LLOYDS
BANKING
GROUP

ANNUAL REPORT AND ACCOUNTS 2012

BECOMING THE BEST BANK FOR CUSTOMERS

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INTRODUCTION

Lloyds Banking Group is a leading UK based financial services group providing a wide range of banking and financial services, primarily in the UK, to personal and corporate customers.

The Group's main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision. The Group operates the UK's largest retail bank and has a large and diversified customer base.

Services are offered through a number of well recognised brands including Lloyds TSB, Halifax, Bank of Scotland, and Scottish Widows, and a range of distribution channels. This includes the largest branch network in the UK and a comprehensive digital, telephony and mobile proposition.

Lloyds Banking Group is quoted on both the London Stock Exchange and the New York Stock Exchange and is one of the largest companies within the FTSE 100.

View our report ONLINE

Our annual report and accounts and information relating to Lloyds Banking Group is also available at:

www.lloydsbankinggroup.com

LLOYDS BANKING GROUP

Annual Report and Accounts 2012

BECOMING THE BEST BANK FOR CUSTOMERS

Our action plan for success

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WE ARE CREATING A SIMPLER, MORE AGILE AND RESPONSIVE ORGANISATION AND ARE MAKING A BIG INVESTMENT IN PRODUCTS AND SERVICES.

BY BECOMING THE BEST BANK FOR CUSTOMERS WE BELIEVE WE CAN HELP BRITAIN PROSPER AND DELIVER STRONG, STABLE AND SUSTAINABLE RETURNS FOR OUR SHAREHOLDERS.

GROUP PERFORMANCE

The substantial progress we made in 2012 means that we are now ahead of our plan to transform the Group, and this was reflected in our stronger underlying financial performance in the year.

António Horta-Osório
Group Chief Executive

Significantly improved Group performance; continue to work through legacy issues

- Substantial increase in Group underlying profit from £638 million to £2,607 million
- Full year Group net interest margin of 1.93 per cent, in line with our guidance at the 2011 full year results
- Costs further reduced by 5 per cent to £10.1 billion, in line with strategic review target two years ahead of plan; Simplification run rate savings increased to £847 million
- Credit quality continues to improve; 42 per cent impairment reduction to £5.7 billion, significantly ahead of original guidance of £7.2 billion; impairment charge as a percentage of average advances improved to 1.02 per cent (2011: 1.62 per cent)
- Statutory loss of £570 million primarily due to PPI provisions of £3,575 million (including £1,500 million in the fourth quarter of 2012), and including £3,207 million of gains from sales of government securities

Confident in capital position; balance sheet further de-risked; funding position transformed

- Strong underlying capital generation with core tier 1 capital ratio increased to 12.0 per cent; on a pro forma fully loaded CRD IV basis the ratio is estimated at 8.1 per cent, including 0.3 per cent from expected CRD IV resolutions
- Continued capital-accretive non-core asset reduction of £42.3 billion, benefiting capital ratios, and exceeding initial 2012 guidance by £17 billion. Non-core portfolio now less than £100 billion, at £98.4 billion
- Deposit growth of 4 per cent; core loan to deposit ratio of 101 per cent, in line with long-term target of 100 per cent; Group loan to deposit ratio of 121 per cent, achieving target two years in advance
- Total wholesale funding reduced by £81.6 billion to £169.6 billion; maturity profile further improved with less than 30 per cent (2011: 45 per cent) of total wholesale funding with a maturity of less than one year

Core business increasingly well positioned for growth and delivering strong returns above cost of equity

- Core return on risk-weighted assets increased from 2.46 per cent to 2.56 per cent
- Underlying profit broadly stable at £6,154 million (2011: £6,196 million)
- Core net interest margin of 2.32 per cent; stable throughout 2012
- 5 per cent reduction in core costs to £9,212 million; 34 per cent reduction in core impairments to £1,919 million

Further improving products and services to support customers and the UK economic recovery

- UK's largest lender to first time buyers, helping over 55,000 customers, and exceeding £5 billion lending target for 2012
- SME net lending growth of 4 per cent, against a shrinking market; exceeded 2012 SME net lending commitment of £13 billion and three year target of assisting 300,000 new start-ups by the end of 2012
- First participant in Funding for Lending Scheme, further enabling us to support the UK economy; £11 billion committed
- Increased Net Promoter Score in all three brands and a further reduction in FSA reportable banking complaints (excluding PPI) to 1.1 per 1,000, more than halving complaints in two years

Further progress expected in 2013 and beyond; confident in meeting medium term guidance

- Expect Group net interest margin of around 1.98 per cent for full year 2013
- Targeting further reduction in total costs to around £9.8 billion in 2013
- Expect further improvement in portfolio quality, and a substantial reduction in the 2013 impairment charge, with a consequential increase in underlying profit before tax
- Targeting core loan growth in the second half of 2013
- Expect a further reduction of non-core assets of at least £20 billion in 2013; on track to achieve target of a non-core asset portfolio of £70 billion or less by the end of 2014, with more than 50 per cent in non-core retail assets

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Consolidated income statement

	2012 £m	2011 £m
Net interest income	10,335	12,210
Other income	8,416	9,179
Insurance claims	(365)	(343)
Total underlying income, net of insurance claims	18,386	21,046
Total costs	(10,082)	(10,621)
Impairment	(5,697)	(9,787)
Underlying profit	2,607	638
Effects of asset sales, volatile items and liability management	1,570	841
Fair value unwind	650	1,206
Management profit	4,827	2,685
Simplification, EC mandated retail business disposal costs and integration costs	(1,246)	(1,452)
Payment protection insurance provision	(3,575)	(3,200)
Other regulatory provisions	(650)	(175)
Past service pensions credit	250	–
Amortisation of purchased intangibles	(482)	(562)
Volatility arising in insurance businesses	306	(838)
Loss before tax – statutory	(570)	(3,542)
Taxation	(773)	828
Loss for the year	(1,343)	(2,714)
Loss per share	(2.0)p	(4.1)p

Presentation of information

In order to provide a more meaningful view of underlying business pursuance, the results of the Group and divisions are presented on a management basis. The key principles adopted in the preparation of the management basis of reporting are described below.

In order to reflect the impact of the acquisition of HBOS, the amortisation of purchased intangible assets has been excluded; and the unwind of acquisition-related fair value adjustments is shown as one line in the management basis income statement, other than unwind related to asset sales which is included within the effects of asset sales, volatile items and liability management.

In order to better present business performance the effects of liability management, volatile items and asset sales are shown on a separate lines in the management basis income statement and 'underlying profit' is profit before taking into account these items and fair value unwind. Comparatives have been restated accordingly. The following items, not related to acquisition accounting, have also been excluded:

- Simplification, EC mandated retail business disposal costs and integration costs;
- payment protection insurance provision;
- other regulatory provisions;
- certain past service pension credits in respect of the Group's defined benefit pension schemes;
- amortisation of purchased intangibles;
- volatility arising in insurance businesses; and
- insurance gross up.

To enable a better understanding of the Group's core business trends and outlook, certain income statement, balance sheet and regulatory capital information is analysed between core and non-core portfolios. The non-core portfolios consist of businesses which deliver below-hurdle returns, which are outside the Group's risk appetite or may be distressed, are subscale or have an unclear value proposition, or have a poor fit with the Group's customer strategy. The EC mandated retail business disposal (Project Verde) is included in core portfolios. A full reconciliation of the management to the statutory basis is given in note 4 on pages 229 to 234. Unless otherwise stated, the commentaries on pages 44 to 75 are on a management basis.

GROUP KEY PERFORMANCE INDICATORS

MEASURING STRATEGIC PERFORMANCE

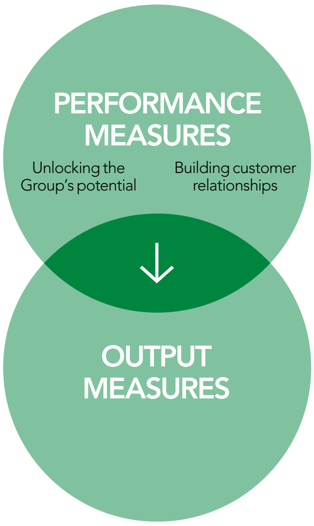
Our strategy

Lloyds Banking Group operates a simple, lower risk, customer focused UK retail and commercial banking business model. Our strategy is built around becoming the best bank for customers and creating value by investing in areas that make a real difference to these customers. Customer leadership driven by superior customer insight, tailored products, better service and relationship focus is the overriding priority. By leveraging these capabilities and our strategic assets we believe we can help Britain prosper and deliver strong, stable and sustainable returns for shareholders.

We have over 30 million customers, iconic brands, including Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows, and high-quality, committed people. We are creating a simpler, more agile, efficient and responsive organisation with a real focus on operating sustainably and responsibly. We will focus on core markets which offer strong returns and attractive growth, while maintaining a prudent approach to risk and further strengthening the Group's balance sheet.

How we measure performance

We track our progress against our strategy to become the best bank for customers using a range of performance measures. Our progress in these areas is measured against a number of key financial indicators which are shown here.


PERFORMANCE MEASURES
Unlocking the Group's potential
Building customer relationships
↓
OUTPUT MEASURES

Alignment of remuneration with performance

To help ensure individuals are acting in the best interest of customers and shareholders, remuneration at all levels of the organisation across the business is aligned to the strategic development and financial performance of the business. All staff, including Executive Directors, have a balanced scorecard which measures performance across five areas (customer, building the business, risk, people and finance) which is aligned to the Group's strategic priorities and reviewed on a regular basis. Executive remuneration, in particular bonuses and incentive plans, is also assessed against balanced scorecard measures which incorporate Group financial performance measures, notably profit before tax, economic profit, earnings per share and total shareholder return.

PERFORMANCE MEASURES

Unlocking the Group's potential

We are reshaping our business portfolio to fit our assets, capabilities and risk appetite, strengthening the Group's balance sheet and liquidity position, simplifying the Group to improve agility and efficiency and investing to be the best bank for customers. A comprehensive set of Key Performance Indicators (KPIs) has been developed to track progress in each of these areas and is outlined in the Strategy section.

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More on our strategy and KPIs

Building customer relationships

Customer relationships are key to our strategy and critical for all our businesses. The significant differences across the divisions means financial and non-financial strategic indicators for the development of customer relationships are generally tracked at a divisional level and commentary is included in the specific divisional commentaries.

To assess progress in our aim of becoming the best bank for customers we measure customer satisfaction and are publicly committed to reducing complaints. Our colleagues are a key differentiator and we use an engagement survey to assess individual motivation and organisational processes.

30 34 →
More on customer satisfaction and customer complaints
More on our staff engagement score

OUTPUT MEASURES

Significant progress has been made against our strategic priorities during 2012 which has been reflected in improved underlying profits and a stronger capital position. This was also reflected in an improved statutory performance despite a number of one off items including the £3.6 billion provision for PPI. Further detail on these measures is contained within the business review.

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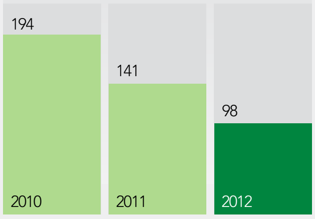
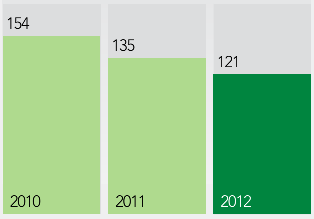
More on our Group results

Balance sheet reduction (non-core assets)



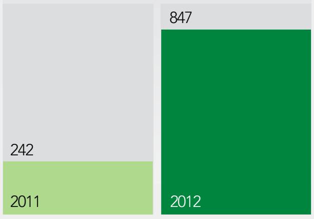
Excellent progress continues to be made in reshaping the business through the reduction of our non-core assets which now stand at £98 billion.

Loan to deposit ratio



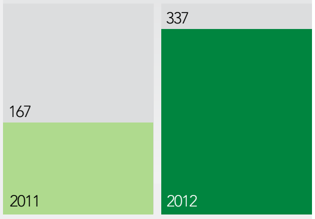
We have made good progress in reducing our loan to deposit ratio with the core loan to deposit ratio now at 101 per cent, very close to our core long-term target of 100 per cent, thereby strengthening our balance sheet.

Simplification cost savings (run-rate)



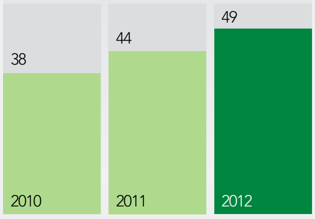
The Simplification programme has been running for 18 months and has maintained strong progress throughout the year, with over 200 initiatives underway across the Group.

Investment



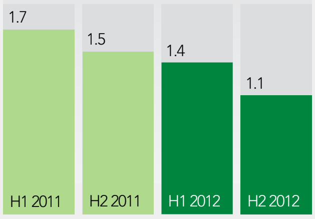
As Simplification benefits materialise we are looking to increase the investment in the business and have committed to invest £500 million pa by 2014 in addition to our business as usual investment programme.

Customer satisfaction (net promoter score)



We have developed a comprehensive customer experience programme measuring customer service at key touch points and their likelihood to recommend us. This is measured through the cross industry net promoter score metric where we have seen continued progress.

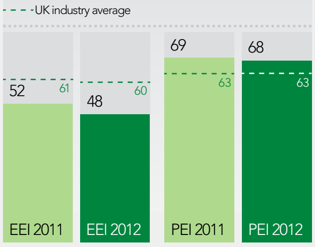
Customer complaints (FSA banking complaints* per 1,000 a/c)



Through our Simplification programme and continued focus on becoming the best bank for customers, our FSA reportable banking complaints continued to fall.

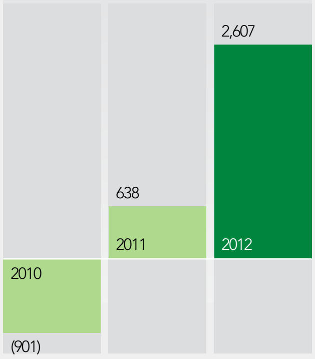
*Excluding PPI

Staff engagement score

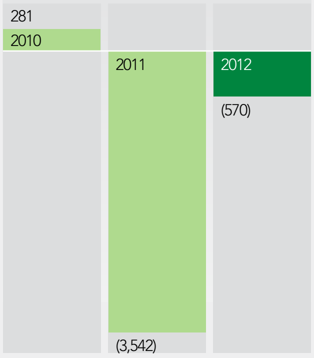


The Employee Engagement Index (EEI) measures the individual motiviation of colleagues whilst the Performance Excellence Index (PEI) measures how strongly colleagues believe the Group is committed to improving customer service.

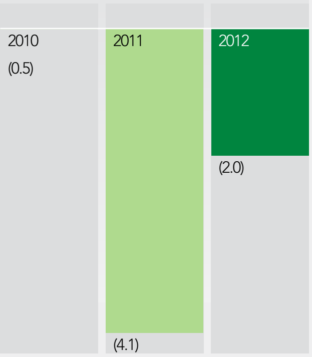
Underlying profit (loss) before tax



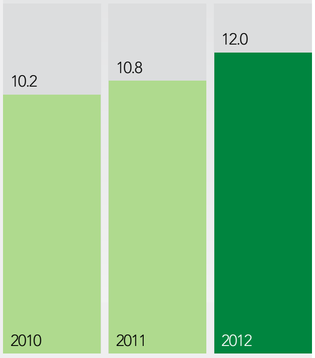
Statutory profit (loss) before tax



Earnings per share



Core tier 1 capital ratio



DIVISIONAL OVERVIEW AND KPIs

RETAIL

The Retail division operates the largest retail bank in the UK and is a leading provider of current accounts, savings, personal loans, credit cards and mortgages.

The division is focused on improving customer service and advocacy and becoming the best bank for customers. With its strong stable of brands including Lloyds TSB, Halifax, Bank of Scotland and Cheltenham & Gloucester, it serves over 30 million customers through one of the largest branch and fee free ATM networks in the UK and a comprehensive digital, telephony and mobile proposition.

In meeting the financial needs of its customers the division provides a comprehensive product range to ensure differing customer requirements can be effectively met. This includes a range of current accounts including packaged accounts and basic banking accounts. It is also the largest provider of personal loans in the UK, as well as being the UK's leading credit card issuer. Retail provides one in five new residential mortgages and provided over 55,000 mortgages to help first time buyers in 2012, making it one of the leading UK mortgage lenders. Retail is the largest private sector savings provider in the UK. It is also a major general insurance and bancassurance distributor, offering a wide range of long-term savings, investment and general insurance products.

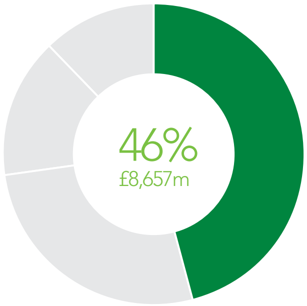
Key brands include:

Lloyds TSB
HALIFAX
BANK OF SCOTLAND
C&G Cheltenham & Gloucester
BM SAVINGS
INTELLIGENT FINANCE

2012 highlights

- In 2012, Retail further increased its profits and returns, and made substantial progress towards its goal of being the best bank for customers.
- Underlying profit increased by 16 per cent, and core underlying profit by 21 per cent, driven by strong cost control and a significant reduction in impairment.
- Return on risk-weighted assets increased to 3.21 per cent from 2.56 per cent in 2011, driven primarily by the increase in profits.
- Retail has made continued progress in improving its customer service scores and saw a reduction in customer complaints (excluding PPI) of 28 per cent during 2012, both key indicators of customer advocacy. This has supported the strengthening of brand consideration to market leading levels.
- The Simplification programme has delivered significant improvements in customer experience, process efficiencies and reduced sourcing costs. This contributed to the strong cost performance delivered by Retail.
- We continued to support the first time buyer mortgage market, lending to one in four first time buyers. We also increased our commitment for lending to first time buyers during 2013. In addition, we continue to deliver strong growth in customer deposit balances attracting funds from almost one in every four savers.
- Retail continues to support local communities through its contribution to Group programmes and through direct commitments by Retail colleagues. In 2012 over 8,500 colleagues in Retail used their 'Day to Make a Difference' in local communities, including supporting National School Sports Week.

Contribution towards total Group income[1]



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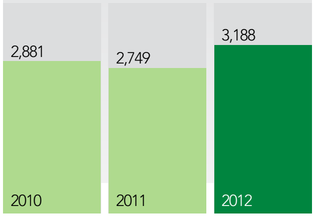
More on our
Retail division results

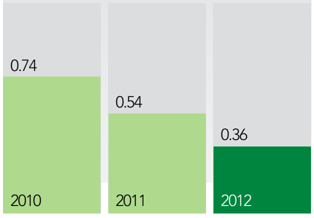
[1]Excludes Group Operations, Central items and insurance claims.

Performance indicators

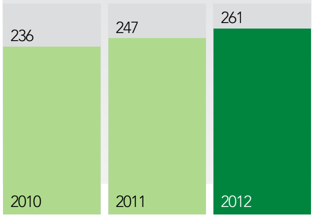
Underlying profit before tax £m



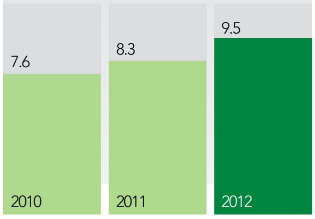
Impairment as a percentage of average advances %



Customer deposits (excluding repos) £bn



Active online customers million



COMMERCIAL BANKING

The Commercial Banking division supports our business clients from small businesses to large corporates.

The division operates a client-centric approach, primarily focused on UK businesses and businesses with strong links to the UK, with coverage comprising SMEs, Mid Markets, Global Corporates and Financial Institutions. Strong local knowledge, a real client focus and a comprehensive product range enables us to quickly provide clients with tailored solutions and an effective service.

Commercial Banking provides support to corporate clients through the provision of core banking products, such as lending, deposits and transaction banking services whilst also offering clients expertise in capital markets (private placements, bonds and syndicated loans), financial markets (foreign exchange, interest rate management, money market and credit) and private equity. This enables us to meet the varying and sometimes complex needs of corporate clients whilst ensuring capital efficiency.

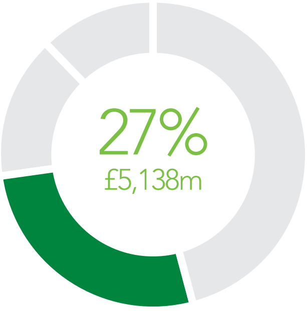
Key brands include:

Lloyds TSB
BANK OF SCOTLAND
LLOYDS BANK
AMC

2012 highlights

- Commercial Banking was created in the fourth quarter of 2012 bringing Small and Medium-sized Enterprises (SME) together with larger corporate UK and global clients to ensure consistent and effective client coverage. The former Wholesale division has been combined with the Australian and European corporate businesses previously reported in the International segment of Wealth, International and Asset Finance.
- We continued to deepen our relationships with core clients through our investment in new products and capabilities to drive capital efficiency and through our lending commitments to support the UK economy and SMEs, including our involvement in the UK Government's National Loan Guarantee and the Funding for Lending Scheme (FLS).
- Underlying loss reduced by 60 per cent due to a 30 per cent reduction in impairments, which more than offset the reduction in total underlying income.
- Core underlying profit increased by 1 per cent to £1,748 million, driven by reduced impairments and improved other income from resilient performances in Capital Markets, Financial Markets and LDC. This was offset by lower net interest income. Return on risk-weighted assets increased to 1.36 per cent from 1.32 per cent.
- Underlying loss in the former Wholesale business reduced by 36 per cent due to a 31 per cent reduction in impairments and improved other income. This more than offset lower net interest income, resulting from our strategic non-core asset reduction and increased wholesale funding costs.
- Underlying profit in the former Commercial business increased by 10 per cent, driven by reduced impairments and costs partly offset by lower underlying income. Core net lending grew by 4 per cent against market contraction of 4 per cent and we assisted in excess of 120,000 SMEs to start up in 2012.

Contribution towards total Group income[1]



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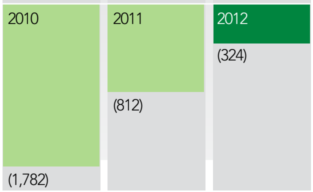
More on our Commercial Banking division results

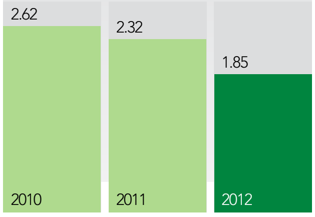
[1]Excludes Group Operations, Central items and insurance claims.

Performance indicators

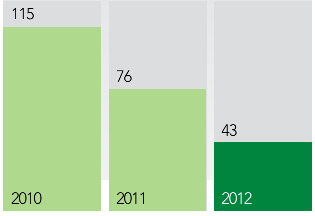
Underlying loss before tax £m



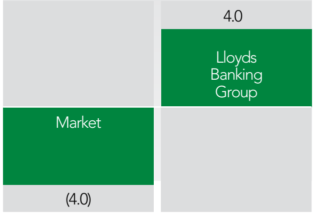
Impairment as a percentage of average advances %



Non-core assets £bn



Commercial net lending growth 2012 (core) %



DIVISIONAL OVERVIEW AND KPIs

WEALTH, ASSET FINANCE AND INTERNATIONAL

Wealth, Asset Finance and International comprises our UK and international wealth businesses, our UK and international asset finance and online deposit businesses along with our international retail businesses.

The Wealth business comprises private banking and asset management. Wealth's private banking operations cater to the full range of wealth clients from affluent to Ultra High Net Worth within the UK, Channel Islands and Isle of Man, and internationally. Scottish Widows Investment Partnership (SWIP) provides asset management services to both internal and external clients.

Asset Finance consists of a number of leasing and speciality lending businesses in the UK including Lex Autolease and Black Horse Motor and Personal Finance along with our leasing and speciality lending businesses in Australia and our European online deposit business.

The international business comprises the Group's non-core banking business outside the UK, with the exception of corporate business written through the Commercial Banking division. This primarily comprises Ireland, Retail Europe and Asia.

Key brands include:

BANK OF SCOTLAND

SCOTTISH WIDOWS INVESTMENT PARTNERSHIP PERFORM

Lloyds TSB | International

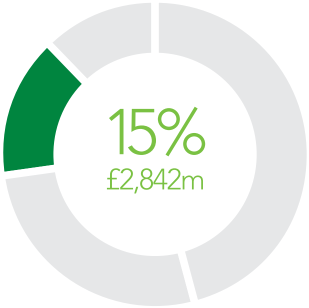
blackhorse

Lex Autolease

2012 highlights

- In 2012 we achieved strong profitable growth in our Wealth and Asset Finance businesses while simultaneously making progress in strengthening our balance sheet, simplifying our international operating model and investing in building capability for the future.
- Divisional performance improved in 2012 with losses reducing by 67 per cent to £929 million primarily driven by lower impairments, mainly in Ireland. Profits in the core business increased by 27 per cent, to £459 million driven by strong performance in the Wealth and Asset Finance businesses.
- Core return on risk-weighted assets increased from 3.62 per cent to 5.07 per cent.
- The balance sheet has been further strengthened through 24 per cent growth in customer deposits and a reduction in non-core assets of a further 20 per cent, including a £3.7 billion reduction in our Irish portfolio.
- We achieved cost savings of 5 per cent through further progress on Simplification initiatives which in turn enabled further investment in the core businesses to improve the customer experience.
- We continue to reshape our operations by further streamlining our international footprint through the announced exits from five countries (following seven exits last year) and a significantly reduced presence in a further four.

Contribution towards total Group income[1]



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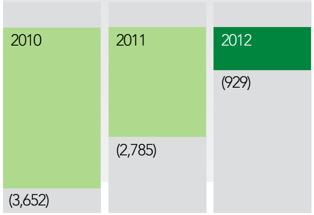
More on our Wealth, Asset Finance and International division results

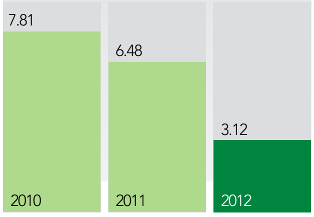
[1] Excludes Group Operations, Central items and insurance claims.

Performance indicators

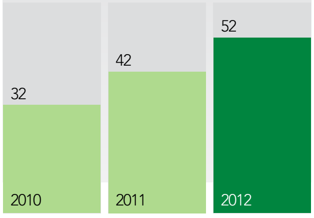
Underlying loss before tax £m



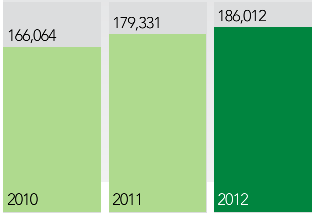
Impairment as a percentage of average advances %



Customer deposits (excluding repos) £bn



UK wealth relationships Clients



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INSURANCE

The Insurance division provides long-term savings, protection and investment products and general insurance products to customers in the UK and Europe.

The UK Life, Pensions and Investments business provides long-term savings, protection and investment products distributed through the bancassurance, intermediary and direct channels of the Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows brands. The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands.

The General Insurance business is a leading distributor of home insurance in the UK, with products sold through the branch network, direct channels and strategic corporate partners. It operates primarily under the Lloyds TSB, Halifax and Bank of Scotland brands.

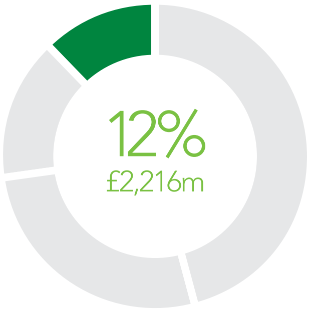
Key brands include:

BANK OF SCOTLAND HALIFAX
Lloyds TSB SCOTTISH WIDOWS

2012 highlights

- In 2012 we combined our UK Life Pensions and Investments and General Insurance businesses and restructured our operation to enable greater customer and market focus which contributed to an 8 per cent decrease in costs and leaves us well placed to realise benefits from risk diversification.
- Total underlying profit reduced by 24 per cent and core underlying profit by 21 per cent, primarily reflecting a reduction in total underlying income, largely due to the subdued economic climate and increased weather related claims, partly offset by an 8 per cent decrease in costs.
- We have invested in extending our life insurance proposition with a new earnings protection offer which has simpler application and claims processes.
- We have further enhanced our Corporate Pensions proposition, with the addition of AssistMe, an auto-enrolment tool that complements our MyMoneyWorks corporate pension platform. The strength of our proposition, combined with strong activity in the run up to implementation of the Retail Distribution Review (RDR), has driven 23 per cent growth in corporate pensions.
- Our recent enhanced annuities pilot has been an important step towards further strengthening our overall retirement savings business.
- Our focus on putting customers first has led us to improve our home insurance claims management processes which has enabled us to get our customers back into their homes more quickly following the extreme weather events throughout 2012, helping improve customer satisfaction and contain claims costs.
- We have delivered balance sheet initiatives that have strengthened the Group's balance sheet, providing £1.4 billion liquidity and have now mitigated £5.3 billion of the potential impact of CRD IV, whilst improving Insurance returns.

Contribution towards total Group income[1]



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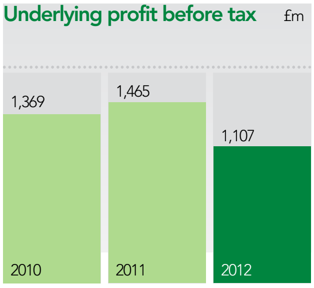
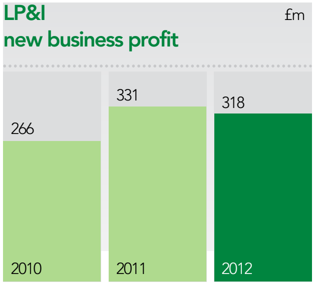
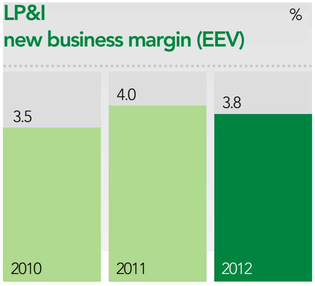
More on our Insurance division results

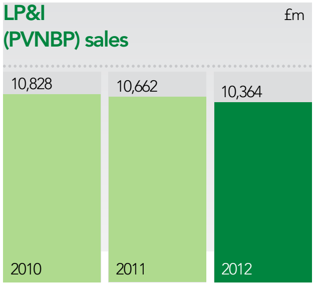
[1] Excludes Group Operations, Central items and insurance claims.

Performance indicators









CHAIRMAN'S STATEMENT

Sir Winfried Bischoff

> *"Another year of progress for the Group against a still challenging economic and regulatory backdrop."*

Overview

2012 was a momentous year for the United Kingdom. We celebrated the Diamond Jubilee and the London 2012 Olympic and Paralympic Games. Lloyds Banking Group was appointed a National Partner to the Games in 2007, and in this role we helped fund emerging athletes, supply volunteers and, crucially, support local businesses to enable them to take full advantage of the available commercial opportunities. We are proud of the significant role the Group played and of our part in creating a lasting legacy.

It was also a year of progress for the Group against a still challenging economic and regulatory backdrop. We continued to implement our strategy and are now ahead of our plan to transform the Group and create an efficient, lower-risk retail and commercial bank, focused on being the best bank for customers. This was reflected in our share price, which rose 85 per cent in 2012, substantially outperforming the FTSE 350 banks index, which rose by 34 per cent, and making our shares the best performer in the FTSE 100 over the year. However, we need to continue to manage a number of legacy issues which have had an adverse impact on our financial performance.

To put this into figures: Even though the operating environment in the UK remained challenging, we delivered consistent underlying performance in our core business, demonstrating the strength of our strategy and management team. This resulted in an increase of our underlying profit before tax over that of 2011 from £638 million to £2,607 million. The statutory results, however, were impacted by a number of items including payment protection insurance, for which we took provisions totalling an additional £3,575 million in 2012, bringing the total amount provided to £6,775 million since 2011. Additionally we made a further provision in respect of possible claims arising from SME derivatives amounting to £400 million.

Supporting the UK Economic Recovery

We play an active part in supporting the UK economy, to which our success is inextricably linked, and in 2012 we confirmed our commitment to helping Britain prosper through a number of initiatives. These included leading the way in participating in the Government's Funding for Lending Scheme and growing our lending to small and medium-sized businesses against the backdrop of a contracting market. We made strong commitments to supporting sectors, such as manufacturing, that play a key role in economic recovery. We also underlined our support to the UK housing market by continuing to be the UK's largest mortgage provider to first time buyers, helping over 55,000 customers take their first steps onto the property ladder.

Regulation

The regulatory framework governing the UK banking industry continued to evolve in 2012, and whilst there was greater clarity, a considerable degree of uncertainty remains about the final outcome of the shape of our industry. We continue to implement regulatory changes alongside the current Basel 3 draft legislation and await its finalisation when we will be able fully to assess the changes required and their effect on the Group. The largest challenge for regulators remains to devise a regulatory framework that strikes the right balance between enhancing financial stability, and encouraging innovation, competition and growth.

We have been a consistent supporter of the proposals to ring-fence systemically important banking operations outlined by the Independent Commission on Banking (ICB), given their close alignment to our simple UK focused retail and commercial banking model. It is our intention, subject to discussions with the regulator and the interests of our shareholders, to become a ring-fenced bank ahead of the 2019 deadline. This will be a step-change for the UK banking industry that should reduce risk and ensure clear distinction between retail and commercial banks on the one hand, and investment banks on the other.

During 2012 we have made good progress regarding the EC mandated disposal, Project Verde. We have created Verde as a stand-alone bank, which from the summer 2013, will be operating as a separate business within the Group. We are well-positioned to divest the business either through a sale or an Initial Public Offering. Our discussions with The Co-operative Group plc continue towards signing a binding sale and purchase agreement. The formation of a new banking business, when completed, will be an effective challenger in the UK's retail banking market.

Dividends

We strengthened our capital position during 2012 despite provisions and charges for regulatory issues. As we stated in 2011, we remain committed to restarting dividend payments as soon as we are able, and fully understand the difficulties that their absence is causing our shareholders. Once regulatory requirements have been clearly defined and we have prudently met them, and the financial position of the Group and market conditions permits, it is our intention to recommence dividend payments.

Management and Staff

The Board is committed to achieving long-term success for the Group and generating strong, stable and sustainable returns for shareholders, and this is underpinned by our high standards of corporate governance. We have a strong executive management team, with deep experience and broad understanding of our business challenges. The team's aim is to be the best bank for customers, while acting as ambassadors in leading cultural change in the organisation. In this way I feel confident we will deliver the value which our shareholders expect and deserve.

It is vital to ensure our colleagues are fully engaged in meeting our business objectives and in making further progress. I thank all of them for their commitment. Delivering excellent service and simple customer focused products is at the heart of our strategy and we know we have to demonstrate this in all our actions. By acting in our customers' best interests in every contact we have with them, we will become the great business we aspire to be and a source of pride for our employees. This in turn will enable us to build sustainable returns for our shareholders.

Directors

We have strengthened and further diversified the knowledge and experience on our Board. On 31 May 2012, two new Non-Executive Directors were appointed, Carolyn Fairbairn and Lord Blackwell. Carolyn's background in strategy, public policy and regulation complements the experience of Lord Blackwell in banking, consulting and life insurance. These appointments add to the existing combination of skills, and banking and life insurance perspectives, already present on our Board and will contribute to the quality of decision making.

On 22 November 2012 we announced that Martin Scicluna, Audit Committee Chairman, will step down from the Board and leave the Group at the end of March 2013 following his appointment as Chairman of RSA plc. I thank him for the substantial contribution he has made as Audit Committee Chairman and for his constructive views on all aspects of our business. I am pleased Nicholas Luff has joined us and will be taking over as Audit Committee Chairman on 1 April 2013. He brings substantial financial and audit committee experience to that role and we look forward to working with him.

We also announced Timothy Ryan will retire from the Board in April 2013. Tim, too has made a substantial contribution to the Board over the last three years with his deep knowledge and understanding of the global financial services sector and the wider regulatory impact on our business.

I want to express my thanks to our Non-Executive Directors for their judgement, wisdom and commitment. They have spent substantial amounts of time – far more than expected – on our business over the last four years and have done so without any increase in their fees since January 2008. These fees are now significantly below those of every other major banking institution. We review fees annually and directors have decided once again to forego any increase in light of the fact that the Group in 2012 was still loss making at the statutory level.

I am pleased that we achieved our commitment of 25 per cent female representation on the Board three years ahead of the 2015 timeline mandated by the Lord Davies report. We believe that diversity in background and experience helps to enhance the quality of deliberations and decision making, and we will continue to promote it within the Board as an example to our entire organisation.

Community

We believe that businesses should support the communities where they operate. For Lloyds Banking Group, this not only strengthens and grows our business, but also helps to rebuild trust and confidence in the banking sector and the positive role banks should play in society as a whole.

Making a difference in communities by supporting education, employability and enterprise is central to the vision of the type of bank we want to be, a UK focused retail and commercial bank that exists to serve the needs of its customers. If we continue to focus on our Group values: putting customers first, keeping it simple and making a difference together we will build a strong and profitable Group, with a culture which reinforces these behavioural standards.

Following our strategic Review in 2011 we are committed to keeping our charitable and community investment at £85 million for the period of the strategic plan. This has meant thousands of colleagues have been able to volunteer in local community activities through our staff giving days. I am pleased that we raised over £3.6 million in charitable donations over the two years duration of our partnership with Save the Children as our 'Charity of the Year'. We are already actively supporting our new Charity of the Year: the Alzheimer's Society and Alzheimer Scotland, who have launched the *Live Well Campaign*, the first UK-wide dementia carers' programme. We also continue to run a number of charitable programmes using our business capabilities to support local communities, including our recognised *Lloyds Scholars* programme, *Money for Life* our financial capability programme, and *Business in the Community* of which we have been a supporter of for over 20 years.

This year we saw the culmination of our partnership with London 2012. The success of the Olympic and Paralympic Games reflected the dedication of so many of our colleagues who had supported the run-up to the Games over the past five years. The Games themselves continued the positive impact on our local communities, which is why we are delighted to be building on their legacy by developing our National School Sport Week and Local Heroes programmes.

£3.6 million

Charity of the year
During the two years of our partnership with Save the Children this sum was raised to support the work of the charity.

25%

Board representation
Three years ahead of the mandated timeline we have 25 per cent female representation.

CHAIRMAN'S STATEMENT

"We remain committed to operating as a privately owned Group, which is profitable, self supporting and dividend paying."

Culture

We believe culture is values brought to life and is the consequential outgrowth of the strategy of a bank. Ours is to place the customer first. Just as with strategy, the Board has a major role in shaping culture and in setting out principles and values that will drive long-term success. In addition we believe it is the duty of the Board to ensure that these common objectives of management and Board are implemented throughout the institution. In banking there is a place for re-balancing the priorities between shareholders and customers. When customers come first, shareholders will naturally be rewarded.

Within Lloyds Banking Group we recognise the value of diversity in our colleagues from a broad and representative mix of backgrounds and experiences: different perspectives allow us to see and develop new opportunities. We promote internal initiatives to support diversity and inclusion within the Group and I was pleased to see our achievements also being recognised at the Business Disability Forum. We can only achieve our customer-focused strategy by building a sound reputation founded on the highest standards of responsible behaviour. In 2012 we launched the Codes of Responsibility to guide our decision making and help us put into practice our commitment to strive always to do the right thing.

Remuneration

The Remuneration Committee undertook a further review of remuneration and executive remuneration in 2011. Anthony Watson, the chairman of the Remuneration Committee, provides his usual review of our approach elsewhere in the report but due to the importance of remuneration to our stakeholders and the Group, as Chairman, I also want to provide some context to the decisions we have taken.

We continue to believe that the remuneration policy at all levels, including for senior executives, needs to incentivise staff to deliver strong, sustainable growth whilst reflecting the work required to reshape and transform the Group. We have a strong conviction to align reward to the longer term, sustainable success of our business and through this the return of value to shareholders. We are also mindful however both of the economic outlook and the views of our stakeholders.

We have therefore focused on the need to manage aggregate variable pay and the overall size of the bonus pool. The total bonus pool has been reduced by approximately 3 per cent to £365 million with the greater impact being applied to more senior staff and managed in the context of business and individual performance. As we are primarily a retail and commercial bank the awards under our Group bonus scheme remain a very small percentage of revenues at approximately 2 per cent, and represent approximately 7 per cent of pre-bonus management profit before tax, compared to 12.5 per cent in 2011. Cash bonuses are capped at £2,000 with additional amounts paid in shares and subject to deferral and performance adjustment. The average value of bonuses paid per employee, will remain similar to 2011 at less than £3,900.

With regard to executive remuneration we feel it is appropriate that the fixed elements of Directors' pay should remain unchanged for a further year, recognising the continued economic climate and the need to evidence sustained returns for shareholders. Our 2012 bonus awards have been determined conservatively against robust financial performance measures, and these awards will continue to be deferred into shares, until at least 2015.

In recognition of the Group's performance in 2012, the Remuneration Committee has decided to make an annual performance award to António Horta-Osório of £1,485,000 deferred in shares. The deferral period for this award will be extended to five years, and so will not be released until 2018, and will be subject to additional conditions related to the share price at which the UK Government invested. António has led the Group through a strong year that has put us ahead in the implementation of our strategic plan. I believe this, in part, is a reason for the Group being the best performing stock in the FTSE 100 in 2012.

With respect to the Long-Term Incentive Plan (LTIP), as key targets for the 2010 LTIP were not met awards made under this plan will not be paid. This means that LTIP awards have not been made for Executive Directors in any of the last four years. The LTIP however remains a core part of our reward strategy and we hope that the performance conditions attached to the plan which ensure alignment with the Group's strategic objectives and timeline of our medium term plan, will be met in 2013.

Outlook

We have a strong foundation on which to build our strategy to be the best bank for customers to the benefit of our shareholders. As I have indicated in the past, the first task of the Board was to strengthen the Balance Sheet and to have a robust funding profile. Now that the Balance Sheet has been substantially strengthened and all of the liquidity support received from the UK Government has been repaid, our focus is on increasing profitability and returns to shareholders. Over time, this should in turn allow the government the opportunity to commence the sale of its shareholding, which currently stands at approximately 39.2 per cent. We remain committed to operating as a wholly privately owned Group, which is profitable, self supporting and dividend paying. 2012 has been a year in which that possibility has been enhanced. As for the immediate future I believe that, with a reasonably positive development of the UK economy, we are well positioned for growth.

I am encouraged by and grateful for the ongoing support of all of our shareholders as we implement our strategy. We have many strengths, including iconic brands, strong heritages and great people. Consequently, we are well positioned to realise the Group's full potential for growth, help Britain prosper and deliver sustainable returns for our shareholders.

Sir Winfried Bischoff
Chairman

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A COMMITMENT TO GOOD GOVERNANCE

Governance

The Board is committed to achieving long-term success for the Group, and governance plays an integral part in ensuring consistency and rigour in decision making to allow us to maximise shareholder value over time. This remains uppermost in our minds when applying the principles described in relevant provisions relating to the combined code on corporate governance published by the Financial Reporting Council. The Board aims to exceed these requirements as we believe that good governance is a key contributor to the Group's long term success.

Our Board

The Board has seen a number of changes this year, and in line with the provisions of the UK Corporate Governance Code and the interests of good corporate governance, all Directors are required to submit themselves for re-election on an annual basis. We are committed to ensuring we have the right balance of skills and experience within the Board, and we annually review its composition, and the diversity of backgrounds of its members.

Executive Remuneration

As a Group we are aware of the views of our various stakeholders on executive remuneration. We seek to motivate, incentivise and retain our talent whilst remaining mindful of the current economic outlook. As examples of the justified restraint in the current circumstances we have made no changes for 2013 in senior executives' pay (with one exception) and our incentive compensation for 2012 in absolute amount and as a percentage of revenues (less than 2 per cent) is lower than that of any other major banking institution in the United Kingdom.

Additionally the Board is committed to maintaining alignment between our senior executives and shareholders and we continue to operate a stringent deferral policy to ensure individual reward is aligned with the Group's performance, the interests of its shareholders, and a prudent approach to risk management allowing where necessary for appropriate adjustment of incentive compensation to reflect malus. In March 2012, the Group announced that it had applied a performance adjustment to the deferred bonuses of certain directors and senior managers in relation to PPI. The Long Term Incentive Plan remains a core element of our reward package, although this did not pay out for four years to 2012.

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Board oversight – key topics

Throughout 2012 the Board has continued to review the corporate strategy, the operation of the business and our results within a framework of prudent and effective controls, including the assessment and management of risks. This framework has allowed us to deal with key issues arising throughout the year, including:

- the Group Chief Executive's return to work in January 2012 following a short leave of absence. Having ensured that he was medically fit to return, the Board has assisted Antonio in making appropriate adjustments to his reporting line and corporate support. It is clear from his energy and commitment to the role that he has made a full recovery
- ongoing review of board composition including a number of new appointments which are explained on page 90
- oversight and challenge of the strategy and five year operating plan. This included a two day strategy offsite for the Board and executive team. Insurance and Commercial Banking have been a particular focus for the year. Performance against plan is reported on pages 4 to 9
- following the appointment of Lord Blackwell, changes have been made to the governance and oversight of the Insurance board to ensure closer alignment with the Group Board
- monitoring of the progress of Project Verde, the EU mandated divestment of branches
- oversight of conduct issues with emphasis on embedding a culture of 'doing the right thing'
- an ongoing review of the adequacy of provisions, most recently in relation to legacy conduct issues such as PPI and SME derivatives
- establishment of a board committee chaired by David Roberts, the Chairman of our Risk Committee, to oversee the Group's handling of the process and issues arising from the industry investigation into LIBOR setting. This also included implementation of the Wheatley Review to ensure robust processes going forward
- close scrutiny and control over executive remuneration arrangements including open and effective engagement with shareholders on a range of remuneration matters. The Board through the Risk and Remuneration Committees has been particularly anxious to ensure appropriate risk adjustment. At the Annual General Meeting in May 2012 the Group achieved over 97 per cent votes in favour of its Directors' Remuneration Report

GROUP CHIEF EXECUTIVE'S REVIEW

António Horta-Osório

"Significantly improved Group performance with core business increasingly well positioned for growth."

Summary

In 2012, we accelerated the delivery of our strategic initiatives and are now ahead of our plan to transform the Group, despite the challenging economic environment and continued regulatory uncertainty. As a result of our actions, the Group is now in a far stronger position, with capital ratios further improved, our funding position transformed, a significant and capital-accretive reduction in non-core assets achieved, costs reduced in absolute terms and asset quality further improved. While legacy issues, notably payment protection insurance (PPI), resulted in the Group still reporting a loss at the statutory level, our achievements resulted in a significant improvement in both Group underlying and statutory performance, and continued strong returns, above our cost of equity, being delivered in our core business.

We are a UK focused retail and commercial bank, and our aim, as defined in our Strategic Review in June 2011 is to build a strong competitive advantage in terms of operational efficiency and risk premium, that will allow us to become the best bank for customers.

Our drive to enhance operational efficiency and improve service continued at a pace in 2012, notably through the successful execution of our Simplification programme. Due to the progress made, we are now very close to achieving our original target of around £10 billion of total costs, two years ahead of plan. We are now targeting a further reduction in Group total costs to around £9.8 billion in 2013.

At the same time as achieving this further absolute reduction in costs, we have re-invested a third of our Simplification savings and we are continuing to strengthen our core business by directing this investment to products and channels which better meet the needs of our customers. The provision of simpler and more transparent products and services to our customers, built around their needs and delivered efficiently, is a key part of regaining their trust. The speed of our progression towards becoming the best bank for customers is clearly demonstrated by increasing customer advocacy and steadily falling levels of banking complaints (excluding PPI).

In addition to investing for sustainable growth and returns in our core business, we are reducing risk through substantial reductions in our non-core asset portfolios and a sustainable approach to risk in our core business, which together have resulted in a significant reduction in the impairment charge. We are also continuing to reduce risk and strengthen the balance sheet by reducing wholesale funding, lowering operational leverage and building higher capital ratios. We expect these initiatives, together with our focus on lower-volatility retail and commercial banking, to lower our risk premium over time, and give us a significant competitive advantage.

2012 results overview

We delivered Group underlying profit before tax of £2,607 million in 2012, a substantial increase of approximately £2 billion when compared to 2011 reflecting a significant reduction in losses in our non-core business and stable profitability in the core business. Income fell by 13 per cent to £18,386 million as a result of customer deleveraging and lower margins in the core business, and the substantial £42.3 billion reduction in the non-core portfolio. However, this was more than offset by our actions to significantly reduce costs, which fell 5 per cent to £10,082 million, and by further improvements in asset quality, which resulted in a 42 per cent reduction in the impairment charge to £5,697 million.

On a statutory basis, the Group reported a loss before tax of £570 million, with the principal reconciling items with underlying profit being provisions taken during the year in relation to the legacy issues of payment protection insurance and interest rate hedging products (IRHP) sold to small and medium-sized businesses (SMEs) of £3,575 million and £400 million respectively, a profit from asset sales of £2,547 million, and Simplification and EC mandated retail business disposal costs together amounting to £1,246 million. Other reconciling items, which are detailed on pages 47 and 48 of this annual report in the Group Finance Director's Review, resulted in a net charge of £503 million. The statutory loss before tax of £570 million represented a significant improvement on last year's statutory loss of £3,542 million.

The core business continues to deliver strong and stable returns above our cost of equity, with a return on risk-weighted assets of 2.56 per cent achieved in 2012, an increase of 10 basis points when compared to 2011 despite the challenging environment, with a small reduction in underlying profit of £42 million to £6,154 million being more than offset by a reduction of £6.1 billion in core risk-weighted assets. We continued to reduce costs in the core business, where they fell 5 per cent to £9,212 million, while the continued application of our conservative risk appetite meant that asset quality remained good, and the core impairment charge reduced by £968 million to £1,919 million.

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We made substantial progress in reshaping the Group and strengthening the balance sheet. We have proactively managed the run-down of our non-core assets, reducing the portfolio by almost a third in 12 months to £98.4 billion, ahead of plan, and we have continued to do so in a capital-accretive way. We have transformed our funding structure with our use of wholesale funding reduced by £81.6 billion in the year, and the average maturity profile of the remaining wholesale funding further improved, with less than 30 per cent now having a maturity of under one year. The non-core reduction, together with above market deposit growth of 4 per cent, resulted in the Group's loan to deposit ratio reducing to 121 per cent, with the core loan to deposit ratio at 101 per cent, in line with our core long-term target of 100 per cent.

