act or a transfer of its engagements to any extent to another building society under Section 94 of and Schedule 16 to the Act, the PIBS shall become deferred Shares in the amalgamated or transferee building society (as appropriate) without any alteration in their terms.
- (2) Upon a transfer by the Society of the whole of its business to a successor in accordance with Section 97 of the Act, the successor will, in accordance with Section 100(2)(a) of the Act, assume, as from the vesting date, a liability (subject to this Condition 8(2)) to every qualifying Member of the Society as in respect of a deposit made with the successor corresponding in amount to the value of the qualifying Shares held by the Member in the Society. The liability so assumed by the successor in respect of each PIBS shall be the same as the liability in respect of a non-transferable subordinated deposit carrying the same rate of interest as the PIBS ranking behind any undated subordinated debt previously issued by the Society (each a **Subordinated Deposit**). Each Subordinated Deposit will be applied on the vesting date (or as soon as reasonably practicable thereafter), on behalf of the PIBS holder, in the subscription of a principal amount of undated subordinated Tier 1 Notes of the successor ranking behind any undated subordinated debt previously issued by the Society or its successor (the **Tier 1 Notes**) equivalent to the principal amount of the Subordinated Deposit and carrying the same Rate of Interest as the PIBS.

The terms of each Subordinated Deposit and the terms and conditions of the Tier 1 Notes will (a) be such as to secure in the opinion of the Board that they will be treated as Tier 1 Capital or its equivalent (if any) as determined by the auditors of the Society for the purposes of Applicable Regulatory Capital Requirements; (b) include such changes and additional provisions deemed necessary by the Board and an independent investment bank appointed by the Society for the purpose to give effect to and preserve substantially the economic effect of these Conditions, including, without limitation, the PIK Payment and AISM Payment mechanisms described in Condition 4(3)(c) to (f) and the restrictions set out in Condition 4(3)(g), in each case as applied to the Successor Entity; (c) include a requirement that the Successor Entity, subject to compliance with applicable law, use all reasonable endeavours to obtain and maintain at all times all corporate authorisations and take any other corporate actions required for the issue of a sufficient number of ordinary shares (free from any pre-emption right) to satisfy any AISM Payment; and (d) be on terms no less beneficial than these Conditions.

The terms of the Subordinated Deposits and the terms and conditions of the Tier 1 Notes will, not later than the time at which notice is given to Members of resolutions to be proposed to approve such transfer, be available for inspection by the PIBS holders at the Principal Office and the specified office of the Registrar at that time and, subject as provided above, will be determined by the Board in its absolute discretion.

- (3) The Society undertakes to procure that any amalgamation or transfer referred to in Condition 8(1) or (2) above will comply with the provisions of Condition 8(1) or, as the case may be, (2) above.

9 Variations of these Conditions

- (1) These Conditions may only be varied by the Society with the consent in writing of the PIBS holders holding not less than three-quarters in principal amount of the PIBS for the time being outstanding or with the sanction of a resolution passed at a separate meeting of the PIBS holders held in accordance with Condition 10.
- (2) The Society undertakes not to initiate any change to the Rules that is both (a) inconsistent with the provisions of these Conditions and (b) materially prejudicial to the interests of the PIBS holders in that capacity.
- (3) These Conditions do not limit the rights of Members to change the Rules.

Any amendment to the Rules that is both (a) inconsistent with the provisions of these Conditions and (b) materially prejudicial to the interests of the PIBS holders in that capacity shall not limit any rights of any PIBS holder to bring an action for breach of contract against the Society in circumstances where the Society is in breach of these Conditions nor afford the Society any defence to any claim made in any such action.