We further strengthened our capital ratios in 2012, with the Group core tier 1 capital ratio increasing by 1.2 per cent to 12.0 per cent and our total capital ratio increasing by 1.7 per cent to 17.3 per cent, which is already in excess of the ICB's primary loss-absorbing capacity (PLAC) recommendations. On an estimated pro forma CRD IV fully loaded basis the Group's common equity tier 1 capital ratio would have been 8.1 per cent, including the successful resolution of two CRD IV items now likely to happen. Given our strongly capital generative core business and continued progress in simultaneously releasing capital and reducing risk through non-core asset disposals, we continue to be confident in our capital position.

The substantial progress we are delivering in reducing risk and delivering on our strategic initiatives was reflected in the outcome of Moody's Investor Service rating review of 114 financial institutions, where we received only a single notch downgrade on Lloyds TSB Bank plc's longer-term senior debt and deposit ratings, and retained our short-term Prime-1 rating in June 2012.

Accelerated delivery of strategic initiatives

In addition to further ***strengthening*** our balance sheet, we have made substantial progress in the execution of the other elements of our strategic plan to be the best bank for our customers, through reshaping and simplifying our business and investing in our core franchise.

As we ***reshaped*** our business portfolio, we delivered improving credit quality trends in all divisions thanks to the rigorous application of risk controls on all new business and the further de-risking of existing portfolios. As a result, we achieved a further reduction in the Group impairment charge of 42 per cent to £5,697 million, significantly ahead of our expectation at the beginning of 2012. The improving quality of our portfolios and their decreasing risk profile was also reflected in a 12 per cent decrease in risk-weighted assets when compared to December 2011, principally driven by the reduction in non-core assets.

In line with our UK-focused strategy, we have made further progress in reducing our international presence, and have now completed or announced our exit from twelve countries or overseas branches, as well as announcing a reduced presence in a further four locations.

Our ***Simplification*** programme is central to the successful delivery of our strategy and we continue to make significant progress in driving further cost savings and efficiencies throughout the business. We have reviewed our organisational structures, increasing average spans of control and reducing the average number of management layers, while our Cost Board continued to drive a focus on cost efficiency by business line and by functional category. The success of this approach is evidenced by our achievement of run rate cost savings from the programme of £847 million at the end of 2012, ahead of plan, an achievement which gives us confidence in reaching our run rate cost savings target of £1.9 billion by the end of 2014.

5%

Total costs
Total costs reduced to £10.1 billion, in line with strategic review target two years ahead of plan.

£98.4 billion

Non-core assets
We have proactively managed the run-down of our non-core assets by almost a third in the year.

The benefits of the Simplification programme extend far beyond cost reductions. Customers and staff are already benefiting from faster, more automated and less complex processes: for example, in Commercial Banking we improved the lending process allowing businesses to receive their funds in almost half the time, while mobile and voice recognition technologies and simpler, faster processes in Retail and a quicker claims process in Insurance are further examples of how our actions are contributing to increased customer advocacy.

Reinvesting a proportion of the savings from the Simplification programme into our core franchise allows us to provide even greater levels of support and service to our customers.

In Retail, investment in our digital distribution capabilities continues to be rewarded with the number of active internet customers increasing by 1.2 million in 2012 to 9.5 million, whilst our mobile banking apps, which were launched in October 2011, now have 3.3 million users. We also achieved a major milestone of over a billion customer logons for the year. Alongside our digital services we are committed to investing in our branch network and refurbished 421 branches in 2012 and extended our opening hours. In recognition of our ongoing commitment to customers we received a number of external awards including 'Best Overall Lender' at the Your Mortgage Awards for the eleventh consecutive year and a three star mark from the Fairbanking Foundation for the Lloyds TSB Classic Account.

As part of being the best bank for customers, and reflecting the fact that the re-focusing of our SME business on delivery for customers is well under way, we announced the creation of our 'Commercial Banking' division which brings together the Group's SME clients together with larger corporate UK and global clients under the leadership of Andrew Bester who joined us in June 2012. The changes will allow us to transfer best practices from SMEs into mid-sized corporates and to deliver operational synergies between the different segments in order to become the best bank for our corporate and SME customers.

Across Commercial Banking, as part of our programme to enhance our capabilities in capital efficient products, we have continued to invest in the Transaction Banking platform, delivering new product propositions in Card Payments & Acceptance, Currencies and International Cash Management. We also continued to invest in enhancing our online capabilities, with the number of clients migrating to our foreign exchange and money market e-portal 'Arena' tripling in 2012. We also launched specialised products, including a deposit account tailored to the needs of businesses in the agricultural sector. We were voted 'Business Bank of the Year' for the eighth consecutive year at the Real FD/CBI Excellence awards, a testament to our support for British businesses.

Within the Wealth business we have continued to leverage our expertise to deepen customer insight and to invest in products and services that are tailored to meet the needs of our clients. In preparation for the implementation of the Retail Distribution Review (RDR) we invested in training our advisers to ensure that they are fully-qualified and best-positioned to continue to advise clients, and ensured that our systems and processes comply with new standards. In 2012, we also launched our private banking client centre which improved the 'on-boarding' experience for our UK Wealth clients, whilst making the referral process simpler for colleagues. We have a strong market position in Asset Finance and have continued to invest in our technology platform in 2012 to provide an improved, cost-effective customer experience.

GROUP CHIEF EXECUTIVE'S REVIEW

Mortgages

We provided £26.2 billion of gross new mortgage lending in 2012. This included supporting over 55,000 customers in buying their first home, equivalent to one in every four first time buyers.

In Insurance, we continued to invest in our core systems, products and processes in advance of RDR and the launch of pension auto-enrolment, to enable us to support both retail and commercial customers through this period of change. We have taken the first steps towards launching an enhanced annuities proposition, with full implementation into this growing market expected in mid-2013. We are pleased with the further progress in enhancing our proposition, with Scottish Widows being recognised for its products, service and quality, receiving a number of industry awards including 'Best Group Pension Provider' in the Corporate Adviser Awards 2012.

Further supporting our customers and the UK economy

Our future and that of the UK economy are inextricably linked, and as the largest UK retail and commercial bank we are aware of the importance of our role in helping Britain prosper and the mutual benefit of doing so. Our utilisation of the UK Government's Funding for Lending Scheme (FLS) underlined our support in 2012 for the UK economic recovery. We were the first bank to participate in the scheme and have committed in excess of £11 billion in gross funds to customers through the scheme since its launch in September, having only drawn £3 billion from the scheme so far. We are committed to passing the financial benefit of this low-cost funding on to our customers and to the areas that can be of the most economic benefit to the UK, including SMEs and first time home buyers.

SMEs play a key part in UK economic growth and we continued to actively support them in 2012. We exceeded our SME Charter lending commitment of £13 billion, having increased the original £12 billion target during the year, while also committing to lend an extra £1 billion to UK manufacturing businesses. In addition, we beat our three year target of assisting 300,000 new start-ups by the end of 2012, helping to stimulate economic output and improve business confidence. This support for UK SME customers is underlined by our net SME lending growth of 4 per cent in the year, for the second year running, compared to the market which saw a reduction in net lending to SMEs of 4 per cent.

Lloyds Banking Group is an important institution for the prosperity and growth of the UK and we are committed to nurturing UK business. The Lloyds TSB Enterprise Awards, now in their second year, celebrate innovation, drive and dedication within UK businesses and provided a number of winners with business support and a cash prize to invest in their business in 2012.

For our UK Retail customers, we provided £26.2 billion of gross new mortgage lending in 2012. This included supporting over 55,000 customers in buying their first home, equivalent to one in every four first time buyers. We also launched a number of innovative shared equity and shared ownership mortgage offers as well as supporting the Local Lend a Hand Scheme which has helped over 900 first time buyers to become homeowners.

Our customers must be the focus of everything we do, and getting customer service right is at the heart of our strategy. The further substantial improvement in our Net Promoter Scores in 2012 shows the progress we have made in rebuilding trust with our customers. We also delivered a substantial reduction in FSA reportable banking complaints, excluding PPI, ending 2012 with one of the best performances of UK banks with just 1.1 complaints per 1,000 accounts. We have now brought forward the 2014 complaint reduction target of 1.0 complaint per 1,000 accounts to 2013.

In 2012, and over the past five years, we have supported many of our customers in their involvement in, and initiatives relating to, London 2012. Through our partnership with the Olympic and Paralympic Games, we supported 1 in 3 of the 2,000 companies that won London 2012 contracts, and played our role in the unprecedented success of the Games for the UK.

Greater clarity emerging on UK regulatory framework

In October the Government published the draft Financial Services Bill, the first step in implementing the recommendations of the Independent Commission on Banking. We support the recommendation to ring-fence retail banking operations, and recent proposals to ensure its implementation, as we believe that it will result in a safer, more stable UK banking sector and economy, and will therefore require lower capital and liquidity requirements than would otherwise be necessary.

We agree with the Financial Policy Committee that banks need to focus on strengthening their balance sheets in order to become increasingly resilient and to support the economy, and this is entirely consistent with the Group's strategy and the progress we continue to deliver. Greater clarification from both the UK regulator and the European Union on rules surrounding capital, funding and liquidity is expected to be received in 2013.

Dividends

We remain committed to recommencing dividend payments when the financial position of the Group and market conditions permit and after regulatory capital requirements are clearly defined and prudently met. Although we made considerable progress in 2012, given regulatory uncertainty and the statutory loss in the year, a dividend payment has not been recommended this year.

EC mandated business disposal (Project Verde)

We continue to make good progress in the creation of Verde as a stand-alone bank which, as contemplated from the start of the process, will allow the Group to divest the business either through a sale or an Initial Public Offering. From the summer 2013, Verde will be operating as a separate business within the Lloyds Banking Group under the TSB brand. We reached an agreement on non-binding Heads of Terms with The Co-operative Group plc in July 2012 and continue to make progress with these discussions towards signing a binding sales purchase agreement. Our aim remains to obtain best value for our shareholders as well as certainty, also for our customers and colleagues, while complying with the EC requirement to divest the business by the end of November 2013.

Addressing legacy issues including payment protection insurance

The Group continues to address legacy issues, and remains committed to resolving them and treating our customers fairly. The Group has had further experience of PPI complaint volumes, uphold rates and operational and redress costs since our third quarter 2012 Interim Management Statement. As a consequence, we have made a further provision of £1,500 million in the fourth quarter, which brings the amount provided for PPI in 2012 to £3,575 million, and the total amount provided to £6,775 million. Total costs incurred to the end of 2012 were £4,344 million, including approximately £700 million of related administration costs.

Given the agreement with the FSA reached on 30 January 2013 following the outcome of a pilot review of IRHP sales to small and medium-sized businesses, the Group now believes it is appropriate to increase its provision for IRHP by £310 million in the fourth quarter, based on the revised estimates of redress and related administration costs. The provision in relation to IRHP redress is now £300 million, and we have also provided for £100 million of related administration costs, all of which was accounted for in 2012.

Our commitment to colleagues

The progress we continue to deliver and our achievements in 2012 are a product of the commitment, drive and performance of our colleagues, and we see a real opportunity to improve engagement across all parts of the Group.

The results of our colleague survey shows strong levels of engagement in some areas, such as using customer feedback to improve processes. However work still remains to ensure that Lloyds Banking Group is a great place to work. The current economic climate, and the constant focus on the financial services sector has undoubtedly affected colleague engagement, but we now have a real opportunity, through visible action, to improve engagement across the Group which in turn will continue to support the delivery of our strategy.

SME lending

We exceeded our 2012 SME Charter lending commitment of £13 billion, while also committing to lend an extra £1 billion to UK manufacturing businesses.

We aim to ensure that all of our colleagues uphold the highest ethical standards and have the right tools to do their jobs, and in part this will be achieved by creating a positive working environment. As part of this, we have continued to develop our internal programmes supporting diversity, enhancing our ability to retain and attract talent across the Group. In September 2012 we launched our Codes of Responsibility which define how we aspire to do business and which provide all our stakeholders – colleagues, customers, communities and suppliers – with clarity and transparency about what we stand for, helping us to rebuild our culture and reinforce our values.

Remuneration continues to be an important topic for the Group and for our stakeholders. We are actively working to ensure continued alignment between performance and reward, and that colleagues are appropriately incentivised, with variable pay reflecting effective risk controls and the best outcome for customers. Bonus awards are subject to deferral and adjustment, and in 2012 total discretionary awards were approximately 3 per cent lower than last year. Salary rewards have been limited, and frozen at more senior levels for the second year running, to reflect the continuing challenging economic environment.

Outlook

After a year of challenging economic conditions in 2012, we expect to see some economic growth in 2013, although this is expected to be below-trend, with the Bank of England base rate remaining at current levels. However, house prices are expected to rise slowly and the FLS should progressively have a further impact on lending. Some stabilisation in the Eurozone, combined with lower borrowing costs, should see investment start to contribute to the improving environment. Future economic developments do, however, remain dependent on progress in the Eurozone, and the impact of new banking regulation on the supply of credit to the economy.

In this context, and with continuing successful delivery against our strategic initiatives, we are targeting core loan growth in the second half of 2013 and an increase in the Group net interest margin to around 1.98 per cent for the full year. We anticipate a further improvement in asset quality, driving an expected substantial reduction in the 2013 impairment charge, with the correspondent increase in underlying profit before tax, while we also expect costs will continue to decrease with Group total costs reduced to around £9.8 billion in 2013. We also remain confident in meeting our medium-term guidance.

We expect to reduce the non-core asset portfolio at least by a further £20 billion in 2013, and we therefore remain on track to achieve a non-core asset portfolio of £70 billion or less by the end of 2014, with more than half of this amount in retail assets.

Conclusion

We have delivered a substantial transformation of Lloyds Banking Group in the first 18 months of delivery on our strategy, despite a challenging environment and the need to address legacy issues. We are now ahead of plan in creating a competitive advantage through a reduced risk premium and best-in-class efficiency. We are making significant investments in our simple, lower-risk, customer-focused UK retail and commercial banking model, thereby continuing to support our customers and helping Britain to prosper. We expect this to enable us to return to profitability and to grow our core business, to realise our full potential to deliver strong, stable and sustainable returns to shareholders, and to allow UK taxpayers' investment in the Group to be repaid.

António Horta-Osório
Group Chief Executive

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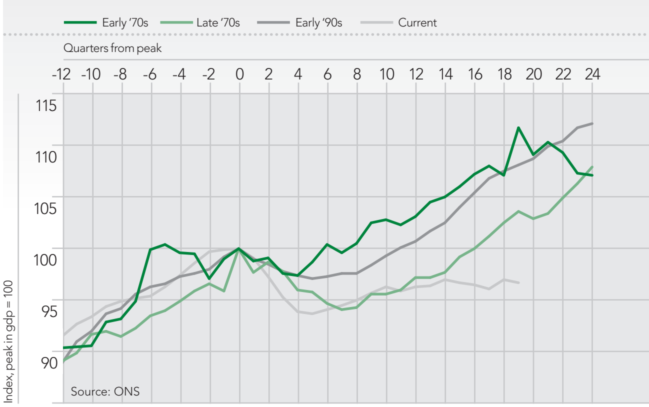
MARKETPLACE TRENDS

The external macro economic and regulatory environment in which we operate remains uncertain. We have outlined below some of the key regulatory, economic and social factors impacting our markets.

The economy

2012 turned out to be a year of two very different halves. The aftermath of the financial crisis continued to influence the global economy during the first half of the year, with worsening conditions in Eurozone sovereign and bank credit markets a particular drag on growth. But an improvement in crisis response in the second half of the year reduced financial market stresses and economic prospects have brightened as a result.

Chart 1: **UK GDP, real terms**



Source: ONS

The weakness of developed economies since the end of the initial financial crisis-driven recession in 2009 is due to the high levels of indebtedness that many countries accumulated prior to 2008. These have been holding back economic growth through deleveraging of, initially, the private sector, but now governments too. Private sector deleveraging now looks largely complete in the US and significant progress has been made in the UK. But some Eurozone countries still appear to have significantly further to go. Across the UK, Eurozone and the US governments also need to rein in borrowing significantly. Thus, with many countries trying to reduce debt all at the same time, there has been no external offset to weak demand at home in each country. The weakness of growth in some Eurozone countries has not been fully anticipated and this has led to slippage against fiscal targets, which in turn has often triggered further cuts in government spending or higher taxes, feeding back to even weaker growth. As the market lost confidence in countries with particularly high government debt or deficit levels through 2011 and the first half of 2012, a further feedback loop developed between rising sovereign bond yields and a deteriorating outlook for government finances, raising the prospect of Eurozone break-up. Naturally this impacted consumer and business confidence, further damaging economic growth through 2012.

The response to the sovereign debt crisis in the Eurozone has improved since the middle of 2012. Decisive support from the European Central Bank to struggling sovereigns, a slightly softer stance on further austerity and agreement on steps towards a banking union have together reversed the trend of spiralling sovereign yields. At the same time banks' funding costs have been reduced and the outlook for their capital positions improved by stronger liquidity and the declining risk of Eurozone break-up, helping to limit the need for more bank recapitalisations which would be a further burden on governments. Some concerns remain over continued pressure for further austerity in weak countries, and over the detail of banking union which at this stage doesn't appear to sever the link between banks and sovereigns. But the sign of increased willingness and ability of Eurozone authorities to deal with crisis development has already raised financial market confidence and is key to the future improvements in consumer and business confidence necessary to secure sustained economic recovery.

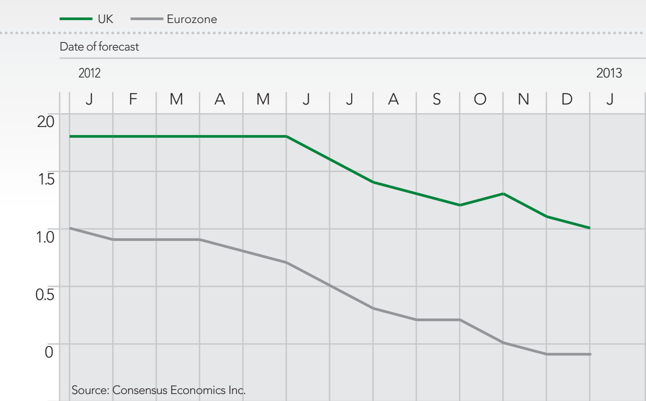
The weakness of the Eurozone was a significant drag on the UK economy in 2012, with net exports down from the previous year. With inflation squeezing consumer spending power, and government spending growing well below its normal rate, the economy was broadly flat through 2012, excluding the volatility caused by the Olympics and an additional Bank holiday for the Queen's Diamond Jubilee. As a result, the path of this UK economic recovery has fallen even further behind that seen in previous recoveries.

Early estimates suggest output of the UK economy grew only marginally by 0.2 per cent in 2012 from 2011. The unemployment rate, however, is estimated to have fallen from 8.4 per cent in the last quarter of 2011 to 7.8 per cent in the three months to December 2012, a direction and scale of change that would normally only be associated with healthy economic growth. Some of the rise in employment is likely to have been a temporary boost from the Olympics but it also appears that productivity has fallen since pre-crisis, boosting growth in companies' unit wage costs and being a likely contributor to inflation remaining higher than expected. Company failures have also continued to decline, down from 4,294 in England and Wales in the final quarter of 2011 to 3,834 by the final quarter of 2012, and the failure rate has improved from 0.8 per cent to 0.7 per cent of companies, close to its pre-recession trough. House prices appear to have turned upwards during the final two months of the year, ending the year 2.3 per cent up on end 2011, but commercial property prices fell on average by 4.2 per cent.

Based on data for the first three quarters of 2012, the Irish economy appears to have grown weakly after having expanded in 2011 for the first time since 2007. The unemployment rate is estimated to have started to fall around mid-year, and at 14.6 per cent at the end of 2012 was lower than 14.8 per cent at the end of 2011. Strict austerity measures in recent years, targeted at improving international competitiveness, are beginning to pay off – falling domestic demand is now being more than offset by increasing net exports. The huge correction in property markets also appears to be nearing completion. CRE prices fell by 6.5 per cent in 2012, the smallest fall since the decline started in 2008 and house prices ended 2012 4.5 per cent lower than at the end of 2011, but with a trend of monthly increases since May.

Future economic developments in the UK and Ireland continue to be highly contingent on (i) how successful political leaders are at maintaining progress against the Eurozone crisis and enacting a tough but gradual fiscal tightening in the US, (ii) the extent to which the UK private sector can offset the effect of a shrinking public sector, and (iii) how the implementation of new regulation on banks impacts their ability to supply credit. With consensus forecasts for 2013 having stabilised in recent months, the most likely outlook for the Eurozone is another broadly flat year (Chart 2).

Chart 2: **Consensus forecasts for 2013 GDP growth %**



Source: Consensus Economics Inc.

MARKETPLACE TRENDS

The current consensus view for 2013 UK GDP growth is better at 1.0 per cent. The low level of imbalances in the economy relative to the 2008 position suggests that recent weakness should not deteriorate into significant recession provided the Eurozone continues to move towards a solution to the sovereign debt crisis. Indeed, the recent abatement of the inflation squeeze on consumers should help growth improve. But with growth expected to pick up only gradually, held back by fiscal tightening and weak export markets, the Bank Rate is expected to stay at current low levels through 2013 and most probably longer, and property prices are expected to be broadly stable. The recent improvement in unemployment is expected to moderate. The recent loss of the UK's AAA rating is not assumed to have a material impact on the outlook since it had been largely expected by financial markets.

The current consensus view for 2013 Irish GDP growth is 0.9 per cent, and the unemployment rate there is expected to improve only very gradually. House prices are expected to continue their recent rise, but the overall pace of increase is likely to be very slow.

However, whilst a definitive agreed and fully-implemented solution to the Eurozone crisis remains lacking, there continues to be some risk that ongoing uncertainty around the Eurozone economic outlook, the survival of the Euro currency and the availability of credit could cause return to a recession in the UK and Ireland, albeit that risk has declined over the past six months. Such a scenario would likely result in higher UK corporate failures, a second leg of falling property prices, albeit by less than during the 2008-9 recession, and rising commercial tenant defaults. Irish property prices would also fall further. In turn, this would have a negative impact on the Group's income, funding costs and impairment charges. The Group has made significant progress in reducing its non-core assets, although our secondary and tertiary commercial real estate portfolios in Business Support and leverage finance portfolios do remain vulnerable.

The impact on our markets

The weak economic recovery has kept growth in our markets subdued. With the economy expected to grow slowly in 2013, our central expectation is that growth in our markets will also remain weak.

For the market as a whole, net new mortgage lending has amounted to just 0.6 per cent of outstanding balances during 2012, very similar to the previous two years. Consumers' use of unsecured credit has begun to improve slightly – consumers made net borrowings of 0.9 per cent of outstanding balances in 2012 after 3 years of making net repayments. Household deposits rose by 5.7 per cent in 2012, however, well above the 2-3 per cent growth rates of the previous 3 years, although still a third below the pre-crisis rate.

Companies have continued to hold back investment spending and prioritise cashflow, feeding both into lower borrowing and higher deposits. Non-financial companies made net repayments of 2.6 per cent of sterling lending from banks and building societies in 2012, after repayments of 2.9 per cent in 2011, 3.5 per cent in 2010 and 2.4 per cent in 2009. These aggregates reflect a significant amount of refinancing in capital markets by large companies. Company deposits with UK banks rose by 4.9 per cent in 2012, the greatest rate of increase for 5 years.

Our central expectation of a year of only gradual recovery for the UK economy in 2013, is likely to be accompanied by a slight fallback in customer deposit growth with demand for borrowing improving but only slowly.

Regulation

Greater clarity is now emerging over the shape of the regulatory landscape but significant uncertainty remains and a number of key regulatory changes will impact our markets:

Financial Services (Banking Reform) Bill

On 12 October 2012 the Government published the draft Financial Services (Banking Reform) Bill to implement the recommendations of the Independent Commission on Banking. The draft Bill would require banks to ring-fence some retail and SME activities from investment banking activities, conform to additional capital requirements beyond those required by Basel III and implement a 7-day current account switching service. Importantly for the Group, given we are primarily a UK-focused retail and commercial bank, the vast majority of our operations are likely to be within the ring-fence.

The Bill is being scrutinised by the Commission on Banking Standards prior to its introduction into Parliament. The Commission released an interim report in December 2012 that called for the Bill to be amended to give the regulator powers to force a bank to implement full separation if there is thought to be 'significant risk' to the ring-fence. The Commission will continue to take evidence on the Bill throughout the first quarter of 2013 on questions that remain open such as which services banks can place within the ring-fence. It is expected to produce its final report in the second quarter of 2013. Uncertainty therefore remains over what the Commission will ultimately recommend and whether the Government will accept the amendments that it proposes.

Capital Requirements Directive IV (CRD IV)

In November 2010 the G20 endorsed the recommendations of the Basel Committee for Banking Supervision to strengthen global capital and liquidity rules. The recommendations are being implemented in the EU through CRD IV. The new rules will strengthen capital and liquidity standards, change the definition of capital, introduce new definitions for the calculation of counterparty credit risk and leverage ratios, introduce additional capital buffers and develop a global liquidity standard. Negotiations on the final text for CRD IV continue in Europe. An implementation date has not yet been confirmed, although current consensus is that it will be 1 January 2014 at the earliest.

Once CRD IV is fully implemented it will make banks more resilient in the face of financial and economic shocks.

Recovery & Resolution Mechanisms

The European Commission published the Recovery & Resolution Directive on 6 June 2012. It requires all firms to develop a recovery plan, proposes new early intervention powers for supervisors and introduces new powers for regulators at resolution stage. This was in line with the recommendations of the Financial Stability Board. The UK has pre-empted the European legislative process, with firms already required to prepare recovery plans.

It is not yet clear how the new resolution powers such as 'bail-in' will work in practice. Further uncertainty surrounds how the Recovery & Resolution Directive interacts with other European legislative proposals such as the Deposit Guarantee Scheme and the work on Banking Union.

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UK Supervisory Structure

The Financial Services Bill that will reform the UK financial supervisory system received Royal Assent on 19 December 2012. The legislation will formalise the responsibilities of the Financial Policy Committee for 'macro-prudential regulation' and replace the FSA with the Prudential Regulation Authority and the Financial Conduct Authority. The new institutions will assume their regulatory responsibilities on 1 April 2013.

We are supportive of the new 'twin peaks' model of regulation and believe it will help enhance stability in the sector.

Other regulatory reforms

The amount of regulatory change continues to rise. Other examples that could have significant impact on the Group include changes to accounting standards, the Dodd-Frank Act, EU Market Infrastructure Regulation, FATCA, the Markets in Financial Instruments Directive Review, the OFT Personal Current Account Market Review and Solvency II.

Customer drivers, including competition

- Want simplicity and transparency
- Demand a quality, multi-channel customer service experience
- Increasingly demand better value for their money

In the competitive open markets in which we operate, customers benefit from an increasing range of products and services from a growing choice of providers. The expectations and demands of customers continue to rise.

Access to convenient branches remains important for many customers, but demand for a quality multi-channel banking proposition is now more prevalent. More customers expect to be able to manage their finances whenever and wherever is most convenient for them, whether by telephone, online, or using smartphones. Service remains one of the key drivers of customer satisfaction and customers are less accepting of poor service given the competitive nature of the market.

In the current low interest rate environment, many customers are motivated by their desire to achieve better value for money, but security and reputation remain important factors. Customers want clear and transparent products delivered with good service and access to helpful, relevant, expert advice when they need it. Product innovation is also important for some, whereas long-standing relationships remain important for others.

There are some clear customer trends emerging, but we recognize that every customer, whether an individual or an organisation, has particular needs and must be treated accordingly. Every customer has a choice and will select the provider that can most effectively service their personal needs.

The Verde business will have the capability to be a strong and effective challenger in what is already a highly competitive sector. We are seeing a number of new or expanding players including Virgin Money and Metro Bank looking to make inroads into the sector and an enhanced industry-wide switching service will be launched in September 2013, giving customers increased confidence to change provider when dissatisfied or offered a better deal elsewhere.

Technological developments are already reshaping the banking industry and we expect this change to accelerate exponentially in the coming years. We anticipate influx of new entrants, with business models that do not rely on expensive branch networks, offering innovative digital banking services. These new entrants are likely to have expertise and experience in digital product offerings, with strong funding positions, credible brands, and pre-existing customer bases.

Alongside these market developments the regulatory environment will also change this year, with new bodies for prudential and conduct regulation. The new conduct regulator, the Financial Conduct Authority, will have a competition duty giving it a strong and explicit mandate to tackle competition issues, such as hurdles to switching or barriers to entry, swiftly and effectively.

Our strategy, as outlined on the next few pages, reflects the market conditions and the changing needs of customers. Above all it recognises that we operate in a competitive market where additional challengers continue to emerge and the only way of ensuring success is by focusing on the ever-changing needs of our customers.

Marketplace trends

Key opportunities

- **Economic environment:** Significant progress in reducing the Group's risk profile and strengthening the balance sheet in recent years along with strategic actions taken in the last couple of years means we are better positioned to benefit as the economy recovers.
- **Customer requirements:** Our strategic assets, including a comprehensive multi-channel distribution network, strong customer relationships, well recognised brands and high quality people mean we are well positioned to address the customer trends.
- Regulatory environment: Greater clarity emerging on regulatory requirements.

Key challenges

- **Economic environment:** a weak, outlook for the UK economy, along with continuing economic uncertainty in the Eurozone .
- **Regulatory environment:** Uncertainty remains over key elements of the Independent Commission on Banking reforms, particularly recovery and resolution mechanisms and retail ring fencing, and future capital and liquidity requirements arising from CRD IV remain unclear.
- **Competition:** Increasingly competitive market for lending and deposits creates margin pressure.

BUSINESS MODEL AND STRATEGY

UNLOCKING THE GROUP'S POTENTIAL

Customers are at the heart of the organisation and by leveraging our strategic assets and capabilities effectively in all of our divisions we believe we can help Britain prosper and deliver strong, stable and sustainable returns for shareholders.

Our business model

Lloyds Banking Group is a leading financial services group with a simple, lower risk, customer focused, UK retail and commercial banking business model.

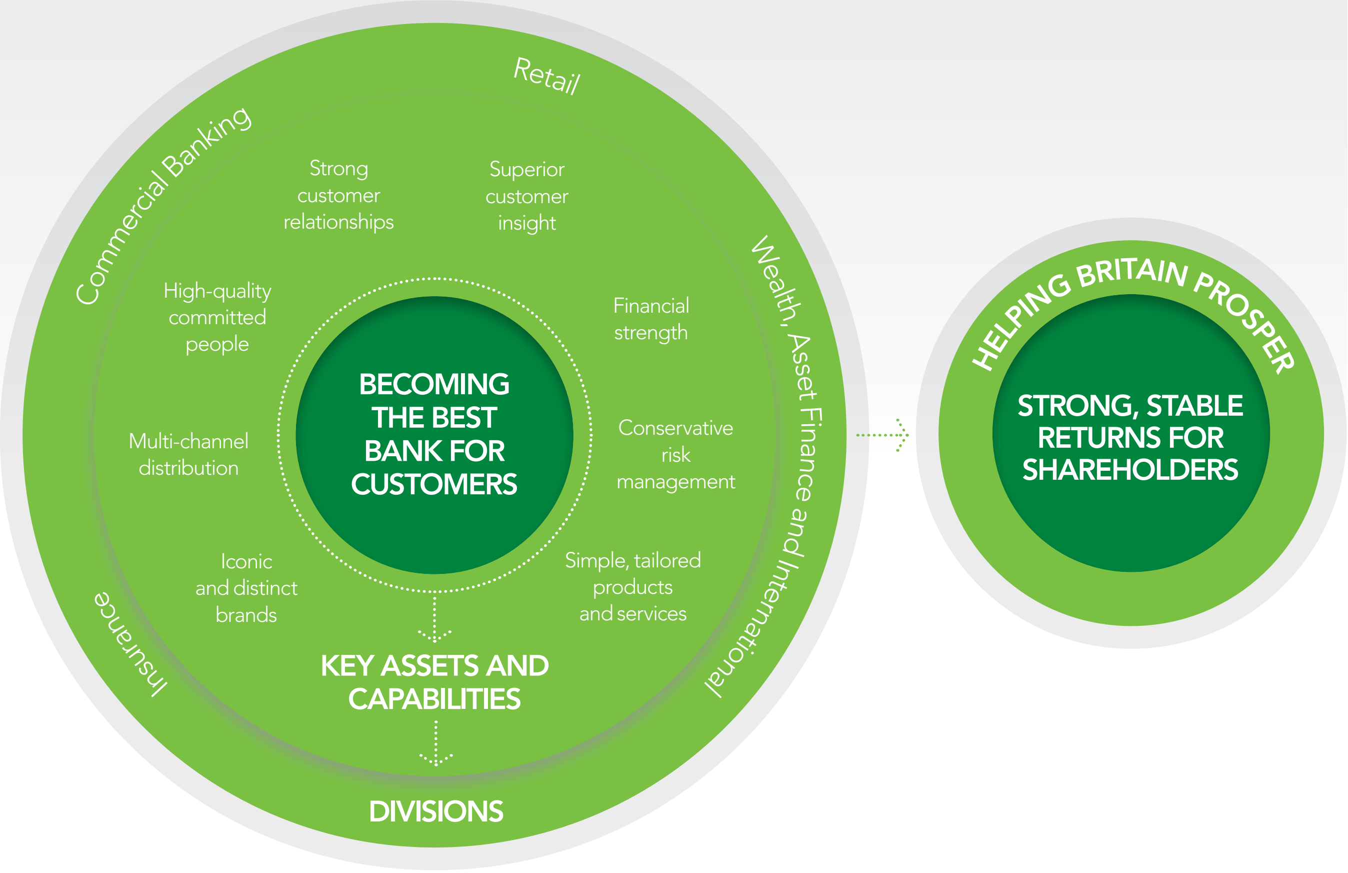
We provide a range of banking and financial services, primarily in the UK, to personal, commercial and corporate customers and have designed our business model around our distinctive assets and capabilities in serving customers effectively. By really focusing on the needs of customers, and operating sustainably and responsibly, we believe we will help Britain prosper and create value for shareholders.

Our iconic and distinct brands, our broad multi channel distribution network, our financial strength, conservative approach to risk management and our high quality, committed colleagues are the foundation for providing customers with effective service. Through distinctive strengths, in particular superior customer insight, simpler tailored products and relationship focus we want to meet the financial needs of our customers, whether that be through banking, insurance, investment, debt financing or risk management products, and help them succeed financially.

We also deliver value through a focus on increasing the efficiency of operations and processes across the value chain, simplifying the organisation and reducing costs. Creating a lower risk, more agile, efficient organisation enables us to more effectively address customer needs whilst reducing the cost base.

The UK financial services market remains one of the largest in the world and although our business model and strategy have been formulated in the context of a cautious outlook for the UK economy it remains appropriate for all stages of the economic cycle. Whilst providing real differentiation and positioning us well for future regulatory reform.

Ultimately as a simple, lower risk, customer focused UK retail and commercial bank, we can rebuild the trust of our customers and other stakeholders, help Britain prosper and deliver strong, stable and sustainable returns for shareholders.


Retail
Commercial Banking
Wealth, Asset Finance and International
Insurance
Strong customer relationships
Superior customer insight
High-quality committed people
Financial strength
Multi-channel distribution
Conservative risk management
Iconic and distinct brands
Simple, tailored products and services
BECOMING THE BEST BANK FOR CUSTOMERS
KEY ASSETS AND CAPABILITIES
DIVISIONS
HELPING BRITAIN PROSPER
STRONG, STABLE RETURNS FOR SHAREHOLDERS

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Our strategy

The Group's strategy is built on being the best bank for customers, and creating value by investing where we can make a real difference for them. Customer leadership driven by superior customer insight, simple tailored products, better service and relationship focus is the overriding priority. The customer is at the heart of everything we do, whether that be in our branches, our brands or our people. This commitment is supported by the Group values of putting customers first, keeping it simple and making a difference together.

We are creating a simpler, more agile, efficient and responsive customer focused organisation with a real focus on operating sustainably and responsibly and helping Britain prosper. We are reshaping and simplifying the business and investing a portion of the savings realised from our Simplification programme in customer related growth initiatives. Whilst focusing on core markets which offer strong returns and attractive growth we are maintaining a prudent approach to risk and further strengthening the Group's balance sheet and liquidity position.

We are reshaping our business portfolio to fit our assets, capabilities and risk appetite. We are strengthening the balance sheet through the continued reduction of our non-core assets and reducing the risk in the business through the application of a conservative approach to, and prudent appetite for risk. We are also reducing our international presence in order to focus on our core UK customers.

We believe we can unlock the potential in our franchise and deliver value to customers and shareholders by creating a simpler organisation. Opportunities exist to increase the efficiency of operations and processes and reduce costs whilst addressing changing customer needs and the external environment more effectively.

Our customer focus remains the key driver for strategy and business decision making and substantial customer related investment is planned. Our strategy reflects our customers' needs for product simplicity and transparency, access to credit, demands for access through multiple channels, value for money products and services and the importance of our staff in managing customer relationships.

Our strategy is being delivered though a clear action plan focused on reshaping our business portfolio to fit our assets capabilities and risk appetite, strengthening the Group's balance sheet and liquidity position, simplifying the Group to improve agility and efficiency and investing to be the best bank for customers. Our progress against this plan and the key priorities for 2013, is described on the next few pages.

Our action plan for success

The four key elements of our action plan to deliver our strategy are outlined in more detail on the next few pages:

RESHAPE
our business portfolio to fit our assets, capabilities and risk appetite.

STRENGTHEN
the Group's balance sheet and liquidity position.

SIMPLIFY
the Group to improve agility and efficiency.

INVEST
to be the best bank for customers.

DELIVERING OUR ACTION PLAN

RESHAPE

our business portfolio to fit our assets, capabilities and risk appetite.

Aim

We continue to focus on attractive UK customer segments and their product needs to target a sustainable statutory return on equity of between 12.5 and 14.5 per cent. We will invest behind core areas which offer strong returns and attractive growth: these are businesses which are capital and liquidity efficient, with sustainable competitive advantage, and which are central to our core customer strategy. In reshaping our business, our focus will be on reducing non-core assets, improving our asset quality and reducing our international presence.

Priorities for 2013

- Continue to reduce our non-core assets in a capital accretive manner
- Continue to improve our asset quality ratio
- Continue to reduce our international presence

Key initiatives and progress in 2012

We continued to make significant progress in reshaping our business to become a simpler, customer focused organisation supported by better quality assets.

Continued reduction in non-core assets

In 2012 we delivered a further substantial reduction in non-core assets of £42 billion exceeding initial 2012 guidance by £17 billion. The amount of non-core assets now stands at £98 billion with nearly 90 per cent of our original target for non-core reduction already achieved. As a result we have now increased the target and are looking to reduce non-core assets to less than £70 billion by the end of 2014.

We have continued to take a disciplined approach to the management and reduction of our non-core assets and the 2012 reductions have been capital accretive.

A prudent appetite for risk

Across the business we have embedded a conservative approach to, and prudent appetite for, risk, and have in place disciplined controls over the risk profile of all new business. We are comfortable that our existing portfolios are adequately provisioned.

The continued reduction of non-core assets and the prudent management of risk should result in an improvement in the Group's asset quality ratio to 50-60 basis points by the end of 2014, with the core business expected to be at the bottom end of this range. In 2012 we have made excellent progress, with our asset quality ratio dropping from 162 to 107 basis points.

Reshaping our international presence

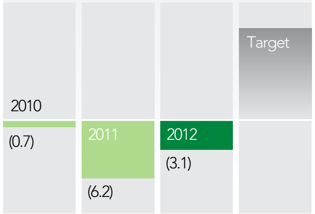
The strategic reshaping of our international footprint supports our ambition to help Britain prosper, as we focus on countries where we can service customers in the UK and with ties to the UK.

We are streamlining our international presence from around 30 countries to less than half that number by 2014 and have already made good progress having completed or announced our exit from 12 countries to date.

Performance against our targets

Return on equity

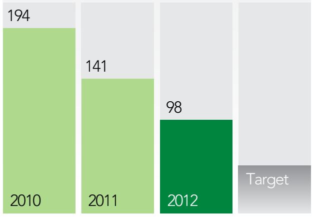
Target
12.5-14.5%



As a result of the repositioning we continue to believe the strategy will deliver a statutory return on equity of between 12.5 and 14.5 per cent.

Non-core assets

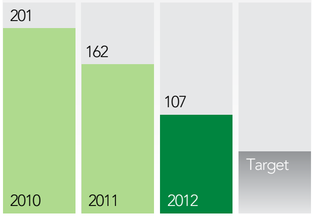
2014 target
<£70bn



Excellent progress continues to be made in reshaping the business through the reduction of our non-core assets which now stand at £98 billion.

Asset quality ratio

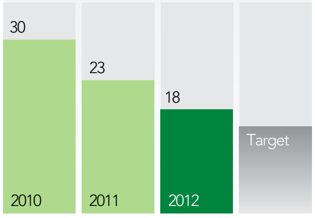
2014 target
50-60 basis points



Asset quality ratio continues to improve towards our 50-60 basis points target.

International presence

2014 target
<15 countries



We will further streamline our international presence and expect to exit or announce exit from at least 15 countries by 2014.

STRENGTHEN

the Group's balance sheet and liquidity position.

Aim

We continue to strengthen the Group's balance sheet ensuring the financial strength and security of the Group. We are enhancing our capital ratios and ensuring we exceed regulatory liquidity requirements, whilst maintaining a stable funding base and ensuring loan to deposit ratios remain close to our long term target.

Priorities for 2013

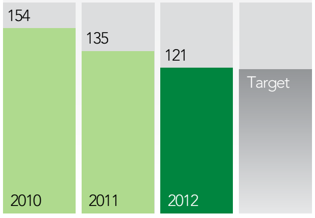
- Continue to build on our strong capital position with further improvements to our capital ratios
- Maintaining the Group's core loan to deposit ratio close to our long term target of 100 per cent
- Continued reduction in wholesale funding requirements

Performance against our targets

Loan to deposit ratio

2014 target

120%

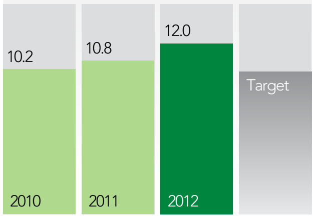


We have made good progress in reducing our loan to deposit ratio and though we initially targeted a loan to deposit ratio of less than 130 per cent by the end of 2014, we are now targeting 120 per cent.

Core tier 1 ratio

2013 target

>10%



We have continued to improve our core tier 1 ratio, which now stands at 12.0 per cent on a Basel II basis. We continue to target a core tier 1 ratio prudently in excess of 10 per cent on a transitional basis.

Key initiatives and progress in 2012

We continued to make good progress in strengthening the Group's balance sheet in 2012. In addition to further improving our core tier 1 capital ratio, we have further improved our funding profile and position. We have been continuing to ensure we maintain strong liquidity, funding and capital positions and an appropriate loan to deposit ratio.

Strong capital position

In 2012 our core tier 1 capital ratio increased to 12.0 per cent providing us with a strong capital position prudently in excess of our 10 per cent target and substantially above that currently required by regulation. On an estimated fully loaded CRD IV basis our core tier 1 capital ratio was 8.1 per cent.

The Group continues to deliver on its strategy to strengthen the balance sheet and given our strongly capital generative core business and the ongoing capital accretive non-core asset reduction, we remain confident in the capital position.

Continue to exceed regulatory liquidity requirements

The Group continues to maintain a strong liquidity position. Our primary liquid asset portfolio at the year end was £88 billion, which represents approximately three times our money market funding and approximately one and half times our aggregate wholesale funding with a maturity of less than a year, thus providing a substantial buffer in the event of market dislocation. In addition the Group has secondary liquidity holdings of more than £117 billion.

We expect to meet the requirements for our Liquidity Coverage Ratio and our Net Stable Funding Ratio to be in advance of regulatory time table which has yet to be confirmed.

Maintaining a stable funding base

The Group has completed the transformation of its funding profile, with customer deposit growth and non-core reduction driving a reduction in our wholesale funding requirement to £170 billion, a 32 per cent reduction in the year. At the same time the maturity profile of our wholesale funding further improved with only 30 per cent of total wholesale funding now having a maturity of less than one year.

In the last quarter of 2012 we also repaid the remaining liquidity support received from the UK Government.

Improved Group's loan to deposit ratios

With a substantial reduction in our non-core assets, and further growth in our relationship customer deposits, we have already achieved our initial Group loan to deposit ratio target of 130 per cent or below, reaching 121 per cent in 2012, two years ahead of our original target. Our core loan to deposit ratio of 101 per cent is already in line with our long term target of 100 per cent.

DELIVERING OUR ACTION PLAN

SIMPLIFY

the Group to improve agility and efficiency.

Aim

Our Simplification programme continues to focus on creating a more efficient, agile organisation, reducing costs in the business whilst improving the customer and colleague experience. As announced last year, we are now targeting £1.9 billion of run rate cost savings by the end of 2014 through a series of Simplification initiatives. Savings will be realised by focusing on: operations and processes, channels and products, sourcing and creating a more agile organisation.

Priorities for 2013

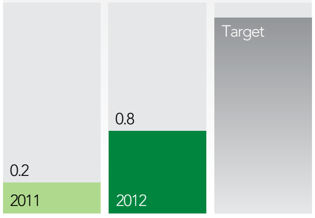
- Maintained focus on sourcing and further reducing the number of supplier relationships
- Further improving and streamlining our key operations and processes
- Increased utilisation and development of digital distribution channels

Performance against our targets

Cost savings (Simplification run rate savings)

2014 target

£1.9bn

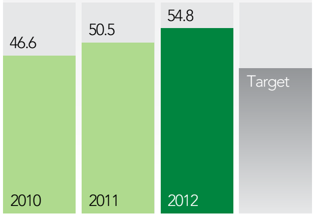


We are targeting £1.9 billion of run rate cost savings by the end of 2014 through a series of Simplification initiatives and are well on track having already delivered £0.8 billion of run rate cost savings by the end of 2012.

Cost:income ratio

Target

42-44%



Although the cost:income ratio increased again in 2012 we continue to believe the cost savings we are already delivering and investment initiatives will deliver a cost:income ratio of 42-44 per cent over time.

Key initiatives and progress in 2012

The Simplification programme is central to the successful delivery of our strategy and we continue to make significant progress in driving further cost savings and efficiencies throughout the business whilst improving the customer experience. The success of this approach is evidenced by our achievement of run rate cost savings of £847 million at the end of 2012, which gives us confidence in reaching our run rate cost savings target of £1.9 billion by the end of 2014.

The benefits of the Simplification programme extend far beyond cost reductions. Customers and staff are already benefiting from faster, more automated and less complex processes, for example: in Commercial Banking we improved the lending process allowing businesses to receive their funds in half the time; while mobile and voice recognition technologies combined with simpler, faster processes in Retail; and a quicker claims process in Insurance are further examples of how our actions are contributing to increased customer advocacy.

The Group continues to be in a strong position to deliver further Simplification initiatives and, given previous Integration and Simplification experience, we are confident our £1.9 billion target can be completed as planned.

The main initiatives now being progressed are:

Operations and processes

We continue to make significant progress re-engineering our end to end processes. We have implemented process automation across the business including ISA and account transfers, account closures, and mortgage surveyor and valuation services. We are also materially reducing the number of IT applications and modernising our IT infrastructure estate. This will improve the customer experience, increase productivity and reduce risk, errors, complexity and costs.

Channels and products

We continue to streamline our product suite and migrate products to digital distribution channels, encompassing the internet, mobile applications and telephony. In 2012 we have seen continued growth of our internet and mobile channels. We intend to create a highly efficient distribution platform whilst providing customers with greater choice and convenience.

Sourcing

We continue to optimise our demand management and are further strengthening our supplier relationships. By reducing the number of suppliers to the Group to under 10,000, and further focusing on a core group of lead suppliers, we will achieve approximately a 15 per cent saving in addressable spend. In 2012 we made progress towards this goal by reducing supplier numbers by 4,700 to around 10,500 and have further concentrated our expenditure within our top tier of suppliers.

More agile organisation

We have already made good progress in creating a more agile organisation through delayering our management structure and centralising control functions. Our focus will continue to be on reduction in middle management, bringing our top team closer to the customers and front-line staff.

INVEST

to be the best bank
for customers.

Aim

We intend to invest approximately £500 million annually by 2014, equivalent to approximately one-third of the savings from our Simplification initiatives, to grow our core income. This will result in an incremental investment of approximately £2 billion between 2011 and 2014. Our investment is subject to disciplined tests, including financial returns, fit to our risk appetite and alignment with our strategy to be the best bank for customers. The investment will primarily be focused on becoming the best bank for personal customers, becoming the best partner for our business customers and enhancing our insurance proposition.

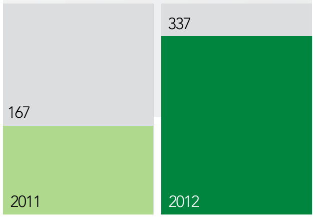
Priorities for 2013

- Further investment across our branch network including revitalisation of the Lloyds Bank brand
- Continued support of the SME sector and commercial banking customers
- Targeted investment transforming our Wealth offering and improving our insurance proposition

Performance against our targets

Investment

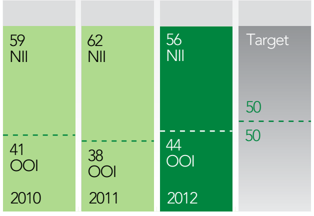
2014 Target
c.£500m per annum



As Simplification benefits materialise we are looking to increase the investment in the business and have committed to invest £500 million per annum by 2014.

NII:OOI split

Target
50:50



We expect other operating income (net of insurance claims) to increase to approximately 50 per cent of total income built on deepening customer relationships and our focus on less capital intensive products.

Key initiatives and progress in 2012

Much of the additional investment we intend to make in the business will be delivered from the cost savings delivered from our Simplification initiatives and we were able to invest an additional £337 million in 2012 due to the Simplification savings already made. This investment in the core franchise is allowing us to provide greater levels of service and support to customers.

Investing to be the best bank for personal customers

In 2012 Retail made a real investment in customer initiatives, in particular our product proposition and distribution channels. We refurbished 421 branches and extended our opening hours which have had a significant effect on the service provided, as demonstrated through substantial increases in our Net Promoter Scores.

We have also continued to revitalise the Halifax brand to be a challenger to the UK's retail banks focusing on delivering a simple, efficient and fair customer experience, alongside innovative products and services such as our Savers Prize Draw and switching incentives.

Significant investment has also been made in our digital proposition including the expansion of services available on smart phones. These have supported continued growth in active internet customers of 1.2 million in 2012 to 9.5 million whilst our mobile banking apps now have 3.3 million users representing substantial growth since their launch in October 2011. We also reached a significant milestone of over one billion customer logons during the year.

Invest to be the best partner for our business customers

As part of being the best bank for customers we announced the creation of our Commercial Banking division which brings together the Group's UK corporate and SME focused businesses into one division. The changes will allow us to transfer best practices from SMEs into mid-sized corporates and to deliver operational synergies between the different segments in order to become the best bank for our corporate and SME clients.

Across Commercial Banking, as part of our programme to enhance our capabilities in capital efficient products, we have continued to invest in the Transaction Banking platform delivering product enhancements in Card Payments & Acceptance, Currencies and International Cash Management. We also continued to invest in enhancing our online capabilities, with the number of customers using our foreign exchange and money market e-portal 'Arena' tripling in 2012. We also launched a number of specialised products, including a deposit account tailored to the needs of businesses in the agricultural sector.

Investing in the insurance proposition

Significant progress has been made in repositioning insurance as a core part of our proposition. We combined our UK Life Pensions and Investments and General Insurance businesses in 2012, helping us optimise the opportunities arising from the industry wide regulatory changes.

The Life and Pensions business is being transformed and during the year, we continued to invest in our core systems, products and processes in advance of RDR and the launch of pension auto-enrolment, to enable us to support both retail and commercial customers through this period of change. We have taken the first steps towards launching an enhanced annuities proposition, with full implementation into this growing market expected in mid-2013.

In general insurance we have further enhanced our processes including our claims management process helping improve customer satisfaction and contain claims costs.

RELATIONSHIPS AND RESPONSIBILITY

BUILDING VALUABLE RELATIONSHIPS

THE SUCCESSFUL DELIVERY OF OUR STRATEGY AND FOCUS ON HELPING BRITAIN PROSPER WILL BE DRIVEN BY THE RELATIONSHIPS WE DEVELOP

With over 30 million personal and business customers and a presence in communities across the country, we are very well placed to help unlock the potential of families, businesses and communities we serve, and make a significant contribution to the future strength and prosperity of the UK. Being the best bank for customers, alongside a focus on operating sustainably and responsibly, underpins our approach to business.

In order to meet our ambitions to be the best bank for customers and to help Britain prosper we need strong relationships with our customers as well as our colleagues and communities. This section of our report explains why and how we nurture these relationships.

At Lloyds Banking Group, we see ourselves as having a clear role to play in helping Britain prosper. As the UK's largest retail and commercial bank, we are already doing more than our peers to help people manage their finances.

Lloyds Banking Group brands offer essential services to our customers – helping people to buy their first homes, offering SMEs support, and using our people's skills to give UK communities access to appropriate financial products. But with faith in the sector at a low level, we recognise the need to rebuild trust with our customers.

Rebuilding trust

Recent external research undertaken by Ipsos MORI[1] on behalf of Lloyds Banking Group showed that, through the eyes of our customers and potential customers, relationships and responsibility are inseparable.

When it comes to responsible banking, our customers don't just think of the areas covered by a traditional 'corporate responsibility' programme. For them, taking responsibility more seriously means being a bank that:

- is offering better service
- looks after the financial interests of customers
- responds to customer needs, e.g. offering longer opening hours in branches, enhancing access through a range of channels including the internet
- provides clear communication
- has policies in place on environmental protection
- has policies in place on human rights and ethics
- invests in communities

Alongside these findings, Ipsos MORI's Issues Index shows that the state of the UK economy remained the primary concern of the British public throughout 2012.

Operating responsibly whist improving customer service and helping Britain prosper are fundamental components of our group strategy. We can only achieve our customer focused strategy by building a sound reputation founded on the highest standards of corporate behaviour.

Relationships and responsibility

The Group considers the three stakeholder groups of Customers, Colleagues and Communities as key – crucially recognising their interdependence as we realise our vision of being the best bank for customers.

Meeting customers needs by developing appropriate products can only be achieved through the commitment and applied skills of our colleagues. Equally, we recognise the role our people play in helping communities to thrive through the services and advice we give to UK business, and through the programmes that promote financial capability and inclusion.

[1] The full research findings for the Ipsos MORI research are available at www.ipsos-mori.com

Corporate Responsibility

Ensuring the business is run sustainably and responsibly is a priority for the Group. Our responsible business strategy, focused around working with households, businesses and communities, is aligned to our overall business strategy and our aim to help Britain prosper.

Our approach to Corporate Responsibility, along with current priorities is developed by our Responsible Business Steering Group (RBSG), which reports directly to the Group Board. The RBSG develops principles and priorities from a top-level perspective and ensures they are embedded throughout our operations. The RBSG is chaired by Anita Frew, Non-executive Director of Lloyds Banking Group, and includes senior representation from across Lloyds Banking Group.

The RBSG also guides and focuses the areas that are most material to our business. The top priorities at present are: customer care; supporting financial inclusion; and helping UK business and households. The Steering Group will continue to review areas of focus in 2013, with a particular view to integrating stakeholder interests on material issues.

In addition to this internal committee we have also established a high-level experts group, an external stakeholder panel and have created a colleague focus group to ensure the views of our stakeholders are considered and effectively addressed in our reporting and communications.

To ensure the highest standards of corporate behaviour in 2012 we launched the new Codes of Responsibility to guide our decision making. These Codes, governed by the RBSG, specifically outline the way we aspire to do business as individuals and as a corporation, and are based on five pillars of responsible business which include customers, colleagues and communities.

Lloyds Banking Group has retained our position in the FTSE4Good socially responsible investment index and our overall scores remained broadly stable in the Dow Jones Sustainability Index. In addition we maintained our position in the Carbon Disclosure Project and retained Platinum status in the Business in the Community CR Index. We are looking to build a leadership position in responsible business and developing a roadmap which will help us improve our performance and related rankings going forward.

We aspire to conduct business in a way that values and respects the human rights of our colleagues, customers and those of the communities in which we operate. We adhere to the principles of the United Nations Declaration of Human Rights, International Labour Organisation Fundamental Conventions and are signatories to the Equator Principles (see page 167). Our Codes of Responsibility set standards of ethical behaviour for our colleagues. We also take into account social, ethical and environmental issues in our investment, lending and service operations.

The day-to-day implementation of our responsible business strategy is managed by the Group Community & Sustainable Business team. During 2012 we continued to develop our Community Strategy around the themes of Education, Employability and Enterprise. More detail on our approach to corporate responsibility and future plans will be described in our 2012 Responsible Business report which will be published in May 2013. Our 2011 report along with further information on our approach to corporate responsibility and our codes of responsibility can be found on our website at www.lloydsbankinggroup-cr.com.

In line with the Group's values of putting customers first, keeping it simple, and making a difference together we are looking to build a strong and profitable Group, with a culture which reinforces stringent behavioural standards and ensures we are operating sustainably and responsibly, both inside and outside of the organisation.

CUSTOMERS
30 →

COLLEAGUES
34 →

COMMUNITIES
38 →

RELATIONSHIPS AND RESPONSIBILITY

BE THE BEST FOR OUR CUSTOMERS…

SMEs and fast growing enterprises play a vital role in creating jobs and generating growth in the UK. We demonstrated our support for SME customers with gross lending of £13.2 billion in 2012, delivering year on year net lending growth of 4 per cent in this business area. This was in contrast to a decline in the stock of lending of 4 per cent across the industry.

CUSTOMERS

Only by focusing on customers' needs and addressing those needs can we expect to deliver benefit to our stakeholders.

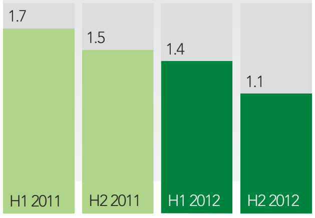
Aim

Our aim is to be the best bank for customers. Becoming the best bank for customers means being the best bank for families, for businesses and for our communities. We will achieve this by focusing on:

- UK customers and those connected to the UK
- Simplifying processes, policies and systems
- Investment in growth initiatives
- An appropriate risk appetite
- Ensuring the business has the strength in funding and capital to meet the most challenging of headwinds.

Performance in 2012

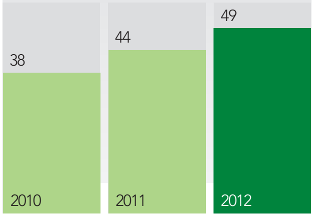
Customer complaints (FSA banking complaints* per 1,000 a/c)



Through our Simplification programme and continued focus on becoming the best bank for customers, our FSA reportable banking complaints continued to fall.

*Excluding PPI

Customer satisfaction (Net Promoter Score)



We have developed a comprehensive customer experience programme measuring customer service at key touch points and their likelihood to recommend us. This is measured through the cross industry Net Promoter Score metric where we have seen continued progress.

Priorities for 2013

- Continue to simplify systems, processes and products by making it easier and more convenient for customers to do business with us, thereby improving the overall experience
- Continue to improve our complaint handling performance reducing FSA reportable banking complaints per 1,000 accounts to 1.0 by the end of 2013
- Maximise the use of our customer relationships and insight to enable us to engage more effectively with our customers and become more responsive to customer needs. This will enable us to deliver against their expectations at key customer touch points to improve our customers' current and future experience

Customer focus

The Group's strategy is built on being the best bank for customers, and creating value by investing where we can make a real difference for customers. The customer is at the heart of everything we do, whether that be in our branches, our brands or our people. This commitment is supported by the Group values of putting customers first, keeping it simple and making a difference together.

During 2012 we underlined our commitment to SME and Mid Markets lending by successfully participating in both the National Loans Guarantee Scheme (NLGS), and the government's Funding for Lending (FLS) initiative. We issued our full funding allocation of £1.4 billion under NLGS, as well as becoming the first bank to participate in the Funding for Lending scheme and have committed in excess of £11 billion in gross funds to customers through the scheme since its launch in September.

We have continued to support our SME and Mid Market customers throughout the economic cycle in order to ensure their financial health, viability and growth. In cases where businesses have experienced financial difficulties, our Business Support Unit (BSU) is specifically tasked with providing help. Since 2009 the BSU has restructured facilities for around 10,000 businesses and has protected more than 250,000 UK jobs.

As further evidence of the long-term assistance that we offer to enterprise, at the start of 2010 we launched our SME Charter. Within this we pledged to support 300,000 new businesses set up by the end of 2012. We are delighted to say that this target was exceeded with 350,000 such businesses being helped across the three year period.

We are committed to supporting the UK housing market and first time buyers in particular, writing 1 in 4 of all first time buyer mortgage loans completed in the UK. We advanced more than £6 billion of new lending to first time buyers in 2012, helping over 55,000 customers own their own homes. We have committed publicly to lending £6.5 billion to 60,000 first time buyers in 2013, an increase of 30 per cent on our £5.0 billion commitment in 2012, and the UK's biggest-ever commitment to support first time buyers. Our gross new residential mortgage lending totalled £26.2 billion in the UK in 2012 across all customer segments.

London 2012

This year saw the culmination of our partnership with the London 2012 Olympic and Paralympic Games, following five years of activity aimed at bringing the Games closer to customers, communities and colleagues across the UK. Some of the highlights of the community benefits include; £1 billion of lending to help businesses benefit from London 2012 opportunities, 1,000 local heroes supported in communities across the UK, 24,000 schools taking part in National School Sport Week, inspiring over 9 million children to try sporting activities, 1,497 Olympic and Paralympic torchbearers selected by Lloyds Banking Group, and 3,000 customers were taken to the Games. The Games were just the beginning, highlighting and reinforcing the positive impact we can have on our communities. This is why we are delighted to be building on the legacy of the Games by developing both National School Sport Week and Local Heroes. These two programmes underpinned our partnership and had significant impact, opening doors to millions of children and communities up and down the country, encouraging them to play more sport.

RELATIONSHIPS AND RESPONSIBILITY

Complaint handling

As part of our strategy to become the best bank for customers we publicly committed to reduce the level of FSA reportable banking complaints, excluding PPI, we receive by 20 per cent year on year. We achieved a reduction from 1.5 complaints per 1,000 accounts in the second half of 2011, to 1.1 in the second half of 2012. We aim to reduce this further in 2013 to 1.0 complaint per 1,000 accounts. The progress to date has been accomplished through the ongoing success of our phone-a-friend service, a dedicated team which branch and call centre staff can refer to for specialist support with complaint handling, and the training we provide to our c. 40,000 front line colleagues. We are the first financial services organisation to roll out an externally accredited complaint handling qualification to all our complaint handling staff. As a result of these and other initiatives, we are now resolving over 90 per cent of complaints at first touch. In addition, we offer a 24 hours a day, 7 days a week service, helping colleagues to resolve complaints around the clock, ensuring customers get the right outcome faster. We have also made a significant improvement to our online complaint handling form, meaning we are now able to respond to these complaints within 6 hours.

Our Group wide Root Cause Analysis team, who conduct detailed analysis and research into the source of customer complaints, reduced complaints further this year. They achieved a reduction of approximately 39,000 per month by continuing to listen to customers to understand the cause of their complaints, and by making improvements to fix these issues to prevent repeat occurrences. For example, changes to customers' pending funds information has enabled telephone banking advisors to provide a much clearer breakdown of current account transactions to customers, resulting in a reduction of approximately 2,500 complaints per month. These improvements have been driven by listening to our customers and acting directly on their feedback.

Listening to our customers

We have made some great improvements to our ISA processes. We have simplified the ISA account opening process and made it easier to transfer funds in, enhanced our systems and removed administration hurdles, instated 'Savings Champions' in branch to deal with ISA customer queries and improved interest rate visibility.

Simple, tailored products and services

Our strategy recognises our customers' needs for product simplicity and transparency, access through multiple channels and value for money products and services. We have worked hard to ensure we are offering products and services that respond to customers evolving needs, and as a result, a number of new and innovative products have been launched in 2012. We also built on our disability principles for product and process design; these involve adhering to our legal duty to make reasonable adjustments to anticipate the needs of customers with disabilities and prevent discrimination and also to make reasonable adjustments to stop less favourable treatment if it is occurring.

We have enhanced our internet banking offering to enable our retail customers to do more online. This has helped to drive large increases in the number of customers who use both traditional online services and mobile banking with customers increasing to 9.5 million and 3.3 million respectively. In addition we have become one of the founding partners of Go On, a nationwide campaign which aims to help improve digital capability for all, with a particular focus on SMEs.

We have extended the innovative Lloyds TSB Lend a Hand Mortgage to help customers purchase a home with the help of their local authority. We also launched our Best for Business campaign and reaffirmed our continued support for the SME Charter to respond to 90 per cent of lending appeals within 15 working days which will exceed the industry standard of 30 days. In addition we have made significant investments in the Business Growth Fund, Scottish Investment Bank and Big Society Capital.

Our Retail division continued to develop their savings product offering. The Halifax Savers Prize Draw has been very popular, with over 1 million customers subscribing, supporting strong increases in customer advocacy. They also continued to develop the ISA Promise that resonated with customers and helped to support a record new ISA performance in 2012. In addition, they developed new ways to support our customer's savings requirements including the recently launched Junior ISA that allows young people to start to build a tax free savings pot.

We continue to be recognised with external awards. Our Corporate and Commercial businesses won the Best Bank of the Year award for the eighth consecutive year at the Real FD/CBI excellence awards, and in our Insurance division we were named as Britain's Most Popular Home Insurance Provider by the independent market researchers GFK NOP for the eleventh year in a row.

In meeting the needs of our customers, we also made strong progress this year on improving the products and services we offer customers with disabilities. The progress to date has been accomplished through many initiatives including the launch of the Disability Services Support Team, a specialised team set up to help front line colleagues with queries or complaints, our ongoing work under the Prime Ministers' challenge on dementia, the introduction of a comprehensive colleague guide, working with Disability Rights UK to hold customer focus groups to understand how we capture and action customers' appropriate service needs and the introduction of an online accessibility feedback form so we get greater understanding of our customers' requirements. The Business Disability Forum ranked Lloyds Banking Group joint second in the Disability Standard 2011/12 and this activity will continue into 2013 with the introduction of additional services to improve our accessibility to customers with a wide range of disabilities.

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Online sign language service

The Group was the first financial services provider in the UK to introduce Sign Video – a sign language communication service for deaf customers. This technology enables customers to communicate in their first or preferred language of British Sign Language.

Customer service and Simplification

In line with our strategy to become the best bank for customers, customer needs remain at the heart of how we reshape our businesses. Through our Simplification programme we have continued to enhance and streamline customer processes, with a number of significant improvements having been made during the year. These include the re-design of our account switching and closure processes, improvements to our Cash ISA transfer process, enhancements to our end-to-end bereavement process and the streamlining of our Commercial lending process. We have also introduced advanced Interactive Voice Response technology, bringing a new and more flexible approach to the way customers undertake their telephone banking.

Customer satisfaction is assessed through the Net Promoter Score (NPS), which measures the likelihood of customers recommending us to others. Our high street brands made significant headway in 2012, achieving their highest ever NPS scores, with the Group wide score rising from 44 in 2011 to 49 at the end of 2012.

Treating customers fairly

Central to our aim of building deep and lasting customer relationships is our determination to treat customers fairly and ensure we are transparent in dealings with them. We conduct regular monitoring to check that we are complying with our robust customer treatment policies and are achieving fair outcomes for customers. Customer outcomes are an important component in colleague reward and remuneration. Our approach to fair customer treatment takes into consideration product, sales and after sales:

- Products: we have strengthened our framework for developing and managing our product range, including the introduction of new product governance processes and a comprehensive risk assessment tool that centres on fair customer treatment.
- Sales: our sales processes consider affordability and are designed to minimise the risk of customers buying products they do not need or cannot afford. We review these processes continuously and update them as necessary.
- After sales: we listen carefully to customer feedback, and take a proactive stance to after sales.

Financial Inclusion

We aim to lead the banking sector in reaching those who are financially excluded and equip them with the confidence and capability to manage their money effectively.

Retail division also provides current accounts to one in three people in the UK and are the UK's biggest provider of basic bank accounts, making a significant investment in helping to bring people into the financial system. We currently provide over 3 million such accounts and in 2012 opened around 225,000 new accounts. In conjunction with the National Offender Management Service, we offer more basic banking facilities to prisoners than any other bank. Almost as importantly, we can help our customers move to a full facility current account. In 2012 over 100,000 customers who previously had a basic bank account either upgraded to or opened a mainstream bank account. We have recently made a number of improvements to make it easier for basic bank account customers to upgrade.

Supplier relationships

Having strong relationships with our suppliers is key to the delivery of our strategy and ensuring both the bank's and our customers' needs are effectively met. The Group looks to build and develop strong collaborative relationships and engage in regular dialogue, meaning we can better understand the environment in which we operate and help access and drive the continuous improvement and innovation in our value chain. Through working with our suppliers, we also get the opportunity to leverage their unique specialist knowledge in order to drive increased value and proactively optimise our supply chain. We consider our suppliers' social, ethical and environmental performance as a standard part of our procurement process. We are also a signatory to the Prompt Payment Code which requires us to provide clear guidance on payment procedures and encourage similar good practice amongst our suppliers and other businesses.

RELATIONSHIPS AND RESPONSIBILITY

COLLEAGUES WHO PUT CUSTOMERS FIRST…

With colleagues who put customers first, keep it simple and make a difference together, we will deliver the service that makes us the best bank for customers.

COLLEAGUES

Our colleagues will deliver the service that makes us the best bank for customers.

Aim

Our ambition is to be a bank where our colleagues give their best and want to build their career. Our people are at the heart of our business and are critical in ensuring that we deliver our strategy to be the best bank for customers and through this, help Britain prosper.

Each colleague should have access to the training and development opportunities that enable them to do their role well. This should also ensure that we are able to grow talent internally, to drive our business in a sustainable way.

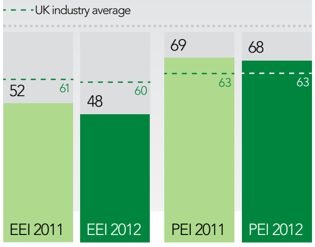
Having a diverse workforce is also a priority for us. At Lloyds Banking Group, we want the diversity of our employee base to reflect the population of the UK and who our customers are: the better we reflect our marketplace, the better we can serve it.

We also encourage our colleagues to work closely with the community to build lasting relationships that are the foundation for our business in the future.

Performance in 2012

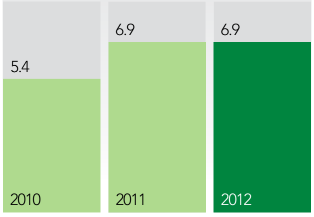
Staff engagement score

%



The Employee Engagement Index (EEI) measures the individual motiviation of colleagues whilst the Performance Excellence Index (PEI) measures how strongly colleagues believe the Group is committed to improving customer service.

Staff training days



Colleagues received an average of 6.9 days formal learning in 2012 reflecting ongoing commitment to learning and development.

Priorities for 2013

- Ensuring colleagues live our values
- Building colleague pride and trust in the Group and our future
- Helping colleagues fulfil their potential through learning and development
- Managing all aspects of performance
- Building a diverse and inclusive workforce

Living through our Values

To unlock the great potential in our business, we ask all colleagues to focus on our three values: putting customers first, keeping it simple and making a difference together.

Putting customers first means thinking about what's best for customers in everything we do. That means understanding and anticipating customers' needs, delivering on our promises to customers and each other and taking ownership to get things right for every customer. We need to ensure that what we are doing enables our customers to get the most from their money; living this value will enable colleagues to deliver our strategy to be the best bank for customers.

PUTTING CUSTOMERS FIRST
1st
KEEPING IT SIMPLE
MAKING A DIFFERENCE TOGETHER
BEST BANK FOR CUSTOMERS

Keeping it simple means being easy to do business with and communicating clearly and openly. Our colleagues are continually identifying opportunities to simplify the things we do and work hard to get things right first time every time.

Making a difference together means working together to deliver for customers, listening to how we can improve what we do; treating all people fairly and acting responsibly at all times; and contributing to the communities we serve. We see our involvement in the work we do in fundraising for charity as an important part of our contribution. Colleagues have raised £3.6 million for Save the Children since the beginning of 2011. As part of our involvement with the National School Sport Week initiative, over 5,000 colleagues have volunteered their support over the last four years. Overall 32,000 colleagues have volunteered their time this year to communities.

Colleague engagement

Our annual Colleague Engagement Survey is an important way for us to find out how we are working together and how well we are building a high performance culture. More than 77,000 colleagues took part in this year's Colleague Survey, giving us the clearest insight yet into how colleagues feel about working for Lloyds Banking Group. The survey also gives each colleague an opportunity to add their own individual comments and around 40,000 colleagues took time to do this.

The outputs provide two separate and measurable scores, the Employee Engagement Index (EEI), which measures the individual motivation of colleagues, and the Performance Excellence Index (PEI), measuring how strongly colleagues believe the Group is committed to improving customer service. These inform Group wide and local action plans that will prioritise the things that will make the Group a better place to work.

RELATIONSHIPS AND RESPONSIBILITY

The results highlight strong levels of engagement in some areas including using customer feedback to improve processes and providing colleagues with appropriate training to keep up with customer demands. Our PEI score is again well above the UK industry average, showing that colleagues believe in the Group's commitment to delivering and continuously improving the products and services we provide to our customers. These scores indicate that our colleagues are committed to the Group's strategy of becoming the best bank for customers.

Our EEI score shows that we have more to do to engender trust in the organisation and in its future. The current economic climate and the constant external focus on the financial services sector and banks have undoubtedly contributed to a lack of confidence and trust in the organisation. Building colleagues' pride and trust in the Group and our future is something the senior leadership team is fully committed to and an area that we will continue to focus on throughout 2013.

Thanks to colleague feedback and the strategic input from the Group's leaders, in 2013 we are focusing on three key areas:

- fostering authentic and credible leaders who, through their actions, engender trust and understanding and personify the Group Values;
- demonstrating that there is a promising future for colleagues with attractive opportunities for learning and development and a compelling reward offering; and
- creating a solid platform to share and reinforce our strategic vision and help colleagues understand the role they play in helping us to be Best Bank for Customers.

We have four recognised Unions who we have consulted about these actions and have been involved in discussions on a series of changes that we have made this year. We value the partnerships we have with these organisations.

Learning and Development

Learning and development supports our colleagues to be the best they can be to help us be the best bank for customers.

An important sign that we are doing the right thing, is the proportion of appointments that we can fill internally. During 2012 we have been successful in filling 78 per cent of executive roles with internal talent. We also focused on building rounded general management experience by moving some of our highest potential executives across our different businesses and in 2013 we will continue our work to validate and improve internal succession.

We have continued to deliver Group wide leadership programmes to accelerate the development of the most effective leaders and to strengthen our leadership capability overall. Embedded in these programmes is a focus on building a high-performance culture and putting customers at the heart of everything we do. This year, we have worked with the Open University to launch our new core curriculum of leadership training to equip a wider range of colleagues with the knowledge and skills required to improve performance in their roles. Overall, 3,000 of our leaders have experienced leadership training in 2012.

The Group significantly increased its focus on its Emerging Talent programmes in 2012. We launched two new Group wide programmes. In its inaugural year our Apprenticeship scheme made 500 places available offering a range of career opportunities across the Group. We are building on the success of the scheme by offering more places in 2013. At the more senior level we launched our Future Executives Programme giving 23 MBA graduates the chance to fast track their careers through a structured leadership programme. In addition, the Group maintained its focus on hiring significant numbers of UK graduates, with a 20 per cent increase on 2011 hires across its six core schemes.

Significant progress has been made on improving both the efficiency and effectiveness of the Learning offered to colleagues. We moved more classroom training to e-Learning, and increased the average amount of training received to a level above industry benchmarks.

The Group wide Academies have now been fully implemented, providing a clear learning standard and a clear way to plan their careers for all colleagues.

Performance and Reward

Managing performance plays a critical role in helping us to develop our colleagues to build long term partnerships supporting customers and strong relationships with each other.

Reflecting the regulatory environment, continued good progress has been made in the strengthening of reward governance, particularly incentives, and the alignment of long term incentives with our strategic goals. The performance management process ensures we calibrate between colleagues and take full account of risk at all levels to assess risk stewardship by all our senior executives.

Encouraging colleague share ownership in Lloyds Banking Group is important. The first Save-As-You-Earn plan in 3 years has been announced, commencing in 2013, as well as the continued promotion of our Sharematch scheme. Our Flex programme, which offers a range of benefit choices, continues to be popular with colleagues. We also began Pensions Auto-Enrolment from 1 January 2013 for those colleagues who do not participate in one of our existing Pension plans.

Growing great leaders

The Group has continued to provide leadership programmes with success; highlighted by the fact that 78% of our executive roles in 2012 were filled with internal talent. The Group has also increased focus on our Emerging Talent shown through the launch of the Apprenticeship scheme and the Future Executives Programme.

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Diversity Networks

The Group has four diversity networks, which were formed by groups of colleagues to help focus on the specific challenges and barriers that they face at work. They do this through connecting their members (virtually and face to face), focusing on development and playing an active role in supporting the development of the diversity strategy.

Diversity and Inclusion

A key element of achieving our vision is having a diverse and inclusive workforce; and we have made progress during 2012. With a footprint that touches nearly every community and household in the UK, understanding and meeting those diverse needs, as well as our workforce reflecting the communities we serve, will support our goal of being the best bank for customers.

Our gender programme has made strong progress throughout the year. In 2011 Lord Davies' Review recommended that organisations have a target of 25 per cent female representation on the board by 2015. The Group committed to meet this goal and we are proud to have exceeded this during 2012 – two years ahead of target with 27 per cent female representation. We also launched a role model programme across the Group. Footprints in the Snow showcases the career paths of the Group's most senior women, providing footprints and stepping stones for other women to follow, be inspired by and succeed. This has proved to be one of our most successful programmes to date with positive feedback from the women who have attended sessions. Role model programmes for ethnic minority, disabled, and lesbian, gay, transgender and bisexual colleagues are now being developed to launch during 2013.

Our sexual orientation programme continues to be recognised as amongst the best. In the Stonewall 2012 Top 100 Employers index the Group was placed in the top 20 organisations and was named Top Welsh Private Sector Employer and 2nd best Scottish Employer. Our Rainbow Network was also given 'star performer' status. We are also leading the way for customers with both Lloyds TSB and Halifax featuring gay couples in product advertising.

In 2012 our disability programme was ranked joint 2nd, achieving 'Gold Standard' and named 'Best Private Sector Employer' by the Business Disability Forum, the world's leading employers' organisation on disability and business. Our end-to-end Workplace adjustment programme is industry leading and, to date, almost 10,000 cases have been managed through this process.

We continued to focus on developing our talented ethnic minority colleagues throughout 2012. Ten Career Development Programme courses were delivered to over 120 colleagues. The programme is aimed at colleagues who are looking to achieve their first management or senior management position and supports participants in achieving their full potential. The course receives outstanding feedback from delegates and has produced excellent results with improved promotion rates, improved performance ratings and increased engagement.

To ensure that we continue to provide one of the best packages for working parents in the UK we introduced a number of improvements, which included, better advice and guidance for colleagues and line managers, e-Learning modules to support new parents, and a Parents forum where colleagues can connect and share experiences around working parent issues.

These activities are showing positive outcomes, with higher engagement scores for female and ethnic minority colleagues, and some steady progress in closing the gap for lesbian, gay and bisexual colleagues. We will continue to build upon our progress during 2013 to ensure we reflect the diverse needs of our customers, colleagues and communities.

London 2012 Partnership

Colleagues were an integral part of the successful delivery of the London 2012 Partnership. A key objective for the Partnership was to ensure that all colleagues within the Group were proud of the Partnership. We also wanted to provide a platform for colleague participation and community engagement and give colleagues the opportunity to build customer relationships.

As part of our objective to ensure that colleagues were engaged in the Games we launched a Group wide Reward and Recognition programme, Go for Gold, in July 2010. Colleagues were recognised for supporting and living our Group Values. 500 colleagues were rewarded with a pair of tickets to the Olympic or Paralympic Games. In addition we provided 250 colleagues with the unique opportunity to be an Olympic Torchbearer for making a difference in their community. Beyond these Group wide recognition programmes we awarded around 2,500 colleagues with tickets to the Olympic or Paralympic Games for exceptional performance through other Divisional Recognition Programmes. Also 500 colleagues were given places in the LOCOG Volunteer Programme, giving a once in a lifetime opportunity to support the Games by being a Gamesmaker. Further to this approximately 145 of our best customer service colleagues were given the unique opportunity to work in the Athlete Village and Media Centre branches at the Olympic Park during the Games.

The Torch Relay was a key event for us as part of the London 2012 build-up and over 350 colleague volunteers supported the Colleague Advance Tour and the Evening Celebration Events as part of our Olympic Torch Relay campaign. Many more branch staff and other colleagues lined the streets to support the Relay as it passed through their communities and at sponsor stops.

RELATIONSHIPS AND RESPONSIBILITY

Our 2013/14 Charity of the Year is supporting Alzheimer's Society and Alzheimer Scotland's Live Well Campaign.

HOW WE ARE DOING MORE. . .

We recognise that if we are to be the best bank for our customers, we must also aim to be the best bank for communities. By doing more to be a responsible business we are able to make a sustainable contribution to help Britain prosper.

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COMMUNITIES

One of the ways Lloyds Banking Group helps Britain prosper is by contributing positively to the communities we serve. Our scale and reach through our brands and branches means we are doing more to help communities across the UK.

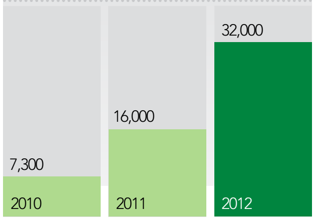
Aim

The aim of our community strategy is to help the UK's most disadvantaged communities prosper as a result of our financial and colleagues' commitment. During 2012 we continued to develop our community strategy around the themes of Education, Employability and Enterprise.

Last year the Group invested £85 million in a range of flagship programmes and initiatives. Despite the challenging economic environment the Group committed to keep our investment at this level for the period of its strategic plan.

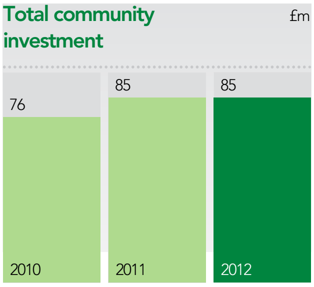
Performance in 2012

Colleague volunteers



In 2012, the Group supported over 32,000 colleagues' volunteering for charities and community groups. The Foundations also provided Matched Giving to some of these organisations for colleagues' time spent volunteering outside of working hours.

Total community investment



Our Community Investment total includes support for financial inclusion, community initiatives, leveraged colleague fundraising, sponsorship and support for grass roots charities.

Priorities for 2013

- Continuing our level of investment in UK communities aligned with our strategy themed around Education, Employability and Enterprise and support of the UK charity sector through our Foundations
- Continuation of our plan to strengthen our responsible business governance, including our reporting assurance and verification process
- Develop a set of measures that will help us to understand the extent to which we help Britain prosper. From the outputs of the measures we will look to create associated robust KPIs and targets
- Launch a Financial Inclusion Steering Group and set priorities in 2013

money for life
CHALLENGE

Money for Life Challenge

The Money for Life Challenge is a national competition that provides £500 grants to empower teams of 16-24 year olds to develop innovative money management projects that impact their communities. We awarded 110 grants in 2012.

Community Programmes

We want to build thriving communities in the UK, both with direct investment and by encouraging our colleagues to support communities with their skills and knowledge. This aim is supported by our community programmes themed around Education, Employability and Enterprise.

Education

Personal money management is a fundamental life skill. In recent years there has been a huge groundswell of support to introduce compulsory financial education in schools, but there remains a lost generation of adults who have passed through the education system without acquiring these skills.

Our response to this is *Money for Life*, an award-winning personal money management programme, targeted at young people and adults in the wider Further Education, work-based learning and community learning sectors. Lloyds Banking Group has invested £4 million in the programme since 2009 and has committed a further £4 million over the next two years.

The Money for Life Qualifications programme provides accredited training to enable organisations ranging from Citizens Advice Bureaus to Housing Associations, charities and colleges to embed money management skills at a local level. We trained 1,400 people to run money management sessions in communities in 2012.

The Money for Life Challenge is a national competition that provides £500 grants to empower teams of 16-24 year olds to develop innovative money management projects that impact their communities. We awarded 110 grants in 2012.

In September 2012 we announced a partnership with Family Action to train our employees to deliver money management workshops to 1,500 vulnerable families by August 2013.

Money for Life was awarded a Big Tick and was highly commended in Business in the Community's Awards for Excellence 2012.

RELATIONSHIPS AND RESPONSIBILITY

Employability

Lloyds Scholars, our social mobility programme aimed at UK students, was established in 2011. In partnership with six leading universities across the UK, we offer students from lower income households a complete support package, helping them manage the financial strain of university whilst improving their employability.

Scholars receive a unique combination of financial support, a Lloyds Banking Group mentor, sessions to develop their skills and the opportunity to gain valuable work experience through paid internships. In return we ask that they volunteer for local causes, enabling them to enhance their CV whilst giving back to the community. We accept students from nearly all disciplines and all have the opportunity, but no obligation, to join our Graduate Leadership Programme after university.

Lloyds Scholars was named Corporate Responsibility Project of the year at the 2012 Charity Times Award.

Enterprise

In January 2012 the *School of Social Entrepreneurs* and the bank launched the Lloyds Banking Group Social Entrepreneurs programme. Supporting this programme demonstrates Lloyds Banking Group's commitment to aiding the UK's economic recovery by enabling social entrepreneurs to realise their ambitions and thereby supporting enterprise and strengthening communities.

The aim over the next five years is to help over 1,300 social entrepreneurs to start up or scale up their social enterprise, creating jobs across the UK and helping local communities to help themselves. The programme offers grants of between £4,000 - £25,000 as well as a Lloyds Banking Group mentor to help them be sustainable and successful in their ideas. Additional funding for this project is provided by the Big Lottery.

We are a major sponsor of the *Business Connectors* programme in partnership with Business in the Community, a Prince of Wales Charity. In 2012 we made a commitment to second up to 20 senior managers per year to become Business Connectors, working in their local communities to help broker relationships between charities, community groups and local business, with the goal of helping to build thriving communities across the UK.

Lloyds Scholars

Lloyds Scholars, our social mobility programme aimed at UK students, was established in 2011. In partnership with six leading universities across the UK we offer students from lower income households a complete support package, helping them manage the financial strain of university whilst improving their employability.

Business Connectors was developed in the wake of the UK riots in 2011, and in particular the devastating effect these events had on the sense of community in some of the UK's most disadvantaged neighbourhoods. The programme was therefore designed to tackle these issues head on by harnessing expertise from business to tackle local needs.

Community volunteering

Our *Day to Make a Difference* volunteering programme enables colleagues to spend one day a year volunteering for a charity or community project of their choice. Over 32,000 of our colleagues registered to use their day to volunteer in 2012. This compares with 7,300 colleagues in 2010 and 16,000 colleagues in 2011.

Empowering our people to participate in activities, during work time, that benefit their local communities, helps to build pride in the bank. As well as the benefits that our people's skills bring to communities, which equate to millions of pounds of in-kind support for organisations, it also gives them the opportunity to develop skills which are valuable to our business. Community activity also helps us to work alongside our customers, visibly demonstrating that we are committed to the same things as they are.

Give & Gain Day

We are the largest participant in Business in the Community's Give & Gain day – the UK's single biggest day of volunteering. In 2012 more than 4,500 colleagues took part, doubling the engagement seen in 2011. We have committed to sponsor Give & Gain day until 2014.

National School Sport Week

Our vision for London 2012 was to inspire and support young people, communities and business all over Britain on their journey to the Games and beyond. Part of this vision was running National School Sport Week, a week long sporting celebration for schools. Over 2,500 volunteered, helping to bring the excitement of London 2012 to their local communities.

Funding grassroots charities

Much of the our charitable giving is through the *Lloyds TSB and Bank of Scotland Foundations*. During 2012 the Group donated more than £29 million to the Foundations enabling them to make grants to local, regional and national charities across the UK. Many charities working in the UK's most deprived areas have received support, making a significant difference to the communities that need it most. In addition to making grants, the Foundations encourage our colleagues to become active in their community by providing Matched Giving for charities they support. Each colleague can claim up to £1,000 per year for their charitable fundraising efforts and time given to charities.

Funding local organisations

The 2012 Community Fund provided grants to local community organisations supporting young people. Nominated by our colleagues and voted on by members of the public, 132 organisations across the UK each won a Community Fund award worth £5,000. The Group's sponsorship of London 2012 allowed us to promote nominated organisations at Olympic Torch Relay events. This raised their profile and encouraged communities to support them by voting. We estimate 100,000 young people across the UK will be positively impacted as a result of the awards.

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Colleague Volunteering

We are the largest participant in Business in the Community's Give & Gain day – the UK's single biggest day of volunteering. In 2012 more than 4,500 colleagues took part, doubling the engagement seen in 2011

Fundraising

Through a range of engaging fundraising initiatives and personal commitment, colleagues from across the Group have raised over £3.6 million, including Matched Funding, for our 2011/12 Charity of the Year Save the Children. This has by far exceeded our fundraising target of £2.5 million.

The funds raised will help over 12,000 children in our local communities through the Families & Schools Together (FAST) programme. FAST provides support to parents by engaging them in their children's education. The programme aims to reinforce family bonds and create a supportive network between parents, children, schools and communities. Teachers have reported a 5 per cent improvement in reading, writing and maths amongst children enrolled in FAST after just eight weeks.

Our 2013/14 Charity of the Year, chosen by colleagues, is supporting Alzheimer's Society and Alzheimer Scotland's Live Well Campaign, the first UK-wide dementia carers programme.

Measuring our performance

In order to measure and manage our overall community investment in a systematic way, we use the industry standard London Benchmarking Group model. The model records cash, colleague time, in-kind donations and management time, as well as the outputs and longer-term community and business impacts of our projects.

Reducing our environmental impact

As a responsible business, we are working to reduce our own environmental footprint and support the UK Governments targets to move towards a low-carbon economy.

Our Environmental Action Plan incorporates programmes to reduce our impacts in the areas of energy, paper, business travel, waste and water. Specific initiatives include 'no travel' weeks, embedding an enhanced dry mixed recycling process and optimisation of our building controls to reduce the energy we use.

All programmes are on track to meet their 2020 targets with some delivering early. More detail on the progress of our initiatives will be described in our 2012 Responsible Business Report, which will be published in May 2013.

As an example our 'No Travel Week' policy has changed the Group's business travel culture since its introduction in June 2011. By promoting viable technology alternatives travel bookings have decreased by 130,000 during this period. We have also met the World Wildlife Fund 1 in 5 challenge and made significant progress against our target to reduce business travel by 20 per cent by 2020.

As well as benefitting the environment, making fewer journeys means our colleagues are away from home less, improving their health and well being.

These programmes have contributed to the Group's reportable CO_2 emissions reducing by around 9 per cent from the previous period.

CO_2 Emissions (tonnes)

	2012	2011
Total UK CO_2 emissions	374,361	410,237
Scope 1 emissions	49,414	58,572
Scope 2 emissions	290,726	308,844
Scope 3 emissions	34,221	42,821

The Group reports those energy emissions arising from its own direct business activities where it holds the title to the energy supply contract directly with the energy supplier.

We have improved the accuracy of energy data for the 2011 reporting period, replacing estimates with actual data. We have also applied the latest DEFRA conversion factors to both reporting periods. Our reporting periods are from the 1 October to the 30 September each year.

Supporting the Green Economy

In supporting the Green Economy, we need to create 'real' opportunities for the provision of finance for low carbon products, services and green technologies in a socially inclusive way. To achieve this we recognise the need to work with governments and other stakeholders to address the global sustainability mega trends that will impact our future.

As one of the most active participants in the Project Finance market, Lloyds Banking Group is playing a key role in finding solutions to current and future funding requirements. We currently have commitments to renewable energy projects in the UK with capacity totalling over 1800MW. More detail will be available in our 2012 Responsible Business Report.

www.lloydsbankinggroup-cr.com

RISK OVERVIEW

EFFECTIVE RISK MANAGEMENT AND CONTROL

Aim

Managing risk effectively is important for any bank and fundamental to our strategy. We are looking to create a more efficient, lower risk, UK focused retail and commercial bank. In doing this we maintain a conservative business model embodied by a risk culture founded on a prudent appetite for risk.

The Group's approach to risk is founded on an effective control framework and a strong risk management culture which guides the way all employees approach their work, the way they behave and the decisions they make. The amount and type of risk that the organisation is prepared to seek, accept or tolerate, otherwise known as risk appetite, is driven by our strategy and approved by the Board. This risk appetite is then embedded within policies, authorities and limits across the Group.

Risk as a strategic differentiator

The Group strategy and risk appetite were developed together to ensure one informed the other in creating a strategy that delivers on becoming the best bank for our customers whilst helping Britain prosper and creating sustainable growth over time.

We believe effective risk management can be a strategic differentiator, in particular:

- **Conservative approach to risk:** The Group has a fully embedded conservative approach to, and prudent appetite for risk with risk culture and appetite driven from the top.
- **Strong control framework:** The Group has a strong risk control framework which is the foundation for the delivery of effective risk management. This framework ensures appropriate engagement in developing risk appetite whilst also ensuring business units operate within approved parameters.
- **Effective risk analysis, management and reporting:** Effective risk analysis ensures the identification of opportunities as well as risks and ensures risks are managed appropriately and consistently with strategy. The Group's key risks and performance against risk appetite are monitored and reported regularly to senior management using quantitative and qualitative analysis and are subject to relevant stress testing. This ensures we fully understand the risk in the business at both an individual risk type and aggregate portfolio level. The key risks to the Group are outlined on the next page.
- **Business focus and accountability:** Managing risk effectively is a key focus for the Group and is one of the five principal criteria within the Group Balanced Scorecard on which business areas and individual performance are judged. The Group's approach to risk means that businesses remain accountable for risk but a strong and independent risk function also helps ensure adherence to the Group's risk and control frameworks. Continued investment in risk systems and processes will also help differentiate our risk management approach.

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The full risk management report

Risk achievements in 2012

Significant progress has been made in reducing the risk in the business in 2012 through the consistent application of our prudent approach to risk. Key deliverables have been aligned to the delivery of our customer focused strategy and the four pillars of our action plan.

We have made good progress in reshaping the business portfolio to fit our resources, capabilities and risk appetite. A conservative approach to, and prudent appetite for risk is fully embedded across the organisation and effective controls over the risk profile of all new business are in place. We have continued to take a disciplined approach to the management and reduction of our non-core assets, which reduced by £42.3 billion in the year, ahead of plan, whilst also being capital generative. Asset sales in total were within impairment provisions demonstrating the prudence of our approach to credit risk management and the adequacy of our provisioning. The reduction of non-core assets and prudent management of risk have led to significantly lower impairment, down 42 per cent, and the core Asset Quality Ratio, (impairment as a percentage of average advances), at 0.44 per cent is already in line with target.

We have continued to strengthen and de-risk the Group's balance sheet by improving our capital ratios and funding and liquidity position. The Group's funding position has now been transformed with wholesale funding of £170 billion reduced by £81 billion in the year. At the same time we have reduced the level of short term wholesale funding which at £51 billion now accounts for less than 30 per cent of total wholesale funding. Our liquidity position also continued to improve and our liquidity is now greater than wholesale funding and covers short term funding by more than four times. Our core tier 1 capital ratio further increased to 12.0 per cent in the year and we remain confident in our capital position.

The complaints process has been simplified and as a result we have seen a further reduction in FSA reportable banking complaints to 1.1 per 1,000 accounts, the lowest level of any major UK bank. This is aligned to our customer focused strategy and reduced conduct risk.

We have also continued to invest, with our Risk Transformation having delivered improved analytics and enhanced customer support for our retail customers as well as simplified processes for rating the risk of commercial customers. This investment has also driven reductions in the Group's impairments and risk-weighted assets. Further investment during 2012 has allowed us to keep pace with the growing range of regulatory demands, and prepare for future changes required under the Banking Reform Bill including Ring Fencing and Recovery and Resolution planning.

Priorities for 2013

- Continue to support delivery of the Group's customer focused strategic plan within risk appetite
- Continue programme of investment in the Group's risk systems
- Maintain and strengthen the Group's strong risk culture by managing performance to ensure risk based behaviours
- Deliver against new regulatory requirements
- Continue to attract, retain and develop high quality people

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PRINCIPAL RISKS AND UNCERTAINTIES

The most significant risks faced by the Group are detailed below.

Credit risk

Arising in the Retail, Commercial Banking, and Wealth, Asset Finance and International divisions, reflecting the risks inherent in the Group's lending activities and, to a lesser extent in the Insurance division in respect of investment holdings and exposures to reinsurers. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group's assets and materially increase the Group's allowances for impairment losses.

Conduct risk

Conduct risk and how the Group manages its customer relationships affect all aspects of the Group's operations and our management of this risk is closely aligned with achievement of the Group's strategic vision to be the best bank for customers. As a provider of a wide range of financial services products across different brands and distribution channels to an extremely broad and varied customer base, and as a participant in market activities, the Group faces significant conduct risks, which could result in selling products to customers which do not meet their needs; failure to deal with a customer's complaint effectively where the Group has got it wrong and not met customer expectations; and behaviours which do not meet market standards.

Market risk

Market risk comprises of three principal risks. Interest rate risk – This risk to the Group's banking income arises from competitive pressures on product terms in existing loans and deposits, which can restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates. Equity risk – This risk arises from movements in equity market prices. The main equity market risks arise in the insurance business companies and defined benefit pension schemes; Credit spread risk – This risk arises when the market perception of the creditworthiness of a particular counterparty changes. The main credit spread exposure arises in the insurance business, defined benefit pension schemes and banking businesses.

Operational risk

The principal operational risks currently facing the Group are: Information Security – The risk of information leakage, loss or theft. The threat profile related to this is rapidly changing; with increasingly sophisticated attacks by cybercrime groups; IT Systems – The risk of loss resulting from the failure to develop, deliver or maintain effective IT solutions; and Customer Process – The risk of process weaknesses and control deficiencies within the Group's customer facing processes as the business continues to evolve.

People risk

The Group has a strategic aim to be the best bank for customers. It is committed to addressing issues within the business that could contribute to customers receiving unfair outcomes. The Group believes the quality, values and engagement of its people are fundamental to successful delivery of this strategy. This belief coincides with our regulators' increasing focus on the culture which underpins the performance and behaviour of employees in the development and delivery of fair outcomes to customers.

Liquidity and funding risk

Liquidity and funding continue to remain a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and long term wholesale funding markets and deposit markets. Should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding, its ability to fund its financial obligations and meet its commitments as they fall due could be impacted.

Insurance risk

The major sources of insurance risk are within the Insurance business and the Group's defined benefit pension schemes. Insurance risk is inherent in the Insurance business and can be affected by demographic trends and customer behaviour. Insurance risks accepted relate primarily to mortality, longevity, morbidity, persistency, property and unemployment. The primary insurance risk of the Group's defined benefit pension schemes is related to longevity. Insurance risk has the potential to significantly impact the earnings and capital position of the Insurance business of the Group. For the Group's defined benefit pension schemes, insurance risk could significantly increase the cost of pension provision and impact the balance sheet of the Group.

State Funding and State Aid

On behalf of HM Treasury the Treasury solicitor holds 39.2 per cent of the Group's share capital. HM Treasury's shareholding continues to be managed without interference in day to day management decisions however there is a risk that a change in Government priorities could result in the framework agreement currently in place being replaced leading to interference in the operations of the Group. The Group also continues to make good progress in meeting its EU State Aid commitments arising from the original provision of Government support although failure to meet EU State Aid commitments could lead to sanctions.

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More on the Group's principal risks and uncertainties, including mitigating actions

A further reduction in FSA reportable banking complaints (excluding PPI) to 1.1 per 1,000 accounts, a strong performance relative to our peers.

Prudent risk appetite and strong risk management resulted in a reduction of 42 per cent in the Group's impairment charge.

Non-core assets reduced by £42.3 billion and our international presence was reduced in line with the Group's strategy to focus on UK customers.

SUMMARY OF GROUP RESULTS

Overview

The Group delivered a significantly improved performance in 2012, in a continued challenging economic and regulatory environment. We have substantially increased Group underlying profit and delivered strong returns in excess of the cost of equity in the core business, while further strengthening our balance sheet and delivering significant reductions in costs and risk. Our statutory results for the year were however affected by further provisions for contact and redress costs in relation to legacy PPI business and IRHP sales to small and medium-sized businesses, and also included £3,207 million of gains from sales of government securities.