10 Meetings of the PIBS holders

- (1) The Society alone may at any time convene a separate meeting of the PIBS holders. Every meeting shall be held at such place as the Society may approve.
- (2) At least 21 clear days' notice, calculated from the final date for the receipt of proxies under Condition 10(11), specifying the hour, date and place of the meeting shall be given to the PIBS holders entered in the PIBS Register 35 days prior to the date specified for the meeting by sending it by post to the addresses shown in the PIBS Register. The notice shall specify generally the nature of the business to be transacted at the meeting and the terms of any resolution to be proposed to alter these Conditions.
- (3) Any person (who may, but need not, be a PIBS holder) nominated in writing by the Society shall be entitled to take the chair at every meeting but if no nomination is made or if at any meeting the person nominated shall not be present within 15 minutes after the time appointed for holding the meeting, the PIBS holders present shall choose one of their number who is present to be chairman.
- (4) At any meeting one or more persons present in person or by proxy and holding or representing in aggregate not less than one-third of the principal amount of the PIBS for the time being outstanding shall form a quorum for the transaction of business and no business (other than the choosing of a chairman) shall be transacted at any meeting unless the requisite quorum shall be present at the commencement of business. Every question submitted to the meeting (other than the choosing of a chairman which will be decided by a simple majority) shall be decided by a poll of one or more persons present and holding PIBS or being proxies and representing in aggregate not less than three-quarters of the principal amount of the PIBS represented at such meeting voting in favour of such question.
- (5) If within half an hour after the time appointed for any meeting a quorum is not present, the meeting shall stand adjourned for such period, being not less than 14 days nor more than 42 days and at such place as may be appointed by the chairman and if at the adjourned meeting a quorum shall not be present within half an hour from the time appointed for the adjourned meeting, the PIBS holders present in person or by proxy at the adjourned meeting shall be a quorum.
- (6) Notice of any adjourned meeting shall be given in the same manner as notice of an initial meeting but as if 10 were substituted for 21 in Condition 10(2).
- (7) A poll shall be taken in such manner as the chairman directs and the result of the poll shall be deemed to be the resolution of the meeting.
- (8) The chairman may with the consent of (and shall if directed by a resolution of) the meeting adjourn any meeting from time to time and from place to place but no business shall be transacted at any adjourned meeting other than business left unfinished or not reached at the meeting from which the adjournment took place.
- (9) Any director or officer of the Society and its professional advisers may attend and speak at any meeting of the PIBS holders. Save as provided in this Condition, no person shall be entitled to attend and speak nor shall any person be entitled to vote at any such meeting unless it is a PIBS holder or is a proxy thereof.
- (10) Subject as provided in Condition 10(9), at any meeting every PIBS holder who is present in person or by proxy shall have one vote, irrespective of the principal amount of the PIBS so held or in respect of which he is a proxy.
- (11) A PIBS holder entitled to attend a separate meeting of the Society:
 - (a) may appoint one Person (whether a PIBS holder or not) as its proxy to attend and, on a resolution, to vote at such meeting instead of him; and

- (b) may direct the proxy how to vote at the meeting.

A proxy shall be appointed by an instrument in writing which shall be in such form and include such declarations as the Board may from time to time determine. The instrument shall enable the PIBS holder appointing the proxy to direct him how to vote provided that, if the instrument is not in the form specified by the Society or is not signed by the appointer, the appointment of the proxy shall be invalid. The appropriate forms of declaration shall, with such additional or amended wording as the Board may consider appropriate, be used in the case of a body corporate. If the appropriate declaration is not included in the instrument, the appointment of the proxy shall be invalid. The instrument appointing a proxy or a representative shall be deposited at the Principal Office not less than two clear days before the day appointed for holding the meeting, or adjourned meeting, and in default the instrument shall be treated as invalid. The instrument appointing a proxy shall be deemed to confer authority to demand or join in demanding a poll but, save as provided by this Condition 10(11), a proxy shall have no right to speak at the meeting. A vote given in accordance with the terms of an instrument of proxy shall be valid notwithstanding the previous death or mental disorder of the appointer or revocation of the proxy or of the authority under which the proxy was executed, or the transfer of a PIBS in respect of which the proxy is given, provided that no intimation in writing of such death, mental disorder, revocation or transfer shall have been received by the Society at its Principal Office before the commencement of the meeting or adjourned meeting at which the proxy is used.

- (12) Any resolution passed at a meeting duly convened and held in accordance with these provisions shall be binding upon all the PIBS holders whether or not present at the meeting and whether or not voting and each of them shall be bound to give effect to the resolution accordingly and the passing of any resolution shall be conclusive evidence of the circumstances justifying the passing of the resolution. Notice of any resolution duly passed by the PIBS holders shall be given in writing to each PIBS holder by the Society within 14 days of the passing of the resolution, provided that the non-publication of the notice shall not invalidate the resolution.
- (13) Minutes of all resolutions and proceedings at every meeting shall be made and duly entered in books to be from time to time provided for that purpose by the Society and any minutes purporting to be signed by the chairman of the meeting at which resolutions were passed or proceedings conducted shall be conclusive evidence of the matters contained in the minutes and, until the contrary is proved, every meeting in respect of the proceedings of which minutes have been so made and signed shall be deemed to have been duly held and convened and all resolutions passed or proceedings had to have been duly passed or conducted.
- (14) The accidental omission to send notice of a separate meeting or to send any document required to be sent with the notice or otherwise before the meeting to, or the non-receipt of notice of a separate meeting or any such document as aforesaid by, any person entitled to receive notices or documents shall not invalidate the proceedings at that meeting.

11 Further issues

The Society shall be at liberty from time to time without the consent of the PIBS holders to create and issue further permanent interest bearing shares either:

- (a) ranking *pari passu* in all respects (or in all respects save for the first payment of interest thereon) and so that the same shall be consolidated and form a single series with the outstanding permanent interest bearing shares of any series (including the PIBS); or
- (b) upon such other special terms of issue as the Society may at the time of issue determine provided that the Society shall not issue any permanent interest bearing shares ranking ahead of the PIBS.