Significantly improved Group underlying profitability

We reported a Group underlying profit before tax of £2,607 million, an increase of £1,969 million, with another strong performance from the core business at £6,154 million (2011: £6,196 million) and a reduction of £2,011 million in non-core losses to £3,547 million. This was driven by continued improvement in asset quality and further progress on our Simplification programme, which resulted in, respectively, a substantial improvement in the impairment charge, down 42 per cent to £5,697 million, and a further reduction in total costs of 5 per cent to £10,082 million. These improvements more than offset an expected reduction in underlying income, down 13 per cent to £18,386 million, due mainly to a decline in net interest margin, further non-core asset reductions and continued subdued demand for lending and customer deleveraging.

Returns increased in the core business

In our core business, the return on risk-weighted assets improved 10 basis points to 2.56 per cent, and underlying profit was broadly stable at £6,154 million (2011: £6,196 million). Core total costs reduced 5 per cent to £9,212 million as a result of further Simplification savings, and the impairment charge decreased 34 per cent to £1,919 million driven primarily by continued improvement in the quality of our portfolios. These effects broadly offset a reduction of 8 per cent in underlying income which reflected expected continued subdued lending demand and customer deleveraging, as well as a decline in core net interest margin of 10 basis points year-on-year. This decline was mainly a result of higher wholesale funding costs, but was mitigated throughout the year by the benefit of repricing certain lending portfolios and further improvements to the funding mix.

Further substantial non-core asset reduction and lower non-core losses

We delivered a further substantial reduction in non-core assets of £42.3 billion (30 per cent) in 2012, significantly ahead of our original guidance for the year, resulting in a remaining non-core asset portfolio of £98.4 billion. The percentage reduction in risk weighted assets on the portfolio was in line with that of non-core assets. Continued high wholesale funding costs were the main driver behind a reduction in the non-core margin of 46 basis points to 0.55 per cent. Given a substantial improvement in the impairment charge, which reduced by 45 per cent to £3,778 million, and a further 7 per cent cost reduction, the non-core business delivered a reduced underlying loss of £3,547 million (2011: £5,558 million).

Management and statutory results

Management profit, which includes the effects of asset sales, liability management, volatile items and fair value unwind was £4,827 million, an increase of £2,142 million or 80 per cent compared to 2011. This included a profit on government bond sales of £3,207 million (2011: £196 million) as a result of our active management of our balance sheet in response to the low interest rate environment, and a positive fair value unwind of £650 million, partly offset by a loss on asset sales of £660 million, charges for own debt volatility of £270 million, and other volatility of £478 million.

The statutory loss before tax of £570 million included provisions of £3,575 million in relation to legacy PPI business and £400 million in relation to IRHP sales to small and medium sized business. Charges relating to Simplification amounted to £676 million, while costs relating to the EC mandated retail business disposal (Verde) totalled £570 million. The loss after tax was £1,343 million, with a tax charge of £773 million. This tax charge reflects a policyholder tax charge arising from the revaluation of policyholder tax credits in the light of current economic forecasts and recent changes to the taxation of life insurance companies and the impact of the announced reduction in UK corporation tax rate to 23 per cent on the net deferred tax asset.

Charges relating to Simplification amounted to £676 million, while costs relating to the EC mandated retail business disposal (Verde) totalled £570 million.

Balance sheet further strengthened; remain confident in our capital position

We continue to make good progress in strengthening our balance sheet, further improving our core tier 1 capital ratio by 1.2 per cent to 12.0 per cent by the end of 2012. The total capital ratio improved from 15.6 per cent at the end of 2011 to 17.3 per cent, which already exceeds the Independent Commission on Banking's (ICB) primary loss-absorbing capacity (PLAC) recommendations. Our fully loaded core tier 1 ratio increased by 1 per cent to 8.1 per cent. We continued to reduce risk in the balance sheet, achieving a significant non-core asset reduction and completing the transformation of our funding position. We remain confident in our capital position given our strongly capital generative core business and the capital accretive non-core asset reduction achieved in the year.

The non-core asset reduction and further deposit growth of 4 per cent (excluding repos) also allowed us to further transform our funding position in 2012, with the core loan to deposit ratio of 101 per cent at the end of 2012 now very close to our long-term target of 100 per cent. The total amount of Group wholesale funding reduced by 32 per cent to £169.6 billion at the end of 2012 from £251.2 billion at the end of 2011, and its maturity profile was further improved, with wholesale funding with a maturity of less than one year reduced to less than 30 per cent of total wholesale funding at the end of 2012, down from 45 per cent at the end of 2011.

Our liquidity position remains strong, with a primary liquid asset portfolio of £87.6 billion. The total liquid asset portfolio of £205 billion represents approximately four times our wholesale funding with a maturity of less than one year at the end of 2012, providing a substantial buffer in the event of market dislocation.

Organisational and reporting changes

A number of alterations were made to the management and organisation of the Group during the year.

In the first half of 2012 the Asset Finance business, previously reported within Wholesale, was transferred to the Wealth, Asset Finance and International division. In the fourth quarter of 2012, the Group's Wholesale and Commercial divisions were combined to form the new Commercial Banking division. The Group's European and Australian wholesale business has also been transferred from Wealth, Asset Finance and International to Commercial Banking.

Comparative figures have been restated accordingly.

We continue to simplify our reporting and this is the last time we will report management profit as a separate item. Going forward our reporting will focus on underlying and statutory profit. In addition, impairment charges directly related to asset sales are now included in the asset sales line.

Total underlying income

	Group			Core		
	2012 £m	2011 £m	Change %	**2012 £m**	2011 £m	Change %
Net interest income	**10,335**	12,210	(15)	**9,868**	10,893	(9)
Other income	**8,416**	9,179	(8)	**7,782**	8,215	(5)
Insurance claims	**(365)**	(343)	(6)	**(365)**	(343)	(6)
Total underlying income	**18,386**	21,046	(13)	**17,285**	18,765	(8)
Banking net interest margin	**1.93%**	2.07%	(14)bp	**2.32%**	2.42%	(10)bp
Average interest-earning banking assets	**£543.3bn**	£585.4bn	(7)	**£423.7bn**	£438.7bn	(3)
Loan to deposit ratio	**121%**	135%	(14)pp	**101%**	109%	(8)pp

Total underlying income for the year decreased 13 per cent to £18,386 million, principally reflecting the effects on the core business of continued subdued lending and customer deleveraging, and further asset reductions in the non-core business.

Trends in total underlying income were more stable in the second half of the year, as the effect on non-core income from the reduction of non-core assets was broadly offset by core income growth which, having reduced by 5 per cent in the first half of 2012, increased by 2 per cent in the second half.

Group income

Group net interest income for the year fell by 15 per cent to £10,335 million due to lower asset balances and a decline in margin. Average interest-earning banking assets fell 7 per cent, mainly due to further non-core asset reductions, while the banking net interest margin reduced 14 basis points to 1.93 per cent, due to competitive deposit markets and higher wholesale funding costs continuing into 2012, with the average cost of new funding continuing to be higher than the average cost of maturing funds. These effects were partly mitigated by the benefits of re-pricing certain lending portfolios, an improving funding mix, and the reduction in lower margin non-core banking assets.

A reduction in other income of 8 per cent to £8,416 million was mainly driven by lower expected returns in the Insurance business and low customer confidence affecting sales of insurance products. In addition, fee income in Asset Finance and International was lower, while managed reduction in the balance sheet also reduced fees and commissions.

Core income

The reduction in core net interest income of 9 per cent to £9,868 million reflected the 3 per cent decrease in core average interest-earning banking assets, and a 10 basis point decline in banking net interest margin which was a result of continued elevated funding costs. The decline in core assets slowed in the second half, with customer loans and advances down by £3.2 billion compared with a reduction of £8.5 billion in the first half. The core net interest margin was stable throughout the year. Core other income reduced by 5 per cent, reflecting lower expected returns in the Insurance business, and reduced sales of insurance products.

Total costs

	2012 £m	2011 £m	Change %
Core	**9,212**	9,682	5
Non-core	**870**	939	7
Total costs	**10,082**	10,621	5
Simplification savings annual run rate	**847**	242	

Total costs decreased by 5 per cent compared to 2011, and are now close to our £10 billion target. This is two years ahead of the plan we set out in our 2011 Strategic Review and an absolute reduction in the cost base of around £1 billion since 2010, despite inflation and increased investment in the core business.

SUMMARY OF GROUP RESULTS

Core total costs reduced by 5 per cent driven by the benefits of our Simplification programme, partly offset by inflationary pressures and increased investment in the business, while in the non-core business, the reduction of 7 per cent was mainly a result of a smaller non-core portfolio.

The charge to the Group in respect of the Financial Services Compensation Scheme costs was £175 million (2011: £179 million). The Bank Levy was £179 million (2011: £189 million), in spite of an increase in the rate of the levy, as a consequence of the lower levels of wholesale funding a reduction in the Group's balance sheet and an increase in the proportion of funding with a maturity of greater than one year.

As at 31 December 2012, we had realised annual run rate savings of £847 million from our initiatives to simplify the Group, an increase of £605 million since 31 December 2011, with the Simplification programme contributing in year cost savings of £774 million in 2012.

Since the start of the programme 18 months ago, we have made strong progress in our Simplification programme, with over 200 improvements delivered. We continue to simplify our business operations through streamlining and improving customer processes, reducing management layers and increasing spans of control as well as restructuring business units. The latter includes consolidation of back office operations sites, optimisation of our model for delivery of IT and outsourcing of our property facilities and asset management services. These improvements are also contributing to improved customer service and significant reductions in customer complaints (excluding PPI).

Given the good progress we have made in the delivery of the Simplification programme in restructuring, simplifying and improving processes, we remain on track to meet our increased run rate target of £1.9 billion by the end of 2014. This compares with the original target of £1.7 billion announced in June 2011 as part of our Strategic Review. We are now also targeting a reduction in Group total costs to around £9.8 billion in 2013.

Impairment

	Impairment charge			Impairment charge as a % of average advances	
	2012 £m	2011 £m	Change %	2012 %	2011 %
Core	**1,919**	2,887	34	**0.44**	0.64
Non-core	**3,778**	6,900	45	**3.08**	4.60
Total impairment	**5,697**	9,787	42	**1.02**	1.62

We continue to improve asset quality through the ongoing application of our conservative credit risk appetite, strong risk management controls and de-risking of our portfolios. This resulted in a reduction in the Group impairment charge of 42 per cent to £5,697 million. The overall performance of the portfolio continues to improve and benefits from low interest rates and broadly stable UK residential property prices, partly offset by the subdued UK economy, the weak commercial real estate market, and high, although reducing, unemployment.

Core impairment

The core impairment charge of £1,919 million was 34 per cent lower than the charge in 2011, primarily driven by better performance in Retail, which reduced by 34 per cent to £1,192 million, and Commercial Banking, which reduced by 33 per cent to £704 million. The reduction in Retail was mainly driven by a reduction in the unsecured charge driven by our sustainable approach to risk, reduced balances and effective portfolio management, while the secured portfolio also saw a lower charge as a result of a fall in impaired loans. Within Commercial Banking the fall in core impairment charge was primarily attributable to lower impairments in some core portfolios, including Mid Markets, Corporate and SME. In Mid Markets and Corporate, there were specific large impairments in these portfolios in 2011, which were not repeated in 2012. The core impairment charge as a percentage of average advances improved to 0.44 per cent, remaining better than our long-term target for the Group as a whole.

Non-core impairment

The non-core impairment charge of £3,778 million was 45 per cent lower than the charge in 2011, driven by material reductions of 29 per cent to £2,242 million in the Commercial Banking charge, and of 60 per cent to £1,321 million in the International charge. In Commercial Banking, non-core impairments decreased, particularly in the Australasian and Acquisition Finance portfolios, partly offset by further deterioration in the Shipping portfolio as a result of a weak market. In International, the impairment charge reduction was largely as a result of lower charges in the Irish business.

Non-core loans and advances to customers accounted for 72 per cent of the Group's impaired loans and had a coverage ratio of 51 per cent at 31 December 2012 (31 December 2011: 48 per cent).

Management profit

Management profit was £4,827 million in 2012, an increase of £2,142 million when compared to 2011. This incorporates the effects of asset sales, liability management, volatile items and fair value unwind.

	2012 £m	2011 £m
Underlying profit	**2,607**	638
Asset sales[1]	**2,547**	284
Liability management	**(229)**	1,295
Own debt volatility	**(270)**	248
Other volatile items	**(478)**	(986)
Fair value unwind	**650**	1,206
Management profit	**4,827**	2,685

[1] Net of associated fair value unwind of £689 million (2011: £737 million).

The Group's management profit has been affected by our active management of the balance sheet position in response to the low interest rate environment and the reduction in wholesale funding spreads seen in 2012.

The profit from asset sales of £2,547 million primarily relates to £3,207 million gains from sales of Government securities, as the Group has taken the opportunity afforded by the continuing low yields on these securities to rebalance and reduce the level of these holdings. Also included are losses from asset disposals of £1,349 million, principally relating to the run-down of the non-core portfolios, partially offset by a related fair value unwind of £689 million.

Liability management losses of £229 million arose on transactions undertaken as part of the Group's management of wholesale funding and capital, including a loss of £397 million in the second half resulting from debt repurchases and a gain of £168 million relating to the exchange of certain capital securities for other subordinated debt instruments in the first half.

Own debt volatility of £270 million is primarily driven by a charge relating to the change in fair value of the small proportion of the Group's wholesale funding which was designated at fair value at inception, and which reflects the tightening in credit spreads in the second half of 2012. This was partly offset by a positive impact relating to the change in fair value of the equity conversion feature of the Enhanced Capital Notes.

Other volatile items include the change in fair value of interest rate derivatives and foreign exchange hedges in the banking book not mitigated through hedge accounting, reflecting the volatile market conditions in the period, and a positive net derivative valuation adjustment.

Management profit also includes a gain of £650 million relating to an unwind of acquisition-related fair value adjustments. The unwind of fair value relating to assets disposed of in the period is included in the asset sales line.

Statutory loss

Statutory loss before tax was £570 million in 2012. Management profit was offset by provisions relating to legacy PPI business totalling £3,575 million, other regulatory provisions of £650 million, and other charges totalling £1,172 million. Further detail on the reconciliation to management and statutory results is included in note 4 on page 233.

	2012 £m	2011 £m
Management profit	**4,827**	2,685
Simplification, EC mandated retail business disposal and integration costs	**(1,246)**	(1,452)
Payment protection insurance provision	**(3,575)**	(3,200)
Other regulatory provisions	**(650)**	(175)
Past service pensions credit	**250**	–
Amortisation of purchased intangibles	**(482)**	(562)
Volatility arising in insurance businesses	**306**	(838)
Loss before tax – statutory	**(570)**	(3,542)
Taxation	**(773)**	828
Loss for the period	**(1,343)**	(2,714)
Loss per share	**(2.0)p**	(4.1)p

SUMMARY OF GROUP RESULTS

Simplification and EC mandated retail business disposal costs

The costs of the Simplification programme were £676 million in 2012, with a total of £861 million spent to date. These costs related to severance, IT and business costs of implementation. FTE role reductions of 4,892 were announced in 2012 taking the total to 6,990 since the start of the programme. Simplification of our business operations continues through reduction in management layers and increasing spans of control as well as restructuring business units. The latter includes consolidation of back office operations sites, optimisation of our IT delivery model and outsourcing of our property facilities and asset management services. Costs relating to the EC mandated business disposal in 2012 were £570 million and from inception to date total £782 million (costs in the year ended 31 December 2011: £170 million).

Payment protection insurance provision

The Group has had further experience of PPI complaint volumes, uphold rates and operational and redress costs since the announcement of our third quarter 2012 Interim Management Statement. As a consequence, we have made a further provision of £1,500 million in the fourth quarter, which brings the amount provided for PPI in 2012 to £3,575 million, and the total amount provided to £6,775 million. Total costs incurred to the end of 2012 were £4,344 million, including approximately £700 million of related administration costs.

The net volume of PPI complaints and costs of contact and redress continue to trend downwards. Complaints received in the fourth quarter of 2012 were approximately 20 per cent lower than the preceding quarter, and around 30 per cent lower than the second quarter of 2012. The average monthly spend for the fourth quarter of 2012 was approximately £200 million, a reduction of approximately 25 per cent on the third quarter. While uncertainty remains, we expect the average monthly spend to reduce further in the first half of 2013, by broadly 20 per cent when compared to the fourth quarter of 2012, before further reducing in the second half of the year.

Other regulatory matters

In June 2012, a number of banks, including Lloyds Banking Group, reached agreement with the Financial Services Authority (FSA) to carry out a thorough assessment of IRHP sales made since 1 December 2001 to certain small and medium sized businesses. The Group agreed that, on conclusion of this review, it would provide redress to any of these customers where appropriate. At that time the total cost was not expected to be material.

Given the agreement with the FSA reached on 30 January 2013 following the outcome of a pilot review of IRHP sales to small and medium-sized businesses, the Group now believes it is appropriate to increase its provision for IRHP by £310 million, based on revised estimates of redress and related administration costs. The provision in relation to IRHP now totals £300 million for the cost of redress and £100 million for related administration costs, all of which was accounted for in 2012. At the end of 2012, only £20 million of the original provision had been utilised.

We have received a number of claims in the German courts relating to policies issued by Clerical Medical Investment Group Limited, principally during the late 1990s and early 2000s, and recognised an additional provision of £150 million in respect of this litigation in the third quarter of 2012, taking the total provision to £325 million.

The Group has also taken a provision of £100 million for potential redress and other costs relating to UK Retail and other legacy conduct of business issues.

Further detail on these matters is contained in note 44 on page 278 of this annual report.

Interbank offered rate setting investigations

We continue to co-operate with investigations by government agencies in the UK, US and overseas into submissions made to the bodies that set various interbank offered rates. In addition the Group, together with other panel banks, has been named in private lawsuits in the US including with regard to the setting of BBA London interbank offered rates. It is currently not possible to predict the scope and ultimate outcome of the various regulatory investigations or private lawsuits, including the timing and scale of the potential impact of any investigations and private lawsuits on the Group.

Past service pensions credit

As previously disclosed at the 2012 Half-Year Results, following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The effect of this change is a reduction in the Group's defined benefit obligation of £250 million, the benefit of which has been recognised in the Group's income statement in 2012.

Volatility arising in insurance businesses

The Group's statutory result before tax is affected by insurance volatility, caused by movements in financial markets, and policyholder interests volatility, which primarily reflects the gross up of policyholder tax included in the Group tax charge. In 2012 the Group's statutory result before tax included positive insurance and policyholder interests volatility totalling £306 million compared to negative volatility of £838 million in 2011. Further detail is given on pages 74 and 75.

Taxation

The tax charge for 2012 was £773 million. This represents a greater tax burden than that implied by the UK statutory rate. This is primarily due to a policyholder tax charge of £583 million arising from the revaluation of policyholder tax credits in the light of current economic forecasts and recent changes to the taxation of life insurance companies. An additional £308 million of the tax charge results from the impact of the announced reduction in UK corporation tax rate to 23 per cent on the net deferred tax asset.

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Balance sheet

Confident in Group's capital position: capital ratios further improved and substantial further progress on balance sheet reduction

We have a strong capital position, and increased our core tier 1 capital ratio to 12.0 per cent at the end of December 2012 (31 December 2011: 10.8 per cent). This increase was principally driven by a reduction in risk-weighted assets of £42.0 billion, mainly driven by the non-core reduction, and the contribution from management profit, partly offset by statutory items and tax costs. The total capital ratio at 31 December 2012 improved to 17.3 per cent (31 December 2011: 15.6 per cent), which is already in excess of the Independent Commission Banking's (ICB) primary loss-absorbing capacity (PLAC) recommendations.

When applying the draft July 2011 CRD IV rules on both transitional and fully loaded bases, the Group's pro forma common equity tier 1 (CET1) capital ratios would have been 11.6 per cent and 8.1 per cent respectively as at 31 December 2012. The pro forma capital resources are based on our interpretation of the draft July 2011 CRD IV rules with risk-weighted assets estimates updated to reflect the Group's best expectation of how these rules will be amended for subsequent Basel announcements and EU discussions. Our calculation now includes a benefit of approximately 30 basis points from the expected favourable resolution of the definition of corporate exceptions from derivative valuation adjustments and of changes to the definition of default for retail mortgages. In addition, if the alternative treatment was allowed under CRD IV in relation to insurance holdings, we believe this would increase the fully loaded pro forma CRD IV CET1 ratio by approximately 1.0 per cent assuming application of the July 2011 text.

	At 31 Dec 2012	At 31 Dec 2011	Change %
Funded assets	**£535.3bn**	£587.7bn	(9)
Risk-weighted assets	**£310.3bn**	£352.3bn	(12)
Non-core assets	**£98.4bn**	£140.7bn	(30)
Non-core risk-weighted assets	**£72.9bn**	£108.8bn	(33)
Core tier 1 capital ratio	**12.0%**	10.8%	1.2pp
Tier 1 capital ratio	**13.8%**	12.5%	1.3pp
Total capital ratio	**17.3%**	15.6%	1.7pp
Pro forma fully loaded CRD IV core tier 1 capital ratio	**8.1%**	7.1%	1.0pp

We are pleased with the progress made on our balance sheet reduction plans, given challenging market conditions. In 2012, we achieved a substantial reduction of £42.3 billion in the non-core portfolio, resulting in the portfolio at 31 December 2012 amounting to £98.4 billion. The reduction continues to be managed in a capital efficient manner, and was capital accretive in 2012. It included reductions of £14 billion in treasury assets, £6 billion in UK commercial real estate and £9 billion in International assets of which £4 billion was in Ireland and £2 billion in Australasia.

The 33 per cent fall in non-core risk-weighted assets over the last year is in line with the 30 per cent of asset reductions achieved and reflects the substantial decrease in risk we have achieved over this period. We continue to expect our non-core assets to reduce to £70 billion or less by the end of 2014, at which point we expect more than 50 per cent to be retail assets.

The substantial reduction we have achieved in our non-core portfolio means we have now met our EC asset reduction commitment of £181 billion and we will now seek formal release from this commitment, substantially ahead of the deadline of 31 December 2014.

The Financial Policy Committee (FPC) published its Financial Stability Report on 29 November 2012 recommending that the Financial Services Authority (FSA) takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. The Group has made significant progress and continues to deliver on its strategy of strengthening the balance sheet, including its capital position, to improve the resilience of the Group.

The Group has strong governance, processes and controls which, combined with the Group's proactive management of risk, result in an appropriate level of capital. This includes:

- Rigorous stress testing exercises where the results are shared with the FSA; and
- Prudent internal models, based on empirical data, that meet regulatory and stringent internal requirements

In the context of on-going macro prudential policy discussions the Board has decided to issue new Lloyds Banking Group ordinary shares to fund discretionary payments on tier 1 hybrid capital securities to be made during 2013. Such discretionary payments are estimated to amount to approximately £350 million and will be made subject to the terms and conditions of the tier 1 hybrid capital securities. Further detail is included on page 184.

Overall, given our strongly capital generative core business and the ongoing capital accretive non-core asset reduction, we remain confident in the Group's capital position.

SUMMARY OF GROUP RESULTS

Funding position transformed; liquidity coverage further increased

The Group has transformed its funding profile and by the end of 2012, the Group loan to deposit ratio had improved from 135 per cent at 31 December 2011 to 121 per cent. The core loan to deposit ratio also improved to 101 per cent from 109 per cent at 31 December 2011.

	At 31 Dec 2012	At 31 Dec 2011	Change %
Customer deposits[1]	**£422.5bn**	£405.9bn	4
Wholesale funding	**£169.6bn**	£251.2bn	(32)
Wholesale funding <1 year maturity	**£50.6bn**	£113.3bn	(55)
Of which money market funding <1 year maturity	**£31.0bn**	£69.1bn	(55)
Wholesale funding <1 year maturity as a % of total wholesale funding	**29.8%**	45.1%	(15.3)pp
Loan to deposit ratio[2]	**121%**	135%	(14)pp
Core business loan to deposit ratio[2]	**101%**	109%	(8)pp
Government facilities	**–**	£23.5bn	
Primary liquid assets	**£87.6bn**	£94.8bn	(8)
Secondary liquidity	**£117.1bn**	£107.4bn	9

[1] Excluding repos of £4.4 billion (31 December 2011: £8.0 billion).

[2] Loans and advances to customers excluding reverse repos divided by customer deposits excluding repos.

We delivered customer deposit growth of 4 per cent, with good growth in both our Retail and Wealth, Asset Finance and International divisions.

Wholesale funding has reduced by 32 per cent since 31 December 2011 to £169.6 billion. Our short-term money-market funding reduced further by 55 per cent to £31.0 billion (2011: £69.1 billion). We have also improved the maturity profile of wholesale funding, with less than 30 per cent of wholesale funding having a maturity of less than one year at 31 December 2012, compared to 45 per cent at 31 December 2011.

We have also fully repaid all debt issued under the UK Government's Credit Guarantee Scheme, achieving a reduction of £23.5 billion in 2012.

In the first quarter of 2012, we drew €13.5 billion (the Sterling equivalent at the date of drawdown was £11.2 billion) under the European Central Bank's Long-Term Refinancing Operation for an initial term of three years, to part fund a pool of non-core euro denominated assets. Since the year-end, the Group has repaid over £8 billion of these, a decision which demonstrates the Group's balance sheet strength and strong liquidity position. We will retain the remaining funds as a currency hedge against our European portfolio.

In August 2012, we announced our support for the UK Government's Funding for Lending Scheme. We were the first bank to draw on the scheme in September 2012, drawing down £1 billion, with a further £2 billion during the last quarter of 2012.

We continue to maintain a strong liquidity position. Our primary liquid asset portfolio at the year-end reduced to £87.6 billion (2011: £94.8 billion), reflecting a reduction in total assets, wholesale funding and regulatory liquidity requirements. This represents approximately three times our money market funding and is approximately one and half times our aggregate wholesale funding with a maturity of less than a year, providing a substantial buffer in the event of market dislocation. In addition to primary liquidity assets, we have significant secondary liquidity holdings of £117.1 billion. Our total liquid assets represent approximately four times our short-term wholesale funding.

Given the improvements we have made to the strength of our balance sheet, we have significantly greater balance sheet flexibility with a strong liquidity position and reduced funding requirements. We re-purchased over £15 billion of term wholesale funding in 2012, including £8.5 billion through two public tenders for senior funding. These tenders were undertaken to more effectively manage our overall wholesale funding profile and optimise our future interest expense, whilst maintaining a prudent approach to liquidity.

In January 2013, to promote short-term resilience of bank liquidity risk profiles, the Basel Committee amended the calculation of the Liquidity Coverage Ratio. This requirement has been relaxed to allow a wider pool of asset classes to be deemed to be liquid, and to lengthen the implementation timeframe and assumed cash outflows have been reduced. We await the FSA's interpretation as it applies to UK banks before we can assess the impact to our liquidity position.

Conclusion

In 2012 we delivered a significantly improved underlying performance with key metrics in line with or ahead of expectations and guidance. The core business continues to deliver strong and stable returns, above the cost of equity. In a challenging economic and regulatory environment we have further derisked the balance sheet, strengthened the capital position and transformed our funding profile, and as a result, we are now increasingly well positioned for growth.

George Culmer
Group Finance Director

Management basis segmental analysis

2012	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	**7,195**	**2,206**	**799**	**(78)**	**213**	**10,335**
Other income	**1,462**	**2,932**	**2,043**	**2,294**	**(315)**	**8,416**
Insurance claims	**–**	**–**	**–**	**(365)**	**–**	**(365)**
Total underlying income, net of insurance claims	**8,657**	**5,138**	**2,842**	**1,851**	**(102)**	**18,386**
Total costs	**(4,199)**	**(2,516)**	**(2,291)**	**(744)**	**(332)**	**(10,082)**
Impairment	**(1,270)**	**(2,946)**	**(1,480)**	**–**	**(1)**	**(5,697)**
Underlying profit (loss)	**3,188**	**(324)**	**(929)**	**1,107**	**(435)**	**2,607**
Asset sales	**–**	**(464)**	**(196)**	**–**	**3,207**	**2,547**
Volatile items	**–**	**138**	**–**	**–**	**(886)**	**(748)**
Liability management	**–**	**–**	**–**	**–**	**(229)**	**(229)**
Fair value unwind	**482**	**888**	**(51)**	**(42)**	**(627)**	**650**
Management profit (loss)	**3,670**	**238**	**(1,176)**	**1,065**	**1,030**	**4,827**
Banking net interest margin	**2.08%**	**1.58%**	**1.65%**			**1.93%**
Impairment charge as a percentage of average advances	**0.36%**	**1.85%**	**3.12%**			**1.02%**
Return on risk-weighted assets	**3.21%**	**(0.18)%**	**(2.31)%**			**0.78%**
Key balance sheet items at 31 December 2012	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**
Loans and advances to customers excluding reverse repos	**343.3**	**134.7**	**33.4**		**0.7**	**512.1**
Customer deposits excluding repos	**260.8**	**109.7**	**51.9**		**0.1**	**422.5**
Total customer balances	**604.1**	**244.4**	**85.3**		**0.8**	**934.6**
Risk-weighted assets	**95.5**	**165.2**	**36.2**		**13.4**	**310.3**
2011	£m	£m	£m	£m	£m	£m
Net interest income	7,497	3,192	1,003	(67)	585	12,210
Other income	1,660	2,806	2,230	2,687	(204)	9,179
Insurance claims	–	–	–	(343)	–	(343)
Total underlying income, net of insurance claims	9,157	5,998	3,233	2,277	381	21,046
Total costs	(4,438)	(2,600)	(2,414)	(812)	(357)	(10,621)
Impairment	(1,970)	(4,210)	(3,604)	–	(3)	(9,787)
Underlying profit (loss)	2,749	(812)	(2,785)	1,465	21	638
Asset sales	48	61	(21)	–	196	284
Volatile items	–	(736)	–	–	(2)	(738)
Liability management	–	–	–	–	1,295	1,295
Fair value unwind	839	1,562	122	(43)	(1,274)	1,206
Management profit (loss)	3,636	75	(2,684)	1,422	236	2,685
Banking net interest margin	2.09%	1.86%	1.72%			2.07%
Impairment charge as a percentage of average advances	0.54%	2.32%	6.48%			1.62%
Return on risk-weighted assets	2.56%	(0.39)%	(5.82)%			0.17%
Key balance sheet items at 31 December 2011	£bn	£bn	£bn	£bn	£bn	£bn
Loans and advances to customers excluding reverse repos	352.8	155.7	40.2		0.1	548.8
Customer deposits excluding repos	247.1	116.7	41.7		0.4	405.9
Total customer balances	599.9	272.4	81.9		0.5	954.7
Risk-weighted assets	103.2	192.9	43.6		12.6	352.3

DIVISIONAL RESULTS

RETAIL

2012 highlights

- In 2012, Retail further increased its profits and returns, and made substantial progress towards its goal of being the best bank for customers.
- Underlying profit increased by 16 per cent, and core underlying profit by 21 per cent, driven by strong cost control and a significant reduction in impairment.
- Return on risk-weighted assets increased to 3.21 per cent from 2.56 per cent in 2011, driven primarily by the increase in profits.
- Retail has made continued progress in improving its customer service scores and saw a reduction in customer complaints (excluding PPI) of 28 per cent during 2012, both key indicators of customer advocacy. This has supported the strengthening of brand consideration to market leading levels.
- The Simplification programme has delivered significant improvements in customer experience, process efficiencies and reduced sourcing costs. This contributed to the strong cost performance delivered by Retail.
- We continued to support the first time buyer mortgage market, lending to one in four first time buyers. We also increased our commitment for lending to first time buyers during 2013. In addition, we continue to deliver strong growth in customer deposit balances attracting funds from almost one in every four savers.
- Retail continues to support local communities through its contribution to Group programmes and through direct commitments by Retail colleagues. In 2012 over 8,500 colleagues in Retail used their 'Day to Make a Difference' in local communities, including supporting National School Sports Week.

Performance summary

	2012 £m	2011 £m	Change %
Net interest income	**7,195**	7,497	(4)
Other income	**1,462**	1,660	(12)
Total underlying income	**8,657**	9,157	(5)
Total costs	**(4,199)**	(4,438)	5
Impairment	**(1,270)**	(1,970)	36
Underlying profit	**3,188**	2,749	16
Banking net interest margin	**2.08%**	2.09%	(1)bp
Impairment charge as a % of average advances	**0.36%**	0.54%	(18)bp
Return on risk-weighted assets	**3.21%**	2.56%	65bp

	At 31 Dec 2012 £bn	At 31 Dec 2011 £bn	Change %
Key balance sheet items			
Loans and advances to customers excluding reverse repos	**343.3**	352.8	(3)
Customer deposits excluding repos	**260.8**	247.1	6
Total customer balances	**604.1**	599.9	1
Risk-weighted assets	**95.5**	103.2	(7)

Strategic focus

Retail's goal is to be the best bank for customers in the UK. We are working towards this by building deep and enduring relationships with our customers that deliver real value to them, and by continuing to support the UK economy. We are increasing engagement with our customers by delivering greater choice and flexibility through our multiple brands and channels. At the same time we are simplifying the business to increase our agility and enable us to respond more quickly to customers' needs, and improve customer experience. We are particularly focused on continuing to improve customer service and actively reduce customer complaints. In addition, by further developing our customer insight and gaining a deeper understanding of our customers, we are better aligning our products and services to our customers' requirements. This is increasing customer advocacy which ultimately delivers lower customer acquisition costs, greater share of their business and improved customer retention.

Progress against strategic initiatives

Retail has continued to make excellent progress towards being the best bank for customers during 2012. This progress is demonstrated by an increase in customer advocacy, reflected in our customer service scores which have risen by 13 per cent during 2012. This improvement is being supported by the strong focus within Retail on reducing customer complaints, which have decreased by 28 per cent (excluding PPI). Over 2012, based on performance across Branch, Telephone and Internet Banking, Lloyds TSB has been the leading High Street bank for customer service[1].

By ***investing*** in customers and growth, we are positioning ourselves for an improvement in market conditions. We have maintained our position as the UK's largest lender to first time buyers and in 2012 helped one in every four buy their first home. This achievement has been supported by the development of new propositions for first time and new-build property buyers. We have continued to deliver net inflows from switching current accounts as well as attracting deposits from almost one in every four savers. This has supported strong growth in customer deposit balances and contributed to our strengthened balance sheet. In addition, we have supported over half a million customers to buy their cars, improve their homes and manage their finances through unsecured consumer loans.

We are also investing in the channels our customers use to interact with the Group. In particular we have made significant developments to our digital proposition and branches. This includes the expansion of services available on smart phones and mobile devices, which has contributed to the continued growth of our online customer base to 9.5 million and our mobile banking services which are now used by 3.3 million customers.

Earlier in 2012 we concluded a review of the implications of the Retail Distribution Review. We will now offer investment advice to customers with over £100,000 of investible assets through our private banking services. It will allow us to focus on providing market leading savings and protection services to mainstream customers.

We are continuing to successfully ***simplify*** the bank. We have implemented further automation, and improved the functionality of current account and ISA savings switching services to improve customer experience. These processes also require significantly fewer manual interventions, contributing to reduced costs and customer complaints. We have also continued to develop our telephony services for customers and have introduced 'Say Anything' Interactive Voice Response technology, which guides customer calls accurately and promptly to the right service.

Finally, Retail has continued to support the UK economy and local communities through its contribution to Group programmes, and through commitments made by Retail colleagues. In 2012 over 8,500 colleagues volunteered using the Bank's 'Day to Make a Difference' programme. In addition, Retail played a key role in the Group's Partnership with the London 2012 Olympic and Paralympic Games as official sponsors. Our colleagues were involved in many community activities, including the Olympic and Paralympic Torch Relays, and National School Sport Week.

Financial performance

In 2012, Retail's return on risk weighted assets increased to 3.21 per cent, a significant improvement on 2.56 per cent in 2011. This improvement was supported by a 16 per cent increase in underlying profit, and a 21 per cent increase in core underlying profit. The increase in profit in both core and total Retail was the result of strong cost control and continued significant improvements to credit performance. The core performance was very similar to the total performance given that non-core in Retail covers only 4 per cent of customer balances and 1 per cent of income.

Net interest income decreased by 4 per cent in 2012, driven by muted demand for lending, previous de-risking of the balance sheet and increased funding costs. While the prior de-risking of the lending portfolio has suppressed income growth, it also supported an offsetting reduction in impairment charges. Retail has taken a number of actions to offset the pressure on income which includes making strategic investments and re-pricing selected lending portfolios to reflect current funding costs.

Net interest margin was stable at 2.08 per cent in 2012. The net interest margin in the second half of the year particularly benefited from rate changes we made to the lending portfolio, but continues to be affected by higher funding costs and the impact of portfolio de-risking.

Other income decreased by 12 per cent largely as a result of lower bancassurance income that reflected the subdued investment and protection market environment.

[1] Compared to the other major High Street Banks (defined as Barclays, Halifax, HSBC, NatWest and Santander), using a composite weighted score of main current account holder's satisfaction with branch, telephone and internet services (among those using those channels in the last month). © GfK NOP Financial Research Survey (FRS), 12 months ended December 2012 approximately 45,000 adults surveyed.

DIVISIONAL RESULTS
Retail

Total costs fell by 5 per cent, largely as a result of the Simplification programme. As part of this programme we have delivered end-to-end process enhancements, migration of customers to self-service channels, and implemented further improvements in purchasing arrangements across Retail. We have also delivered other day-to-day cost benefits, which, when combined with our work on Simplification, more than offset on-going cost inflation and increased investment spend.

Credit performance across the business continued to be strong considering the subdued economic environment. This was supported by our sustainable approach to risk, a continued focus on lending to existing customers and low interest rates. The unsecured impairment charge reduced to £893 million from £1,507 million in 2011, reflecting the impact of our sustainable approach to risk (resulting in improved new business quality), effective portfolio management and a reduction in unsecured balances. The secured impairment charge decreased to £377 million from £463 million in 2011, reflecting further reductions in impaired loans in the secured portfolio.

Balance sheet progress

Loans and advances to customers decreased by 3 per cent. This was driven by a number of factors, including reduced customer demand for new credit, existing customers continuing to reduce their personal indebtedness, non-core lending run-off and Retail maintaining a sustainable approach to risk. The reduction in lending to customers was in part due to the repayment of unsecured debt where balances reduced by £1.7 billion to £22.0 billion, or 7 per cent. Secured balances reduced by £7.8 billion, to £321.3 billion, of which £1.4 billion was a reduction in non-core mortgage balances.

Customer deposits increased by 6 per cent in 2012. This reflects the success of our multi-brand customer propositions and the agile pricing strategy that Retail has developed. Retail continued to deliver sustained growth in the savings market despite the high levels of competition. Our strong stable of savings brands continues to provide customers with a market leading range of products to meet their savings needs.

Risk-weighted assets decreased by £7.7 billion during 2012. This was the result of lower lending balances, effective portfolio management and prior de-risking of the balance sheet.

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COMMERCIAL BANKING

2012 highlights

- Commercial Banking was created in the fourth quarter of 2012 bringing Small and Medium-sized Enterprises (SME) together with larger corporate UK and global clients to ensure consistent and effective client coverage. The former Wholesale division has been combined with the Australian and European corporate businesses previously reported in the International segment of Wealth, International and Asset Finance.
- We continued to deepen our relationships with core clients through our investment in new products and capabilities to drive capital efficiency and through our lending commitments to support the UK economy and SMEs, including our involvement in the UK Government's National Loan Guarantee and the Funding for Lending Scheme (FLS).
- Underlying loss reduced by 60 per cent due to a 30 per cent reduction in impairments, which more than offset the reduction in total underlying income.
- Core underlying profit increased by 1 per cent to £1,748 million, driven by reduced impairments and improved other income from resilient performances in Capital Markets, Financial Markets and LDC. This was offset by lower net interest income. Return on risk-weighted assets increased to 1.36 per cent from 1.32 per cent.
- Underlying loss in the former Wholesale business reduced by 36 per cent due to a 31 per cent reduction in impairments and improved other income. This more than offset lower net interest income, resulting from our strategic non-core asset reduction and increased wholesale funding costs.
- Underlying profit in the former Commercial business increased by 10 per cent, driven by reduced impairments and costs partly offset by lower underlying income. Core net lending grew by 4 per cent against market contraction of 4 per cent and we assisted in excess of 120,000 SMEs to start up in 2012.

Performance summary

	2012 **£m**	2011[1] £m	Change %
Net interest income	**2,206**	3,192	(31)
Other income	**2,932**	2,806	4
Total underlying income	**5,138**	5,998	(14)
Total costs	**(2,516)**	(2,600)	3
Impairment	**(2,946)**	(4,210)	30
Underlying loss	**(324)**	(812)	60
Wholesale	**(792)**	(1,238)	36
Commercial	**468**	426	10
Total Commercial Banking	**(324)**	(812)	60
Banking net interest margin	**1.58%**	1.86%	(28)bp
Impairment charge as a % of average advances	**1.85%**	2.32%	(47)bp
Return on risk-weighted assets	**(0.18)%**	(0.39)%	21bp

	At **31 Dec** **2012** **£bn**	At 31 Dec 2011[1] £bn	Change %
Key balance sheet items			
Loans and advances to customers excluding reverse repos			
Wholesale	**105.1**	126.9	(17)
Commercial	**29.6**	28.8	3
	134.7	155.7	(13)
Customer deposits excluding repos	**109.7**	116.7	(6)
Risk-weighted assets	**165.2**	192.9	(14)

[1] Restated to reflect transfers from Wealth, Asset Finance and International and transfer of Asset Finance to Wealth, Asset Finance and International.

DIVISIONAL RESULTS
Commercial Banking

Strategic focus

Commercial Banking's strategy is to be the best bank for our clients. We have put clients at the centre of our business model and will lead our business through four coverage segments: Small and Medium-sized Enterprises (SME), Mid Markets, Global Corporates and Financial Institutions. We will meet our clients' needs with a suite of core banking products from Lending and Transaction Banking to Financial Markets and Capital Markets, delivering the full capability of the bank to our clients and serving their needs as they move up the value chain. Our strategy is driven by three guiding principles; to be client centric, UK focused and capital efficient with a rigorous focus on executing our plans according to these core principles. Our business will be delivered through the formation of a simpler leaner organisation, sharper prioritisation of resources to support our core clients and focused investment in product capability to better serve our clients' needs. All of this will contribute to the delivery of strong and sustainable Commercial Banking returns over time.

Progress against strategic initiatives

In the fourth quarter of 2012, Commercial Banking ***reshaped*** the business, bringing SME clients together with larger corporate UK and global clients to ensure consistent and effective client coverage. We continue our exercise to re-segment our client coverage, driven by evolving client behaviours. For SME and Mid Markets clients we are strengthening our face-to-face banking proposition as well as working to improve the delivery of simple products to meet simple needs through enhanced digital capability. For larger corporate clients we are strengthening our product capability through investment in Transaction Banking at the same time as enriching the core proposition in Financial Markets and Capital Markets to improve fee generating solutions.

In 2012, we made good progress in ***simplifying*** the business through a series of initiatives to streamline operational processes and improve client experience and service. We have already delivered benefits through de-layering the organisation and removing inefficiencies and will continue to benefit as we deliver synergies from bringing the legacy divisions together. Within SME, significant progress has been made in simplifying the lending process and the time taken to complete lending transactions to clients has almost halved from the end of 2011 compared to the end of 2012. The reshaping and simplifying of the business is leading to a more effective and agile organisation.

We have sharpened our focus on ***strengthening*** the balance sheet and improving capital efficiency through the development of more considered client participation and controlled reduction of the non-core portfolio. Within our core business, we have further refined our client participation and will rationalise exposure to capital-intensive businesses. In 2012, for example we discontinued our origination of new Project Finance business in the US and restricted new origination in Australia to key clients with strong UK linkage only, and reduced our exposure to parts of the corporate real estate portfolio that do not deliver acceptable returns. We have continued to reduce our exposure to non-core assets, achieving a substantial reduction of £33.2 billion in 2012, a decrease of 44 per cent.

We continued to ***invest*** in product capability in 2012 and are positioning ourselves to benefit from eventual economic recovery. As part of our programme to enhance our capabilities in capital efficient products, we have continued to invest in the Transaction Banking platform delivering product capabilities in Card Payments & Acceptance, Currencies and International Cash Management. Meanwhile, we processed all ticket payments and provided merchant support at all of the principal London 2012 Olympic sites. In Foreign Exchange, client volumes increased by 19 per cent compared to 2011 through investments in electronic channels and improved pricing and risk management capabilities. More specifically on client connectivity we are making good progress in Foreign Exchange service to provide our clients with a seamless 24 hour service globally in 2013.

Additionally, in 2012 we continued our focus to support the UK economy through financing UK SMEs and developing discounted funding propositions for our clients through the UK Government's National Loan Guarantee Scheme and the Funding for Lending Scheme (FLS). In SME we grew our core net lending by 4 per cent in a market which contracted by 4 per cent and we helped in excess of 120,000 SMEs to start up in 2012. External recognition of our support for SMEs includes being voted as the Winner of the Innovation in SME Finance award from Business Moneyfacts, as well as 'Most Supportive Lender of the Year' from the National Association of Commercial Finance Brokers.

In Mid Markets we grew share of lending in a declining market and will invest in additional capacity to support our clients in 2013. In Social Housing, within Mid Markets, we topped the Housing Association Bond league table in 2012 with 10 Bookrunner mandates for 10 separate housing associations, highlighting our support for clients and contributing to the availability of housing stock in the UK.

In 2012, we supported our Global Corporate clients in raising £12.8 billion of financing through the Debt Capital Markets, enabling them to finance and grow their businesses. We have made good progress in creating solutions for our clients, attaining a top five position in Investment Grade Corporate Sterling debt issuance, and were awarded the 2012 Greenwich Quality Leader award for Large Corporate Banking in the UK, recognising our strong client experience.

In Project Finance, we provided in excess of £750 million of lending to UK infrastructure initiatives and achieved the top UK Bookrunner position in 2012. We received the PPP Deal of the Year award in 2012 from Project Finance International, highlighting our commitment and the key role we are playing in supporting UK infrastructure projects that are vital for stimulating economic growth.

In LDC, our private equity arm, we continued to invest equity through the cycle in support of clients across SME and Mid Markets. During 2012, 96 per cent of our investment was focused on the UK with over £300 million invested in new portfolio companies.

As a testament to our client-centric approach, Commercial Banking was awarded for the eighth year in a row the Business Bank of the Year at the FD's Excellence Awards (in association with the Institute of Chartered Accountants in England and Wales, supported by the CBI).

We have grown our capabilities in Transaction Banking and Capital Markets and increased fee based income. This is in line with broader market trends as clients' needs have become less lending-reliant and more focused on liability and risk management solutions. As we execute our strategy to be client centric, UK focused and capital efficient this increase in fee based income from client solutions will be an important driver of our income over time.

Financial performance

Divisional underlying loss reduced by £488 million due to the significant reduction in impairments as a result of lower charges in most of the businesses, increased other income, and lower total costs partially offset by reduced net interest income. Core underlying profit increased by £14 million with core return on risk-weighted assets increasing by 4 basis points.

Net interest income decreased by £986 million. Core net interest income decreased by £604 million as a result of average lending volumes decreasing by £5.4 billion and margin compression. Despite lending growth in the former Commercial division, corporate client demand in the former Wholesale division was subdued continuing the current market trend of deleveraging, and compressed margins reflecting higher wholesale funding costs and improved recognition of the cost and value of funds across the Group. Non-core net interest income decreased by £382 million due to average lending volumes decreasing by £16.9 billion and compressed margins.

Banking net interest margin decreased by 28 basis points to 1.58 per cent, primarily reflecting margin compression from increased wholesale funding costs and competition for customer deposits. Core net interest margin decreased by 32 basis points to 2.22 per cent as there was limited opportunity for asset repricing to offset higher funding costs. Non-core net interest margin decreased by 48 basis points to 0.35 per cent, reflecting higher wholesale funding costs.

Other income increased by £126 million, reflecting higher client activity in Financial Markets and Debt Capital Markets despite difficult market conditions, and a resilient performance in LDC benefiting from a strong vintage.

Commercial Banking costs decreased by 3 per cent, with continued focus on cost management, savings attributable to the Simplification programme and the savings arising from the reduction in non-core assets. The benefits of these cost savings initiatives enabled further investment in Wholesale product capabilities in Financial Markets, Capital Markets and Transaction Banking.

Impairment charges decreased by £1,264 million, due to a 29 per cent reduction in non-core impairments driven by the Australasian and the Acquisition Finance portfolio, partly offset by further deterioration in the Shipping portfolio. Core impairments decreased by 33 per cent including in Mid Markets, Corporate and SME. In Mid Markets and Corporate there were specific large impairments in 2011 which were not repeated in 2012.

Balance sheet progress

Commercial Banking continues to focus on de-risking the balance sheet by reducing non-core assets whilst strengthening its relationships with core customers. Net lending in the former Commercial division increased by £0.8 billion, whilst core client deleveraging, and the non-core asset reduction in the former Wholesale division, more than offset this increase. Non-core assets decreased £33.2 billion mainly driven by a reduction of treasury assets of £14.5 billion and loans and advances to customers, excluding reverse repos.

Loans and advances to customers, excluding reverse repos, decreased by £21.0 billion, of which £16.3 billion was driven by the non-core asset reduction. Core lending decreased by £4.7 billion as demand for new corporate lending and refinancing of existing facilities was more than offset by the level of maturities, reflecting a continued trend of subdued corporate lending demand and client deleveraging as credit facilities matured and were not renewed by clients.

Risk-weighted assets decreased by £27.7 billion primarily reflecting repayments, the impact of subdued corporate lending and balance sheet disposals; core risk-weighted assets remained broadly flat due to the impact of regulatory treatments and rule changes. Non-core risk-weighted assets represented £27.0 billion of this reduction and was driven by non-core disposals.

Wholesale sub-segment – financial performance

	Total			Core		
	2012 £m	2011[1] £m	Change %	**2012 £m**	2011[1] £m	Change %
Net interest income	**1,027**	1,941	(47)	**1,072**	1,617	(34)
Other income	**2,513**	2,380	6	**2,024**	1,810	12
Total underlying income	**3,540**	4,321	(18)	**3,096**	3,427	(10)
Total costs	**(1,628)**	(1,652)	1	**(1,348)**	(1,350)	
Impairment	**(2,704)**	(3,907)	31	**(452)**	(759)	40
Underlying (loss) profit	**(792)**	(1,238)	36	**1,296**	1,318	(2)
Banking net interest margin	**0.96%**	1.35%	(39)bp	1.40%	1.83%	(43)bp
Impairment charge as a % of average advances	**2.10%**	2.56%	(46)bp	0.59%	0.90%	(31)bp
Return on risk-weighted assets	**(0.51)%**	(0.69)%	18bp	**1.24%**	1.23%	1bp
Key balance sheet items at 31 December	**2012 £bn**	2011[1] £bn	Change %	**2012 £bn**	2011[1] £bn	Change %
Loans and advances to customers excluding reverse repos	**105.1**	126.9	(17)	**73.5**	79.3	(7)
Debt securities	**5.2**	12.5	(58)	**0.5**	0.2	
Available-for-sale financial assets	**4.3**	12.5	(66)	**1.8**	3.1	(42)
	114.6	151.9	(25)	**75.8**	82.6	(8)
Customer deposits excluding repos	**75.6**	84.6	(11)	**73.2**	81.8	(11)
Risk-weighted assets	**140.1**	167.5	(16)	**103.7**	104.7	(1)

[1] Restated to reflect transfers from Wealth, Asset Finance and International and transfers of Asset Finance to Wealth, Asset Finance and International.

DIVISIONAL RESULTS

Commercial Banking

Total underlying loss decreased by £446 million with core underlying profit decreasing by £22 million mainly due to the significant reduction in impairments and increased other income, partially offset by reduced net interest income.

Net interest income decreased by £914 million. Core net interest income decreased by £545 million due to average lending volumes decreasing by £6.1 billion as a result of subdued global corporate client demand, continuing the current market trend of deleveraging, and lower margins.

Banking net interest margin decreased by 39 basis points to 0.96 per cent, primarily reflecting margin compression from increased wholesale funding costs and competition for customer deposits. Core net interest margin decreased by 43 basis points to 1.40 per cent following limited opportunity for asset repricing to offset higher funding costs.

Other income increased by £133 million, with core other income increasing by £214 million, reflecting higher client activity in Financial Markets and Debt Capital Markets despite difficult market conditions, and a resilient performance in LDC benefiting from strong vintage.

Commercial sub-segment – financial performance

	Total			Core		
	2012 £m	2011 £m	Change %	2012 £m	2011 £m	Change %
Net interest income	1,179	1,251	(6)	1,170	1,229	(5)
Other income	419	426	(2)	418	425	(2)
Total underlying income	1,598	1,677	(5)	1,588	1,654	(4)
Total costs	(888)	(948)	6	(884)	(942)	6
Impairment	(242)	(303)	20	(252)	(296)	15
Underlying profit	468	426	10	452	416	9
Banking net interest margin	3.96%	4.21%	(25)bp	4.11%	4.37%	(26)bp
Impairment charge as a % of average advances	0.81%	1.06%	(25)bp	0.89%	1.09%	(20)bp
Return on risk-weighted assets	1.86%	1.62%	24bp	1.90%	1.69%	21bp
Key balance sheet items at 31 December	2012 £bn	2011 £bn	Change %	2012 £bn	2011 £bn	Change %
Loans and advances to customers excluding reverse repos	29.6	28.8	3	28.5	27.4	4
Customer deposits excluding repos	34.1	32.1	6	34.0	31.8	7
Total customer balances	63.7	60.9	5	62.5	59.2	6
Risk-weighted assets	25.1	25.4	(1)	24.1	23.8	1

Total underlying profit increased £42 million, with core underlying profit increasing by £36 million due to the significant reduction in impairments and costs, partially offset by reduced underlying income.

Core net lending increased £1.1 billion despite the SME market contracting 4 per cent. Core net interest income decreased £59 million primarily due to compressed margins from higher wholesale funding costs and increased competition for customer deposits. This is reflected in the core net interest margin reduction of 26 basis points.

Total impairments decreased £61 million reflecting the continued benefits from the application of a prudent risk appetite and the low interest rate environment, helping to maintain defaults at a lower level.

Total customer deposits excluding repos increased £2.0 billion reflecting the ongoing success in attracting new customers.

WEALTH, ASSET FINANCE AND INTERNATIONAL

2012 highlights

- In 2012 we achieved strong profitable growth in our Wealth and Asset Finance businesses while simultaneously making progress in strengthening our balance sheet, simplifying our international operating model and investing in building capability for the future.
- Divisional performance improved in 2012 with losses reducing by 67 per cent to £929 million primarily driven by lower impairments, mainly in Ireland. Profits in the core business increased by 27 per cent to £459 million, driven by strong performance in the Wealth and Asset Finance businesses.
- Core return on risk-weighted assets increased from 3.62 per cent to 5.07 per cent.
- The balance sheet has been further strengthened through a 24 per cent growth in customer deposits and a reduction in non-core assets of a further 20 per cent, including a £3.7 billion reduction in our Irish portfolio.
- We achieved cost savings of 5 per cent through further progress on Simplification initiatives, which in turn enabled further investment in the core businesses to improve the customer experience.
- We continue to reshape our operations by further streamlining our international footprint through the announced exits from five countries (following seven exits last year) and a significantly reduced presence in a further four.

Performance summary

	2012 £m	2011[1] £m	Change %
Net interest income	799	1,003	(20)
Other income	2,043	2,230	(8)
Total underlying income	2,842	3,233	(12)
Total costs:	(2,291)	(2,414)	5
Impairment	(1,480)	(3,604)	59
Underlying loss	(929)	(2,785)	67
Banking net interest margin	1.65%	1.72%	(7)bp
Impairment charge as a % of average advances	3.12%	6.48%	(3.36)pp
Return on risk-weighted assets	(2.31)%	(5.82)%	3.51pp

	At 31 Dec 2012 £bn	At 31 Dec 2011 £bn	Change %
Key balance sheet items			
Loans and advances to customers excluding reverse repos	33.4	40.2	(17)
Customer deposits excluding repos	51.9	41.7	24
Total customer balances	85.3	81.9	
Operating lease assets	2.8	2.7	4
Funds under management	189.1	182.0	4
Risk-weighted assets	36.2	43.6	(17)

[1] Restated to reflect transfers to Commercial Banking and transfer of Asset Finance to Wealth, Asset Finance and International.

DIVISIONAL RESULTS

Wealth, Asset Finance and International

Strategic focus

The business segments of the division have been aligned this year to reflect the operating model:

- Wealth – our UK and International Wealth businesses, Scottish Widows Investment Partnership and St James's Place.
- Asset Finance – our UK and International Asset Finance and on-line deposit businesses.
- International – our non-core businesses in Ireland, Europe, Asia and the rest of the world (excluding businesses transferred to the Commercial Banking division in the year).

Wealth provides strong growth opportunities for the Group. Its goal is to be recognised as the Wealth advisor of choice to appropriate Retail and Commercial Banking customers alongside targeted customer acquisition. We aim to grow the amount of customer deposits and funds under management that we manage on behalf of franchise customers, whilst improving margins and operating efficiency.

In Asset Finance, we have been refocusing the business into sectors which fit our risk appetite and profitability and are looking to deliver focused, profitable growth while completing the run-down or disposal of portfolios which are closed to new business.

In the International businesses, the priority is to maximise value in the medium-term. The immediate focus is on close management of the balance sheet where we are contributing to a strengthening of the Group's balance sheet through a significant and managed run-down of non-core assets. At the same time, we continue progress on rationalising our international footprint delivering operational efficiencies and reducing the cost base to fit the reshaped business models.

Progress against strategic initiatives

The significant progress we have made in ***strengthening*** the balance sheet positions us for focused, profitable growth in our core business. Alongside this we will continue to grow total customer balances (including deposits and funds under management) in the Wealth businesses where over time we expect customer appetite to shift from deposits to investment products.

We continue to focus on ***simplifying*** operations and processes, delayering management structures, consolidating supplier relationships and increasing the efficiency of distribution channels.

We are in the process of ***reshaping*** the business, realising additional efficiencies and cost savings through initiatives to consolidate the Wealth businesses and create a shared support infrastructure, develop a single customer platform and to automate core systems and processes for efficiency and improved customer experience in both Wealth and Asset Finance. The division has also made good progress towards reducing its international presence with a further five exits announced in the year bringing the total to twelve, representing over a one third reduction in our international presence over the last two years.

We are ***investing*** in our Wealth business to grow market share in what is viewed as a key growth opportunity for the Group. The investment is geared towards developing compelling propositions for mass affluent and affluent customers within the UK and Channel Islands and also those with UK connections in anglophile territories. During 2012, we created one single Wealth business with the aim of generating synergies across the International and UK businesses.

We are focused on ways to leverage the strength of our core banking franchise which holds a number of significant customers who are 'wealth eligible'. Investment has already been made in customer experience and plans are underway for significant technology and product development. During 2012 there have been approximately 115,000 referrals into the Wealth business from other areas of the Group.

We remain confident that by delivering our strategy to be a simple, customer-focused UK and International business we can increase the trust of both customers and stakeholders. In Wealth this has resulted in an improvement of client service accessibility. This is demonstrated by the faster access to advice and support that customers are now receiving as a result of a new Private Banking Client Centre. The new centre is making the referral process from Retail to our Wealth business simpler and swifter, and will be fully rolled out across the Lloyds TSB and the Halifax networks by the end of 2013.

In Asset Finance we have strong market positions in the UK and Australia and a strong funding base through our online deposit business. We have refocused the businesses and have made substantial progress in exiting portfolios which do not fit our risk appetite while positioning the motor leasing and finance businesses for growth.

In the UK, Lex Autolease delivered strong new business performance with a year on year increase in deliveries of 11 per cent. Lex Autolease is a market leader in the UK and already in the top five car leasing firms in Europe, with a strong customer proposition and deep insights and capabilities in the contract hire market.

The Blackhorse Motor Finance business grew new business by 11 per cent reflecting its return to a growth strategy. The business has a strong established market position and a broad customer franchise. Our focus is on further upgrading our market leading technology platform and using it to launch new customer propositions.

In line with our strategy to grow the motor and direct business, the Australian asset finance business achieved new business growth of 16 per cent in 2012. The business also began a strategic investment to automate and simplify end to end systems with the objective of delivering an improved, cost effective customer experience.

We have further reduced non-core loans by £7.0 billion in 2012 through a mixture of repayments and selected asset disposals. This includes the impact of a £2.6 billion (gross) asset reduction in Ireland in respect of a successful disposal of a portfolio of wholesale assets. Within Asset Finance, the non-strategic portfolio in run-off now represents only 10 per cent of the total business.

Financial performance

Underlying loss reduced by 67 per cent to £929 million primarily due to a £2,124 million reduction in impairments and lower costs, partially offset by a fall in non-core income as a result of the balance sheet reduction.

Core underlying profit increased by 27 per cent to £459 million, largely driven by the strong performance in our Wealth and Asset Finance motor and contract hire businesses where core underlying profit increased by 25 and 13 per cent, respectively, together with improved profitability in our on-line deposit businesses. Core income was flat mainly as a result of lower income from funds under management as investment markets in 2012 remained subdued. Core costs reduced by 5 per cent to £1,795 million reflecting the progress we have made in simplifying and consolidating our Wealth business as part of the Simplification programme. This enabled us to make significant investment within the Wealth business in the year.

Underlying non-core loss reduced by 56 per cent to £1,388 million driven by a continued reduction in impairments in Ireland.

Net interest income decreased by 20 per cent. Core net interest income grew by 6 per cent due to strong deposit inflows within the Wealth and on-line deposit businesses. Non-core net interest income reduced by 31 per cent driven by a 20 per cent fall in non-core assets, higher funding costs and the increased level of impaired assets in Ireland.

Net interest margin fell to 1.65 per cent from 1.72 per cent in 2011 despite margins in our core business increasing to 5.90 per cent in 2012, up from 5.04 per cent in 2011. The year on year reduction in divisional margin was driven by our non-core business where margins fell from 1.35 per cent in 2011 to 1.13 per cent in 2012 as a result of significant non-core asset run-off in the year together with increased levels of impaired assets, mainly in Ireland.

Other income decreased by 8 per cent. Core other income decreased by 1 per cent with modest growth in Wealth against a background of subdued investment markets and customer appetite off-set by reduced non-core income in Asset Finance and International driven by business sales in the year and continued non-core asset run-off.

Total costs decreased by 5 per cent despite a 4 per cent increase in total customer balances and funds under management. This reflected our continued focus on simplifying our business model and reducing our international footprint.

The impairment charge reduced by 59 per cent to £1,480 million, largely as a result of lower charges in the Irish business where the charge amounted to £1,245 million (2011: £3,187 million). The rate of increase in newly impaired loans in Ireland has slowed through 2012 from £4.1 billion to £1.6 billion.

	Wealth		Asset Finance		International		Total	
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Net interest income	**328**	321	**414**	496	**57**	186	**799**	1,003
Other income	**940**	934	**1,087**	1,163	**16**	133	**2,043**	2,230
Total underlying income	**1,268**	1,255	**1,501**	1,659	**73**	319	**2,842**	3,233
Total costs	**(887)**	(935)	**(1,029)**	(1,122)	**(375)**	(357)	**(2,291)**	(2,414)
Impairment	**(23)**	(33)	**(136)**	(232)	**(1,321)**	(3,339)	**(1,480)**	(3,604)
Underlying profit (loss)	**358**	287	**336**	305	**(1,623)**	(3,377)	**(929)**	(2,785)
Return on risk-weighted assets	**6.38%**	4.15%	**2.71%**	2.03%	**(7.32)%**	(13.04)%	**(2.31)%**	(5.82)%

The focus in Wealth has been to grow market share in UK and International Wealth through increasing deposits and funds managed on behalf of franchise customers, whilst improving margins and operating efficiency. Customer deposits increased by £4.6 billion or 18 per cent to £30.8 billion reflecting continued growth in our core Wealth businesses whilst funds under management grew by 4 per cent reflecting a shift of customer appetite away from investment products towards deposits.

Underlying profit increased by 25 per cent to £358 million driven by increased income, reflecting strong deposit and margin growth and lower costs, driven by cost saving initiatives across the business.

In Asset Finance, underlying profit increased by 10 per cent, despite an 8 per cent reduction in loans and operating lease assets as we completed the refocusing of the business to fit our risk appetite. This resulted in improving margins in our motor finance and lending business, together with a 46 per cent growth in on-line deposits.

In International, underlying loss reduced by £1,754 million to £1,623 million largely driven by Ireland where there was a decrease in the impairment charge from £3,187 million in 2011 to £1,245 million in 2012.

DIVISIONAL RESULTS
Wealth, Asset Finance and International

Balance sheet progress

Net loans and advances to customers decreased by £6.8 billion to £33.4 billion with continued management focus continued on de-risking the balance sheet. This reflects net repayments and asset sales of £7.5 billion, additional impairment provisions of £1.4 billion mainly within the International businesses, and foreign exchange movements of £0.7 billion.

Our Wealth and on-line deposit businesses continued to grow strongly with balances as at December 2012 of £51 billion, an increase of £11 billion in 2012. Overall, the Wealth, Asset Finance and International businesses have become a significant contributor to the Group's funding with an £18 billion excess of deposits over customer advances.

Risk-weighted assets fell by 17 per cent from £43.6 billion to £36.2 billion reflecting continued focus in the year on non-core asset run-off and balance sheet de-risking.

	Wealth		Asset Finance		International		Total	
At 31 December	**2012** **£bn**	2011 £bn	**2012** **£bn**	2011 £bn	**2012** **£bn**	2011 £bn	**2012** **£bn**	2011 £bn
Key balance sheet items								
Loans and advances to customers excluding reverse repos	**4.2**	4.8	**9.3**	10.4	**19.9**	25.0	**33.4**	40.2
Customer deposits excluding repos	**30.8**	26.2	**20.2**	13.8	**0.9**	1.7	**51.9**	41.7
Total customer balances	**35.0**	31.0	**29.5**	24.2	**20.8**	26.7	**85.3**	81.9
Risk-weighted assets	**5.7**	5.8	**10.9**	13.8	**19.6**	24.0	**36.2**	43.6

Funds under management

	At **31 December** **2012** **£bn**	At 31 December 2011 £bn
Scottish Widows Investment Partnership (SWIP)		
Internal	**118.5**	116.8
External	**23.2**	23.1
	141.7	139.9
Other Wealth:		
St James's Place	**34.8**	28.5
Invista Real Estate	**–**	0.8
Private and International Banking	**12.6**	12.8
Closing funds under management	**189.1**	182.0
	2012 **£bn**	2011 £bn
Opening funds under management	**182.0**	192.0
Inflows:		
SWIP – internal	**0.8**	2.7
– external	**1.6**	1.5
Other	**10.5**	8.5
	12.9	12.7
Outflows:		
SWIP – internal	**(7.7)**	(4.5)
– external	**(2.5)**	(5.3)
Other	**(9.3)**	(10.1)
	(19.5)	(19.9)
Investment return, expenses and commission	**13.7**	(2.8)
Net operating increase (decrease) in funds	**7.1**	(10.0)
Closing funds under management	**189.1**	182.0

Funds under management increased by £7.1 billion to £189.1 billion primarily driven by improved investment markets. Inflows have increased in the year primarily in St James's Place. However this was largely offset by a reduced level of inflows in SWIP, where we have also seen an increase in the level of outflows in the year, in part reflecting a lack of consumer confidence in investment products across the industry. Outflows in SWIP also consist of attrition within the insurance funds and strategic asset allocation decisions.

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INSURANCE

2012 highlights

- In 2012 we combined our UK Life Pensions and Investments and General Insurance businesses and restructured our operation to enable greater customer and market focus which contributed to an 8 per cent decrease in costs and leaves us well placed to realise benefits from risk diversification.
- Total underlying profit reduced by 24 per cent and core underlying profit by 21 per cent, primarily reflecting a reduction in total underlying income, largely due to the subdued economic climate and increased weather related claims, partly offset by an 8 per cent decrease in costs.
- We have invested in extending our life insurance proposition with a new earnings protection offer which has simpler application and claims processes.
- We have further enhanced our Corporate Pensions proposition, with the addition of AssistMe, an auto-enrolment tool that complements our MyMoneyWorks corporate pension platform. The strength of our proposition, combined with strong activity in the run up to implementation of the Retail Distribution Review (RDR), has driven 23 per cent growth in corporate pensions.
- Our recent enhanced annuities pilot has been an important step towards further strengthening our overall retirement savings business.
- Our focus on putting customers first has led us to improve our home insurance claims management processes which has enabled us to get our customers back into their homes more quickly following the extreme weather events throughout 2012, helping improve customer satisfaction and contain claims costs.
- We have delivered balance sheet initiatives that have strengthened the Group's balance sheet, providing £1.4 billion liquidity and have now mitigated £5.3 billion of the potential impact of CRD IV, whilst improving Insurance returns.

Performance summary

	2012 £m	2011 £m	Change %
Net interest income	(78)	(67)	(16)
Other income	2,294	2,687	(15)
Insurance claims	(365)	(343)	(6)
Total underlying income, net of insurance claims	1,851	2,277	(19)
Total costs	(744)	(812)	8
Underlying profit	1,107	1,465	(24)
EEV new business margin	3.8%	4.0%	(0.2)pp
Life, Pensions and Investments sales (PVNBP)	10,364	10,662	(3)
General Insurance combined ratio	72%	69%	3pp

DIVISIONAL RESULTS

Insurance

Strategic focus

Insurance is focused on helping our customers to protect themselves today whilst preparing for a secure financial future. Our objective is to be the best insurance and retirement savings business for customers; providing simple, trusted, value for money propositions accessible through multiple channels.

Progress against strategic initiatives

2012 has been characterised by huge changes in the Insurance industry which has been reflected in our Insurance business. Our strategy of ***Simplification*** is in line with the direction of regulation, which has removed complex commission structures, gender discrimination and tax cross subsidies. By combining our UK Life Pensions and Investment (LP&I UK) business with our General Insurance business, we have a single leadership team, a simpler, flatter structure and a lower cost base. We have also transferred most of our operations to the Group Operations functions, where we expect scale economies and depth of expertise to yield further cost savings and improvements to customer service. This simplified business model has already strengthened our position as a cost leader in the industry.

Our focus is on ***investing*** to build profit streams in areas where we have market scale and competitive advantage, leveraging Group synergies. Roughly one third of new business income and the majority of our General Insurance income comes from insurance sales (home and life protection) to retail bank customers, building on strong linkages to our banking and mortgage businesses under the Lloyds TSB, Halifax and Bank of Scotland brands. The rest of our business is focused on retirement savings, both the provision of annuities and pensions sold externally through intermediary and direct channels under the iconic Scottish Widows brand. In 2012 we were the market leaders in corporate pensions. Whilst we also have a strong stream of ongoing profits from our legacy back book, including £24 billion invested in our With Profits funds, we are streamlining and ***reshaping*** the business including exiting the offshore bonds market.

We see strong potential in the bancassurance channel. Whilst we withdrew investment advisors following a review of the implications of RDR, we continue to maintain a strong advisor force within branches to service insurance needs of customers. We have expanded our life insurance proposition with a new earnings protection product with simple application and claims processes. We are investing to improve customer experience in our market leading home insurance business: for example, improving our claims function to settle claims faster and get customers back in their homes more quickly. This will enable us to protect and grow the business, leverage sales opportunities linked to online banking services and make more effective use of the deep understanding we have of our customers. We will use this experience to expand in other core customer insurance needs such as commercial insurance.

We are committed to ***strengthening*** our position in the growing retirement savings market. In corporate pensions, strong activity in the run up to RDR resulted in 23 per cent growth, with auto-enrolment expected to drive further growth over the next 3 to 5 years. In partnership with the People's Pension, we launched AssistMe, a technology tool that supports our customers in meeting their auto-enrolment obligations, complementing our existing corporate platform MyMoneyWorks. In annuities, we are developing our propositions to compete more effectively in an increasingly open market. We launched our enhanced annuities pilot in the last quarter of the year and expect this to be fully rolled out by mid 2013. This is the first step in expanding our participation in the annuity market, supported by our investment strategy that saw us purchase over £1 billion of attractive, high yielding, long-dated assets to match long duration Insurance liabilities. Looking forwards we see enormous potential to serve the retirement needs of our retail bank customers, many of whom may no longer be able to get independent financial advice at retirement.

We continue to focus on retention of customers within our legacy LP&I books, including opportunities to migrate customers with maturing products into new investment propositions. These customers provide 34 per cent of our total underlying profit. Whilst we have invested in the systems and processes to help Independent Financial Advisers through RDR, we anticipate exits from the market and the direct channel will be increasingly important for the 'orphan' customers created.

We are strengthening our balance sheet and achieving capital efficiencies, realising synergies between Insurance and the rest of the Group. Our business model positions us to maximise the capital benefits from risk diversification available under the proposed Individual Capital Assessment Plus regime and ultimately Solvency II. Activities within Insurance during 2012 contributed further to a total £5.3 billion mitigation of the potential impact of CRD IV within the Group since 2010 and enabled £1.4 billion of excess liquidity within Insurance to be provided to the Group.

We have developed a deep understanding of the protection and savings needs of our customers through our annual Protection, Pension and Savings reports. The Centre for the Modern Family, which aims to improve understanding of families' needs in the UK, was launched in December 2011 as part of our commitment to better understanding our customers' needs and Helping Britain Prosper. The benefits of this insight are reflected in the strength of our customer propositions which have won several industry awards including; 'Best Stakeholder Pension provider' for the third year running at the Moneywise 2012 Pension Awards, 'Best Group Pension Provider' in the Corporate Adviser awards and 'Best Personal Pensions Provider' in the Professional Adviser awards.

Financial performance and balance sheet progress

	LP&I		General Insurance		Total	
	2012 **£m**	2011 £m	**2012** **£m**	2011 £m	**2012** **£m**	2011 £m
Existing business income	**760**	1,031	**–**	–	**760**	1,031
New business income:						
New Intermediary and direct income	**357**	321	**–**	–	**357**	321
New bancassurance income	**162**	233	**–**	–	**162**	233
	519	554	**–**	–	**519**	554
General Insurance income	**–**	–	**937**	1,035	**937**	1,035
Total income	**1,279**	1,585	**937**	1,035	**2,216**	2,620
Insurance claims	**–**	–	**(365)**	(343)	**(365)**	(343)
Total underlying income net of insurance claims	**1,279**	1,585	**572**	692	**1,851**	2,277
Total costs	**(581)**	(617)	**(163)**	(195)	**(744)**	(812)
Underlying profit	**698**	968	**409**	497	**1,107**	1,465
LP&I existing business profit	**380**	637				
LP&I new business profit	**318**	331				
Underlying profit	**698**	968				

Underlying profit reduced by £358 million to £1,107 million in 2012, with a 19 per cent reduction in total underlying income, largely due to the subdued economic climate and increased property claims, being partially offset by an 8 per cent decrease in costs.

LP&I existing business profit reduced by £257 million to £380 million in 2012. More than £200 million of this reduction is attributable to the subdued economic environment. For LP&I insurance contracts, returns on existing business reflect long-term economic assumptions for these policies. The subdued economic environment has resulted in the rate of return used in calculating the 2012 results being significantly lower than the comparable rate in the prior year and this was the main driver of the reduction in existing business profit. Existing business profits in our European business were impacted by the non-recurrence of net positive prior year assumption changes.

LP&I total new business profit also decreased by 4 per cent to £318 million, primarily reflecting a 3 per cent reduction in PVNBP driven by lower bancassurance volumes, reflecting the impact of the economic environment on customers' desire to invest and the decision to only offer investment advice for customers with savings above £100,000 ahead of RDR. High volumes of corporate pension sales through the intermediary channel have partially offset this; however, this change in business mix has resulted in a slight decrease in EEV new business margin which remains strong at 3.8 per cent.

General Insurance other income reduced by £98 million primarily reflecting the run-off of the PPI book and lower investment returns. Home insurance income was broadly in line with last year and reflects the maturity and competitiveness of the market. Increased claims of £22 million, 6 per cent higher than the prior year, were mainly driven by adverse property claims following weather events that have impacted during the year, with 2012 being the second wettest year on record. Weather related claims totalled £110 million which is £95 million higher than such claims in 2011. This was partly offset by lower underlying home claims reflecting our improved claims management processes which improved customer experience and reduced average claims costs as well as lower claims as a result of the reduction in the size of the PPI book. Despite the impact of weather related claims our combined ratio remains strong at 72 per cent.

Costs reduced by 8 per cent reflecting a continued strong focus on cost management across the business and the ongoing delivery of Simplification cost saving initiatives.

The capital position of the Insurance group remains robust. The estimated Insurance Groups Directive (IGD) capital surplus was £3.7 billion (£3.7 billion at 31 December 2011). A dividend of £0.6 billion was paid to the Group further mitigating the potential impact of CRD IV on the Group.

DIVISIONAL RESULTS

Insurance

Present Value of New Business Premiums (PVNBP)

An analysis of the present value of new life business premiums for business written by the Insurance division, split between the UK and European Life, Pensions and Investments Businesses is given below:

	2012			2011			
	UK £m	Europe £m	Total £m	UK £m	Europe £m	Total £m	Change %
Analysis by product							
Corporate pensions	**5,427**	**–**	**5,427**	4,423	–	4,423	23
Individual pensions	**1,580**	**97**	**1,677**	1,480	144	1,624	3
Retirement income	**729**	**–**	**729**	747	–	747	(2)
Protection	**554**	**53**	**607**	729	53	782	(22)
Investments (inc OEICs)	**1,715**	**209**	**1,924**	2,840	246	3,086	(38)
Total	**10,005**	**359**	**10,364**	10,219	443	10,662	(3)
Analysis by channel							
Intermediary	**7,053**	**359**	**7,412**	6,415	443	6,858	8
Bancassurance	**2,325**	**–**	**2,325**	3,216	–	3,216	(28)
Direct	**627**	**–**	**627**	588	–	588	7
Total	**10,005**	**359**	**10,364**	10,219	443	10,662	(3)

Total sales (PVNBP) have decreased by 3 per cent to £10,364 million primarily reflecting lower investments and protection volumes partially offset by strong sales of corporate and individual pensions in LP&I UK.

Sales of investment products and protection through the bancassurance channel have reduced due to subdued customer demand (reflecting the economic environment) and the withdrawal in the second half of 2012 from investment advice within the Retail business for customers with savings below £100,000.

There has been strong growth in the Intermediary channel, particularly in corporate pensions where sales were 23 per cent higher than 2011 ahead of to the introduction of RDR. This reflects the underlying strength of our proposition and the quality of service provided to customers. Initiatives such as MyMoneyWorks and our market leading auto enrolment engine, combined with a continuing focus on our strong relationships, ensure that we are well placed to take advantage of the changing market-place as a result of RDR. Individual pensions sales have increased by 3 per cent, driven by sales of our flagship Retirement Account product.

The direct channel continues to perform well and is being developed for future growth. This channel will become even more important to our business with the introduction of RDR.

The reduction in European sales reflects an expected reduction in new business due to the strategy of focusing on the relationship with our key distributors and securing value in the existing book of business.

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GROUP OPERATIONS

	2012 £m	2011[1] £m	Change %
Total underlying income	30	42	(29)
Direct costs:			
Information technology	(1,150)	(1,177)	2
Operations	(670)	(739)	9
Property	(884)	(909)	3
Support functions	(100)	(109)	8
	(2,804)	(2,934)	4
Result before recharges to divisions	(2,774)	(2,892)	4
Total net recharges to divisions	2,723	2,836	4
Underlying loss	(51)	(56)	9

[1] 2011 comparative figures have also been amended to reflect the effect of the continuing consolidation of operations across the Group. To ensure a fair comparison of 2012 performance, 2011 direct costs have been restated with an equivalent offsetting increase in recharges to divisions.

During 2012, direct costs have fallen by £130 million (4 per cent) driven by Simplification savings and the continued focus on cost management which more than offset inflationary rises and incremental costs from Group investment projects. Group Operations continues to play a major part in leading the delivery of the programme as well as through initiatives to improve sourcing, re-engineer end-to-end process, and consolidate and rationalise property and IT.

We are continuing to optimise our demand management, simplify specifications and strengthen our supplier relationships. We have reduced the number of suppliers to the Group from just over 18,000 at the start of the programme to around 10,500; while further concentrating our expenditure within our top tier of suppliers. We have also introduced a number of efficiencies across our IT estate including the rationalisation of servers and storage devices and the optimisation of licence arrangements, with IT costs falling by 2 per cent after absorbing increased costs from delivering Group Strategic initiatives which deliver income and cost benefits in other Divisions. Operations costs decreased by 9 per cent through the continuing rationalisation of our major Operations functions.

We have delivered a number of significant improvements to our core processes and are seeing the benefits come through in terms of improved customer experience and reduced complaints. These include re-engineering our account switching and closure processes; streamlining our Commercial lending process; and a quicker General Insurance claims experience with dedicated advisers managing claims end-to-end.

Group Property costs decreased by 3 per cent as we continued to consolidate the Group's property portfolio; as well as having set up a number of specialist operations centres of excellence and successfully outsourced our property facilities and asset management services.

CENTRAL ITEMS

	2012 £m	2011 £m
Total underlying (expense) income	(132)	339
Total costs	(251)	(259)
Impairment	(1)	(3)
Underlying (loss) profit	(384)	77

Total underlying income largely reflects the net impact of items not recharged by the Group's Corporate Treasury to the divisions. The reduction in income in 2012 is partly due to the retention in the centre of expense items relating to certain risk and balance sheet management actions, including the run-off of prior year actions. Total costs include the costs of certain central and head office functions and corporate costs such as the Financial Services Compensation Scheme charge and the Bank Levy.

OTHER FINANCIAL INFORMATION

Core and non-core business analysis

Core and non-core management basis consolidated income statements

Core	**2012** **£ million**	2011 £ million
Net interest income	**9,868**	10,893
Other income	**7,782**	8,215
Insurance claims	**(365)**	(343)
Total underlying income, net of insurance claims	**17,285**	18,765
Total costs	**(9,212)**	(9,682)
Impairment	**(1,919)**	(2,887)
Underlying profit	**6,154**	6,196
Effects of asset sales, volatile items and liability management	**2,217**	781
Fair value unwind	**(229)**	(628)
Management profit	**8,142**	6,349
Banking net interest margin	**2.32%**	2.42%
Impairment charge as a % of average advances	**0.44%**	0.64%
Return on risk-weighted assets	**2.56%**	2.46%

Non-core	**2012** **£ million**	2011 £ million
Net interest income	**467**	1,317
Other income	**634**	964
Insurance claims	**–**	–
Total underlying income, net of insurance claims	**1,101**	2,281
Total costs	**(870)**	(939)
Impairment	**(3,778)**	(6,900)
Underlying loss	**(3,547)**	(5,558)
Effects of asset sales, volatile items and liability management	**(647)**	60
Fair value unwind	**879**	1,834
Management loss	**(3,315)**	(3,664)
Banking net interest margin	**0.55%**	1.01%
Impairment as a % of average advances	**3.08%**	4.60%

The basis of preparation of the core and non-core income statements is set out on the inside front cover.

Non-core portfolios consist of non-relationship assets and liabilities together with assets and liabilities which are outside the Group's current risk appetite.

Core and non-core business analysis (continued)

Core and non-core business

2012	Underlying income, net of insurance claims £m	Impairment charge £m	Loans and advances to customers[1] £bn	Risk-weighted assets £bn	Customer deposits[1] £bn
Core portfolios					
Retail	**8,609**	**(1,192)**	**317.3**	**86.6**	**260.8**
Commercial Banking	**4,684**	**(704)**	**107.1**	**127.8**	**111.6**
Wealth, Asset Finance and International	**2,276**	**(22)**	**5.3**	**9.6**	**51.0**
Insurance	**1,793**	**–**	**–**	**–**	**–**
Group Operations & Central items	**(77)**	**(1)**	**–**	**13.4**	**0.1**
	17,285	**(1,919)**	**430.4**	**237.4**	**423.5**
Non-core portfolios					
Retail	**48**	**(78)**	**26.0**	**8.9**	**–**
Commercial Banking	**454**	**(2,242)**	**32.7**	**37.4**	**2.5**
Wealth, Asset Finance and International	**566**	**(1,458)**	**28.1**	**26.6**	**0.9**
Insurance	**58**	**–**	**–**	**–**	**–**
Group Operations and Central Items	**(25)**	**–**	**–**	**–**	**–**
	1,101	**(3,778)**	**86.8**	**72.9**	**3.4**
Total Group	**18,386**	**(5,697)**	**517.2**	**310.3**	**426.9**
	%	**%**	**%**	**%**	**%**
Core portfolios	**94.0**	**33.7**	**83.2**	**76.5**	**99.2**
Non-core portfolios	**6.0**	**66.3**	**16.8**	**23.5**	**0.8**

2011	Underlying income, net of insurance claims £m	Impairment charge £m	Loans and advances to customers[1] £bn	Risk-weighted assets £bn	Customer deposits[1] £bn
Core portfolios					
Retail	8,884	(1,796)	325.1	92.6	247.1
Commercial Banking[2]	5,081	(1,055)	123.5	128.5	121.6
Wealth, Asset Finance and International[2]	2,278	(33)	5.1	9.8	40.4
Insurance	2,141	–	–	–	–
Group Operations & Central items	381	(3)	0.1	12.6	0.4
	18,765	(2,887)	453.8	243.5	409.5
Non-core portfolios					
Retail	273	(174)	27.7	10.6	–
Commercial Banking	917	(3,155)	49.0	64.4	3.1
Wealth, Asset Finance and International	955	(3,571)	35.1	33.8	1.3
Insurance	136	–	–	–	–
	2,281	(6,900)	111.8	108.8	4.4
Total Group	21,046	(9,787)	565.6	352.3	413.9
	%	%	%	%	%
Core portfolios	89.2	29.5	80.2	69.1	98.9
Non-core portfolios	10.8	70.5	19.8	30.9	1.1

[1] Includes reverse repos and repos.

[2] Restated for transfers between Wealth, Asset Finance and International, and Commercial Banking.

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Core and non-core business analysis (continued)

Core business

	2012 £ million	2011 £ million	Change %
Net interest income	9,868	10,893	(9)
Other income	7,782	8,215	(5)
Insurance claims	(365)	(343)	(6)
Total underlying income, net of insurance claims	17,285	18,765	(8)
Total costs	(9,212)	(9,682)	5
Impairment	(1,919)	(2,887)	34
Underlying profit	6,154	6,196	(1)
Effects of asset sales, volatile items and liability management	2,217	781	
Fair value unwind	(229)	(628)	64
Management profit	8,142	6,349	29
Banking net interest margin	2.32%	2.42%	(10)bp
Impairment charge as a % of average advances	0.44%	0.64%	(20)bp
Return on risk-weighted assets	2.56%	2.46%	10bp

Key balance sheet items	At 31 December 2012 £bn	At 31 December 2011 £bn	Change %
Loans and advances to customers (excluding reverse repos)	425.3	437.0	(3)
Reverse repos with customers	5.1	16.8	(70)
Loans and advances to banks	29.0	32.0	(9)
Debt securities held as loans and receivables	0.5	0.2	
Available-for-sale financial assets	28.8	27.9	3
Other assets:			
Derivative financial instruments	56.6	66.0	(14)
Trading and other financial assets at fair value through profit and loss	154.0	138.8	11
Other	126.8	111.1	14
	337.4	315.9	7
Total core assets	826.1	829.8	
Customer deposits (excluding repos)	419.0	401.5	4
Repos with customers	4.4	8.0	(45)
Risk-weighted assets	237.4	243.5	(3)

Core and non-core business analysis (continued)

Management basis consolidated income statement – core

2012	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International[1] £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	**7,163**	**2,242**	**312**	**(87)**	**238**	**9,868**
Other income	**1,446**	**2,442**	**1,964**	**2,245**	**(315)**	**7,782**
Insurance claims	**–**	**–**	**–**	**(365)**	**–**	**(365)**
Total underlying income, net of insurance claims	**8,609**	**4,684**	**2,276**	**1,793**	**(76)**	**17,285**
Total costs	**(4,197)**	**(2,315)**	**(1,795)**	**(715)**	**(282)**	**(9,212)**
Impairment	**(1,192)**	**(704)**	**(22)**	**–**	**(1)**	**(1,919)**
Underlying profit (loss)	**3,224**	**1,665**	**459**	**1,083**	**(360)**	**6,154**
Asset sales	**–**	**–**	**(13)**	**–**	**3,207**	**3,194**
Volatile items	**–**	**138**	**–**	**–**	**(886)**	**(481)**
Liability management	**–**	**–**	**–**	**–**	**(229)**	**(229)**
Fair value unwind	**394**	**80**	**(34)**	**(42)**	**(627)**	**(229)**
Management profit	**3,618**	**1,966**	**412**	**1,041**	**1,105**	**8,142**
Banking net interest margin	**2.25%**	**2.22%**	**5.90%**			**2.32%**
Impairment charge as a % of average advances	**0.37%**	**0.67%**	**0.45%**			**0.44%**
Return on risk-weighted assets	**3.60%**	**1.36%**	**5.07%**			**2.56%**
Key balance sheet items at 31 December 2012	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**
Loans and advances to customers excluding reverse repos	**317.3**	**102.0**	**5.3**		**0.7**	**425.3**
Customer deposits excluding repos	**260.8**	**107.2**	**51.0**		**0.1**	**419.0**
Total customer balances	**578.1**	**209.2**	**56.3**		**0.8**	**844.4**
Risk-weighted assets	**86.6**	**127.8**	**9.6**		**13.4**	**237.4**
2011	£m	£m	£m	£m	£m	£m
Net interest income	7,246	2,846	293	(77)	585	10,893
Other income	1,638	2,235	1,985	2,561	(204)	8,215
Insurance claims	–	–	–	(343)	–	(343)
Total underlying income, net of insurance claims	8,884	5,081	2,278	2,141	381	18,765
Total costs	(4,432)	(2,292)	(1,884)	(772)	(302)	(9,682)
Impairment	(1,796)	(1,055)	(33)	–	(3)	(2,889)
Underlying profit	2,656	1,734	361	1,369	76	6,196
Asset sales	48	(20)	–	–	196	224
Volatile items	–	(736)	–	–	1	(753)
Liability management	–	–	–	–	1,295	1,295
Fair value unwind	657	24	8	(43)	(1,274)	(628)
Management profit (loss)	3,361	1,002	369	1,326	291	6,349
Banking net interest margin	2.20%	2.54%	5.04%			2.42%
Impairment charge as a % of average advances	0.54%	0.95%	0.60%			0.64%
Return on risk-weighted assets	2.75%	1.32%	3.62%			2.46%
Key balance sheet items at 31 December 2011	£bn	£bn	£bn	£bn	£bn	£bn
Loans and advances to customers excl reverse repos	325.1	106.7	5.1		0.1	437.0
Customer deposits excluding repos	247.1	113.6	40.3		0.4	401.5
Total customer balances	572.2	220.3	455		0.5	838.5
Risk-weighted assets	92.6	128.5	9.8		12.6	243.5

[1] Restated in 2011.

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Core and non-core business analysis (continued)

Non-core business

	2012 £ million	2011 £ million	Change %
Net interest income	467	1,317	(65)
Other income	634	964	(34)
Insurance claims	–	–	
Total underlying income, net of insurance claims	1,101	2,281	(52)
Total costs	(870)	(939)	7
Impairment	(3,778)	(6,900)	45
Underlying loss	(3,547)	(5,558)	36
Effects of asset sales, volatile and liability management	(647)	60	
Fair value unwind	879	1,834	(52)
Management loss	(3,315)	(3,664)	10
Banking net interest margin	0.55%	1.01%	(46)bp
Impairment charge as a % of average advances	3.08%	4.60%	(1.52)pp

Key balance sheet items	At 31 December 2012 £bn	At 31 December 2011 £bn	Change %
Loans and advances to customers	86.8	111.8	(22)
Loans and advances to banks	0.4	0.6	(33)
Debt securities held as loans and receivables	4.7	12.3	(62)
Available-for-sale financial assets	2.6	9.5	(73)
Other	3.9	6.5	(40)
Total non-core assets	98.4	140.7	(30)
Risk-weighted assets	72.9	108.8	(33)

Core and non-core business analysis (continued)

Management basis consolidated income statement – non-core

2012	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International[1] £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	32	(36)	487	9	(25)	467
Other income	16	490	79	49	–	634
Insurance claims	–	–	–	–	–	–
Total underlying income, net of insurance claims	48	454	566	58	(25)	1,101
Total costs	(6)	(284)	(496)	(34)	(50)	(870)
Impairment	(78)	(2,242)	(1,458)	–	–	(3,778)
Underlying (loss) profit	(36)	(2,072)	(1,388)	24	(75)	(3,547)
Asset sales	–	(464)	(183)	–	–	(647)
Volatile items	–	–	–	–	–	–
Liability management	–	–	–	–	–	–
Fair value unwind[1]	88	808	(17)	–	–	879
Management profit (loss)	52	(1,728)	(1,588)	24	(75)	(3,315)
Banking net interest margin	0.12%	0.35%	1.13%			0.55%
Impairment charge as a % of average advances	0.29%	4.28%	3.42%			3.08%
Key balance sheet items at 31 December 2012	£bn	£bn	£bn	£bn	£bn	£bn
Total non-core assets	26.0	43.0	28.9	0.5		98.4
Risk-weighted assets	8.9	37.4	26.6			72.9
2011	£m	£m	£m	£m	£m	£m
Net interest income	251	346	710	10	–	1,317
Other income	22	571	245	126	–	964
Insurance claims	–	–	–	–	–	–
Total underlying income, net of insurance claims	273	917	955	136	–	2,281
Total costs	(6)	(308)	(530)	(40)	(55)	(939)
Impairment	(174)	(3,155)	(3,571)	–	–	(6,900)
Underlying profit (loss)	93	(2,546)	(3,146)	96	(55)	5,558
Asset sales	–	81	(21)	–	–	60
Volatile items	–	–	–	–	–	–
Liability management	–	–	–	–	–	–
Fair value unwind	182	1,538	114	–	–	1,834
Management profit (loss)	275	(927)	(3,053)	96	(55)	(3,664)
Banking net interest margin	0.83%	0.83%	1.35%			1.01%
Impairment charge as a % of average advances	0.58%	4.60%	7.11%			4.60%
Key balance sheet items at 31 December 2011	£bn	£bn	£bn	£bn	£bn	£bn
Total non-core assets	27.7	76.2	36.2	0.6	–	140.7
Risk-weighted assets	10.6	64.4	33.8			108.8

[1] Restated in 2011.

OTHER FINANCIAL INFORMATION

Volatility arising in insurance businesses

The Group's statutory result before tax is affected by insurance volatility, caused by movements in financial markets, and policyholder interests volatility, which primarily reflects the gross up of policyholder tax included in the Group tax charge.

In 2012 the Group's statutory result before tax included positive insurance and policyholder interests volatility totalling £306 million compared to negative volatility of £838 million in 2011.

Volatility comprises the following:

	2012 £m	2011 £m
Insurance volatility	183	(557)
Policyholder interests volatility[1]	143	(283)
Total volatility	326	(840)
Insurance hedging arrangements	(20)	2
Total	306	(838)

[1] Includes volatility relating to the Group's interest in St James's Place.

Insurance volatility

The Group's insurance business has liability products that are supported by substantial holdings of investments, including equities, property and fixed interest investments, all of which are subject to variations in their value. The value of the liabilities does not move exactly in line with changes in the value of the investments, yet IFRS requires that the changes in both the value of the liabilities and investments be reflected within the income statement. As these investments are substantial and movements in their value can have a significant impact on the profitability of the Group, management believes that it is appropriate to disclose the division's results on the basis of an expected return in addition to results based on the actual return.

The expected sterling investment returns used to determine the normalised profit of the business, which are based on prevailing market rates and published research into historical investment return differentials, are set out below:

United Kingdom (Sterling)	2012 %	2011 %
Gilt yields (gross)	2.48	3.99
Equity returns (gross)	5.48	6.99
Dividend yield	3.00	3.00
Property return (gross)	5.48	6.99
Corporate bonds in unit-linked and With Profit Funds (gross)	3.08	4.59
Fixed interest investments backing annuity liabilities (gross)	3.89	4.78

The impact on the results due to the actual return on these investments differing from the expected return (based upon economic assumptions made at the beginning of the year) is included within insurance volatility. Changes in market variables also affect the realistic valuation of the guarantees and options embedded within the With Profits Funds, the value of the in-force business and the value of shareholders' funds.

The positive insurance volatility during 2012 in the Insurance division was £183 million, primarily reflecting the benefits of an increase in equity market values relative to the expected return and a reduction in gilt yields and a narrowing of corporate bond spreads. This has been partially offset by lower cash returns compared to the long-term expectation.

Group hedging arrangements

To protect against further deterioration in equity market conditions, and the consequent negative impact on the value of in-force business on the Group balance sheet, the Group purchased put option contracts in 2011, financed by selling some upside potential from equity market movements. These expired in 2012 and the charge booked in 2012 on these contracts was £3 million. New protection was acquired in 2012 to replace the expired contracts. There was no initial cost associated with these hedging arrangements. On a mark-to-market valuation basis a loss of £17 million was recognised in relation to the new contracts in 2012.

Volatility arising in insurance businesses (continued)

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life, pensions and investments business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group's tax charge rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the normalised approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility.

In 2012, the statutory results before tax included a credit to other income which relates to policyholder interests volatility totalling £143 million (2011: £283 million charge).

Banking net interest margin

	2012	2011
Banking net interest income	**£10,480m**	£12,094m
Average interest-earning banking assets	**£543.3bn**	£585.4bn
Average interest-bearing banking liabilities	**£391.3bn**	£364.0bn
Banking net interest margin	**1.93%**	2.07%
Banking asset margin	**1.09%**	1.46%
Banking liability margin	**1.16%**	0.98%
Core		
Banking net interest margin	**2.32%**	2.42%
Banking net interest income	**£9,818m**	£10,612m
Average interest-earning banking assets	**£423.7bn**	£438.7bn
Non-core		
Banking net interest margin	**0.55%**	1.01%
Banking net interest income	**£662m**	£1,482m
Average interest-earning banking assets	**£119.6bn**	£146.7bn

Banking net interest income is analysed for asset and liability margins based on interest earned and paid on average assets and average liabilities respectively, adjusted for Funds Transfer Pricing, which prices intra-group funding and liquidity. Centrally held wholesale funding costs and related items are included in the Group banking asset margin.

Average interest-earning banking assets, which are calculated gross of related impairment allowances, and average interest-bearing banking liabilities relate solely to customer and product balances in the banking businesses on which interest is earned or paid. Funding and capital balances including debt securities in issue, subordinated debt, repos and shareholders' equity are excluded from the calculation of average interest-bearing banking liabilities. However, the cost of funding these balances allocated to the banking businesses is included in banking net interest income.

A reconciliation of banking net interest income to Group net interest income showing the items that are excluded in determining banking net interest income follows:

	2012 **£m**	2011 £m
Banking net interest income – management basis	**10,480**	12,094
Insurance division	**(78)**	(67)
Other net interest income (including trading activity)	**(67)**	183
Group net interest income – management basis	**10,335**	12,210
Fair value unwind	**(237)**	(710)
Banking volatility and liability management gains	**199**	843
Insurance gross up	**(1,230)**	336
Volatility arising in insurance businesses	**8**	19
Group net interest income – statutory	**9,075**	12,698

FIVE YEAR FINANCIAL SUMMARY

The statutory financial information set out in the table below has been derived from the annual report and accounts of Lloyds Banking Group plc for each of the past five years.

The financial statements for each of the years presented have been audited by PricewaterhouseCoopers LLP, independent auditors.