12 Notices

All notices regarding the PIBS shall be valid if sent by post to the PIBS holders at their respective addresses in the PIBS Register. Any such notice shall be deemed to have been given on the second day following the mailing of such notice.

13 Governing law

The rights and obligations in respect of the PIBS are governed by, and shall be construed in accordance with, English law.

14. Definitions

For the purposes of these Conditions:

Applicable Regulatory Capital Requirements means any requirements contained in Capital Regulations for the maintenance of capital from time to time applicable to the Society.

Business Day means a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealings in foreign exchange and foreign currency deposits) in London.

Call Redemption Price means, in respect of each of the PIBS, the price, expressed as a percentage (rounded to four decimal places, 0.00005 being rounded upwards), at which the gross redemption yield (as calculated by the Independent Investment Bank on the basis set out by the United Kingdom Debt Management Office in the paper "*Formulae for calculating Gilt Prices from Yields*" page 4, section One: Price/Yield Formulae "*Conventional Gilts; Double-dated and Undated Gilts with Assumed (or Actual) Redemption on a Quasi-Coupon Date*" (published 8 June 1998 (as supplemented, amended or replaced from time to time)) on the PIBS, if they were to be purchased at such price on the third dealing day prior to the date fixed for redemption, would be equal to the gross redemption yield on such dealing day of the Reference Gilt plus 0.985 per cent. on the basis of the middle market price of the Reference Gilt prevailing at 11:00 a.m. (London time) on such dealing day as determined by the Independent Investment Bank.

Capital Regulations means at any time the regulations, requirements, guidelines and policies relating to capital adequacy then in effect of the Supervisory Authority.

Creditors means all creditors (including all subordinated creditors) of the Society and Shareholding Members (other than holders of deferred Shares (including the PIBS)) as regards the principal and interest due in respect of their Shares.

Demutualisation Event means a transfer by the Society of the whole of its business to a successor in accordance with section 97 of the Act (the **Successor Entity**).

Interest Determination Date means, in respect of any Interest Period commencing on or after the Reset Date, the first day of that Interest Period.

Margin means 2.56 per cent. per annum.

Payment PIBS means (i) prior to a Demutualisation Event, such additional permanent interest bearing shares of the Society or (ii) following a Demutualisation Event, such additional Tier 1 Notes of the Successor Entity, in each case issued in connection with a PIK Payment pursuant to Condition 4(3)(d) having terms that are identical to the terms and conditions of the PIBS or the Tier 1 Notes, as the case may be, except in respect of (a) the first payment of interest thereon and (b) their nominal amount, which shall be £1 each.

The **PIBS** means £50,000,000 6.875 per cent. Permanent Interest Bearing Shares of the Society and, unless the context otherwise requires, includes any Payment PIBS issued pursuant to Condition 4(3)(b) and any further permanent interest bearing shares issued pursuant to Condition 11 and forming a single series with the PIBS.

PIBS holder means a Person whose name is entered in the PIBS Register as the holder of PIBS or, in the case of a joint holding of PIBS, the first person whose name is entered in the PIBS Register in respect of the joint holding of the PIBS.

PIBS Register means the records of the Society maintained for the purposes of the PIBS.

Reference Banks means the principal London office of each of four major banks engaged in the London interbank market selected by the Agent Bank.

Reference Dealers means three brokers of gilts and/or gilt-edged market makers selected by the Independent Investment Bank in consultation with the Society, or such other three persons operating in the gilt-edged market as are selected by the Independent Investment Bank in consultation with the Society.

Reference Gilt means, in relation to any calculation of the Call Redemption Price, the 4 per cent. United Kingdom Treasury Stock due September 2016, or if such security is no longer in issue, such other United Kingdom government security as the Independent Investment Bank, may, with the advice of the Reference Dealers, determine to be appropriate for determining the Call Redemption Price.

Registrar means Lloyds TSB Registrars or such other registrar appointed by the Society from time to time in respect of the PIBS.

Relevant Supervisory Consent means consent by the Supervisory Authority to the relevant repayment, redemption or (as referred to in Condition 5(5)) purchase.

Reset Date means 13 April 2017.

Screen Rate means, in respect of any Interest Period, the rate for three month deposits in Sterling which appears on Reuters Page LIBORO1 (or such replacement page on that service which displays that information) at 11:00 a.m. (London time) on the Interest Determination Date for that Interest Period.

The **Society** means Scarborough Building Society.

Supervisory Authority means the Financial Services Authority (or any successor body performing for the time being the same or similar functions in relation to building societies (or, in the event that the Society transfers its business to a company under Section 97 of the Act, companies of that nature) in the United Kingdom).

Tier 1 Capital has the meaning given to it in the Supervisory Authority's Prudential Sourcebook for Banks, Building Societies and Investment Firms (as amended, supplemented or updated from time to time) or any successor publication replacing such guide, or is issued capital of the Society regardless of name or designation which is otherwise treated as issued Tier 1 Capital by the Supervisory Authority.

Tier 1 Notes have the same meaning as in Condition 8(2).

CERTAIN PROVISIONS OF THE ACT AND REQUIREMENTS OF THE SUPERVISORY AUTHORITY

In this section, **Supervisory Authority** means the FSA and any successor organisation responsible for the supervision of building societies or authorised persons under the FSMA in the United Kingdom.

Amalgamation

Section 93 of the Act permits a building society to amalgamate with one or more building societies by establishing a building society as their successor. Amalgamation requires a shareholding members' resolution passed by the shareholding members of each amalgamating society and a borrowing members' resolution (each as defined in Schedule 2 to the Act) passed by the borrowing members of each amalgamating society and confirmation of amalgamation by the Supervisory Authority. The Act provides that on the date specified by the Supervisory Authority all of the property, rights and liabilities (which, in the case of the Society, would include the PIBS) of each of the societies shall by virtue of the Act be transferred to and vested in the successor, whether or not otherwise capable of being transferred or assigned. In the event of such an amalgamation by the Society with another building society, the PIBS would, pursuant to their terms, become deferred Shares in the successor without any alteration of their terms.

Transfer of engagements

Section 94 of the Act permits a building society to "transfer its engagements to any extent" to another building society which undertakes to fulfil such engagements. A transfer requires approval by a shareholding members' resolution and a borrowing members' resolution of each of the transferor society and the transferee society. However, the resolutions of the transferee society are not required if the Supervisory Authority consents to the transfer proceeding by a resolution of its board of directors only. The transfer must be confirmed by the Supervisory Authority. The Act provides that on the date specified by the Supervisory Authority and to the extent provided in the instrument of transfer, the property, rights and liabilities of the transferor society shall by virtue of the Act be transferred to and vested in the transferee society, whether or not otherwise capable of being transferred or assigned. In the event of a transfer of all or part of the property and/or all or some of the liabilities (including the PIBS) of the Society, the PIBS would, pursuant to their terms, become deferred Shares in the transferee without any alteration of their terms.

Transfer of business

Sections 97 to 102D of the Act permit a building society to transfer the whole of its business to a company which has been specially formed by the society wholly or partly for the purpose of assuming and conducting the society's business in its place or is an existing company which is to assume and conduct the society's business in its place. The transfer must be approved by a requisite shareholders' resolution, in accordance with Schedule 2, paragraph 30(2)-(5) of the Act, passed by shareholding members and by a borrowing members' resolution passed by borrowing members and the society must obtain the confirmation of the Supervisory Authority to the transfer and its terms. If the Supervisory Authority confirms the transfer then the Act provides that on the vesting date (as defined in the Act) all of the property, rights and liabilities (which would include the PIBS) of the transferor society, whether or not capable of being transferred or assigned, shall by virtue of the Act and in accordance with the transfer regulations (then in force) be transferred to and vested in the successor. Pursuant to Section 100(2)(a) of the Act, the PIBS would be converted into deposits with the successor. The terms of the PIBS provide that the deposits will be subordinated and will be applied in the subscription of undated subordinated bonds of the successor subject as provided therein.

Where, in connection with any transfer, rights are to be conferred on members of the society to acquire shares in priority to other subscribers, the right is restricted to investing members of the society who have held their shares throughout the period of two years expiring on a qualifying day specified by the society in the transfer agreement. On any transfer, investing members of the society who were members on the qualifying date but not entitled to vote on the requisite shareholders' resolution will receive a statutory cash bonus equal to their notional share of the reserves of the society. If the transfer is to an existing company, any distribution of funds (apart from the statutory cash bonus referred to above) may only be made to certain investing members of the society who have held their shares for at least two years expiring on a qualifying day specified by the society in the transfer agreement. No distribution of funds (apart from the statutory cash bonus referred to above) may be made, and restrictions are imposed on the

issue by the successor of negotiable instruments acknowledging rights to shares, if the transfer is to a company specially formed by the society.

General

The Society may, as a result of an amalgamation, transfer of engagements or transfer of business as described above, be replaced as the principal debtor, under all or some of the PIBS, by an entity substantially different in nature from the Society at present or with a substantially different capital position. In all cases the confirmation of the Supervisory Authority is required before any such change can take place.

SCARBOROUGH BUILDING SOCIETY

Introduction

Scarborough Building Society (the **Society**) was established in May 1846 and was incorporated with the Registrar of Building Societies in England on 2 July 1878 in Yorkshire, England as the Scarborough and North and East Yorkshire Permanent Building and Investment Building Society. Its name was changed to the Scarborough Building Society in 1903. It is incorporated for an indefinite duration.

The Society is authorised and regulated by the Financial Services Authority and operates under the Building Societies Act 1986 (registration number 500B and registration number 206062), as amended, and the Society's Memorandum and Rules.