	2012	2011	2010	2009[7]	2008
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims[1]	**20,510**	20,802	24,868	22,526	9,872
Operating expenses	**(15,931)**	(16,250)	(13,270)	(15,984)	(6,100)
Trading surplus[1]	**4,579**	4,552	11,598	6,542	3,772
Impairment	**(5,149)**	(8,094)	(10,952)	(16,673)	(3,012)
Gain on acquisition	**–**	–	–	11,173	–
(Loss) profit before tax	**(570)**	(3,542)	281	1,042	760
(Loss) profit for the year	**(1,343)**	(2,714)	(258)	2,953	798
(Loss) profit for the year attributable to equity shareholders	**(1,427)**	(2,787)	(320)	2,827	772
Total dividend for the year[2]	**–**	–	–	–	648
	31 December 2012	31 December 2011	31 December 2010	31 December 2009	31 December 2008
Balance sheet data (£m)					
Share capital	**7,042**	6,881	6,815	10,472	1,513
Shareholders' equity	**43,999**	45,920	46,061	43,278	9,393
Net asset value per ordinary share	**62p**	67p	68p	68p	155p
Customer deposits	**426,912**	413,906	393,633	406,741	170,938
Subordinated liabilities	**34,092**	35,089	36,232	34,727	17,256
Loans and advances to customers	**517,225**	565,638	592,597	626,969	240,344
Total assets	**924,552**	970,546	991,574	1,027,255	436,033
	2012	2011	2010	2009	2008
Share information					
Basic earnings per ordinary share	**(2.0)p**	(4.1)p	(0.5)p	7.5p	6.7p
Diluted earnings per ordinary share	**(2.0)p**	(4.1)p	(0.5)p	7.5p	6.6p
Total dividend per ordinary share[2]	**–**	–	–	–	11.4p
Market price (year end)	**47.9p**	25.9p	65.7p	50.7p	126.0p
Number of shareholders (thousands)	**2,733**	2,770	2,798	2,834	824
Number of ordinary shares in issue (millions)[3]	**70,343**	68,727	68,074	63,775	5,973
	2012	2011	2010	2009	2008
Financial ratios (%)[4]					
Dividend payout ratio	**–**	–	–	–	83.9
Post-tax return on average shareholders' equity	**(3.1)**	(6.2)	(0.7)	8.8	7.0
Cost:income ratio[1,5]	**77.7**	78.1	53.4	71.0	61.8
	31 December 2012	31 December 2011	31 December 2010	31 December 2009[8]	31 December 2008[8]
Capital ratios (%)[6]					
Total capital	**17.3**	15.6	15.2	12.4	11.1
Tier 1 capital	**13.8**	12.5	11.6	9.6	7.9
Core tier 1 capital	**12.0**	10.8	10.2	8.1	5.5

[1] Restated in 2012 to reflect the share of results of joint ventures and associates within total income.

[2] Annual dividends comprise both interim and estimated final dividend payments. Under IFRS, the total dividend for the year represents the interim dividend paid during the year and the final dividend which will be paid and accounted for during the following year.

[3] This figure excludes 81 million (2008: 79 million) limited voting ordinary shares.

[4] Averages are calculated on a monthly basis from the consolidated financial data of Lloyds Banking Group.

[5] The cost:income ratio is calculated as total operating expenses as a percentage of total income (net of insurance claims).

[6] Capital ratios are in accordance with Basel II requirements.

[7] Restated in 2009 for IFRS 2 (Revised) and to separate the share of results of joint ventures and associates from total income.

[8] Restated in 2010 to reflect a prior year adjustment to available-for-sale revaluation reserves.

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BOARD OF DIRECTORS

NON-EXECUTIVE DIRECTORS

Sir Winfried Bischoff
Chairman

Chairman of the Nomination & Governance Committee. Member of the Remuneration Committee and the Risk Committee

Joined the Board in September 2009

Age: 71

Skills and experience: Sir Winfried has substantial experience of leading complex international boards in the UK, Asia and the US. His background spans a range of sectors, including banking and capital markets, finance and government regulation and public policy. Sir Winfried is a highly respected leader with the proven experience and judgement to lead the Board of Lloyds Banking Group.

External appointments: Sir Winfried is a Non-Executive Director of Eli Lilly and Company and The McGraw Hill Companies Inc. He is Chairman of the Advisory Council of TheCityUK and a Member of the Akbank International Advisory Board.

Former appointments: Sir Winfried was appointed Chairman of Citigroup Europe in 2000. He became the acting Chief Executive Officer of Citigroup Inc. in 2007 and was subsequently appointed as Chairman in the same year until his retirement in February 2009. Prior to this, he was the Group Chief Executive and then Chairman of Schroders.

David Roberts
Deputy Chairman
Independent Director

Chairman of the Risk Committee. Member of the Audit Committee, the Remuneration Committee and the Nomination & Governance Committee

Joined the Board in March 2010

Age: 50

Skills and experience: David has many years experience at board and executive management level in retail and commercial banking in the UK and internationally. As Chair of the Risk Committee, he has a deep understanding of risk management, underpinned by recent, in-depth knowledge of all aspects of banking operations. David's valuable contributions to the deliberations of the Board and Committee meetings, combined with natural leadership qualities, make David an effective Deputy Chairman.

External appointments: David is the Non-executive Chairman of The Mind Gym.

Former appointments: David joined Barclays in 1983 and held various senior management positions culminating in Executive Director, member of the Group Executive Committee and Chief Executive, International Retail and Commercial Banking, a position which he held until December 2006. He is a former Non-Executive Director of BAA and Absa Group and was Chairman and Chief Executive of BAWAG P.S.K. AG.

Lord Blackwell
Independent Director

Member of the Audit Committee and the Risk Committee
Chairman of Scottish Widows Group

Joined the Board on 1 June 2012

Age: 60

Skills and experience: Lord Blackwell has in-depth insurance, banking, regulatory and public policy experience gained from senior positions in a wide range of industries. He has the knowledge and experience to contribute effectively as a Non-Executive Director and lead the Board of Scottish Widows Group.

External appointments: Lord Blackwell is the Chairman of Interserve plc. He is a Non-Executive Director of Ofcom and Halma plc and a member of the Board of the Centre for Policy Studies.

Former appointments: Lord Blackwell is a former Senior Independent Director of Standard Life and Chaired their UK Life and Pensions Board. He was a Non-Executive Director of Dixons Group and SEGRO and a Non-Executive Member of the Office of Fair Trading. He was a partner of McKinsey & Co. and a Director of Group Development at NatWest Group. From 1995 to 1997, Lord Blackwell was Head of the Prime Minister's Policy Unit and was appointed a Life Peer in 1997.

Carolyn Fairbairn
Independent Director

Member of the Audit Committee and the Remuneration Committee

Joined the Board on 1 June 2012

Age: 52

Skills and experience: Carolyn has extensive digital and on-line, Government and regulatory experience gained across a range of sectors including media and financial services. With her broad experience and strong analytical mind, Carolyn plays an active part in reviewing the strategy of the Board and contributing to the debate at Board and Committee meetings.

External appointments: Carolyn is a Non-Executive Director of The Vitec Group and a member of its Audit, Nominations and Remuneration Committees. In January 2012, she was appointed a trustee of Marie Curie Cancer Care.

Former appointments: Carolyn was a Non-Executive Director of the Financial Services Authority and chaired their Risk Committee, a Director of Group Development and Strategy at ITV plc and Director of Strategy and a member of the Executive Board at the BBC. She is a former partner of McKinsey & Co. and was a policy adviser in the Prime Minister's Policy Unit. Carolyn began her career as an Economist at the World Bank.

Anita Frew
Independent Director

Member of the Audit Committee and the Risk Committee

Joined the Board in December 2010

Age: 55

Skills and experience: Anita has extensive board, financial and general management experience across a range of sectors, including banking, asset management, manufacturing and utilities. Her breadth of experience and strong leadership qualities make her an effective Non-Executive Director.

External appointments: Anita is the Chairman of Victrex plc, having previously been its Senior Independent Director, and is the Senior Independent Director of Aberdeen Asset Management. She is a Non-Executive Director of IMI.

Former appointments: Anita was an Executive Director of Abbott Mead Vickers, Director of Corporate Development at WPP Group and a Non-Executive Director of Northumbrian Water. She has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland.

Nicholas Luff
Independent Director

Member of the Audit Committee and Risk Committee (with effect from 5 March 2013). Chairman of the Audit Committee (with effect from 1 April 2013)

Joining the Board on 5 March 2013

Age: 45

Skills and experience: Nick has significant financial experience in the UK listed environment having served in a number of senior finance positions within a range of sectors. His background and experience enables him to fulfil the role of Audit Committee Chair and for SEC purposes the role of Audit Committee Financial Expert.

External appointments: Nick is the Group Finance Director of Centrica.

Former appointments: Nick was previously the Finance Director of The Peninsular & Oriental Steam Navigation Company and Chief Financial Officer of P&O Princess Cruises plc. Until December 2010, he served as a Non-Executive Director and was the Audit Committee Chair of QinetiQ Group. Nick started his career with KPMG where he qualified as a chartered accountant in 1991.

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T Timothy Ryan, Jr
Independent Director
(Until 18 April 2013)

Member of the Remuneration Committee and the Risk Committee

Joined the Board in March 2009

Age: 67

Skills and experience: Tim is a senior investment banker with international board and management experience and a strong background in the US government sector. Tim brings an international perspective to the Board with a strong focus on financial markets and securities, government relations and international emerging best practice.

External appointments: Tim is the Global Head of Regulatory Strategy and Policy at JP Morgan. He is a director of the Great-West Life Insurance Co., Power Corporation of Canada and Power Financial Corp.

Former appointments: Tim was the President and Chief Executive of the Securities Industry and Financial Markets Association and a Director in the Office of Thrift Supervision, US Department of the Treasury. He is a former Director of Koram Bank, the International Foundation of Election Systems and the US-Japan Foundation. He held a number of senior appointments in JP Morgan Chase including Vice Chairman, Financial Institutions and Governments. Tim was also a member of the Global Markets Advisory Committee for the National Intelligence Council.

Anthony Watson, CBE
Senior Independent Director

Chairman of the Remuneration Committee. Member of the Audit Committee, the Risk Committee and the Nomination & Governance Committee

Joined the Board in April 2009

Age: 67

Skills and experience: Tony has over 40 years' experience in the investment management industry and related sectors. As Senior Independent Director and Chair of the Remuneration Committee, he ensures close and regular dialogue with shareholders with the aim of better aligning executive reward with shareholder interests. His former experience as Chief Executive of Hermes Pensions Management places him in an ideal position to carry out these roles.

External appointments: Tony is a Non-Executive Director of Vodafone Group. He is the Senior Independent Director of Hammerson and Witan Investment Trust and Chairman of the Lincoln's Inn Investment Committee and Marks & Spencer Trustees.

Former appointments: Tony is the former Chief Executive of Hermes Pensions Management. He was also formerly Chairman of the Asian Infrastructure Fund, MEPC and of the Strategic Investment Board (Northern Ireland). He was a member of the Financial Reporting Council and a member of the Norges Bank Investment Management Advisory Board.

Martin Scicluna
Independent Director
(Until 31 March 2013)

Chairman of the Audit Committee. Member of the Risk Committee and Nomination & Governance Committee

Joined the Board in September 2008

Age: 62

Skills and experience: Martin has significant finance experience. He was with Deloitte for 34 years including 26 years as an Audit Partner serving a number of FTSE100 companies. His background and experience enables him to fulfil the role of Audit Committee Chair and for SEC purposes the role of Audit Committee Financial Expert.

External appointments: Martin is the Chairman of RSA Insurance Group and Great Portland Estates and a Governor of Berkhamsted School.

Former appointments: Martin was a member of the Board of Partners of Deloitte UK from 1991 to 2007 and served as its Chairman from 1995. He joined the firm in 1973 and was a partner from 1982 until he retired in 2008. Martin was a member of the Board of Directors of Deloitte Touche Tohmatsu from 1999 to 2007.

Sara Weller
Independent Director

Member of the Remuneration Committee and the Risk Committee

Joined the Board on 1 February 2012

Age: 51

Skills and experience: With a background in retail and associated sectors, including financial services, Sara brings a broad perspective to the Board. She is a strong advocate of customers and of the application of new technology, both of which directly support Lloyds Banking Group's strategy. Sara has considerable experience of boards at both executive and non-executive level.

External appointments: Sara is a Non-Executive Director of United Utilities Group and Chair of their Remuneration Committee.

Former appointments: Sara is the former Managing Director of Argos. She held various senior positions at J Sainsbury including Deputy Managing Director and served on its Board between January 2002 and May 2004. She was a Non-Executive Director of Mitchells & Butler and also held senior management roles for Abbey National and Mars Confectionery.

EXECUTIVE DIRECTORS

António Horta-Osório
Group Chief Executive

Appointed Group Chief Executive in March 2011

Joined the Board in January 2011

Age: 49

Skills and experience: António brings extensive experience in, and understanding of, both retail and commercial banking. This has been built over a period of more than 25 years, working both internationally as well as in the UK. António's drive, enthusiasm and commitment to customers, along with his proven ability to build and lead strong management teams, brings significant value to all stakeholders of Lloyds Banking Group.

External appointments: António is a Non-Executive Director of Fundação Champalimaud and Sociedade Francisco Manuel dos Santos in Portugal and a Governor of the London Business School.

Former appointments: António joined Grupo Santander in 1993 and held various senior management positions culminating in Executive Vice President of Grupo Santander and a member of its Management Committee. In November 2004 he was appointed as a Non-Executive Director of Santander UK and from August 2006 until November 2010, served as its Chief Executive. António is also a former Non-Executive Director of the Court of the Bank of England.

George Culmer
Group Finance Director

Joined the Board on 16 May 2012

Age: 50

Skills and experience: George has deep operational and financial expertise including strategic and financial planning and control. He has worked in financial services in the UK and overseas for over 20 years. With a strong background in insurance and shareholder advocacy, his skills and experience enhance the Board and strengthen further the senior management team.

External appointments: None.

Former appointments: George was an Executive Director and Chief Financial Officer of RSA Insurance Group. He is also the former Head of Capital Management of Zurich Financial Services and Chief Financial Officer of its UK operations. George previously held various senior management positions at Prudential.

Claire A Davies
Company Secretary

GROUP EXECUTIVE COMMITTEE

DELIVERING OUR VISION
MANAGING A MORE AGILE ORGANISATION

The Group benefits from the depth and diversity of experience within the management team. The complementary skill sets across the team strengthens the Group's ability to effectively adjust to changing market environments, deliver on our strategic plan and become the best bank for customers. Brief biographies of the management team are outlined below:

António Horta-Osório
Group Chief Executive

António joined the Board in January 2011 as an Executive Director and became Group Chief Executive in March 2011.

Further details can be found on page 79.

George Culmer
Group Finance Director

George joined the Board as Finance Director on 16 May 2012.

Further details can be found on page 79.

Andrew Bester
Chief Executive,
Commercial Banking

Andrew , CEO Commercial Banking, was appointed as a Group Director on 1 July 2012. He is also the Chairman of Lloyds Development Capital. Prior to joining Lloyds Banking Group, Andrew worked at Standard Chartered Bank in a variety of senior roles including Global COO of Consumer Banking, Chief Financial Officer of Consumer Banking and Co-Head of Wholesale Banking for Greater China and before that the same role for the Africa region. Before joining Standard Chartered, Andrew was the Group Finance Director for Xchanging, a leading European outsourcing firm. Prior to this, he worked at Deutsche Bank in Europe.

Andrew qualified as a Chartered Accountant with Deloitte & Touche. He is a member of the South African Institute of Chartered Accountants, the Chartered Institute of Management Accountants and is a Chartered Global Management Accountant. He is also a member of the Association of Corporate Treasurers, Association of Financial Markets in Europe and Global Financial Markets Association.

Alison Brittain
Group Director, Retail

Alison joined Lloyds Banking Group in September 2011 as Group Director for the Retail Division. The Retail Division consists of Lloyds TSB, Bank of Scotland and Halifax community banks as well as Retail Products and Intermediaries, Marketing, Telephony and Digital banking.

Her last role was as Executive Director for Retail Distribution and a Board Director at Santander UK. She previously worked at Barclays for 19 years in various roles including Director of Barclays and Woolwich Retail networks, and as Managing Director of Barclays Business Banking.

Alison attended university in Scotland and the USA and has an MBA from Cambridge University's Judge Institute.

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Juan Colombás
Chief Risk Officer

Juan was appointed as the Group's Chief Risk Officer on 24 January 2011. A member of the Group Executive Committee, he is responsible for effective risk management across the bank. His team is represented across all the Divisions and the extended Risk Community includes some 7,000 colleagues.

Juan has over 25 years of experience in banking having completed a range of Risk, Control and Business Management roles across the Corporate, Investment, Retail and Risk Divisions of the Santander Group. He has lived in the UK since 2006 when he joined the Santander UK business as the Chief Risk Officer.

Mark Fisher
Director, Group Operations

Mark joined Lloyds Banking Group as the Director of Group Operations in March 2009. In September 2009 his responsibilities expanded to include Group Integration Director. Mark became the Chairman of Lloyds TSB Scotland in December 2009 and is also the Group's Executive Sponsor for disability.

Prior to joining Mark was Chief Executive Officer of ABN AMRO and was appointed as Chairman of the Managing Board in November 2007. Mark was a Director of The Royal Bank of Scotland Group from March 2006, and Chief Executive of the Manufacturing division at RBS since 2000. Other achievements have included: Chairman of the Association for Payment Clearing Services (2003 – 2007).

Mark is a career banker having joined NatWest in 1981. He was Retail Finance Director and later Chief Operating Officer before NatWest was bought by RBS.

Antonio Lorenzo
Group Director, Wealth, Asset Finance & International and Group Corporate Development

Antonio joined Lloyds Banking Group in March 2011. He is a Group Director with responsibility for Wealth, Asset Finance, International & Group Corporate Development. Since joining the Group, Antonio's highlight has been leading the Group Strategic Review. His division has since been fundamental in supporting the Group's agenda to both reshape its international presence and strengthen the balance sheet through significant non-core reduction and double-digit deposit growth.

Antonio has over 20 years of experience in the financial services industry. He worked for Arthur Andersen for over nine years before joining Santander in 1998. During his time at Santander, he was working in a number of different finance and business roles. Antonio was part of the management team in 2004 that took over Abbey National whilst also becoming Chief Financial Officer of Santander UK.

David Nicholson
Group Director, Halifax Community Bank

David is Group Director of the Halifax Community Bank. He has specific responsibility for the Halifax branch network and its 10,500 colleagues. Halifax is playing a key role in the Group's strategy as a challenger brand, with a focus on making customers better off.

David has over 25 years experience in retail financial services. He is Chairman of the 'Your Tomorrow' pension fund trustees and is a member of the Institute of Financial Services School of Finance Board of Governors. He is also community ambassador for Yorkshire and Humberside.

Toby Strauss
Group Director, Insurance

Toby joined Lloyds Banking Group in October 2011 as Group Director for Insurance and CEO of Scottish Widows. Before joining the Group, Toby was UK Life CEO at Aviva and prior to this he was Chief Operating Officer for UK Life, having joined Aviva in 2008. He previously worked at Charcol, becoming Managing Director, before moving to JS & P (now Towry) as Chief Executive. Before that, Toby spent a number of years at McKinsey, specialising in the financial services and technology sectors.

Matthew Young
Group Corporate Affairs Director

Matt joined Lloyds Banking Group in February 2011 as Group Corporate Affairs Director. He has responsibility for internal and External Communications, Public Affairs, Regulatory Developments, Competition, Community Investment including the Group's Archives and Museums. Prior to joining the Group, he was the Communications Director at Santander UK and has also held senior positions with Abbey National and NatWest.

Matt is a member of the Board of Trustees at In Kind Direct, one of the Prince's charities, and founded by HRH Prince of Wales in 1996. He is a member of the City UK's Strategic Advisory Committee and of the Chartered Institute of Public Relations.

DIRECTORS' REPORT

Results

The consolidated income statement shows a loss for the year ended 31 December 2012 of £1,343 million.

Principal activities

The Company is a holding company and its subsidiary undertakings provide a wide range of banking and financial services through branches and offices in the UK and overseas.

Business review, future developments and financial risk management objectives and policies

The information that fulfils the requirements of the business review, future developments and financial risk management objectives and policies can be found in the following sections of the annual report, which are incorporated into this report by reference:

	Pages
Business review and future developments	10 to 76 and 115 to 202
Key performance indicators	4 to 9
Financial risk management objectives and internal control policies	115 to 202 and page 92
Principal risks and uncertainties	118 to 124
Financial risk management objectives and internal control policies in relation to the use of financial instruments	115 to 202 (and in note 55 on pages 318 to 338)

Post balance sheet events

There have been no material post balance sheet events.

Going concern

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of key dependencies which are set out in the risk management section under principal risks and uncertainties: liquidity and funding on page 123 and pages 177 to 184 and capital position on pages 187 to 200 and additionally have considered projections for the Group's capital and funding position. Having considered these, the Directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Directors

Biographical details of Directors are shown on pages 78 and 79. Particulars of their emoluments and interests in shares in the Company are given on pages 98 to 114. Changes to the composition of the Board since 1 January 2012 up to the date of this report are shown in the table below:

	Joined the Board	Retired from the Board
S V Weller	1 February 2012	
G T Tate		6 February 2012
T J W Tookey		24 February 2012
Lord Leitch		29 February 2012
M G Culmer	16 May 2012	
Sir Julian Horn-Smith		17 May 2012
G R Moreno		17 May 2012
Lord Blackwell	1 June 2012	
C J Fairbairn	1 June 2012	

M A Scicluna and T T Ryan, Jr will retire from the Board on 31 March 2013 and 18 April 2013, respectively.

N L Luff will be appointed to the Board on 5 March 2013.

Lord Blackwell, C J Fairbairn and N L Luff were, or will be, appointed to the Board since the annual general meeting held in 2012 and will therefore stand for election at the forthcoming annual general meeting.

In the interests of good corporate governance and in accordance with the provisions of the UK Corporate Governance Code, all of the other Directors will retire and those willing to serve again will submit themselves for re-election at the forthcoming annual general meeting.

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Directors' conflicts of interest

The Board, as permitted by the Company's articles of association, has authorised all potential conflicts of interest that have been declared by individual Directors. Decisions regarding these conflicts of interest could be and were only taken by Directors who had no interest in the matter. In taking the decision, the Directors acted in a way they considered, in good faith, would be most likely to promote the Company's success. The Directors have the ability to impose conditions, if thought appropriate, when granting authorisation. Any authorities given are reviewed periodically, and as considered appropriate, and at least every 15 months. No Director is permitted to vote on any resolution or matter where he or she has an actual or potential conflict of interest. The Board confirms that no material conflicts were reported to it during the year.

Directors' indemnities

The Directors of the Company, including the former Directors who retired during the year and since the year end, have entered into individual deeds of indemnity with the Company which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. In addition, the Company has granted a deed of indemnity through deed poll which constituted 'third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' to the Directors of the Group's subsidiary companies, including to former Directors who retired during the year and since the year end. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Directors who joined the Boards in 2012 and 2013. The indemnities remain in force for the duration of a Director's period of office. The deeds indemnify the Directors to the maximum extent permitted by law. Deeds for existing Directors are available for inspection at the Company's registered office. In addition, the Group has in place appropriate Directors and Officers Liability Insurance cover which was in place throughout 2012.

Corporate governance report

The corporate governance report can be found on pages 86 to 97 and, together with this directors' report of which it forms part, fulfils the requirements of the Corporate Governance Statement for the purpose of the Financial Service Authority's Disclosure and Transparency Rules (DTR).

Share capital

Information about share capital is shown in note 46 on pages 285 and 286 and is incorporated into this report by reference.

The powers of the Directors are determined by the Companies Act 2006 and the Company's articles of association. The Directors were granted authority at the 2012 annual general meeting to issue and allot shares and to repurchase its own shares. Renewal authorities will be sought at the 2013 annual general meeting.

The Company did not repurchase any of its shares during the year (2011: none).

Substantial shareholders

Information provided to the Company by substantial shareholders pursuant to the DTR is published via a Regulatory Information Service and is available on the Company's website.

As at the date of this report, the Company had been notified under Rule 5 of the DTR that The Solicitor for the Affairs of Her Majesty's Treasury had a direct interest of 39.76 per cent in the issued share capital with rights to vote in all circumstances at general meetings. No other notification has been received that anyone has an interest of 3 per cent or more in the issued ordinary share capital. The actual direct interest in the issued share capital of the Company held by The Solicitor for the Affairs of Her Majesty's Treasury as at the date of this report is 39.25 per cent.

Dividends

The Directors do not propose to pay a final dividend in respect of the year ended 31 December 2012. Further information on ordinary dividends is shown in note 50 on page 290 and is incorporated into this report by reference.

Change of control

The Company is not party to any significant contracts that are subject to change of control provisions in the event of a takeover bid.

The Company is party to a deed of covenant with each of the four Lloyds TSB Foundations (the Foundations) which hold limited voting shares in the Company (the limited voting shares are further described in note 46 on page 286). Under the terms of the deeds of covenant, the Company makes an annual payment to each of the Foundations. In the event of a successful offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting share would convert to an ordinary share under the terms of the Company's articles of association. The payment obligation under the deeds of covenant would come to an end one year following the conversion of the limited voting shares.

Donations

The income statement includes a charge for charitable donations totalling £33,657,000 in 2012 (2011: £32,972,000), including £28,228,000 (2011: £28,228,000) which will be paid under the deeds of covenant to the four Lloyds TSB Foundations during 2013 and £1,000,000 paid to the Bank of Scotland Foundation during 2012.

Research and development activities

During the ordinary course of business the Group develops new products and services within the business units.

DIRECTORS' REPORT

Employees

Lloyds Banking Group is committed to providing employment practices and policies which recognise the diversity of our workforce. We will not unfairly discriminate in our recruitment or employment practices on the basis of any factor which is not relevant to individuals' performance including sex, race, disability, age, sexual orientation or religious belief. We work hard to ensure Lloyds Banking Group is inclusive for all our colleagues.

To support us in this aim, Lloyds Banking Group belongs to a number of major UK employment equality campaign groups, including the Business Disability Forum, The Age and Employment Network, Stonewall and Race for Opportunity. Our involvement with these organisations enables us to identify and implement best practice for our staff. Lloyds Banking Group has a range of programmes to support colleagues who become disabled or acquire a long-term health condition. These include a workplace adjustment programme to provide physical equipment or changes to the way a job is done. The Group also runs residential Personal and Career Development Programmes to help colleagues deal positively with the impact of a disability and the colleague disability network, Access, provides peer support.

Employees are kept closely involved in major changes affecting them through such measures as team meetings, briefings, internal communications and opinion surveys. There are well established procedures, including regular meetings with recognised unions, to ensure that the views of employees are taken into account in reaching decisions.

Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in Lloyds Banking Group.

Lloyds Banking Group is committed to providing employees with comprehensive coverage of the economic and financial issues affecting the Group. We have established a full suite of communication channels, including an extensive face-to-face briefing programme, which allows us to update our employees on our performance and any financial issues throughout the year.

Further information on employees can be found on pages 34 to 37.

Policy and practice on payment of creditors

The Company has signed up to the 'Prompt Payment Code' published by the Department for Business Innovation and Skills, regarding the making of payments to suppliers. Information about the 'Prompt Payment Code' may be obtained by visiting www.promptpaymentcode.org.uk.

The Company's policy is to agree terms of payment with suppliers and these normally provide for settlement within 30 days after the date of the invoice, except where other arrangements have been negotiated. It is the policy of the Company to abide by the agreed terms of payment, provided the supplier performs according to the terms of the contract.

The number of days required to be shown in this report, to comply with the provisions of the Companies Act 2006, is 25 (2011: 23 days). This bears the same proportion to the number of days in the year as the aggregate of the amounts owed to trade creditors at 31 December 2012 bears to the aggregate of the amounts invoiced by suppliers during the year.

Essential business contracts

There are no persons with whom the Group has contractual or other arrangements that are considered essential to the business of the Group.

Significant contracts

Details of related party transactions are set out in note 52 on pages 298 to 301.

Statement of directors' responsibilities

The Directors are responsible for preparing the annual report, the directors' remuneration report and the financial statements in accordance with applicable law and regulations. Company law requires the Directors to prepare financial statements for each financial year. Under that law, the Directors have prepared the Group and parent Company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law, the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and the Company and of the profit or loss of the Company and Group for that period. In preparing these financial statements, the Directors are required to: select suitable accounting policies and then apply them consistently; make judgements and accounting estimates that are reasonable and prudent; and state whether applicable IFRSs as adopted by the European Union have been followed.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements and the directors' remuneration report comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the financial statements is placed on our website www.lloydsbankinggroup.com. The Directors are responsible for the maintenance and integrity of the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors, who are in office and whose names and functions are listed on pages 78 and 79 of this annual report, confirm that, to the best of his or her knowledge:

- the Group financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and Group; and
- the management report contained in the business review includes a fair review of the development and performance of the business and the position of the Company and Group, together with a description of the principal risks and uncertainties that they face.

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Independent auditors and audit information

Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Company's auditors are unaware and each Director has taken all the steps that he or she ought to have taken as a Director to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

Resolutions concerning the re-appointment of PricewaterhouseCoopers LLP as auditors and authorising the Audit Committee to set their remuneration will be proposed at the annual general meeting.

On behalf of the Board

Claire A Davies
Company Secretary
1 March 2013

Company number SC95000

CORPORATE GOVERNANCE REPORT

The Board is committed to achieving long term success for the Company by being the best bank for customers and generating stable and sustainable returns for shareholders. Fundamental to the Board's strategy are high standards of corporate governance designed to ensure rigour in the Board's discussions and decision making. This report explains how our corporate governance standards, in particular, those laid down in the 2010 edition of the Financial Reporting Council (FRC)'s UK Corporate Governance Code (the Code), apply in practice to ensure that the Board and management work together for the long term benefit of the Company and its shareholders. The Code can be accessed at www.frc.org.uk. In 2012, the Code was reviewed by the FRC and amendments were introduced that will apply to financial periods commencing after 1 October 2012 (the New Code). Wherever appropriate, the Board has sought in 2012 to apply the provisions of the New Code.

Leadership

Role of the Board

The Board is collectively responsible for the long term success of the Company. It achieves this by:

- setting the strategy and overseeing delivery against it;
- establishing the culture, values and standards of the Group;
- ensuring that the Group manages risk effectively through the approval and monitoring of the Group's risk appetite and a robust risk management framework;
- monitoring financial performance and reporting, including the approval of the Group's annual report and accounts; and
- oversight of resources including people and other key resources e.g. IT, and by ensuring that appropriate and effective remuneration policies and succession planning arrangements are in place.

To assist the Board in carrying out its functions and to provide independent oversight of the internal control and risk management framework, a substantial part of the Board's responsibilities are delegated to the Board's Committees. Each of the Committees is chaired by an experienced Chairman and comprises Independent Non-Executive Members only. All Non-Executive Directors serve on at least two Committees. The Board is kept up to date on the activities of the Committees through reports from the Committee Chairmen at each board meeting. Terms of Reference for each of the Committees can be found on our website at www.lloydsbankinggroup.com and information on the membership, role and activities of each of the Committees can be found on pages 94 to 97.

Delegation of specialist matters to the Committees allows a degree of rigour and scrutiny that would not be possible by the Board acting alone. Matters of particular importance such as funding and liquidity, the Internal Capital Adequacy Assessment Process, provisioning and risk appetite are debated thoroughly by the relevant Committee but need to be approved by the Board as a whole.

The Board believes that the Committees are operating effectively. The 2012 Board Effectiveness Review carried out by Independent Audit summarised the performance of the Committees as follows:

"A distinctive characteristic of the Board governance at Lloyds Banking Group is that much of the Board's work is done in the Committees ...The Committees themselves are very highly regarded by management and Non-Executive Directors alike, we think entirely justifiably. Their high performance contributes a very large element of the overall positive picture."

In addition to the standing committees, the Board also established ad hoc committees during the year to oversee management's response to the industry investigation into LIBOR and the FSA investigation into HBOS. Both Committees were set up as sub-committees of the Risk Committee and are chaired by David Roberts, Chair of the Risk Committee.

Authority and delegation

The Board operates through a Governance Framework which is reviewed at least annually to ensure that it remains fit for purpose. The Governance Framework comprises the Board Governance Framework, the Executive Governance Framework and the Group Subsidiaries Manual, each of which are explained below.

The Board Governance Framework is, in effect, the Board's operating manual and sets out:

- the matters that the Board has reserved to itself, including: the development and setting of strategy and long term objectives; approval of the medium term plan and financial budgets; capital and structure of capital; significant contracts; and various statutory and regulatory approvals;
- delegation of the responsibility for day to day management of the business to the Group Chief Executive;
- terms of reference of, and delegations to, the Board Committees to ensure an appropriate level of independent oversight by Non-Executive directors; and
- the respective roles and responsibilities of each of the Chairman, Group Chief Executive, Senior Independent Director and Non-Executive Directors.

A summary of the Board Governance Framework is available in the Governance section of our website at www.lloydsbanking.com.

The Executive Governance Framework is the means by which the Group Chief Executive delegates responsibilities at executive level to assist him in carrying out his duties. The Group Chief Executive reserves certain matters to himself and, subject to financial limits, delegates responsibilities to the Executive Directors, his direct reports and other senior executives who collectively make up the Group Executive Committee. The Executive Governance Framework provides for delegation to individuals and not to committees.

Through the adoption of consistent and proportionate standards, the Group Subsidiaries Manual helps the Group to manage the legal, regulatory and reputational risks associated with its subsidiary entities by providing guidance on the required governance structures and controls having regard to the nature and risk profile of the entity.

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Roles of the Chairman and Chief Executive

There is a clear division of responsibilities at the head of the Company. The Chairman has overall responsibility for the leadership of the Board while the Group Chief Executive manages and leads the business.

The responsibilities of the Chairman are set out in the Board Governance Framework and include:

- leadership of the Board;
- promoting the highest standards of corporate governance;
- oversight of the content of the Board meeting agendas to ensure that the Board devotes its time and attention to the right matters. Agendas are finalised at Board Agenda Review meetings involving the Chairman, Group Chief Executive and Company Secretary. The Deputy Chairman and Senior Independent Director also attend;
- effective communication with shareholders and development of understanding of the views of shareholders;
- leading and, with the assistance of the Company Secretary, attending to the identification and provision of induction, training and development needs for Directors and the Board generally;
- ensuring, with the support of the Company Secretary, that Directors receive timely and relevant information and are kept advised of key developments, both during and between formal meetings;
- encouraging open dialogue between directors and to this end, he meets regularly with the Non-Executive Directors in the absence of Executive Directors in private sessions; and
- building an effective and complementary Board and, in conjunction with the Nomination & Governance Committee, planning succession in Board appointments.

The 2012 Board Effectiveness Review summarised the Chairman's contribution as follows:

"The Chairman has brought the Board through an exceptionally difficult time. He is much respected for his wisdom and experience, and for rebuilding the Board to its present high quality. He has been instrumental in the Group establishing good relationships with external stakeholders and is widely trusted."

In addition to the Board Effectiveness Review (the process for which is described on page 89), a separate review of the Chairman's performance is undertaken annually by the Non-Executive Directors. For 2012, the review was led by Anthony Watson, Senior Independent Director, who also provided feedback to the Chairman on the findings. The review focused on three key areas: leadership of the Board; effectiveness; and relations with shareholders. The review was carried out through a questionnaire sent to all directors, follow up meetings with individual Directors and a detailed discussion with the Non-Executive Directors in the absence of the Chairman.

The Group Chief Executive is responsible for:

- managing the business of the Group in accordance with the strategy and long term objectives approved by the Board;
- incurring capital and revenue expenditure, as appropriate, to meet the objectives set by the Board; and
- making decisions in all matters affecting the operations, performance and strategy of the Group's businesses, with the exception of those matters reserved to the Board.

Following a period of absence in 2011, the details of which were explained in last year's report, the Group Chief Executive, António Horta-Osório, returned to work in January 2012. The Board has been impressed with his energy and commitment to the role as evidenced by the demonstrable progress made in delivering the strategy. The Board through the Chairman continues to monitor his progress and is confident that he has fully recovered.

Board effectiveness and governance

The Chairman of the Board leads the rolling review of the Board's effectiveness through, and with the support of, the Nomination & Governance Committee, which he also chairs. To ensure a broad representation of independent views, including perspectives from each of the Committees, membership of the Nomination & Governance Committee comprises the Chairman, the Deputy Chairman, the Senior Independent Director and the Chairmen of the Audit, Risk and Remuneration Committees. Prior to his retirement from the Board in May 2012, Sir Julian Horn-Smith (Independent Non-Executive Director) was also a member. The Group Chief Executive attends meetings as appropriate. Key activities of the Nomination & Governance Committee are summarised in the Committees' section on page 96. Given the importance of its role in ensuring effective governance of the Board, further detail of the essential aspects of the Nomination & Governance Committee are provided here.

Board composition

The Nomination & Governance Committee is responsible for assisting the Chairman in reviewing the overall composition of the Board, including its size, structure, independence and diversity. To ensure transparency and consistency, the Board has established principles that underpin its approach to Board composition.

CORPORATE GOVERNANCE REPORT

Board size

The Board should be of sufficient size to reflect a broad range of views and perspectives whilst allowing all Directors to participate effectively in meetings. At year end, the Board comprised 11 directors, down from 12 in 2011. The size of the Board is within the optimal range set by the Nomination & Governance Committee.

Skills and experience

The primary consideration when determining effectiveness is to ensure that the Board represents a mix of backgrounds and experience that will enhance the quality of its deliberations and decisions.

As part of the ongoing review of composition, specific skills required by the Board are identified with reference to the overall skills of the Board at the time, the need to address longer term succession and current business priorities. All Directors are required to have good – and in most cases have deep – experience and understanding of the banking and financial services sector. The complexity of the Group means that broader skills are also required. Maintaining the right balance is an ongoing priority. More information on the background and experience of our Directors is set out on pages 78 and 79.

The 2012 Board Effectiveness Review concluded that:

"The Chairman is credited with having assembled a very high calibre and committed Board. Recent appointments have brought a wide range of experience, going beyond the core areas of retail banking and insurance to bring additional understanding of, in particular, consumer needs."

Independence

The Board's preference is to ensure a strong majority of independent Directors. At year end, the Board comprised two Executive Directors, eight independent Non-Executive Directors and the Chairman who was independent on appointment.

The Nomination & Governance Committee is responsible for the ongoing assessment of the independence of Non-Executive Directors. In assessing independence, the Committee does not rely solely on the Code criteria but considers whether, in fact, the Non-Executive Director is demonstrably independent and free of relationships and other circumstances that could affect their judgement. It does this with reference to the individual performance and conduct in reaching decisions. It also takes account of any relationships that have been disclosed and authorised by the Board. Based on its assessment for 2012, the Nomination & Governance Committee is satisfied that, throughout the year, all Non-Executive Directors remained independent as to both character and judgement.

Diversity

The Board places great emphasis on ensuring that its membership reflects diversity in the broadest sense including diversity of gender, ethnicity and background. The combination of personalities on the Board provides a good range of perspectives and challenge.

The Board continues to focus on improving gender diversity. With the appointments of Sara Weller and Carolyn Fairbairn as Non-Executive Directors in 2012, the Board has shown demonstrable progress, raising the percentage of female representation on the Board from 8 per cent to 27 per cent, exceeding the 2015 target of 25 per cent recommended by the Davies Review.

To assist in its search for Non-Executive Directors, the Nomination & Governance Committee engaged the services of JCA Group and Egon Zehnder, who are both signatories to the 30% Club's voluntary Code of Conduct and which promotes best practice for related search processes. Neither JCA Group nor Egon Zehnder are connected with the Group in any other capacity.

The 2012 Board Effectiveness review remarked that:

"The Board scores particularly well on diversity … through having a very good combination of different backgrounds and personalities. The mix seems to provide a good range of perspectives with at least one of the group usually ready to challenge from an unexpected angle."

Whilst gender diversity is improving at the Board level, the Board recognises that more needs to done to improve the representation of women in senior management roles. The following table details the percentage of women employed at various levels of seniority within the Group at 31 December 2012 compared with statistics at the same date in 2011.

Workforce Gender Representation

	Female Board Members	Female Senior Managers	Female Managers	All Female Staff
2012	**27%**	**28%**	**45%**	**60%**
2011	8%	26%	43%	60%

The Board recognises that senior management is the feeder group from which future directors may eventually be selected. To improve the representation of women in these roles, the Group has implemented a variety of initiatives. These include: the Breakthrough Women's Network, which boasts a talent pool in excess of 4,000 members; and Footprints in the Snow, a female role model programme that showcases the career paths of the Group's most senior women, providing footprints and stepping stones for other women to follow, be inspired by and succeed. In addition, the Group has a leading suite of policies to support working parents to achieve a sustainable work life balance. These efforts have been recognised by our positive placing in the Times Top 50 Employers for Women and through the Breaking the Mould awards. More information on the Group's commitment to diversity can be found on page 37.

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Succession planning

The Nomination & Governance Committee oversees the Board's arrangements for the longer term succession of Board and Committee members.

Non-Executive Director succession planning is addressed as part of the ongoing review of Board composition. The policy takes account of the need regularly to refresh the intake of Non-Executives to bring new, diverse perspectives to the Board and its deliberations, to ensure appropriate representation on each of the Board's Committees and to plan for longer term succession. The average tenure of the Non-Executive Directors is approximately two and a half years. Following the move to annual re-election of directors, Non-Executive Directors are appointed on a rolling 12 month basis.

The Chairman is responsible for developing and maintaining a succession plan in relation to the Group Chief Executive and for reviewing the plan with the Nomination & Governance Committee at least annually. A detailed exercise was undertaken in 2012 to identify potential internal and external successors to the Group Chief Executive both for contingency purposes and on a longer term development basis.

The Nomination & Governance Committee and the Board are responsible for oversight of the process for succession, management development of the most senior executives both at and below Board level, including Executive Directors and members of the Group Executive Committee. The primary responsibility for developing and maintaining a succession plan for key leadership positions in the senior executive team rests with the Group Chief Executive. Arrangements are reviewed with the Nomination & Governance Committee at least annually with the latest review taking place in September 2012.

Board effectiveness review

The annual evaluation of the Board's effectiveness provides an opportunity to consider ways of identifying greater efficiencies, maximising strengths and highlighting areas for further development.

After conducting external reviews in 2009 and 2010, we conducted an internal review in 2011. Key actions arising from that review included the need for increased focus on executive succession and improving the quality and timeliness of board papers. Both of these have been addressed in 2012 to the Board's satisfaction. As explained below, further improving the information provided to the Board to reflect the refocusing of the agenda will remain a priority for 2013.

In 2012, the Board engaged Independent Audit to conduct a review. Independent Audit, which has no other connection with the Group, considered the Board's performance principally by reference to the balance of skills, experience, independence and knowledge of the Group, its diversity, including gender, and how the Board works together as a unit. The evaluation was conducted between October and December 2012 and consisted of:

- one to one interviews with the Directors, the Company Secretary, members of the Group Executive Committee and other senior management;
- observation of Board and Committee meetings held in November 2012; and
- a review of the 2012 Board and Committee minutes and a selection of papers.

The findings of the 2012 review stressed the progress made under the Chairman's leadership with strong support from experienced Committee Chairmen. It identified a number of key strengths including: a high calibre and committed Board with a wide range of skills; a high degree of trust between Executive and Non-Executive Directors; extensive contact between the Non-Executive Directors and management at various levels; and a clear programme to strengthen the Board's governance and oversight of the Insurance business. Inevitably, it also identified areas for further efficiencies and effectiveness.

The 2012 review was conducted following a period of significant transformation of the Board, with a substantial change in its membership. The period was marked by a discernible shift from crisis management towards building a sustainable business. This move towards recovery provides an opportunity to refocus the Board's attention. The 2013 action plan centres around the following key themes:

- **Refocusing of the Board Agenda.** As the business continues to stabilise, the Board will look to spend an increasing proportion of its time on forward looking matters, reducing the time it spends on operational and business critical matters. A refocusing of the agenda is planned to allow more time for strategic discussion and debate. The content of board packs will also be reviewed to ensure that Directors receive the information they need including more routine reporting of strategic matters centred around customers, competitors, colleagues and culture.
- **Working together.** Given the relative 'newness' of the Board, further opportunities will be sought for Directors, particularly Non-Executive Directors, to meet outside formal meetings to assist them in coming together as a team. The cycle of Board meetings and events will be reviewed to allow greater opportunity for Directors to spend time together outside the boardroom.
- **Continuing development.** After the induction period, ongoing training is primarily provided at Board meetings or via 'deep dive' sessions. A more structured approach to continuing development will be introduced along similar lines to the induction programme which includes a series of half day workshops and focused training sessions.

The Company will report on the progress of the above action plan in the 2013 annual report.

CORPORATE GOVERNANCE REPORT

Appointments

In 2012, as part of its longer term succession planning, the Board identified the need for a number of new Directors. The Nomination & Governance Committee, supported by executive search firms JCA Group and Egon Zehnder respectively, conducted the search for the following appointments which were made during 2012:

- Sara Weller, Non-Executive Director, who was nominated for her strong customer advocacy and technology experience in February 2012;
- George Culmer, Executive Director, who was appointed Group Finance Director in May 2012;
- Lord Blackwell, Non-Executive Director and Chair of the Insurance Board, who was appointed for his insurance, banking and consulting expertise in June 2012; and
- Carolyn Fairbairn, Non Executive Director, who was appointed for her digital and on-line, strategy, public policy and regulatory knowledge in June 2012.

On 28 February 2013, the Group announced that Nick Luff would join the Board on 5 March 2013 as a Non-Executive Director and, in due course, successor to Martin Scicluna as Chair of the Audit Committee. Nick, who has over 10 years experience as a finance director, has recent and relevant financial expertise and a sound understanding of internal reporting and controls.

The Nomination & Governance Committee is currently conducting the search for Tim Ryan's successor.

In August 2012, Claire Davies succeeded Harry Baines as Company Secretary. Harry is thanked for his dedication and wise counsel.

Election and re-election

All Directors appointed to the Board since the annual general meeting in 2012 will stand for election at the 2013 annual general meeting. All other Directors will retire and those willing to serve again will submit themselves for re-election at the annual general meeting. Biographies of all current Directors are set out on pages 78 and 79. Details of the Directors seeking election or re-election at the annual general meeting are set out in the Notice of Meeting.

Time commitment

As in recent years, the time commitment demanded of Non-Executive Directors in 2012 remained substantially in excess of the time envisaged within the terms of their appointment. However, the Board timetable returned to largely scheduled meetings as the need for ad hoc meetings declined. The average expected time commitment for Non-Executive Directors (including attendance at Committee meetings) is between 30 – 35 days. For Committee Chairs, this increases to 40 – 50 days with the Senior Independent Director and Deputy Chairman spending considerably more than 50 days on the Company's business. All of these expected time commitments were significantly exceeded in 2012.

There has been no increase to Non-Executive Director fees since January 2008.

Attendance at meetings

In 2012, a total of 10 Board meetings were held of which eight were scheduled at the start of the year. In addition, Board members attended the annual general meeting held in Edinburgh and a two day off-site strategy session. The attendance of Directors at Board meetings and at meetings of the Audit, Nomination & Governance, Remuneration and Risk Committees is shown in the table below. Whilst all Directors are invited to, and regularly attend other Committee meetings, only their attendance at Committees of which they are members is recorded in the table below.

	Lloyds Banking Group Board											
	Scheduled Meetings		Ad hoc Meetings		Audit Committee		Nomination & Governance Committee		Remuneration Committee		Risk Committee	
	Attended	Held[1]	Attended	Held[1]	Attended	Held[1,2]	Attended	Held[1]	Attended	Held[1]	Attended	Held[1]
Current Directors who served during 2012												
Sir Winfried Bischoff	8	8	2	2	–	–	3	3	10	10	6	6
António Horta-Osório	8	8	1	2	–	–	–	–	–	–	–	–
Lord Blackwell	4	4	–	–	11	11	–	–	–	–	3	3
M G Culmer	5	5	–	–	–	–	–	–	–	–	–	–
C J Fairbairn	4	4	–	–	10	11	–	–	4	4	–	–
A M Frew	8	8	2	2	15	15	–	–	–	–	6	6
D L Roberts	8	8	2	2	15	15	3	3	10	10	6	6
T T Ryan	8	8	2	2	6	7	–	–	10	10	5	6
M A Scicluna	7	8	2	2	14	15	3	3	–	–	5	6
Anthony Watson	7	8	1	2	14	15	3	3	10	10	–	–
S V Weller	7	7	1	1	–	–	–	–	8	8	5	5
Former Directors who served during 2012												
Sir Julian Horn-Smith	3	4	1	2	–	–	1	1	3	6	2	3
Lord Leitch	1	2	1	1	1	2	1	1	2	4	–	–
G R Moreno	3	4	2	2	–	–	1	1	–	–	–	–
G T Tate	–	1	1	1	–	–	–	–	–	–	–	–
T J W Tookey	2	2	1	1	–	–	–	–	–	–	–	–

[1] Number of meetings held during the period that the Director held office.

[2] Includes four special purpose 'deep dive' meetings.

Directors' induction

All Directors are expected to make an informed contribution based on an understanding of the Group's business model and the key challenges facing the Group and its businesses. All Directors undergo an extensive induction programme comprising:

- a corporate induction, including an introduction to the Board and the business. This includes a detailed overview of the Group, its strategy, operational structures and main business activities;
- the roles and responsibilities of a director, including statutory duties and responsibilities of an FSA approved person; and
- a bespoke induction programme tailored by the Chairman to the individual needs of the Director having regard to their specific role on the Board and their skills and experience to date.

Board training

The Board receives regular refresher training and information sessions to address current business or emerging issues. In the course of 2012, Non-Executives Directors undertook approximately 16 to 18 hours of training. This was delivered through a variety of means, including: sessions on matters such as capital and liquidity (including stress testing requirements); regulatory updates for approved persons; accounting development updates; and updates on credit rating agency developments. In addition, the Audit Committee hosted a series of 'deep dives' to which all Board members were invited, and which provided an in-depth review of the operations of each of the business divisions and of the latest accounting standards and operating methodologies.

All Directors, including Non-Executive Directors, have access to the services of the Company Secretary in relation to discharging their duties as a director, or as a member of any Board Committee. The appointment, and removal, of the Company Secretary is a matter reserved for the Board as a whole. In addition, the Group provides access, at its expense, to the services of external advisers in order to assist directors in their role, wherever this is deemed necessary.

CORPORATE GOVERNANCE REPORT

Accountability

Internal control

The Board is responsible for the establishment and review of the Group's system of internal control, which is designed to ensure effective and efficient operations; quality of internal and external reporting; internal control; and compliance with laws and regulations. It should be noted, however, that such a system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives. In establishing and reviewing the system of internal control, the Directors have regard to the nature and extent of relevant risks, the likelihood of a loss being incurred and the costs of control. It follows, therefore, that the system of internal control can only provide reasonable but not absolute assurance against the risk of material loss.

The Directors and senior management are committed to maintaining a control-conscious culture across all areas of operation. This is communicated to all employees by way of published policies and procedures and regular management briefings. A requirement to comply with internal control risk policies is a key component of individual staff objectives expressed in the balanced scorecard. Key business risks are identified, and these are controlled by means of procedures such as physical controls, credit, trading and other authorisation limits and segregation of duties. In addition, there is an annual evaluation review exercise whereby the key businesses and head office functions review specific controls and attest to the accuracy of their assessments. The review covers all enterprise-wide risk management categories and is in accordance with the principles of the Code. As in previous years, this exercise was completed for the year ended 31 December 2012. All returns have been satisfactorily completed and appropriately certified.

The effectiveness of the internal control system is reviewed regularly by the Board and the Audit Committee, which also receives reports of reviews undertaken by Risk division and internal audit. The Audit Committee receives reports from the Company's auditors, PricewaterhouseCoopers LLP (which include details of significant internal control matters that they have identified), and has a discussion with the auditors at least once a year without executives present, to ensure that there are no unresolved issues of concern.

There is an ongoing process for identifying, evaluating and managing the significant risks faced by the Company. This process has been in place for the year under review and up to the date of the approval of the annual report and is regularly reviewed by the Board. Information regarding the main features of the internal control and risk management systems in relation to the financial reporting process is given within the Risk Management Report on pages 115 to 202.

Auditor independence and remuneration

Both the Board and the external auditors have safeguards in place to protect the independence and objectivity of the external auditors. The Audit Committee has a comprehensive policy to regulate the use of auditors for non-audit services. This policy sets out the nature of work the external auditors may not undertake, which includes work which will ultimately be subject to external audit, internal audit services and secondments to senior management positions in the Group that involve decision-making. It also includes the Group's policy on hiring former external audit staff. For those services that are deemed appropriate for the auditors to carry out, the policy sets out the approval process that must be followed for each type of assignment. The Chairman of the Audit Committee must be consulted regarding potential instructions in respect of allowable non-audit services with a value above defined fee limits.

Each year the Audit Committee establishes a limit on the fees that can be paid to the external auditors in respect of non-audit services and monitors quarterly the amounts paid to the auditors in this regard. The external auditors also report regularly to the Audit Committee on the actions that they have taken to comply with professional and regulatory requirements and current best practice in order to maintain their independence. This includes the rotation of key members of the audit team. Total auditor remuneration analysed between audit and other services is shown in note 11 to the financial statements on pages 241 and 242.

The Audit Committee evaluated the performance of the external auditors during the year and will continue to do so periodically. The Audit Committee did not consider it necessary to require an independent tender process this year. The lead audit partner is rotated every five years, the current audit partner having joined the audit team in 2011. The need for a further audit tender will be kept under consideration by the Committee and any recommendation to re-appoint the current auditors will be based on their continued satisfactory performance.

Remuneration

The Remuneration Committee, chaired by Anthony Watson, is responsible for overseeing the Group's remuneration arrangements and compliance with the FSA's Remuneration Code. The Remuneration Committee's terms of reference are available on the website at www.lloydsbankinggroup.com.

An overview of the Remuneration Committee is set out on page 96. The work of the Remuneration Committee is explained in the Directors' Remuneration Report on pages 98 to 114.

Shareholder engagement

The Board recognises the importance of promoting mutual understanding between the Company and its shareholders through greater engagement. In 2012, there was regular dialogue with institutional shareholders with more than 400 equity investor meetings undertaken in the year. Many of these meetings were undertaken by senior management (primarily the Group Chief Executive and Group Finance Director) or other Board members. The Chairman has also attended a number of meetings with shareholders to discuss governance and the Group's strategic direction. Anthony Watson, the Chairman of the Remuneration Committee and the Senior Independent Director, regularly meets the larger shareholders to listen to their views and discuss executive remuneration issues.

The 2011 Remuneration Report received overwhelming support from shareholders at the 2011 annual general meeting with over 97 per cent of the shareholders approving the Report. This was achieved through tough action by the Remuneration Committee in exercising constraint over remuneration and through effective engagement with major shareholders.

The Board is kept advised of the views of major shareholders by means of regular updates at Board and Committee meetings. It also receives monthly reports on market and investor sentiment and shareholder analysis.

Investor Relations has primary responsibility for managing day-to-day communications with institutional shareholders. Supported by the Group Chief Executive and Group Finance Director, they achieve this through a combination of briefings to analysts and institutional shareholders (both at results briefings and throughout the year), as well as site visits and individual discussions with institutional shareholders.

The Company Secretary oversees communications with private shareholders. The Group's annual general meeting provides an opportunity to meet the Group's Directors and to hear more about the strategy of the Group. Shareholders are encouraged to attend the annual general meeting and to raise any questions at the meeting or in advance, using the email address shown in the pack which will be sent to shareholders in March 2013.

Scottish Widows Investment Partnership

Scottish Widows Investment Partnership, one of Europe's largest asset managers and a Group company, complies with the principles of the Financial Reporting Council's Stewardship Code. Details of Scottish Widows Investment Partnership's approach to stewardship and corporate governance can be found on its website, www.swip.com.

Compliance with the British Bankers' Association Code for Financial Reporting Disclosure

In September 2010, the British Bankers' Association published a Code for Financial Reporting Disclosure (the 'Disclosure Code'). The Disclosure Code sets out five disclosure principles together with supporting guidance. The principles are that UK banks: commit to providing high quality, meaningful and decision-useful disclosures; commit to ongoing review of, and enhancement to, their financial instrument disclosures for key areas of interest; will assess the applicability and relevance of good practice recommendations to their disclosures acknowledging the importance of such guidance; will seek to enhance the comparability of financial statement disclosures across the UK banking sector; and will clearly differentiate in their annual reports between information that is audited and information that is unaudited.

The Group has adopted the Disclosure Code and its 2012 financial statements have been prepared in compliance with the Disclosure Code's principles.

Conclusion

In conclusion, the Group confirms its compliance with all provisions of the Code throughout the year ending 31 December 2012. In addition, the Group has voluntarily applied certain New Code provisions, in particular the board diversity and evaluation provisions.

CORPORATE GOVERNANCE REPORT

Board committees

Set out below is a summary of the membership and role of each of the Board Committees, along with the activities they performed during 2012. There is a standing invitation for all Non-Executive Directors to attend Committee meetings of which they are not members. Non-Executive Directors routinely attend Committees of which they are not members. All Committee terms of reference are available on the website, www.lloydsbankinggroup.com or from the Company Secretary.

Committee

AUDIT

Chairman

Martin Scicluna

Members

Lord Blackwell
(from 1 June 2012)

Carolyn Fairbairn
(from 1 June 2012)

Anita Frew

Lord Leitch
(until 29 February 2012)

David Roberts

Tim Ryan
(until 1 September 2012)

Anthony Watson

Purpose

To monitor, review and report to the Board on the formal arrangements established by the Board in respect of the financial and narrative reporting of the Group, the internal controls and the risk management framework, the internal audit and the external audit process.

Responsibilities

Financial Statements and Reporting of the Group

- monitors the integrity of the financial statements of the Group relating to the Group's financial performance, reviewing significant financial reporting issues and the judgements which they contain;
- provides advice to the Board on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy;
- reviews and challenges where necessary, the actions, estimates and judgements of management in relation to the financial statements;
- reviews any significant adjustments to financial reporting resulting from the audit and resolves any disagreements between management and the external auditors regarding financial reporting; and
- reviews the quality and acceptability of the related accounting policies, practices and financial reporting disclosures.

Internal Controls and the Risk Management Framework

- reviews the effectiveness of the systems for internal control, risk management and compliance with financial services legislation and regulations;
- reviews the Group's procedures for detecting financial reporting fraud;
- reviews the Group's procedures for handling of complaints or concerns regarding accounting or auditing matters; and
- reviews the Group's arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters.

Internal Audit

- reviews and monitors the effectiveness of the Group's internal audit function and activities, in the context of the Group's overall risk management system;
- approve the appointment or removal of the Group Audit Director as head of the internal audit function;
- review the internal audit programme and ensure that the internal audit function is adequately resourced and has appropriate access to information; and
- consider the major findings of any significant internal audit escalated to the committee by the Group Audit Director and consider managements responses.

External Auditors

- recommends the external auditors' appointment, re-appointment and removal;
- approves the external auditors' terms of engagement and remuneration;
- assesses the external auditors' effectiveness, independence and objectivity;
- approves the provision of non audit services by the external auditor and related remuneration;
- agree with the Board a policy on the employment of former employees of the Group's auditors and monitoring the implementation of this policy;
- reviews reports from the auditors on audit planning and their findings, significant issues and judgements on accounting and internal control systems; and
- reviews the results of the external audit and its cost effectiveness.

Other Matters

- undertake similar duties for all subsidiary companies where a legal or regulatory provision requires audit committee involvement except where the subsidiary company's board has appointed a separate audit committee.

Committee | **Purpose**

AUDIT

2012 Activities

– reviewed, challenged and recommended to the Board the Group annual and interim reports and accounts;
– reviewed significant accounting issues, matters and judgements as discussed with the auditors (see table below);
– reviewed the Group's position as a going concern;
– reviewed the effectiveness of the external auditor, recommended their re-appointment and determined their remuneration;
– attended four half day 'deep dive' sessions with each of the divisions;
– reviewed litigation and regulatory risks;
– received reports from the Divisional Financial Control Committees and the Group Risk Committee;
– received a report from the Group Secretariat on Corporate Governance Changes relevant to the Audit Committee;
– reviewed internal controls across the Group, including through participating in 'deep dive' meetings on each of the main divisions within the Group and receiving reports from the internal audit department on items such as SOX reporting;
– reviewed the Group's key finance programmes;
– considered the appointment of the Group Audit Director;
– reviewed details of the Group's whistle blowing procedures and incidents; and
– discussed the level of impairments.

Significant Accounting Matters

During the year, the Committee considered the following significant accounting issues, matters and judgements in relation to the Group's financial statements and disclosures:

Issue	Approach
Allowance for impairment losses on loans and receivables	Reviewed and challenged the impairment methodologies and assumptions and were satisfied that they were appropriate.
Fair value of financial instruments	Reviewed the appropriateness of the judgements made by management in valuing certain portfolios of assets and liabilities and were satisfied that these judgements were appropriate.
Recoverability of deferred tax assets	Considered the recognition of deferred tax assets and agreed with management's judgement that the deferred tax assets were appropriately supported by forecast taxable profits.
Retirement benefit obligations	Considered the assumptions underlying the calculation of defined benefit liabilities and were satisfied that they were appropriate.
Valuation of assets and liabilities arising from life insurance business	Considered and challenged the assumptions underlying the calculation of assets and liabilities arising from the life insurance business and were satisfied that they were appropriate.
Payment protection insurance (PPI)	Considered the assumptions made by management in determining the provision for PPI redress, and were content that the assumptions were appropriate, although they will be considered periodically against actual claims experience.
Other regulatory provisions	Considered the assumptions made by management to redress provision for several regulatory matters. These matters included litigation in relation to our insurance branch business in Germany and sales of interest rate hedging products to certain small and medium-sized businesses.

CORPORATE GOVERNANCE REPORT

Committee

NOMINATION & GOVERNANCE

Chairman

Sir Winfried Bischoff

Members

Sir Julian Horn-Smith
(until 17 May 2012)

Lord Leitch
(until 29 February 2012)

Glen Moreno
(until 17 May 2012)

David Roberts

Martin Scicluna

Anthony Watson

Purpose

To keep the Board's governance arrangements under review and make appropriate recommendations to the Board to ensure that the Company's arrangements are consistent with best practice corporate governance standards; and to assist the Chairman in keeping the composition of the Board under review and to lead the appointments process for nominations to the Board.

Responsibilities

- oversees the Board's governance arrangements;
- oversees the Group's implementation of governance requirements in particular reviewing the Governance Frameworks;
- reviews the overall composition of the Board including its size, diversity, independence and structure;
- considers Board succession;
- oversees the selection process for prospective directors;
- makes recommendations to the Board on potential appointments and reappointments of Directors at the end of their specified term, including the ongoing review of independence;
- review of membership of Board Committees;
- oversees the annual evaluation of the performance of the Board; and
- oversees the process for appointments of new Non-Executive Directors and makes recommendations to the Board.

2012 Activities

- reviewed Board composition including the Group's continued response to the Davies Review and diversity targets;
- oversaw the search and selection process for new Non-Executive Directors;
- oversaw the Board Evaluation process including formulation of the actions arising from the outcomes of the evaluation;
- reviewed the Governance Framework to ensure consistency with organisational changes and emerging developments;
- regularly reviewed developments in the regulatory environment around corporate governance; and
- reviewed the adequacy of the Group's succession plan.

Committee

REMUNERATION

Chairman

Anthony Watson

Members

Sir Winfried Bischoff

Carolyn Fairbairn
(from 1 June 2012)

Sir Julian Horn-Smith
(until 17 May 2012)

Lord Leitch
(until 29 February 2012)

David Roberts

Tim Ryan

Sara Weller
(from 1 February 2012)

Purpose

To set the principles and parameters of remuneration policy for the Group, and to oversee remuneration policy and outcomes for those colleagues specified in the terms of reference

Responsibilities

- Information about the Remuneration Committee's responsibilities is given in the Directors' remuneration report on pages 98 to 114.

2012 Activities

- Information about the Remuneration Committee's activities during 2012 is given in the Directors' remuneration report on pages 98 to 114.

Committee

RISK

Chairman

David Roberts

Members

Sir Winfried Bischoff

Lord Blackwell
(from 1 June 2012)

Anita Frew

Sir Julian Horn-Smith
(until 17 May 2012)

Tim Ryan

Martin Scicluna

Anthony Watson
(from 1 December 2012)

Sara Weller
(from 1 February 2012)

Purpose

To review and report its conclusions to the Board on the Group's risk appetite (the extent and categories of risk which the Board regards as acceptable for the company to bear) and the Group's risk management framework (embracing principles, policies, methodologies, systems, processes, procedures and people), taking a forward looking perspective and anticipating changes in business conditions.

Responsibilities

- oversees the development, implementation and maintenance of the Group's overall risk management framework and its risk appetite, strategy, principles and policies to ensure that they are in line with emerging regulatory, corporate governance and industry best practice;
- oversees the Group's risk exposure, risk/return and proposed improvements to the Group's risk management framework and its risk appetite;
- facilitates the involvement of Non-Executive Directors in risk issues and aids their understanding of these issues;
- provides input to the Remuneration Committee on the alignment of remuneration to risk performance;
- reviews the appointment or dismissal of the Chief Risk Officer;
- reviews coordination between the Group Risk Division and the external auditors;
- oversees adherence to Group risk policies and standards and considers any material amendments to them; and
- reviews the work and resources of the Group Risk Division.

2012 Activities

- reviewed and enhanced the Group's risk appetite framework, policies and principles;
- at each meeting, reviewed the Group's consolidated risk profile, key risks and management actions, together with performance against risk appetite. Details of the Group's principal risks are set out in the risk management section on pages 118 to 124;
- reviewed conduct risk at each meeting, including product governance and conduct strategy, complaints, outcome testing and mitigating actions;
- reviewed the Group's capital and funding plan under the Group and FSA stress testing scenarios, including scenarios developed by the Risk Committee;
- reviewed the Internal Capital Adequacy Assessment Process report;
- received reports on the economic outlook, international regulatory relationships, pension and hedging risks, longevity risk within Insurance, anti-money laundering and financial crime and IT resilience and cyber security; and
- four deep dives (in conjunction with the Audit Committee) on risk arising from each of the Divisions and including the critical IT infrastructure and systems operated by the Group.

DIRECTORS' REMUNERATION REPORT

Statement by the Chairman of the Remuneration Committee

As Chairman of the Group's Remuneration Committee, I am pleased to introduce the Directors' Remuneration Report for 2012 and to provide context around the key reward decisions taken in respect of the past year and our future plans.

The ongoing economic challenges currently encountered in our industry and across all aspects of life naturally lead to continuing attention being placed on executive remuneration. As a Committee we have a strong belief in aligning the pay delivered to our executives with the successful performance of the business and, through this, the return of value to our shareholders as set out in our 2011 Strategic Review. To this end, we have continued to develop our performance management process, with the close participation of our Risk team, to embed meaningful challenging but responsible performance measures across our reward structure, which reflect Group and divisional achievement in addition to personal contribution. In order to further align reward to the longer-term, sustainable success of the business we plan to introduce changes to our annual incentive scheme from 2014 to better connect the interests of colleagues with shareholders and to ensure a fair distribution between all stakeholders of the benefits which result from the Group meeting its performance targets.

In setting our reward policy we endeavour to keep the structure as simple as possible and to clearly communicate the aims of the policy to our colleagues and our shareholders. We believe that transparency around our policy and the basis for our performance measures is critical to rebuilding trust with our employees and our numerous stakeholders. This has been evident in the annual disclosures we make to explain our policy approach to remuneration and the actions we undertake to implement this. We support the new proposals made by the Department for Business, Innovation and Skills (BIS) to codify and standardise additional reporting expectations in this area. We are also heartened to note that many elements of the draft regulations published to date are already incorporated in our annual reporting.

Central to the BIS proposals is the active engagement of shareholders to approve the remuneration policy applied by the Company. We maintain an open and transparent exchange of information and feedback with our shareholders and acknowledge the weight of their judgment in setting our policies. In line with the BIS proposals, we have therefore included dedicated commentary on these interactions and the outcome of the shareholder vote on our reward policy in the body of the Report.

The introduction of a binding shareholder vote on policy will promote consistency by requiring strict adherence to policy for a three-year period from approval, permitting exception only by agreement through a further shareholder vote. Whilst, in certain individual circumstances this may require us to revert directly to shareholders within the three year period, the commitment to an approved policy will promote upfront transparency with shareholders and will ensure rigour is embedded into policy design and adherence, firmly underpinning the responsibility and accountability that we as a Committee have to fulfil.

With respect to the proposed reporting of supplementary data – including comparative tables to show the movement of Group Chief Executive pay against TSR, or the relative growth in the total cost of pay against Group profit and dividend performance – we have taken the decision not to incorporate the proposals of these draft regulations in advance of enactment. Whilst the inclusion of illustrative examples of these tables may add value by enabling a year-on-year comparison to be drawn in next year's report, as consultations on the nature and scope of these new disclosures and graphs are still ongoing, there remains a possibility that these may change significantly over the course of the year.

The package delivered to our Executive Directors and our Group Executive Committee remains broadly consistent with that provided in previous years. The composition of the package is approximately as follows:

Long-term incentive	24%	Based on a combination of performance targets comprising economic profit, absolute total shareholder return and strategic financial objectives (shown on an expected value basis)	**Paid in shares after three years**
Short-term incentive	33%	Based on financial measures and on a balanced scorecard of non-financial measures (based on actual award value)	**Deferred into shares until at least March 2015, subject to malus**
Salary	33%	Based on role, market competitiveness, and performance (based on actual value)	**Paid in cash**
Pension and benefits	10%	Based on role and market competitiveness (based on actual value)	**Paid into pension or taken as cash**

Comparable numbers for the Group Chief Executive are: long-term incentive 23 per cent, short-term incentive 30 per cent, salary 30 per cent and pension and benefits 17 per cent.

The Committee firmly believes that fixed pay should be positioned competitively but conservatively against the market and that the variable pay offered to our executives should be directly aligned to the delivery of value to our shareholders. Although shareholder return and operational effectiveness have been very positive over the course of the year, we feel it is appropriate that the fixed pay elements for our Directors should remain unchanged for a further 12 months in recognition of the continuing economic climate and the need to deliver further, sustained economic growth to our shareholders. In addition, bonus awards in respect of the 2012 year have been determined conservatively against the robust performance measures set. The bonus awards will be deferred into shares for varying periods according to the seniority or role of the individual (see page 103 for further information) with attached malus provisions to enable the adjustment of awards where such awards are subsequently considered by the Committee not to reflect appropriately the performance in the period to which they relate. We have demonstrated through the adjustment of bonus payments made in respect of previous years that we are comfortable executing the malus provisions for these awards in situations where it is appropriate to do so.

Across the business as a whole, the Remuneration Committee feels it is important to recognise the contribution of our colleagues in achieving success against our strategic goals and to enable them to share in that success through the payment of bonuses. The assessment of the value of bonus pool to be made available has been undertaken in consideration of our relative, risk-adjusted performance for the year and with a focus on ensuring that the reward is weighted towards our more junior staff. The total bonus pool of £365 million in 2012, which reflects the final statutory results for the Group, is down 3 per cent on 2011 and represents 7 per cent of the pre-bonus management profit before tax compared to 12.5 per cent in the prior year. The average value of bonus per employee is similar to the prior year at £3,900.

In my previous statements I have highlighted the importance of our Long-Term Incentive Plan in aligning our reward strategy to the performance of the business. Through the application of carefully considered, stretching target measures, we are able to ensure that awards are forfeited or restricted where performance does not meet the desired level. We also require executives to retain the net shares (ie.after the deduction of tax) awarded under the LTIP for a minimum period following receipt. This directly connects the financial reward for the executive and senior management team with the growth and prosperity of the Company and motivates them to demonstrate appropriate behaviours across all areas of the business.

Shareholders will also note that revised shareholding guidelines have been introduced from 2012 (as detailed on page 103) which we are considering extending to a broader population in the future.

Our commitment to managing executive reward through the strict application of challenging LTIP performance measures is demonstrated through the confirmation that, as key targets for the 2010 LTIP have not been met, awards made under this plan will not vest. Moreover, for the anticipated 2013 LTIP awards we have once again set challenging targets for delivery of core financial measures (Economic Profit and Absolute Total Shareholder Return) alongside operational measures aligned to the strategic business plan, all underpinned by a clear consideration of the risk impact of our activities.

In general, the Committee retains discretion over all remuneration plans and consideration is given to the exercise of such discretion both at the point of award and subsequently when assessing performance under the LTIP.

As a Committee we are keen to continually review our policy approach and to explore ways in which we may strengthen and simplify the alignment of the Group's remuneration package with the Company's business performance and relative value to shareholders. Over recent years we have introduced to our bonus scheme a mandatory deferral into shares for awards made to our Executive Directors and for any awards in excess of a specific threshold made to other staff. As noted above, our aim is that from 2014 we will implement a restructure of our package which will more effectively recognise the connection between the impact of short-term and long-term goals in driving forward our business and will also further facilitate the adjustment of awards for malus.

The Committee has striven to ensure that the remuneration policies and practices detailed in this Report are appropriate to supporting the delivery of the Company's current and future strategy. This Report will be tabled for shareholder approval at the AGM, which I hope you will support.

Anthony Watson CBE
Chairman, Remuneration Committee

This is a report made by the Board of Lloyds Banking Group plc, on the recommendation of the Remuneration Committee. It covers the current and proposed components of the remuneration policy and details the remuneration for Directors during 2012.

The Group has complied throughout the period with the requirements of the UK Corporate Governance Code (previously known as the Combined Code) in relation to Directors' remuneration. In addition, the report has been prepared in accordance with the Large and Medium sized Companies and Groups (Accounts and Reports) Regulations 2008.

The Committee recognises the attention which Bank remuneration receives and is very aware both of the importance of getting the right balance between the linkage of rewards to performance and the competitive process; recruiting, retaining and motivating staff as well as a more widely perceived concept of fairness for all involved.

DIRECTORS' REMUNERATION REPORT

Policy Report

Directors' remuneration policy

The Group's remuneration policy continues to support our business values and strategy, based on building long-term relationships with our customers and employees and managing the financial consequences of our business decisions across the entire economic cycle.

Our policy is intended to ensure that our remuneration proposition is both cost effective and enables us to attract and retain Executive Directors and senior management of the highest calibre, motivating them to perform to the highest standards.

Our objective is to align individual reward with the Group's performance, the interests of its shareholders, and a prudent approach to risk management. In this way we balance the requirements of our various stakeholders: our customers, shareholders, employees, and regulators. This approach is in line with the Association of British Insurers best practice code on remuneration and the FSA Remuneration Code of Practice, as the policy seeks to reward long-term value creation whilst not encouraging excessive risk taking.

Our overall policy objective is met by a focus on the particular aspects detailed below.

Policy objective	How achieved
Building long-term relationships	We build relationships with our customers and people. Working for Lloyds Banking Group is about more than pay. Our relationship with our people means that we want to pay them fairly and competitively, but our pay is positioned conservatively against the market and we do not seek to align with the highest payers in the sector. In setting pay for Executive Directors and senior managers, we take account of relative pay positioning and target levels of variable remuneration opportunity for all levels of employees in the Group. Our incentive measures are not just financial. Our Balanced Scorecards, which are incorporated into the performance objectives of all of our senior executives for the year, include objectives that cover effective risk management, lending to Corporates including SMEs and retail customers, performance against targets that measure how satisfied our customers are with our service and the extent to which our employees feel engaged with and committed to working for Lloyds Banking Group.
Managing the financial consequences of our business through the economic cycle	Economic profit is a key measure by which we manage our business. This measure takes into account the level of capital required to generate profits as well as the risks taken. The same level of profit generated at lower risk results in higher economic profit. Economic profit also measures risk based on an assessment of how the business will perform through the economic cycle and is a key measure for short term incentives. For example, in good times, when default rates on loans are low, we adjust the economic profit measure downwards based on a higher average expected default experience over the economic cycle. This encourages us to avoid business and funding strategies that are only profitable during boom times but turn bad in a recession. Economic profit plays a prominent role in our incentive plans for executives, with its inclusion in both the annual and LTIP performance measures.
Aligning individual rewards with Group performance and shareholders	Our executives' annual incentives are based on stretching performance objectives and targets in the Group Balanced Scorecard. This Balanced Scorecard is derived from the Medium Term Plan which defines the financial and non-financial targets within our agreed risk appetite over a three year period. Any annual bonus for Executive Directors is deferred into shares and released over time, helping to increase alignment with shareholders. These deferrals are subject to malus in the event of unsustainable performance. Executives are also aligned with shareholders through the LTIP, which pays out in shares based on performance against Group financial targets over a three year period. In addition to purely financial metrics of Economic Profit and Total Shareholder Return, the performance conditions for the 2013 LTIP will comprise measures linked to the Strategic Review that reflect the wider Group objectives. These measures are SME lending, customer satisfaction, total costs at the end of 2015 and non-core assets (excluding UK Retail) at the end of 2015. We operate tough contract provisions relative to market practice, whereby no executive has an entitlement to more than 12 months' notice (not taking into account recruitment provisions), pay in lieu of notice is limited to basic salary, is paid monthly over 12 months and is mitigated if the executive gets another job. This approach avoids the risk of payment for failure.
A prudent approach to risk management	We also have non-financial measures of performance against risk objectives in both the annual and long-term incentive plans for executives. For the 2012 annual incentive plan we continue to align the award to long-term prudent risk management by deferring 100 per cent of the award for Executive Directors, which is subject to malus. Executive Directors are also required to retain any shares vesting from LTIP awards from 2010 onwards for a further 2 years, after allowing for tax and national insurance requirements. For other employees, the immediate cash bonus award is limited to £2,000 with a percentage of larger bonuses being subject to deferral and malus. If the performance is unsustainable during the deferral period some or all of the award may be forfeited. We have a robust governance framework with an independent Remuneration Committee reviewing all compensation decisions for senior executives. This approach to governance and review is cascaded through the organisation. We also ensure that all control function employees are assessed and their remuneration determined jointly by the relevant business Director and the control function Director. The remuneration of senior risk and compliance officers is also reviewed by the Remuneration Committee.

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Policy objective	How achieved
Cost effective packages to attract and retain executives	We aim to ensure that the totality of remuneration for Executive Directors is competitive against our benchmark groups. These groups are other major UK banks and the top 20 companies in the FTSE 100, reflecting practices in large UK companies across all sectors. We aim to be competitively but conservatively positioned against the market. We select incentive plan targets that are directly linked to the business strategy and priorities, ensuring alignment with company performance, targets that are meaningful to executives and incentive packages that are both valued by executives and cost effective.

The remuneration package offered to our Executive Directors and other senior managers within the business is fundamentally based on the same components as are provided to other employees, including the eligibility to participate in all-employee share plans. However, the ratio of fixed to variable income is adjusted such that more than half of total reward for this group is put at risk by linking earnings (through delivery of the annual incentive plan and LTIP) to challenging Company, individual and share price performance. This weighting towards variable pay is intended to promote behaviours focused on the success of the business.

Moreover, the assessment of performance against target measures is moderated by the Group Risk function to ensure that the performance is sustainable in the long term and does not merely produce a positive short-term result. The Committee places great weight on this assessment and holds the Executive Directors to a more stringent standard in this regard.

When setting the policy for Directors' remuneration, the Committee seeks confirmation from the Company's shareholders that its approach is acceptable and over the course of 2012 we have entered into frequent consultation with shareholders and representative bodies who control a significant majority of the Group's share base and all views are taken into consideration in relation to remuneration policy and implementation. We do not directly consult with employees as part of the process of reviewing executive pay, however we are kept informed on general remuneration feedback across the Group in addition to receiving updates on employee engagement surveys and take these into account.

In all executive remuneration discussions the Committee considers the approach towards establishing pay levels elsewhere in the Group. When setting remuneration levels for Executive Directors, the Committee refers to benchmark data from comparable organisations across the FTSE and industry sector to ensure that remuneration is positioned competitively but conservatively against the market.

Summary

Following extensive consultation with shareholders, the Remuneration Committee is proposing a package for Executive Directors for 2013 that is closely based on the structure and principles applied in previous years as follows:

Element	Level/design for 2013	Key purpose
Base salary	Base pay should be set relative to FTSE 20 and banking sector competitors There were again no increases to base salaries for Executive Directors	To provide the basis for a competitive package
Pension	Defined contribution pension provision for new entrants	To enable executives to build long-term retirement savings Retention
Annual incentive	200 per cent of salary maximum (225 per cent for the Group Chief Executive) Based on Group financial targets relating to Profit Before Tax and Economic Profit as well as Balanced Scorecard measures covering divisional financial targets, customers (e.g. SME lending), people, risk and building the business Subject to deferral and malus in line with FSA requirements	Alignment with Group performance Motivation of executives Pay for performance Alignment with sound risk management
Long-term incentive plan	Annual awards of up to 300 per cent of salary for the Group Chief Executive and Executive Directors. Vesting based on financial measures comprising Absolute Total Shareholder Return, Economic Profit and strategic financial objectives. Details of the performance conditions are provided below.	Motivation and retention of executives Alignment with sound risk management Alignment with long-term shareholder interests

DIRECTORS' REMUNERATION REPORT

Base salary

Base salaries are reviewed annually, taking into account individual performance and market information (which is provided by Towers Watson and supplemented with information from Deloitte LLP) and normally adjusted from 1 January of the relevant year. The remuneration committee confirmed during the 2012 review that the FTSE remains the most appropriate comparator group to use to benchmark overall competitiveness of the remuneration package whilst taking particular account of the remuneration practice of our direct competitors, namely the major UK banks.

No increase to salaries will be made in 2013.

Name	A Horta-Osório	M G Culmer
At 1 January 2013	£1,061,000	£720,000
At 1 January 2012	£1,061,000	£720,000[1]

[1] With effect from 16 May 2012.

Annual incentive plan

The annual incentive scheme for Executive Directors is designed to reflect specific goals linked to the successful performance of the business.

Incentive awards for Executive Directors are based upon individual contribution and overall corporate results. Incentive opportunity is driven equally by i) corporate performance based on profit before tax and economic profit, and ii) divisional achievement and individual performance. Individual targets relevant to improving overall business performance are contained in a Balanced Scorecard and are grouped under the following headings:

- Financial
- Building the Business
- Customer Service
- Risk
- People Development

These targets apply differently for the Executive Directors, reflecting differing strategic priorities. The non-financial measures include key performance indicators relating to risk management, SME lending, process efficiency, service quality and employee engagement.

The remuneration committee believes that the structure of the incentive – in particular the use of risk-adjusted and non-financial measures – has been highly successful in promoting a long-term focus within the senior management team.

The maximum annual incentive opportunity is 200 per cent (225 per cent for the Group Chief Executive) of base salary for the achievement of exceptional performance targets.

Deferral

Consistent with the aim of ensuring that short-term financial results are only rewarded if they promote sustainable growth, the 2012 annual incentive is subject to deferral in shares until at least 2015. This deferred amount is subject to malus if the performance that generated the incentive is found to be unsustainable. In 2012 the FSA has reviewed the Group's Risk-adjusted Performance assessment process and advised that it is considered a sound framework.

The Committee reserves the right to exercise its discretion in reducing any payment that otherwise would have been earned, if they deem this appropriate. In this respect, the Committee has recommended to the Board that it should exercise its discretion to adjust the value of certain 2010 bonus awards, on a basis equivalent to that applied in the previous year.

The key achievements of the Group are set out in the Group Chief Executive's review on pages 14 to 17 of this annual report.

The calculation of the annual incentive plan outcomes for Executive Directors, based on the achievement of performance against targets in respect of 2012, has been vigorously discussed by the Remuneration Committee. The bonuses awarded are shown in the table below:

Name	A Horta-Osório	M G Culmer
Maximum Opportunity	225%	200%
% awarded for 2012	140%	97%
Bonus awarded for 2012	1,485,000	700,000

The award for Mr A Horta-Osório will be delivered in the form of a conditional share award. This will be subject to the normal performance adjustment policy and will only vest if a share price of 73.6p has been reached for a given period of time or the Government has sold at least 33 per cent of its shareholding at prices above 61p. This award will not be released before the fifth anniversary of award and will be forfeited if neither of the conditions has been met by that date. The Board believes that these conditions are in the interests of all shareholders and support our common aim of repaying the taxpayer. The award for Mr M G Culmer reflects his contribution for 2012 as a whole and is not based on strict time apportionment.

Long-term incentive award

The current LTIP rules allow for awards to be made of up to 400 per cent of base salary. Under normal circumstances, awards can be made of up to 300 per cent of salary with the additional 100 per cent available for circumstances that the Remuneration Committee deems to be exceptional. Awards in 2013 have been set at 300 per cent for the Group Chief Executive and 275 per cent for Executive Directors and the Group Executive Committee.

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During 2012, the Committee has consulted widely with shareholders on the topic of performance measures and sharing the growth in the Company appropriately between shareholders and management. The Committee believes that the performance measures for the 2013 LTIP award for the Executive Committee should be Economic Profit, Absolute Total Shareholder Return and strategic non-financial measures. These measures capture risk management, profit growth and shareholder experience and align shareholder experience and management reward.

Measure	Basis	Metric	Weighting
Economic Profit	Payout range set relative to 2015 targets	Threshold: £1,254 million Maximum: £1,881 million	35%
Absolute TSR	Growth in share price including dividends	Threshold: 8% per annum Maximum: 16% per annum	30%
Customer satisfaction (FSA reportable complaints per 1,000 customers over 3 years)	Payout range set relative to 2015 targets	Threshold: 1.05 Maximum: 0.95	10%
Total costs	Payout range set relative to 2015 targets	Threshold: <= £9,323 million Maximum: <= £8,973 million	10%
Non-core assets at end of 2015 (excluding UK Retail)	Payout range set relative to 2015 targets	Threshold: £37 billion Maximum: £28 billion	10%
SME lending	Payout range set relative to performance against market lending to SMEs over 3 year period to 2015	Threshold: at market Maximum: 4%	5%

Pension

Executive Directors may participate in the Group's defined contribution scheme (under which their pension entitlement will be based upon both employer and employee contributions). Company contributions are 25 per cent of salary, with the exception of António Horta-Osório who is eligible for 50 per cent of reference salary, including his flexible benefit allowance. These can be taken as cash or pension contributions, or a mixture of each.

Other share plans

The Executive Directors are also eligible to participate in the Group's 'sharesave' and 'share incentive' plans. These are 'all-employee' share plans.

Shareholding guidelines

Executive Directors are required to build up a holding in Lloyds Banking Group shares of value equal to 1.5 times gross salary (2 times gross salary for the Group Chief Executive) and are expected to achieve these targets within 3 years from the later of 1 January 2012 and their date of joining the Board. They are required to retain any shares vesting from LTIP awards from 2010 onwards for a further two years post vesting. The Group Chief Executive is making significant progress in reaching this target. The Group shareholding requirements policy in respect of Executive Directors was restated in May 2012 and was extended to cover all members of the Group Executive Committee at 1 times gross salary.

Chairman's remuneration

The Chairman's remuneration comprises salary and benefits. He does not participate in the annual bonus and long-term incentive arrangements, nor is he entitled to pension benefits. The Chairman's fee was last reviewed in 2012 and is currently £700,000 per annum.

Independent Non-Executive Directors' fees

The fees of the Independent Non-Executive Directors are agreed by the Board within a total amount determined by the shareholders. Non-Executive Directors may also receive fees, agreed by the Board, for membership of Board Committees. The fees are designed to recognise the various responsibilities of a Non-Executive Director's role and to attract individuals with relevant skills, knowledge and experience. The fees are neither performance related nor pensionable and are comparable with those paid by other companies.

The annual fees were reviewed in 2012 and remain unchanged as listed below.

Non-Executive Director – base fee	£65,000
Deputy Chairman	£100,000
Senior Independent Director	£60,000
Audit Committee Chairmanship	£50,000
Audit Committee Membership	£20,000
Remuneration Committee Chairmanship	£30,000
Remuneration Committee Membership	£15,000
Risk Committee Chairmanship	£40,000
Risk Committee Membership	£15,000
Nomination & Governance Committee Membership	£5,000

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In the case of the Nomination & Governance Committee, membership currently comprises the Deputy Chairman, Senior Independent Director and chairs of the Board Committees (the fees for which include membership of the Nomination & Governance Committee) and one other Independent Non-Executive Director. Only this director receives an attendance fee, which is £5,000 per annum.

Independent Non-Executive Directors who serve on the Boards of subsidiary companies may also receive fees from the subsidiaries.

Service agreements

The Group's policy is for Executive Directors to have service agreements with notice periods of no more than one year. All current Executive Directors are entitled to receive 12 months' notice from the Group, but would be required to give at least six months' notice.

Any entitlements under the pension scheme or equity plans will be in accordance with the scheme rules on leaving.

	Notice to be given by the Company	Date of service agreement/letter of appointment
Sir Winfried Bischoff	6 months	27 July 2009
António Horta-Osório	12 months	3 November 2010
M G Culmer	12 months	16 May 2012

Independent Non-Executive Directors do not have service agreements and their appointment may be terminated, in accordance with the articles of association, at any time without compensation.

Termination

It is the Group's policy that where compensation on early termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured. Where it is appropriate to make a bonus payment to the individual, this should relate to the period of actual service, rather than the full notice period, will be determined on the basis of performance as for all continuing employees and will remain subject to malus. In the event of redundancy, the individual may receive a payment in line with statutory entitlements at that time.

Helen Weir left the Company in March 2012 under a redundancy agreement entered into on 7 April 2011. In addition to the contractual salary payments made during the 12-month notice period, she received a payment of £4,200 in respect of her statutory redundancy entitlement. No further non-contractual payments were made in respect of the cessation of employment, in keeping with our policy for handling terminations.

External appointments

The Group recognises that Executive Directors may be invited to become Non-Executive Directors of other companies and that these appointments may broaden their knowledge and experience, to the benefit of the Group. Fees are normally retained by the individual directors as the post entails personal responsibility.

Executive Directors are generally allowed to accept one Non-Executive Directorship.

Implementation Report

Governance and Risk Management

An essential component of our approach to remuneration is the governance process that underpins it. This ensures that our policy is robustly applied and risk is managed appropriately.

The overarching purpose of the Remuneration Committee is to consider, agree and recommend to the board an overall remuneration policy and philosophy for the Group that is defined by, supports and is closely aligned to its long-term business strategy, business objectives, risk appetite and values and recognises the interests of relevant stakeholders. The Group has a conservative business model characterised by a risk culture founded on prudence and accountability. The remuneration policy and philosophy covers the whole Group, but the Committee pays particular attention to the top management population, including the highest paid employees in each division, those colleagues who perform significant influence functions for the Group and those who could have a material impact on the Group's risk profile. The Committee's role is to ensure that these colleagues are provided with appropriate incentives and reward to encourage them to enhance the performance of the Group and that they are recognised for their individual contribution to the success of the organisation, whilst ensuring that there is no reward for excessive risk taking.

The Committee works closely with the Risk Committee in ensuring the bonus pool is moderated. The two Committees meet together every year to determine whether the proposed bonus pool and performance assessments adequately reflected the risk appetite and framework of the Group; whether it took account of current and future risks; and whether any further adjustment is required or merited. We are also determined to ensure that the aggregate of the variable remuneration for all our colleagues is appropriate and balanced with the interests of shareholders and all other stakeholders.

The Committee determines the pensions policy for the Group and advises on other major changes to employee benefits schemes. It also agrees the policy for authorising claims for expenses from the Group Chief Executive and the Chairman. It has delegated power for settling remuneration for the Chairman, the Group Executive Directors, the Company Secretary and any group employee whose salary and annual bonus exceeds a specified amount, currently £750,000. To ensure compliance with the FSA Code of Practice, the Committee approves remuneration for Code Staff and that of senior risk and compliance officers.

The Committee monitors the application of the authority delegated to the Group Chief Executive who in turn delegates to the Group Executive Committee, the Executive Compensation Committee and the divisional Remuneration Committees, to ensure that policies and principles are being fairly and consistently applied. The Committee liaises closely with the Risk Committee and the Group's risk function in relation to risk-adjusted performance measures, including consideration of both current and future risk. Together the management of remuneration and risk form an integral part of the Board's determination of Group corporate strategy.

All the independent Non-Executive Directors are invited to attend meetings and have the opportunity to comment on proposals and have their views taken into account before the Committee's decisions are implemented.

The Committee's terms of reference are available from the Company Secretary and are displayed on the Group's website, www.lloydsbankinggroup.com. These terms were last updated in April 2012 to ensure continued compliance with the FSA Code.

The members of the Committee during 2012 were as follows:

- Anthony Watson (Chairman)
- Sir Winfried Bischoff
- Carolyn Fairbairn (from 1 June 2012)
- Sir Julian Horn-Smith (until 17 May 2012)
- Lord Leitch (until 29 February 2012)
- David Roberts (also Chairman of the Risk Committee)
- Tim Ryan
- Sara Weller (from 1 February 2012)

During 2012, the Committee met 10 times and considered the following principal matters:

- Review of remuneration arrangements for senior executives
- Determination of the appropriate remuneration packages for a number of senior new hires
- Determination of bonus pools based on Group performance and adjustment for risk
- Performance conditions for the Long-Term Incentive Plan
- Bonus and salary awards for Executive Directors and key senior managers
- Approval of remuneration and terms of service that fall within the Committee's terms of reference, including new appointments
- Feedback from the Remuneration Committee Chairman on his meetings with the FSA and shareholders

We thank all committee members for their commitment during the last year and attendance at meetings.

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. During the year, Deloitte LLP advised the Committee. Deloitte has voluntarily signed up to the Remuneration Consultants' Code of Conduct and are judged by the Committee to be independent. Deloitte's fees for 2012 for advising the Committee amounted to £336,000.

During 2012, Deloitte provided information on behalf of the Committee for the testing of TSR performance conditions for the Group's long-term incentive plans (calculated by reference to both dividends and growth in share price).

DIRECTORS' REMUNERATION REPORT

Deloitte also provided other consulting, tax and advisory services to Lloyds Banking Group during the year, but did not provide advice on executive remuneration matters other than for the Committee.

António Horta-Osório, Cathy Turner (as Chief Administrative Officer from 1 June 2012), Angie Risley (Group HR Director until 31 August 2012), Rupert McNeil (Group HR Director from 1 September 2012), Liz Jackson (HR Director, Reward until 31 March 2012) and Paul Hucknall (HR Director, Reward from 1 April 2012) provided guidance to the Committee (other than for their own remuneration). Juan Colombás (Chief Risk Officer), Tim Tookey (Group Finance Director until 24 February 2012) and George Culmer (Group Finance Director from 16 May 2012) also attended the Committee to advise as and when necessary on risk and financial matters.

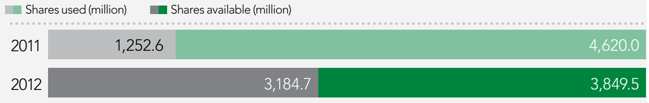
The proposals for the package to be offered to our Executive Directors in 2012 were detailed within the Directors' Remuneration Report for 2011 and were voted upon within the 2012 Annual General Meeting. The shareholder votes submitted at the meeting, either directly, by mail or by proxy, were as follows:

	Votes cast (number of shares – millions)	Percentage of votes cast	Percentage of total issued share capital
Votes in favour	48,784	97.66%	70.26%
Votes against	1,170	2.34%	1.69%
Abstentions	1,353	–	1.95%

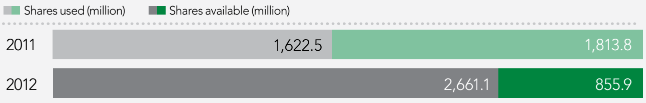
Dilution limits

The following charts illustrate the shares available for the Group's share plans.

All plans (10% of the issued ordinary share capital of the Group in any consecutive 10 years)



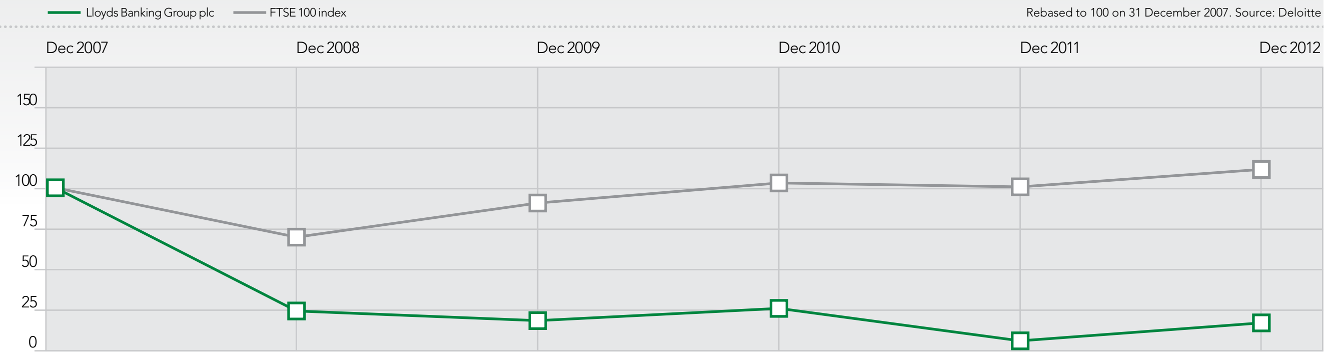
Executive plans (5% of the issued ordinary share capital of the Group in any consecutive 10 years)



Performance graph

The graph below illustrates the performance of the Group measured by TSR against a 'broad equity market index' over the past five years. The Group has been a constituent of the FTSE 100 index throughout this five year period.

Total shareholder return – FTSE 100 index



Rebased to 100 on 31 December 2007. Source: Deloitte

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Directors' emoluments for 2012 (audited)

			Other benefits					
	Salaries/ fees £000	Pension allowance[1] £000	One-off payments[2] £000	Other cash benefits[3] £000	Non-cash benefits[4] £000	Performance-related payments[5,6] £000	2012 Total £000	2011 Total £000
Current Directors who served during 2012								
Executive Directors								
António Horta-Osório	1,061	549	171	54	59	1,485	3,379	1,765
M G Culmer (from 16 May 2012)	451			17		700	1,168	–
Non-Executive Directors								
Sir Winfried Bischoff	700			12	3		715	713
Lord Blackwell (from 1 June 2012)	101						101	–
C J Fairbairn (from 1 June 2012)	58						58	–
A M Frew	100						100	100
D L Roberts	202						202	140
T T Ryan	115						115	115
M A Scicluna	130						130	130
Anthony Watson	152						152	115
S V Weller (from 1 February 2012)	87						87	–
Former Directors who served during 2012								
Sir Julian Horn-Smith (until 17 May 2012)	40						40	100
Lord Leitch (until 29 February 2012)	53						53	320
G R Moreno (until 17 May 2012)	69						69	125
G T Tate (until 6 February 2012)	492	82		21	32		627	1,218
T J W Tookey (until 24 February 2012)	104	19	38	8	7		176	939
	3,915	650	209	112	101	2,185	7,172	5,780

[1] Following changes to the amount of tax relief available on pension contributions in each year, Directors may elect to receive some or all of their allowances as cash. Contributions into the pension scheme shown on page 108 are commensurately reduced.

[2] One-off payments comprise a contractual cash payment to António Horta-Osório as part of the buyout of his benefits from his previous employer and an allowance to Tim Tookey to reflect his additional responsibilities as Interim Group Chief Executive.

[3] Other cash benefits include flexible benefits payments (4 per cent of basic salary) and payments to certain directors who elect to take cash rather than a company car under the car scheme.

[4] The non-cash benefits column includes amounts relating to the use of a company car, use of a company driver and private medical insurance. It also includes a spouse's travel allowance for Truett Tate and the value of any matching shares which are received under the terms of Sharematch, through which employees have the opportunity to purchase shares up to a maximum of £125 per month and receive matching shares on a one for one basis up to a maximum value of £30 per month, rounded down to the nearest whole share.

[5] The award for Mr A Horta-Osório will be delivered in the form of a conditional share award. This will be subject to the normal performance adjustment policy and will only vest if a share price of 73.6p has been reached for a given period of time or the Government has sold at least 33 per cent of its shareholding at prices above 61p. This award will not be released before the fifth anniversary of award and will be forfeited if neither of the conditions has been met by that date. The Board believes that these conditions are in the interests of all shareholders and support our common aim of repaying the taxpayer.

[6] The award for Mr M G Culmer will be subject to 100 per cent deferral into shares until at least 2015.

DIRECTORS' REMUNERATION REPORT

Independent Non-Executive Directors' fees (2012)

	Board £000	Deputy Chairman £000	Senior Independent Director £000	Audit Committee £000	Remuneration Committee £000	Nomination & Governance Committee £000	Risk Committee £000	SWG Board fees[1] £000	2012 Total £000
Lord Blackwell	38			11			9	43	101
C J Fairbairn	38			11	9				58
A M Frew	65			20			15		100
Sir Julian Horn-Smith	26				6	2	6		40
Lord Leitch	11	17		3	2			20	53
G R Moreno	25	21	23						69
D L Roberts	65	62		20	15		40		202
T T Ryan	65			20	15		15		115
M A Scicluna	65			50			15		130
Anthony Watson	65		37	20	30				152
S V Weller	59				14		14		87

[1] Scottish Widows Group Ltd.

Directors' pensions (audited)

The Executive Directors are members of the Lloyds Banking Group defined contribution pension scheme. In previous years the Group also operated a defined benefit pension scheme, however there are now no Directors accruing further pensionable service on a defined benefit basis.

Benefits from a registered pension scheme are subject to the Lifetime Allowance, currently £1.5 million, which is equivalent to an annual pension of £75,000. Any benefit in excess of this amount will incur a tax charge for the individual. The Group has agreed that if an Executive Director has benefits in excess of the Lifetime Allowance he may cease to accrue benefits in the Scheme and receive a salary supplement as an alternative. This will not cost the Group more than the current arrangements. The Group will not compensate any individual in respect of any tax liability arising from the provision of pension.