As at 30 April 2006, the date of its latest published financial statements, the Society was the eighteenth largest building society by asset size in the United Kingdom¹. At that date, the Society had assets of £1.73 billion and nine branches spread over the north of England. During the year ended 30 April 2006, the Society had on average 319 employees.

The Society is a mutual organisation, and each of its retail investors and borrowers are members of the Society. The Society is committed to remaining as a mutual organisation which exists to serve the needs of, and deliver the benefits of mutuality to its members. The Society's strategy is to remain independent and based predominantly in its heartland of Yorkshire and the North East.

Business

The principal purpose of the Society is to make loans which are secured on residential property and are funded substantially by its members. The Society is committed to helping people satisfy their financial needs through a rewarding service experience. The Society provides simple savings, mortgage and related products using technology to enable customers to transact through different contact channels.

The Society has two principal subsidiaries. The first, North Yorkshire Mortgages Limited, makes loans which are secured on residential property under its trading name, Scarborough Specialist Mortgages, and trades mortgage portfolios on the secondary market. The second, Specialist Mortgage Services Limited, administers residential mortgages on behalf of clients under its trading name, Scarborough Mortgage Services, and has recently achieved a Fitch rating of RPS2- (residential primary servicer of prime and sub-prime lending) and RSS3+ (residential special servicer). The subsidiary companies supplement the profitability of the Society and its subsidiaries (together the **Group**) by creating alternative income streams and broadening the base of assets under management, hence realising cost efficiencies. In addition to these two principal subsidiaries, a third, Scarborough Properties Limited, holds a small number of Group properties.

The Society has recently agreed to acquire 100% of the issued share capital of Portman Channel Islands Limited, the Guernsey based offshore deposit-taking business of the Portman Building Society, which after completion of the acquisition will be re-named Scarborough Channel Islands Limited. As at 31 December 2006 this company held in excess of £600m of customer deposits, and the acquisition will give the Society an additional distribution channel with potential to develop both interest and non-interest income. It is expected that the acquisition will complete on 20 April 2007.

Lending

The Society's main lending activity is the provision of residential mortgages, which are originated through the Society's branch network, over the telephone and internet directly from Head Office (Scarborough Direct) and through intermediaries. Funds are advanced mainly to borrowers on the security of first mortgages on freehold and leasehold property. As at 30 April 2006 loans fully secured on residential property represented 99.9% of the Society's business assets.

The Group's residential loan portfolio is of high quality. At 30 April 2006, 1.2% of mortgages were in arrears of which 0.4% were more than three payments in arrears. There were 5 cases greater than 12 months in arrears and only 2 properties in possession. The proportion of business assets not fully secured on residential property as at 30 April 2006 was less than 0.1 % compared with the statutory upper limit of 25%.

¹ KPMG Building Society Database 2006

During the financial year ended 30 April 2006, new loans and advances to customers amounted to £215 million. Mortgage portfolios purchased from third parties totalled £756 million. Loans and advances to customers grew by 7% from £1,260 million at 30 April 2005 to £1,346 million at 30 April 2006.

Funding

The Society primarily obtains funds from the retail market through personal savings and deposit accounts. Members' funds at 30 April 2006 were £1,221 million, an increase of 15% on the previous year.

The Society also raises funds through the wholesale market. As at 30 April 2006, wholesale funding raised by the Society totalled £388 million. The proportion of shares and borrowings (the total amount of shares, amounts owed to credit institutions and amounts owed to customers) not held by members as at 30 April 2006 was 24.11% compared with the statutory upper limit of 50%.

Liquidity

As at 30 April 2006, the Group held liquid assets, consisting of investments, balances at banks and cash in hand, of £358 million representing 22.24% of shares and borrowings.

Capital

As a mutual organisation, the Group's strategy is to retain sufficient profit to support ongoing investment in its business and maintain adequate capital resources.

In the year to 30 April 2006, the Group's retained profit amounted to £52 million and as at the end of that year Group capital stood at £102 million (6.34 % of shares and borrowings.)

Product Offering

In addition to core savings and mortgage offerings, the Group has entered into a number of agreements with third parties which enable it to provide a broader range of products and services designed to meet the needs of its customers. These third parties include the Legal & General Assurance Society Limited, Norwich Union Insurance Limited, MBNA Europe Bank Limited, Aviva Insurance Limited and Credit Suisse. Third party products are made available to customers in return for fee and commission income, without being held on the Society's balance sheet.

Governance

The Board retains ultimate responsibility over the Society and delegates day to day management to, and monitors, the executive management. The Board supports good corporate governance and complies with the guidance set out in the Building Societies Regulatory Guidance issued by the Supervisory Authority. In addition, the Board promotes adherence to the principles of the combined Code (the **Code**) relevant to building societies.

The Society has 11 Directors, comprising 5 Executive Directors. A brief profile of each Director is set out below:

William R Worsley (FRICS (50) Chairman)

A Non-Executive Director since January 1996, appointed as Chairman in August 2002. William is a Chartered Surveyor with extensive experience in finance, property management and agriculture. He is also Chairman of the Board Fees and Board Nominations Committees.

John J Carrier FCIB (58) Chief Executive

Chief Executive since 1992, John has had significant experience with national and regional building societies for more than 35 years providing a complementary balance of skills throughout the range of building society operations. He is also Chairman of the Group Subsidiary Companies.

Andrew C D Holmes LLB (Hons) (46) Operations Director and Secretary

Andrew was appointed to the Board in 2005, having joined the Society in 1999. He is a qualified Solicitor and formerly a Partner in private practice. Andrew has significant managerial experience and a broad knowledge of the financial services sector. He is Secretary of the Group, a Pension Fund Trustee and Director of Specialist Mortgage Services Limited and North Yorkshire Mortgages Limited.

Kevin D Moran (51) IT Director

Appointed to the Executive in 1992 and to the Board in 2005, Kevin is a seasoned IT professional with almost 30 years experience, 21 of which having been with the Society. He is also a Director of Specialist Mortgage Services Limited and North Yorkshire Mortgages Limited.

Martin J Frazer (47) Commercial Director

Martin joined Scarborough in 1989 and was appointed as a Director to the Board in 2005. He is a Building Society professional with more than 25 years experience with a range of different societies. He is also Managing Director of North Yorkshire Mortgages Limited, and Managing Director of Specialist Mortgage Services Limited.

Robin S P Litten ACMA (43) Finance Director

Robin joined the Society in August 2002 as Finance Director, having previously been with Barclays Bank. He is a member of the Chartered Institute of Management Accountants, with significant financial and management experience in the financial services and retail industries. He is also a Director of the Group Subsidiary Companies.

Barbara M Richmond BSc FCA (46)

Non-Executive Director since April 2005, Barbara is Group Finance Director of Inchcape plc. Previous to this she was Group Finance Director of Croda International Plc for 9 years and was Non-Executive Director of Carclo Plc from 1 January 2000 to 31 March 2006. She is Chairman of the Board Audit and Compliance Committee.

Peter J S Thompson (also known as Nimble Thompson) (60)

Appointed a Non-Executive Director on 1 October 2005, Nimble is Chairman of N G Bailey Limited and a Non-Executive Director of other companies. He is former Vice-Chairman of Eversheds, solicitors and senior partner of their Leeds and Manchester offices. He is Chairman of the Board Remuneration Committee and a member of the Board Nominations Committee.

Kate Priestley CQSW MBA (57) Vice Chairman

Non-Executive Director since March 2001, Kate was formerly Chief Executive of NHS Estates. She is Chairman of Local Government Leadership Centre, Chairman of Standing Committee on Structural Safety, Chairman of Island Health Care Charitable Trust, and Director of the Building Research Establishment. She is also a member of the Board Nominations and Board Remuneration Committee.

Neil A Stothard MA FCA (49)

Appointed as a Non-Executive Director on 1 January 2007, Neil is Group Managing Director of Vp PLC. A chartered Accountant and graduate engineer, he has previously held senior positions within the travel and logistics sectors. He is also a member of the Board Audit and Compliance Committee.

James H Newman McA FCT (57)

Appointed as a Non-Executive Director on 1 October 2006, James is non-executive Chairman and Director of a number of public and private companies, including Dignity plc, Scott Wilson Group plc and Straight plc. He is also a Governor of Sheffield Hallam University and was previously Deputy Chief Executive and Group Finance Director of Kelda Group plc. He is also a member of the Board Audit and Compliance Committee.

The business address of each of the directors is that of the principal office of the Society (as set out below).

No director has any actual or potential conflict of interest between his or her duties to the Society and his or her private interests or other duties.

Documents may be served on the directors (marked: "Private and Confidential"), c/o KPMG Audit Plc, 1 The Embankment, Neville Street, Leeds, LS1 4DW.

The Society's principal office is located at Prospect House, Lake View Road, Scarborough, North Yorkshire, YO11 3WZ and its telephone number is 01723 368155.

UNITED KINGDOM TAXATION

The following is a summary of the Society's understanding of current law and practice in the United Kingdom relating to the taxation of the PIBS. The summary only relates to the deduction of United Kingdom tax from interest on the PIBS and to the taxation treatment of United Kingdom taxpayers which are the absolute beneficial owners of the PIBS and the interest on them and some aspects do not apply to certain classes of taxpayer (such as dealers and persons connected with the Society). **Prospective PIBS holders who may be subject to tax in a jurisdiction other than the United Kingdom or who are in any doubt as to their tax position should seek their own professional advice.**

Interest on the PIBS

While the PIBS continue to be listed on a "recognised stock exchange" within the meaning of section 841 Income and Corporation Taxes Act 1988 (the **1988 Act**) (from 6 April 2007, section 1005 of the Income Tax Act 2007) payments of interest may be made without withholding or deduction for or on account of United Kingdom income tax. The London Stock Exchange is a recognised stock exchange. Under Her Majesty's Revenue & Customs (**HMRC**) published practice, securities will be treated as listed on the London Stock Exchange if they are admitted to the Official List and admitted to trading on the Market.

In other cases, if the PIBS were to cease to be so listed then on making a payment of interest an amount would be withheld by the Society on account of United Kingdom tax at the lower rate (currently 20 per cent) unless certain exemptions applied.

Persons in the United Kingdom paying or crediting interest to or receiving interest on behalf of an individual may be required to provide certain information to HMRC regarding the identity of the payee or person entitled to the interest and, in certain circumstances, such information may be exchanged with tax authorities in other countries.

The Society is required each year to supply to HMRC particulars of all interest paid or credited in relation to the PIBS.

United Kingdom corporation tax payers

In general, PIBS holders who are subject to United Kingdom corporation tax will be charged to tax on all returns, profits and gains on, and fluctuations in the value of, the PIBS under the "loan relationships" regime in the Finance Act 1996, broadly in accordance with their accounting treatment.

Other United Kingdom tax payers

Taxation of chargeable gains

The PIBS will constitute "qualifying corporate bonds" within the meaning of section 117 of the Taxation of Chargeable Gains Act 1992. Accordingly, a disposal by a PIBS holder of a PIBS will not give rise to a chargeable gain or an allowable loss for the purposes of United Kingdom taxation of chargeable gains.

Accrued Income Scheme

On a disposal of PIBS by an individual PIBS holder who is resident or ordinarily resident in the United Kingdom or carries on a trade, profession or vocation in the United Kingdom through a branch, agency or permanent establishment to which the PIBS are attributable, the PIBS holder may be chargeable to tax as income on an amount which is just and reasonable under the rules of the accrued income scheme as set out in Chapter II of Part XVII of the 1988 Act (from 6 April 2007, Part 12 of the Income Tax Act 2007).

It should be noted that the PIBS constitute "variable rate securities" for the purposes of the accrued income scheme and accordingly, that will impact on the way in which the provisions of the accrued income scheme could apply on a disposal or acquisition of the PIBS.

Stamp duty

No United Kingdom stamp duty or stamp duty reserve tax is payable on the issue or transfer of the PIBS or on their purchase by the Society.

Further income tax issues

Interest on the PIBS constitutes United Kingdom source income for tax purposes and, as such, may be subject to income tax by direct assessment even where paid without withholding. However, interest with a United Kingdom source received without deduction or withholding on account of United Kingdom tax

will not generally be chargeable to United Kingdom tax in the hands of a PIBS holder (other than certain trustees) who is not resident for tax purposes in the United Kingdom unless that PIBS holder carries on a trade, profession or vocation in the United Kingdom through a United Kingdom branch, agency or permanent establishment in connection with which the interest is received or to which the PIBS are attributable. In addition, there are exemptions for interest received by certain categories of agent (such as some brokers and investment managers). The provisions of an applicable double taxation treaty may also be relevant for such PIBS holders.

EU Directive on the Taxation of Savings Income

The European Union has adopted a Directive (2003/48/EC) regarding the taxation of savings income. The Directive requires Member States to provide to the tax authorities of other Member States details of payments of interest and other similar income paid by a person to an individual in another Member State, except that Belgium, Luxembourg and Austria will instead impose a withholding system for a transitional period unless during such period they elect otherwise. A number of non-EU countries and territories including Switzerland have agreed to adopt similar measures (a withholding system, in the case of Switzerland).

MARKETING ARRANGEMENTS

The Manager has, pursuant to a subscription agreement dated 11 April 2007 (the **Subscription Agreement**), agreed with the Society, subject to the satisfaction of certain conditions (including, without limitation, the admission of the PIBS to the Official List becoming effective by not later than 13 April 2007 or such later date as the Society and the Manager may agree), to subscribe for the PIBS at the issue price of 99.239 per cent. of their principal amount. The Society has agreed to pay the Manager a commission of 0.7 per cent. of such principal amount on issue. The Manager is entitled to terminate the Subscription Agreement in certain circumstances prior to payment to the Society. The Society has agreed to indemnify the Manager against certain liabilities in connection with the issue of the PIBS.

The PIBS have not, prior to the date of this Offering Circular, been marketed or made available in whole or part to the public.

The PIBS have not been and will not be registered under the Securities Act, and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act. Terms used in this section have the meanings given to them by Regulation S under the Securities Act (**Regulation S**).

The Manager has agreed that, except as permitted by the Subscription Agreement, it will not offer or sell the PIBS (i) as part of its distribution at any time or (ii) otherwise until 40 days after the later of the commencement of the offering and the Closing Date (as defined in the Subscription Agreement), within the United States or to, or for the account or benefit of, U.S. persons, and it will have sent to each dealer to which it sells PIBS during the distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the PIBS within the United States or to, or for the account or benefit of, U.S. persons.

The PIBS are being offered and sold outside of the United States to non-U.S. persons in reliance on Regulation S.

In addition, until 40 days after the commencement of the offering of the PIBS, an offer or sale of PIBS within the United States by any dealer, whether or not participating in the offering, may violate the registration requirements of the Securities Act.

The Manager has represented and agreed that:

- (a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of the PIBS in circumstances in which Section 21(1) of the FSMA would not, if the Society was not an authorised person, apply to the Society; and
- (b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the PIBS in, from or otherwise involving the United Kingdom.

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a **Relevant Member State**), the Manager has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in the Relevant Member State (the **Relevant Implementation Date**) it has not made and will not make an offer of PIBS to the public in that Relevant Member State prior to the publication of a prospectus in relation to the PIBS which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and notified to the competent authority in that Relevant Member State, all in accordance with the Prospectus Directive, except that it may, with effect from and including the Relevant Implementation Date, make an offer of PIBS to the public in that Relevant Member State at any time:

- (a) to legal entities which are authorised or regulated to operate in the financial markets or, if not so authorised or regulated, whose corporate purpose is solely to invest in securities;
- (b) to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than EUR43,000,000 and (3) an annual net turnover of more than EUR50,000,000, as shown in its last annual or consolidated accounts; or
- (c) in any other circumstances which do not require the publication by the Society of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression an **offer of PIBS to the public** in relation to any PIBS in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the PIBS to be offered so as to enable an investor to decide to purchase or subscribe the PIBS, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression **Prospectus Directive** means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

No action has been or will be taken by the Society or the Manager that would permit a public offer of the PIBS in any country or jurisdiction where action for that purpose is required. The PIBS may not be, directly or indirectly, offered or sold in any country or jurisdiction where action for that purpose is required. Accordingly, the PIBS may not, directly or indirectly, be offered or sold and neither this Offering Circular nor any other circular, prospectus, form of application, advertisement or other material may be distributed in or from, or published in, any country or jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations.

GENERAL INFORMATION

- (1) The issue of the PIBS was authorised by resolutions of the Board passed on 2 March 2007 and 23 March 2007 and by resolutions of a Committee of the Board dated 11 April 2007.
- (2) There has been no significant change in the financial or trading position of the Group and no material adverse change in the prospects of the Group since 30 April 2006.
- (3) Neither the Issuer nor any member of the Group is, or has during the 12 months preceding the date of this Offering Circular been, involved in any governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Issuer is aware) which may have, or have had in the recent past, a significant effect on the financial position or profitability of the Issuer or the Group.
- (4) The expenses related to the admission of the PIBS to listing are estimated to amount to approximately £6,925 (exclusive of VAT).
- (5) The Society, pursuant to the Registrar's Agreement, has appointed Lloyds TSB Registrars at its specified office at The Causeway, Worthing, West Sussex BN99 6DA to maintain the PIBS Register at such specified office. It is intended that the Registrar will act as agent of the Society for the purposes of maintaining the PIBS Register, accepting instructions for, and effecting, transfers of PIBS, issuing PIBS Certificates to new PIBS holders, receiving requests for the replacement of, and replacing, defaced, damaged, stolen, worn-out, lost or destroyed PIBS Certificates and making payments in respect of the PIBS as they fall due.
- (6) No temporary documents of title will be issued by the Society in respect of the PIBS. The Registrar will, from 13 April 2007, commence despatching the PIBS Certificates to all PIBS holders who decide to hold their PIBS in certificated form, at the risk of the persons entitled thereto, by first class post. The ISIN for the PIBS is GB00B1VYCN43 and the SEDOL number is B1VYCN4. PIBS will be held and transferred through the CREST System operated by CRESTCo Limited.
- (7) For the period of 12 months starting on the date on which this Offering Circular is made available to the public as required by the prospectus rules of the FSA, the following documents will be available during usual business hours on any weekday (Saturdays, Sundays and public holidays excepted), for inspection at the principal office of the Issuer:
 - (i) the Rules and Memorandum of the Issuer; and
 - (ii) the published audited consolidated accounts of the Issuer for the two financial years ended 30 April 2006.

This Offering Circular can also be viewed on the website of the Regulatory News Service operated by the London Stock Exchange at <http://www.londonstockexchange.com/en-gb/pricesnews/marketnews/>.

- (8) KPMG Audit Plc (Chartered Accountants) (authorised and regulated by the FSA for designated investment business) have audited, and rendered an unqualified audit report on, the accounts of the Issuer for the two financial years ended 30 April 2006.

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