Defined contribution scheme members

During the year to 31 December 2012 the Group has made the following contributions to the defined contribution scheme:

	£000
António Horta-Osório	18
T J W Tookey[1]	5

[1] Contributions were made for two months only.

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Interests in share options (audited)

	At 1 January 2012	Granted during the year	Exercised during the year	Lapsed during the year	At 31 December 2012	Exercise price	Exercise periods From	Exercise periods To	Notes
António Horta-Osório	1,452,401	–	–	–	**1,452,401**	–	15/6/2011	30/3/2021	a
	662,116	–	–	–	**662,116**	–	31/1/2012	30/3/2021	a
	1,452,401	–	–	–	**1,452,401**	–	15/6/2012	30/3/2021	a
	438,846	–	–	–	**438,846**	–	31/1/2013	30/3/2021	a
	1,707,763	–	–	–	**1,707,763**	–	15/6/2013	30/3/2021	a, b
M G Culmer	–	**2,216,187**	–	–	**2,216,187**	–	1/4/2013	31/3/2018	b, c
	–	**2,243,816**	–	–	**2,243,816**	–	1/4/2014	31/3/2019	b, c
Former Directors who served during 2012									
G T Tate	129,820	–	–	–	**129,820**	207.97p	18/3/2007	31/1/2014	d, f, i
	55,147	–	–	–	**55,147**	199.91p	12/8/2007	31/1/2014	d, f, i
	499,709	–	–	–	**499,709**	235.26p	17/3/2008	31/1/2014	e, f, i
	19,399	–	–	–	**19,399**	46.78p	1/2/2013	31/7/2013	b, g, j
T W Tookey	19,399	–	–	**19,399**	–	46.78p			g, h

a Share buy out award granted on 30 March 2011 for the loss of deferred share awards forfeited on leaving the Santander Group. Awards are consistent with those forfeited and have a nil option price.

b Not exercisable as the option has not been held for the period required by the relevant scheme.

c Executive share award granted on 6 August 2012 for the loss of deferred share awards forfeited on leaving RSA Insurance Group plc.

d Executive option granted between March 2004 and August 2004.

e Executive option granted between March 2005 and August 2005.

f Exercisable to the extent that the performance condition vested.

g Sharesave.

h Option lapsed on date of leaving.

i Exercisable for a period of one year from date of leaving.

j Exercisable for a period of six months from date of leaving.

None of the other directors at 31 December 2012 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

The market price for a share in the Company at 1 January 2012 and 31 December 2012 was 25.91p and 47.92p, respectively. The range of prices between 1 January 2012 and 31 December 2012 was 25.295p to 49.25p.

The following table contains information on the performance conditions for executive options granted since 2004. The Remuneration Committee chose the relevant performance conditions because they were felt to be challenging, aligned to shareholders' interests and appropriate at the time.

Options granted	Performance conditions
March 2004 – August 2004	That the Company's ranking based on TSR over the relevant period against a comparator group (17 UK and international financial services companies including Lloyds Banking Group) must be at least ninth, when 14 per cent of the option would be exercisable. If the Company was ranked first in the group, then 100 per cent of the option would be exercisable and if ranked tenth or below the performance condition would not be met. Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 24 per cent for Truett Tate's March option and at 14 per cent for all other options granted to Executive Directors during 2004.
March 2005 – August 2005	That the Company's ranking based on TSR over the relevant period against a comparator group (15 companies including Lloyds Banking Group) must be at least eighth, when 30 per cent of the option would be exercisable. If the Company was ranked first to fourth position in the group, then 100 per cent of the option would be exercisable and if ranked ninth or below, the performance condition would not be met. Options granted in 2005 became exercisable as the performance condition was met when tested. Grants vested at 82.5 per cent for all options granted to Executive Directors.
March 2011 (Applicable only to award made to António Horta-Osório on 30 March 2011 over 1,707,763 shares)	That the Company's ranking based on TSR over the relevant period against a comparator group (18 companies including Lloyds Banking Group) must be at least ninth, when 30 per cent of the option will be exercisable. If the Company is ranked first to fifth position in the group, then 100 per cent of the option will be exercisable and if ranked tenth or below, the performance condition is not met.

DIRECTORS' REMUNERATION REPORT

Lloyds Banking Group long-term incentive plan (audited)

The following table shows conditional shares awarded under the plan.

	At 1 January 2012	Awarded during the year	Vested during the year	Lapsed during the year	At 31 December 2012	End of performance period	Notes
António Horta-Osório	7,154,187	–	–	–	**7,154,187**	31/12/2013	
	–	**9,644,684**	–	–	**9,644,684**	31/12/2014	a
M G Culmer	–	**4,657,045**	–	–	**4,657,045**	31/12/2014	a
Former Directors who served during 2012							
G T Tate	1,424,778	–	–	–	**1,424,778**	31/12/2011	
	2,137,169	–	–	**2,137,169**	–	31/12/2011	
	3,175,748	–	–	–	**3,175,748**	31/12/2012	b
	3,159,517	–	–	–	**3,159,517**	31/12/2013	d
T J W Tookey	1,335,730	–	–	**1,335,730**	–	31/12/2011	c
	2,003,597	–	–	**2,003,597**	–	31/12/2011	c
	2,977,264	–	–	**2,977,264**	–	31/12/2012	b, c
	2,962,047	–	–	**2,962,047**	–	31/12/2013	c

a Award price 34.786p.

b The Absolute Share Price element of this award has an end of performance period date of 26 March 2013.

c Mr Tookey's unvested awards all lapsed upon his departure from the Group on 24 February 2012.

d Mr Tate's award will be pro-rated to reflect the number of months employed during the performance period.

The following table contains information on the performance conditions for awards made under the long-term incentive plan. The Remuneration Committee chose the relevant performance conditions because they were felt to be challenging, aligned to shareholders' interests and appropriate at the time.

LTIP awarded	Performance conditions
April 2009	**EPS:** The release of 50 per cent of the shares was dependent on the extent to which growth in EPS achieved cumulative EPS targets over the three year period from January 2009 to December 2011. **Economic profit:** The release of the remaining 50 per cent of shares was dependent on the extent to which the Group achieved cumulative Economic Profit targets over the three year period from January 2009 to December 2011. At the end of the relevant period, neither of the performance conditions had been met and the Awards lapsed.

EPS	Vesting %	Growth in EPS
Threshold	25%	26%
Maximum	100%	36%

Economic profit	Vesting %	Absolute improvement in adjusted EP
Threshold	25%	100%
Maximum	100%	202%

LTIP awarded	Performance conditions
April 2009 Integration award	**Synergy Savings:** The release of 50 per cent of the shares was dependent on the achievement of target run rate synergy savings in 2009 and 2010 as well as the achievement of sustainable synergy savings of at least £1.5 billion by the end of 2011. The award was broken down into three equally weighted annual tranches. Performance was assessed at the end of each year against annual performance targets based on a trajectory to meet the 2011 target. The extent to which targets were achieved determined the proportion of shares to be banked each year. Any release of shares was subject to the Remuneration Committee judging the overall success of the delivery of the integration programme. **Integration Balanced Scorecard:** The release of the remaining 50 per cent of the shares was dependent on the outcome of a Balanced Scorecard of non-financial measures of the success of the integration in each of 2009, 2010 and 2011. The Balanced Scorecard element was broken down into three equally weighted tranches. The tranches were crystallised and banked for each year of the performance cycle subject to separate annual performance targets across the four measurement categories of Building the Business, Customer, Risk and People and Organisation Development. The performance conditions were met and the awards vested to participants in full. On 14 March 2012 it was determined that the Award would not be transferred or issued to the current and former Executive Directors.

LTIP awarded	Performance conditions
March 2010	**EPS:** Relevant to 36 per cent of the award. Performance to be measured based on absolute improvement in adjusted EPS over the three financial years starting on 1 January 2010 relative to an adjusted fully diluted 2009 EPS base. **Economic Profit:** Relevant to 36 per cent of the award. Performance to be measured based on the compound annual growth rate of adjusted Economic Profit over the three financial years starting on 1 January 2010 relative to 2009 adjusted Economic Profit base. **Absolute Share Price:** Relevant to 28 per cent of the award. Performance to be measured based on the Absolute Share Price on 26 March 2013, being the third anniversary of the award date. At the end of the performance period, it has been assessed that none of the performance conditions has been met and therefore the Awards will not vest. The targets are:

EPS	Vesting %	Absolute improvement in adjusted EPS
Threshold	25%	158%
Maximum	100%	180%

Vesting between threshold and maximum will be on a straight line basis.

Economic profit	Vesting %	Compound annual growth rate of adjusted EP
Threshold	25%	57% per annum
Maximum	100%	77% per annum

Vesting between threshold and maximum will be on a straight line basis.

Absolute Share Price	Vesting %	Absolute Share Price
Threshold	0%	75p
Maximum	100%	114p

Vesting between threshold and maximum will be on a straight line basis, provided that shares comprised in the Absolute Share Price element of the award may only be released if both the EPS and Economic Profit performance measures have been satisfied at the threshold level or above.

LTIP awarded	Performance conditions
March 2011	**EPS:** Relevant to 33^1/3 per cent of the award. Performance will be based on 2013 EPS outcome. **Economic Profit:** Relevant to 33^1/3 per cent of the award. The performance target is based on 2013 adjusted Economic Profit. **Absolute Total Shareholder Return:** Relevant to 33^1/3 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2013. The targets are:

EPS	Vesting %	Target
Threshold	25%	6.4p
Maximum	100%	7.4p

Vesting between threshold and maximum will be on a straight line basis.

Economic profit	Vesting %	Target
Threshold	25%	£567m
Maximum	100%	£1,234m

Vesting between threshold and maximum will be on a straight line basis.

Absolute Total Shareholder Return	Vesting %	Annualised Absolute Shareholder Return
Threshold	25%	8%
Maximum	100%	14%

Vesting between threshold and maximum will be on a straight line basis.

DIRECTORS' REMUNERATION REPORT

March 2012 and September 2012

Economic Profit: Relevant to 30 per cent of the award. The performance target is based on 2014 adjusted Economic Profit.

Absolute Total Shareholder Return: Relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2014.

Short-term funding as a percentage of total funding: Relevant to 10 per cent of the award. Performance will be measured relative to 2014 targets.

Non-core assets at the end of 2014: Relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet core assets at 31 December 2014.

Net Simplification benefits: Relevant to 10 per cent of the award. Performance will be measured by reference to the run rate achieved by end of 2014.

Customer satisfaction: Relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FSA reportable complaints per 1,000 customers over the three year period to 31 December 2014.

The targets are:

Economic profit	Vesting %	Target
Threshold	25%	£160m
Maximum	100%	£1,653m

Vesting between threshold and maximum will be on a straight line basis.

Absolute Total Shareholder Return	Vesting %	Target
Threshold	25%	12% per annum
Maximum	100%	30% per annum

Short-term funding as a percentage of total funding	Vesting %	Target
Threshold	25%	20%
Maximum	100%	15%

Vesting between threshold and maximum will be on a straight line basis.

Non-core assets at end of 2014	Vesting %	Target
Threshold	25%	<=£95bn
Maximum	100%	<=£80bn

Vesting between threshold and maximum will be on a straight line basis.

Net Simplification benefits	Vesting %	Target
Threshold	25%	£1.5bn
Maximum	100%	£1.8bn

Vesting between threshold and maximum will be on a straight line basis.

Customer satisfaction	Vesting %	Target
Threshold	25%	1.5
Maximum	100%	1.3

Vesting between threshold and maximum will be on a straight line basis.

Deloitte provided information for the testing of the TSR performance conditions for the Company's long-term incentive plan. EPS is the Group's normalised earnings per share as shown in the Group's report and accounts, subject to such adjustments as the Remuneration Committee regards to be necessary for consistency.

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Directors' interests (audited)

The beneficial interests of those who were Directors at 31 December 2012 in ordinary shares of Lloyds Banking Group were:

Number of shares

	At 1 January 2012 (or later date of appointment)	**At 31 December 2012**	At 1 March 2013
Executive Directors			
António Horta-Osório[1]	1,067,099	**1,407,780**	1,408,359[2]
M G Culmer	872,475	**874,966**	875,546[2]
Non-Executive Directors			
Sir Winfried Bischoff	1,100,000	**1,300,000**	
Lord Blackwell	–	**50,000**	
C J Fairbairn	–	**–**	
A M Frew	300,000	**300,000**	
D L Roberts	968,641	**968,641**	
T T Ryan[1]	400,877	**400,877**	
M A Scicluna	92,572	**92,572**	
Anthony Watson	376,357	**476,357**	
S V Weller	100,000	**150,000**	

[1] Shareholdings held by Mr A Horta-Osório and Mr T T Ryan are either wholly or partially in the form of ADRs.

[2] The changes in beneficial interests for Mr A Horta-Osório and Mr M G Culmer relate to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2012 and 1 March 2013.

A summary of transactions undertaken in the year, including share plan awards vested plus open market purchases and sales made by Directors is shown on page 114.

None of those who were Directors at the end of the year had any other interest in the capital of Lloyds Banking Group plc or its subsidiaries.

The register of Directors' interests, which is open to inspection, contains full particulars of Directors' shareholdings and options to acquire shares in Lloyds Banking Group.

On behalf of the Board

Claire A Davies
Company Secretary

OTHER REMUNERATION DISCLOSURES

Emoluments of the eight highest paid senior executives (unaudited)

Emoluments of the eight highest paid senior executives can be found on the Group's website at www.lloydsbankinggroup.com

Directors' interests – summary of awards vested, purchases and sales made by directors in 2012 (unaudited)

	At 1 January 2012 (or later date of appointment)	Transactions during year			
		Date	Shares	Notes	31 December 2012
Executive Directors					
António Horta-Osório	1,067,099	14/5/12	340,000	Purchase (85,000 ADRs)	
		monthly	681	2012 Share Incentive Plan purchase and matching shares	1,407,780
M G Culmer	872,475	16/5/12	872,169	872,169 Shares purchased on appointment	
		monthly	2,491	2012 Share Incentive Plan purchase and matching shares	874,966
Non-Executive Directors					
Sir Winfried Bischoff	1,100,000	2/8/12	200,000	Purchase	1,300,000
Lord Blackwell	–	12/6/12	50,000	Purchase	50,000
C J Fairbairn	–				–
A M Frew	300,000				300,000
D L Roberts	968,641				968,641
T T Ryan	400,877				400,877
M A Scicluna	92,572				92,572
Anthony Watson	376,357	21/5/12	100,000	Purchase	476,357
S V Weller	100,000	4/5/12	50,000	Purchase	150,000

RISK MANAGEMENT

This section highlights the Principal Risks and Uncertainties as well as the Emerging Risks faced by the Group and explains how all risk types are managed.

Principal risks and uncertainties have been identified through the Group's risk management processes. A brief overview of the Group's principal risks and how these are mitigated can be found on page 118.

The Risk Governance section describes the controls in place to ensure the Group has strong, effective Risk Management.

The analysis of Risk drivers details how all risks are managed across the Group. Each risk driver section includes a ***definition***; a ***risk appetite*** statement; ***exposures*** associated with the risk that the Group faces; and how the risk is ***measured***, ***mitigated*** and ***monitored***.

Further information can be found under note 2(H) (Accounting Policies) on page 219 and note 55 (Financial Risk Management) on page 318.

All narrative is unaudited unless otherwise stated. Tables are both audited and unaudited as stated. The audited information is required to comply with the requirements of relevant International Financial Reporting Standards.

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RISK MANAGEMENT

Risk Management is at the heart of Lloyds Banking Group's strategy to become the best bank for customers, investors, shareholders and its people.

The mission for Risk is to support the business in delivering sustainable growth. This is achieved through informed risk decision making and superior risk and capital management, supported by a consistent risk-focused culture across the Group.

Achievements in 2012

- Robust risk governance framework and conservative risk appetite further embedded across the Group.
- Non-core asset reduction ahead of target and capital generative.
- Sustained improvements in credit quality.
- Prudent approach to underwriting and provisioning has made portfolios resilient to future stresses.
- Implementation of conduct strategy to ensure legacy issues of the past are not repeated.

Priorities for 2013

- Strategy: Continue to support delivery of the Group's customer focused strategic plan within risk appetite.
- Risk infrastructure: Continue programme of investment in the Group's risk systems.
- Risk culture: Maintain and strengthen the Group's strong risk culture by managing performance to ensure risk based behaviours.
- Regulatory change: Deliver against new regulatory requirements.
- People agenda: Continue to attract, retain and develop high quality people.

The Group's approach to risk

The Group operates a strong and independent Risk Division with rigorous management controls to keep the Group safe, support sustainable business growth and minimise losses within risk appetite.

The mission of Risk Division is to maintain a robust control framework, identify and escalate emerging risks and support sustainable business growth within risk appetite through good risk reward decisioning.

Risk culture

The Board ensures that senior management implements risk policies and risk appetites that either limit or, where appropriate, prohibit activities, relationships and situations that could be detrimental to the Group's risk profile.

The Group has a conservative business model embodied by a risk culture founded on a prudent approach to managing risk. The Group refreshed its Codes of Business and Personal Responsibility in 2012 reinforcing its approach; colleagues are accountable for the risks they take and the needs of customers are paramount.

The focus remains on building and sustaining long-term relationships with customers whatever the economic climate.

Risk as a strategic differentiator

The Group strategy and risk appetite were developed together to ensure one informed the other in creating a strategy that delivers on becoming the best bank for our customers whilst helping Britain prosper and creating sustainable growth over time.

We believe effective risk management can be a strategic differentiator, in particular:

– *Conservative approach to risk:* The Group has a fully embedded conservative approach to, and prudent appetite for risk with risk culture and appetite driven top down.

– *Strong control framework:* The Group has a strong risk control framework which is the foundation for the delivery of effective risk management. This framework ensures appropriate engagement in developing risk appetite whilst also ensuring business units operate within approved parameters.

– *Effective risk analysis, management and reporting:* Effective risk analysis ensures the identification of opportunities as well as risks and ensures risks are managed appropriately and consistent with strategy. The Groups key risks and performance against risk appetite are monitored and reported regularly to senior management using quantitative and qualitative analysis and are subject to relevant stress testing. This ensures we fully understand the risk in the business at both an individual risk type and aggregate portfolio level. The key risks to the Group are outlined on pages 118 to 124.

– *Business focus and accountability:* Managing risk effectively is a key focus for the Group and is one of the five principal criteria within its Balanced Scorecard on which business areas and individual performance are judged. The Group's approach to risk means that businesses remain accountable for risk but a strong and independent risk function also helps ensure adherence to the Group's risk and control frameworks. The continued investment in risk systems and processes will also help differentiate our risk management approach.

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The Group has zero appetite for systemic unfair customer outcomes arising from product design, sales or after-sales processes.

The Group expects its leaders to have the highest integrity and values, thinking and acting for the long-term.

The Group's risk culture is embedded within the Group's risk appetites, policies, procedures, controls and reporting. For example:

- The Group's risk culture is embedded within its approach to conduct risk, and is supported by frameworks to help it deliver the right outcomes for customers, and implemented through policies and standards in key areas such as product governance, responsible lending, claims and complaints handling.
- The Group's risk culture is embedded within its approach to managing credit risk: Board level credit risk appetite is supported by more detailed metrics at Divisional and business level; measurement of credit risk for loans and advances to customers at counterparty level; internal systems of control such as credit policies, assurance and review, controls over rating systems, stress testing and scenario analysis; collateral; master netting agreements and support for customers in difficulty.

Risk appetite

- The Group defines risk appetite as 'the amount and type of risk that our organisation is prepared to seek, accept or tolerate.'
- The Group's strategy operates in tandem with the Group's high level risk appetite which is supported by more detailed metrics and limits. An updated Risk Appetite Statement was approved by the Board in 2012 which incorporated recommendations from the non-executive directors and is fully aligned with Group strategy.
- Risk appetite is embedded within policies, authorities and limits across the Group.
- Risk appetite will continue to evolve in tandem with Group strategy.

Governance and control

- Governance is maintained through delegation of authority from the Board, Board Risk Committee and Audit Committee, down through the management hierarchy supported by a committee-based structure designed to ensure that the Group's risk appetite, policies, procedures, controls and reporting are fully in line with regulations, law, corporate governance and industry good-practice.
- The Group's approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions.
- Board-level engagement, coupled with the direct involvement of senior management in Group wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated where required.
- The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.
- A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management.
- The Group optimises performance by allowing business units to operate within approved parameters.

Risk decision making and reporting

- Taking risks which are well understood, consistent with strategy with appropriate margin is a key driver of shareholder value.
- Risk analysis and reporting supports the identification of opportunities as well as risks.
- An aggregate view of the Group's overall risk profile, key risks and management actions, together with performance against risk appetite are reported to and discussed monthly at the Group Risk Committee and Group Asset and Liability Committee with regular reporting to the Board Risk Committee and the Board.
- Rigorous stress testing exercises are carried out to assess the impact of a range of adverse scenarios with different probabilities and severities to inform strategic planning.
- The Chief Risk Officer regularly informs the Board Risk Committee of the aggregate risk profile and has direct access to the Chairman and members of the Board Risk Committee.

A further reduction in FSA reportable banking complaints (excluding PPI) to 1.1 per 1,000 accounts, a strong performance relative to our peers.

Prudent risk appetite and strong risk management resulted in a reduction of 42 per cent in the Group's impairment charge.

Non-core assets reduced by £42.3 billion and international presence was reduced in line with the Group's strategy to focus on the UK.

RISK MANAGEMENT

Principal risks and uncertainties

At present the most significant risks faced by the Group are detailed below. These risks could impact on the success of delivering against the Group's long-term strategic objectives and are aligned to the Group's Risk Drivers.

Further detail on the Group's Risk Drivers and how the Group manages risk can be found on page 131.

For further information on the economy see pages 19 and 20.

CREDIT RISK

Definition

Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their obligations (both on or off balance sheet).

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Further information on Credit Risk

Principal risks

Arising mainly in the Retail, Commercial Banking, and Wealth, Asset Finance and International divisions, reflecting the risks inherent in the Group's lending activities and, to a lesser extent in the Insurance business in respect of investment holdings and exposures to reinsurers. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group's assets and increase the Group's write-downs and allowances for impairment losses. Credit risk can be affected by a range of macroeconomic environment and other factors, including, inter alia, increased unemployment, reduced asset values, lower consumer spending, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates and/or higher tenant defaults.

Over the last five years, the global banking crisis and economic downturn has driven cyclically high bad debt charges, especially in the Group's legacy HBOS portfolios, arising from the Group's lending to both retail (including those in Wealth, Asset Finance and International Division) and commercial customers (including those in Wealth, Asset Finance and International Division). Group portfolios will remain strongly linked to the economic environment, with inter alia house price falls, unemployment increases, consumer over-indebtedness and rising interest rates being possible impacts to the Group's exposures. The Group has exposure to commercial customers in both the UK and internationally, including Europe and Ireland, particularly related to commercial real estate lending, where the Group has a high level of lending secured on secondary and tertiary assets. The possibility of further economic downside risk remains.

Mitigating actions

The Group takes many mitigating actions with respect to this principal risk. The Group manages its credit risk in a variety of ways such as:

- through prudent and through the cycle credit risk appetite and policies;
- clearly defined levels of authority (including, independently sanctioned and controlled credit limits for commercial customers and counterparties, sound credit scoring models and credit policies for retail customers);
- robust credit processes and controls; and
- well-established Group and Divisional committees that ensure distressed and impaired loans are identified, considered, controlled and appropriately escalated and appropriately impaired (taking account of the Group's latest view of current and expected market conditions, as well as refinancing risk).

Reviews are undertaken at least quarterly and incorporate internal and external audit review and challenge.

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CONDUCT RISK

Definition

Conduct risk is defined as the risk of customer detriment or censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

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Further information on Conduct Risk

Principal risks

Conduct risk and how the Group manages its customer relationships affect all aspects of the Group's operations and are closely aligned with achievement of the Group's strategic vision to be the best bank for customers. As a provider of a wide range of financial services products across different brands and numerous distribution channels to an extremely broad and varied customer base, and as a participant in market activities the Group faces significant conduct risks, such as: products or services not meeting the needs of its customers; sales processes which could result in selling products to customers which do not meet their needs; failure to deal with a customer's complaint effectively where the Group has got it wrong and not met customer expectations; behaviours which do not meet market standards.

There remains a high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media and politicians. The FSA in particular continues to drive focus on conduct of business activities through its supervision activity.

There is a risk that certain aspects of the Group's business may be determined by the FSA, other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

Mitigating actions

The Group takes many mitigating actions with respect to this principal risk; key examples include:

- The Group's Conduct Strategy and supporting framework have been designed to support its vision and strategic aim to put the customer at the heart of everything it does. The Group has developed and implemented a framework to enable it to deliver the right outcomes for its customers, which is supported by policies and standards in key areas, including product governance, customer treatment, sales, responsible lending, customers in financial difficulties, claims and complaints handling.
- The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns. The Group develops colleagues' awareness of these and other expected standards of conduct through these and other policies and standards and codes of responsibility. It also undertakes root cause analysis of complaints and makes use of technology and metrics to facilitate earlier detection and mitigation of conduct issues.

RISK MANAGEMENT

MARKET RISK

Definition

Market risk is defined as the risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments), lead to reductions in earnings and/or value.

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Further information on Market Risk

Principal risks

The Group has a number of market risks, the principal ones being:

- Interest rate risk: This risk to the Group's banking income arises from competitive pressures on product terms in existing loans and deposits, which sometimes restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates. A further related risk arises from the level of interest rates and the margin of interbank rates over central bank rates.
- Equity risk: This risk arises from movements in equity market prices. The main equity market risks arise in the Insurance business and defined benefit pension schemes.
- Credit spread risk: This risk arises when the market perception of the creditworthiness of a particular counterparty changes. The main credit spread exposure arises in the Insurance business, defined benefit pension schemes and banking businesses.

Mitigating actions

Market risk is managed within a Board approved framework using a range of metrics to monitor the Group's profile against its stated appetite and potential market conditions.

High level market risk exposure is reported regularly to appropriate committees for monitoring and oversight by senior management.

A variety of risk measures are used such as:

- Sensitivity based measures (e.g. sensitivity to 1 basis point move in interest rates)
- Percentile based measures (e.g. Value at Risk)
- Scenario/stress based measures (e.g. single factor stresses, macroeconomic scenarios)

In addition, profit and loss triggers are used in the Trading Books in order to ensure that mitigating action is discussed if profit and loss becomes volatile.

- Interest rate risk: Exposure arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive assets and interest rate sensitive liabilities, is managed centrally. Matching assets and liabilities are offset against each other and interest rate swaps are also used to manage the residual exposure to within the non-traded market risk appetite. Exposure arising from the margin of interbank rates over central bank rates is monitored and managed within the non-traded market risk appetite through appropriate hedging activity.
- Equity and credit spread risk: The Group continues to liaise with defined benefit pension scheme Trustees with regard to appropriately de-risking the pension scheme portfolio.

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OPERATIONAL RISK

Definition

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

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Further information on Operational Risk

Principal risks

The principal operational risks currently facing the Group are:

- IT systems and resilience: The risk of loss resulting from the failure to develop, deliver or maintain effective IT solutions. The resilience of IT in terms of its availability to customers and colleagues is of paramount importance to the Group.
- Information security: The risk of information leakage, loss or theft. The threat profile is rapidly changing; in particular increasingly sophisticated attacks by cybercrime groups.
- External fraud: The risk of loss to the Group and/or its customers resulting from an act of deception or omission.
- Customer process: The risk of new issues, process weaknesses and control deficiencies within the Group's customer facing processes as the business continues to evolve.

Mitigating actions

The Group operates a robust control environment with regular review and enhancement. Contingency plans are maintained for a range of potential scenarios with a regime of disaster recovery exercises, both Group specific and industry wide. Significant investment has been made in IT infrastructure and systems to ensure their resilience and to enhance the services they support, in recognition of the importance of the ongoing availability of the Group's services both to its customers and to the wider UK financial infrastructure. The Group continues to invest in IT and information security control environments including user access management and records management to address evolving threats.

The Group adopts a risk based approach to external fraud management, reflecting the current and emerging external fraud risks within the market. This approach drives an annual programme of enhancements to the Group's technology, process and people related controls; with emphasis on preventative controls, supported by real time detective controls – wherever feasible. The Group has developed a mature and robust fraud operating model with centralised accountability established, discharged via Group wide policies and operational control frameworks. The Group's fraud awareness programme is a key component of its fraud control environment; in 2012 a Group wide awareness campaign was launched specifically addressing the emerging 'cyber' threats and the role that the Group's colleagues play in helping to keep its customers safe and secure.

Material operational risks are reported regularly to appropriate committees, attracting senior management visibility, and are managed via a range of strategies – avoidance, mitigation, transfer (including insurance), and acceptance.

RISK MANAGEMENT

PEOPLE RISK

Definition

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to reductions in earnings and/or value.

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Further information on People Risk

Principal risks

The Group has a strategic aim to be the best bank for customers; it is committed to addressing issues within the business that could contribute to customers receiving unfair outcomes. The Group believes the quality, effectiveness and engagement of its people are fundamental to its successful delivery of this strategy. This belief coincides with the increasing external focus on the culture which underpins the performance and behaviour of employees in the development and delivery of fair outcomes to customers.

Consequently, the Group's management of material people risks is critical to its capacity to deliver against its strategic objectives. Over the coming twelve months the Group's ability to manage people risks successfully is likely to be affected by the following factors:

- The Group's continuing structural consolidation and the sale of part of its branch network under Project Verde may disrupt its ability to lead and manage its people effectively in some areas;
- The developing and increasingly rigorous and intrusive regulatory environment may challenge the Group's people strategy, remuneration practices and retention; and
- Negative political and media attention on banking sector culture, sales practices and ethical conduct may impact colleague engagement, investor sentiment and the Group's cost base.

Mitigating actions

The Group takes many mitigating actions with respect to people risk. Key examples include:

- Focusing on strengthening the risk-based culture amongst colleagues by developing and delivering a number of initiatives that reinforce risk-based behaviours to generate the best possible outcomes for customers and colleagues;
- Continuing to ensure strong management of the impact of organisational change and consolidation on colleagues;
- Embedding our Codes of Personal and Business Responsibility across the Group;
- Reviewing and developing incentives continually to ensure they promote colleagues' behaviours that meet customer needs and regulatory expectations;
- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;
- Maintaining focus on people risk management across the Group; and
- Ensuring compliance with legal and regulatory requirements related to Approved Persons and the Remuneration Code, and embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities.

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LIQUIDITY AND FUNDING RISK

Definition

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

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Further information on Liquidity and Funding Risk

Principal risks

Liquidity and funding continues to remain a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and long-term wholesale funding markets. Should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding, its ability to fund its financial obligations could be impacted. The key dependencies on successfully funding the Group's balance sheet include:

- Continued functioning of the money and capital markets.
- The continuation of the Group's strategy of right-sizing the balance sheet and development of the retail deposit base which has led to a significant reduction in the wholesale funding requirement over the past year.
- Limited further deterioration in the UK's and the Group's credit rating. In June 2012 the Group experienced a one notch downgrade in its long-term rating from Moody's, following the agency's review of 114 European banks. The impact that the Group experienced following the downgrade was not material and was consistent with the modelled outcomes based on the stress testing framework. Similarly, the internal stress testing framework indicates that Moody's one notch downgrade of the UK's credit rating, announced on 22 February 2013, will not have a material impact on the Group's liquidity and funding positions; and
- No significant or sudden withdrawal of customer deposits.

Mitigating actions

Liquidity and funding risk appetite for the banking businesses is set by the Board and this statement of the Group's overall appetite for liquidity risk is reviewed and approved annually by the Board.

- The Group's liquidity and funding position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term wholesale funding;
- At 31 December 2012, the Group had £205 billion of highly liquid unencumbered assets in its liquidity portfolio which are available to meet cash and collateral outflows;
- Daily monitoring and control processes are in place to address regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group;
- The Group carries out stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA, on an ongoing basis. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics; and
- The Group has a contingency funding plan embedded within the Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing.

RISK MANAGEMENT

INSURANCE RISK

Definition

Insurance risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

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Further information on Insurance Risk

Principal risks

The major sources of insurance risk are within the Insurance business and the Group's defined benefit pension schemes. Insurance risk is inherent in the Insurance business and can be affected by customer behaviour. Insurance risks accepted relate primarily to mortality, longevity, morbidity, persistency, expenses, property and unemployment. The primary insurance risk of the Group's defined benefit pension schemes is related to longevity.

Insurance risk has the potential to significantly impact the earnings and capital position of the Insurance business of the Group. For the Group's defined benefit pension schemes, insurance risk could significantly increase the cost of pension provision and impact the balance sheet of the Group.

Mitigating actions

The Group takes many mitigating actions with respect to this principal risk, key examples include:

- Actuarial assumptions are reviewed in line with experience and in-depth reviews are conducted regularly. Longevity assumptions for the Group's defined benefit pension schemes are reviewed annually together with other IFRS assumptions. Expert judgement is required; and
- Insurance risk is controlled by robust processes including underwriting, pricing-to-risk, claims management, reinsurance and other risk mitigation techniques.

Insurance risk is reported regularly to appropriate committees and boards.

State Funding and State Aid is not considered as one of the Group's Risk Drivers; however the Group does consider State Funding and State Aid to be a Principal Risk.

STATE FUNDING AND STATE AID

Principal risks

HM Treasury currently holds 39.2 per cent of the Group's ordinary share capital. United Kingdom Financial Investments Limited (UKFI), as manager of HM Treasury's shareholding, continues to operate in line with the framework document between UKFI and HM Treasury, managing the investment in the Group on a commercial basis without interference in day-to-day management decisions. There is a risk that a change in Government priorities could result in the framework agreement currently in place being replaced leading to interference in the operations of the Group.

In addition, the Group is subject to European Union State Aid obligations in line with the Restructuring Plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of the Group and remedy any distortion of competition and trade in the European Union (EU) arising from the State Aid given to the Group. This has placed a number of requirements on the Group including an asset reduction target from a defined pool of assets by the end of 2014, known as Project Atlantic, and the divestment of certain portions of its Retail business by the end of November 2013, known as Project Verde. There is a risk that if the Group does not deliver its divestment commitments by November 2013, a Divesture Trustee would be appointed to dispose of the divestment, which could be sold at a negative price.

Mitigating actions

The Group has received no indications that the Government intends to change the existing operating arrangements with regard to the role of UKFI and engagement with the Group.

The Group continues to make good progress in respect to its State Aid commitments. In line with the strengthening of the balance sheet, the Group has made excellent progress against its asset reduction commitment and reached the reduction total required in December 2012, two years ahead of the mandated completion date. The Group is currently working with the European Commission to achieve formal release from this commitment.

On 19 July 2012 the Group announced that it had agreed non-binding heads of terms with The Co-operative Group (the Co-operative) for the disposal of the Verde business. The Group continues to work with the Co-operative to agree a sale and purchase agreement, with completion of the divestment expected by the end of November 2013. The Group has also undertaken planning for an Initial Public Offering (IPO) of the Verde business, should this be required as a fallback option. The Verde business will be rebranded and operating on a standalone basis within Lloyds Banking Group during 2013 and available for sale to another third party as a further fallback option.

The Group continues to work closely with the FSA, EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission to ensure the successful implementation of the restructuring plan and mitigate customer impact.

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Emerging risks

The Group considers the following to be risks that have the potential to increase in significance and affect the performance of the Group. These risks are considered alongside the Group's five year operating plan.

Macroeconomic environment

The operating plan is challenging, with a focus on improving earnings while achieving the required regulatory improvements on capital and liquidity. Any adverse movement in interest rates or deterioration in macroeconomic environment beyond the Group's assumptions would delay improvement of the earnings and return profile.

Mitigating actions

The Group is actively supporting sustainable growth in the UK economy through the focused range of products and services provided to business and personal customers, as well as through partnerships with industry and Government. Capital, liquidity and credit risk are managed conservatively and non-core asset reductions remain ahead of schedule ensuring the Group is better placed to address macroeconomic shocks.

Capital risk

The Group has a strong capital position but remains exposed to the risks of lower than expected profitability, significant losses in a number of stress scenarios or volatility through accounting standards and regulatory changes.

One such area of potential regulatory change relates to the Bank of England's interim Financial Policy Committee (FPC) which published its Financial Stability Report on 29 November 2012. The report recommended that the Financial Services Authority takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. The FSA is expected to respond prior to the March FPC meeting.

Mitigating actions

The Group has made significant progress and continues to deliver on its strategy of strengthening the balance sheet, including its capital position, to improve the resilience of the Group.

The Group has strong governance, processes and controls which, combined with the Group's proactive management of risk, result in an appropriate level of capital. This includes:

- Rigorous stress testing exercises where the results are shared with the FSA; and
- Prudent internal models, based on empirical data, that meet regulatory and stringent internal requirements.

Regulatory change

The Parliamentary Commission on Banking Standards (PCBS) was asked to conduct pre-legislative scrutiny on the draft Banking Reform Bill. The PCBS published its initial report on 21 December 2012. The report contains the Commission's consideration of the Government's draft legislation which gives effect to the recommendations of the Independent Commission on Banking. The PCBS looked at 'Ring fencing', one of the UK Government's main proposals for increasing financial stability.

Mitigating actions

Actions to respond to the proposals on ring fencing are being taken forward alongside planning for recovery and resolution as part of a programme of work with senior executive sponsorship and robust governance arrangements.

Compliance and conduct

Significant legacy costs beyond current provisioning could have significant impact on capital ratios and credit ratings with consequent impact on liquidity risk. There is inherent uncertainty in making estimates of provisions required.

Mitigating actions

Prudent provisioning policy – provisions for legacy conduct issues represent management's best estimate of the anticipated costs of related customer contact and/or redress, including administration expenses.

Group product governance controls – potential risks are monitored through product management information, new product approvals and annual product reviews leading to identification and mitigation of risks at an early stage.

Accounting standards

A number of potential changes to accounting standards are under consultation. These standards are currently scheduled for implementation between 2015 and 2018 and have the potential to add substantial volatility to the Group's reported results and capital.

Mitigating actions

The Group continues to monitor potential changes and where appropriate provide feedback.

Further information can be found under note 57 on page 342: Future accounting developments.

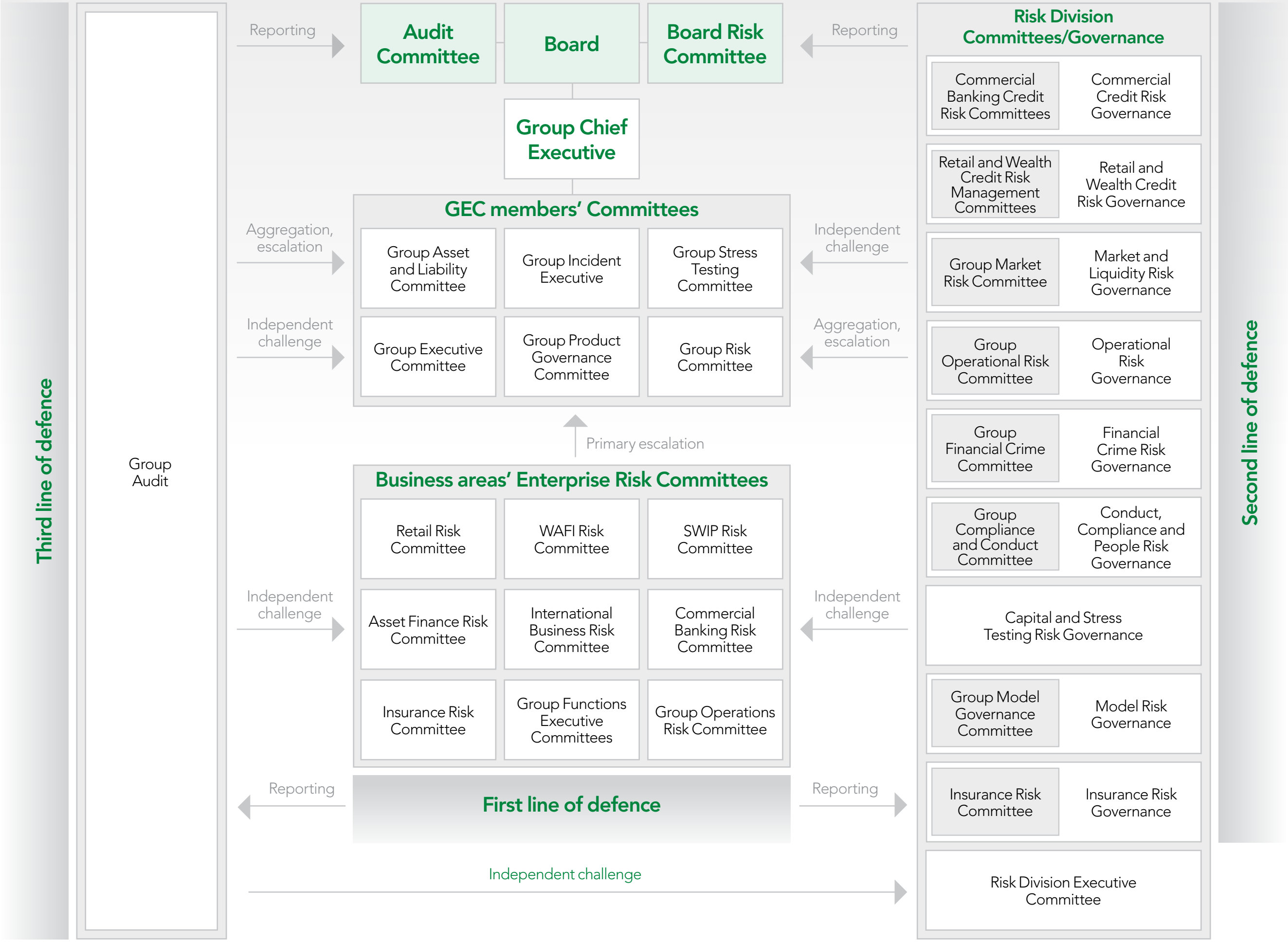
RISK MANAGEMENT

Risk governance

Lloyds Banking Group Enterprise Risk Management (ERM) framework provides a robust and consistent approach to risk management across the Group and is a core component of the Group's Internal Governance framework. Throughout 2012 the integrated governance, risk and control frameworks were further embedded continuing the use of a consistent approach to risk appetite, delegated authorities and governance committee structures.

The Risk Governance structure below is integral to implementing ERM across the Group and by ensuring Risk is appropriately represented on key committees ensures that risk management is discussed in these meetings. This structure outlines the flow and escalation of risk information and reporting from business areas and the Risk Division to the Group Executive Committee (GEC) and Board. Conversely, strategic direction and guidance is cascaded down from the Board and GEC.

Table 1.1: **Risk governance structures**



Third line of defence

Group Audit

Reporting

Audit Committee

Board

Board Risk Committee

Reporting

Group Chief Executive

GEC members' Committees

Aggregation, escalation

Independent challenge

Group Asset and Liability Committee

Group Incident Executive

Group Stress Testing Committee

Group Executive Committee

Group Product Governance Committee

Group Risk Committee

Independent challenge

Aggregation, escalation

Primary escalation

Business areas' Enterprise Risk Committees

Retail Risk Committee

WAFI Risk Committee

SWIP Risk Committee

Asset Finance Risk Committee

International Business Risk Committee

Commercial Banking Risk Committee

Insurance Risk Committee

Group Functions Executive Committees

Group Operations Risk Committee

Independent challenge

Independent challenge

Reporting

First line of defence

Reporting

Independent challenge

Risk Division Committees/Governance

Commercial Banking Credit Risk Committees	Commercial Credit Risk Governance
Retail and Wealth Credit Risk Management Committees	Retail and Wealth Credit Risk Governance
Group Market Risk Committee	Market and Liquidity Risk Governance
Group Operational Risk Committee	Operational Risk Governance
Group Financial Crime Committee	Financial Crime Risk Governance
Group Compliance and Conduct Committee	Conduct, Compliance and People Risk Governance
Capital and Stress Testing Risk Governance	
Group Model Governance Committee	Model Risk Governance
Insurance Risk Committee	Insurance Risk Governance
Risk Division Executive Committee	

Second line of defence

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Board, Executive and Risk Committees

The Group's risk governance structure (see table 1.1) strengthens risk evaluation and management, while also positioning the Group to manage the changing regulatory environment in an efficient and effective manner.

The Board, assisted by the Board Risk and Audit Committees, approves the Group's overall governance, risk and control frameworks and risk appetite. The risk focus of these committees, together with other committees are described below: The roles of the Board, Board Risk and Audit Committees are further described in the Corporate Governance section on pages 86 to 97.

Table 1.2: **Board, Executive and Risk Committees**

Committees	Risk focus
Board Committees	
Board	Assisted by Board Risk Committee and Audit Committee approves the Group's overall governance, risk and control frameworks and risk appetite. The Board also reviews the Group's aggregate risk exposures and concentrations of risk to ensure that these are consistent with the Board's agreed appetite for risk.
Board Risk Committee	Oversees and challenges the development, implementation and maintenance of the Group's risk management framework, ensuring that its strategy, principles, policies and resources are aligned internally to its risk appetite as well as externally to regulation, corporate governance and industry best practice. The Board Risk Committee regularly reviews the Group's risk exposures across the risk drivers and the detailed risk types.
Audit Committee	To monitor and review the formal arrangements established by the Board in respect of internal controls and the risk management framework. The committee also reviews the effectiveness of the systems for internal control, risk management and compliance with financial services legislation and regulations.
Group Executive Committees	
Group Executive Committee	Supports the Group Chief Executive in ensuring the effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, while also reviewing the Group's aggregate risk exposures and concentrations of risk.
The Group Executive is supported by the:	
Group Risk Committee	Reviews and recommends the Group's risk appetite and governance, risk and control frameworks, high-level Group policies and the allocation of risk appetite. The committee also regularly reviews risk exposures and risk/reward returns.
Group Asset and Liability Committee	Responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.
Group Executive Committee Members' Committees	
Group Product Governance Committee	Provides strategic and senior oversight over design, launch and management of products, including new product approval, annual product reviews and management of risk in the back book.
Group Stress Testing Committee	Responsible for reviewing, challenging and recommending to Group Executive Committee the annual stress testing of the Group's operating plan based on internal and FSA recommended scenarios, annual European Banking Authority stress tests, and other Group wide macroeconomic stress tests.
Group Incident Executive	Sets the strategic direction for the Group's response to significant incidents which could affect its ability to continue to operate, and instigates any tactical initiatives required.

RISK MANAGEMENT

The Group Risk Committee is supported by the following committees to ensure more effective risk management, clearer accountabilities and more efficient and simplified processes.

Credit Risk Committees	Responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of credit policy, and compliance with regulatory credit requirements.
Group Market Risk Committee	Monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
Insurance Risk Committee	Monitors, reviews and makes recommendations on the risk management framework, risk strategy and appetite for the Insurance business, ensuring that the policy and oversight framework for insurance risk management is appropriate. The committee reviews and challenges relevant insurance reporting and issues arising, including: the Group's aggregate portfolio of insurance risk against approved plans and risk appetite and the need and opportunity for effecting insurance risk mitigation.
Group Operational Risk Committee	Responsible for identifying significant current and emerging operational risks or accumulation of risks and control deficiencies across the Group and reviewing associated oversight plans to ensure pre-emptive risk management action. The committee also seeks to ensure that adequate business area engagement occurs to develop, implement and maintain the Group's operational risk management framework.
Group Compliance and Conduct Risk Committee	Responsible for monitoring and challenging the Group's compliance and conduct risk management framework, aggregated compliance and conduct risk profile, and its alignment with agreed risk appetite.
Group Financial Crime Committee	Reviews and challenges the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.
Group Model Governance Committee	Responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group's risk modelling framework, specifically regarding consistency of approach across business units and risk types. It approves risk models other than a small number defined as highly material to the Group, which are approved by the Group Risk Committee. This also meets FSA BIPRU requirements regarding the governance and approval for Internal Ratings Based models, including Internal Assessment models, Market Risk VaR and Advanced Measurement approach models.

How risk is managed in Lloyds Banking Group

The Enterprise Risk Management framework is implemented through a 'Three Lines of Defence' model which defines clear responsibilities and accountabilities and ensures effective independent assurance activities take place covering key decisions.

- Business Unit Managing Directors/Executives (**the first line of defence**) have primary responsibility for identifying, measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group's policies and are within the parameters set by the Board, Group Executive Committee and Risk Division.
- Compliance with policies and parameters is overseen by the Board Risk Committee, the Group Risk Committee, the Group Asset and Liability Committee, and Risk Division. Risk Division (**the second line of defence**) provides oversight and independent challenge to the effectiveness of risk decisions taken at a Group level by the Group Chief Executive and Group Executive Committee and at a local level by business unit management and their management committees.
- Group Audit (**the third line of defence**) provides independent, objective assurance across all areas of the Group focusing on the effectiveness of risk management, control and governance processes in line with ERM principles.

Risk management in the business

Line management is directly accountable for the management of risks arising in their individual businesses. A key objective is to ensure that business decisions strike an appropriate balance between risk and reward, consistent with the Group's risk appetite.

All business areas complete a control effectiveness review annually (see page 130), reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Executives of each business area and each Group Executive Committee member certify the accuracy of their assessment.

This approach provides the Group with an effective mechanism for developing and embedding risk policies and risk management strategies which are aligned with the risks faced by its businesses. It also seeks to facilitate effective communication on these matters across the Group.

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Risk management oversight

Risk Division, headed by the Chief Risk Officer, consists of thirteen Risk directors and their specialist teams. These teams provide oversight and independent challenge to business management and support senior management and the Board with independent reporting on risks and opportunities. Risk directors, responsible for each risk type, meet on a regular basis under the chairmanship of the Chief Risk Officer to review and challenge the risk profile of the Group and to ensure that mitigating actions are appropriate.

The Chief Risk Officer

- oversees and promotes the development and implementation of consistent Group wide governance risk and control frameworks;
- provides objective challenge to the Group's senior management with the support of the Risk directors;
- provides regular briefings and guidance to the Group Executive Committee and the Board ensuring awareness of the Group's risk profile and the overarching risk management framework with a clear understanding of their accountabilities for risk and internal control.

Risk directors

- report directly to the Chief Risk Officer;
- have allocated responsibility for specific risk types;
- are responsible for ensuring the adequacy of the framework for their risk types as well as the oversight of the associated risk profile across the Group; and
- support specific business areas to provide an enterprise-wide risk management perspective.

Independent Challenge

Group Audit provides independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group Audit is fully independent of Risk, seeking to ensure objective challenge to the effectiveness of the risk governance framework.

Risk management framework

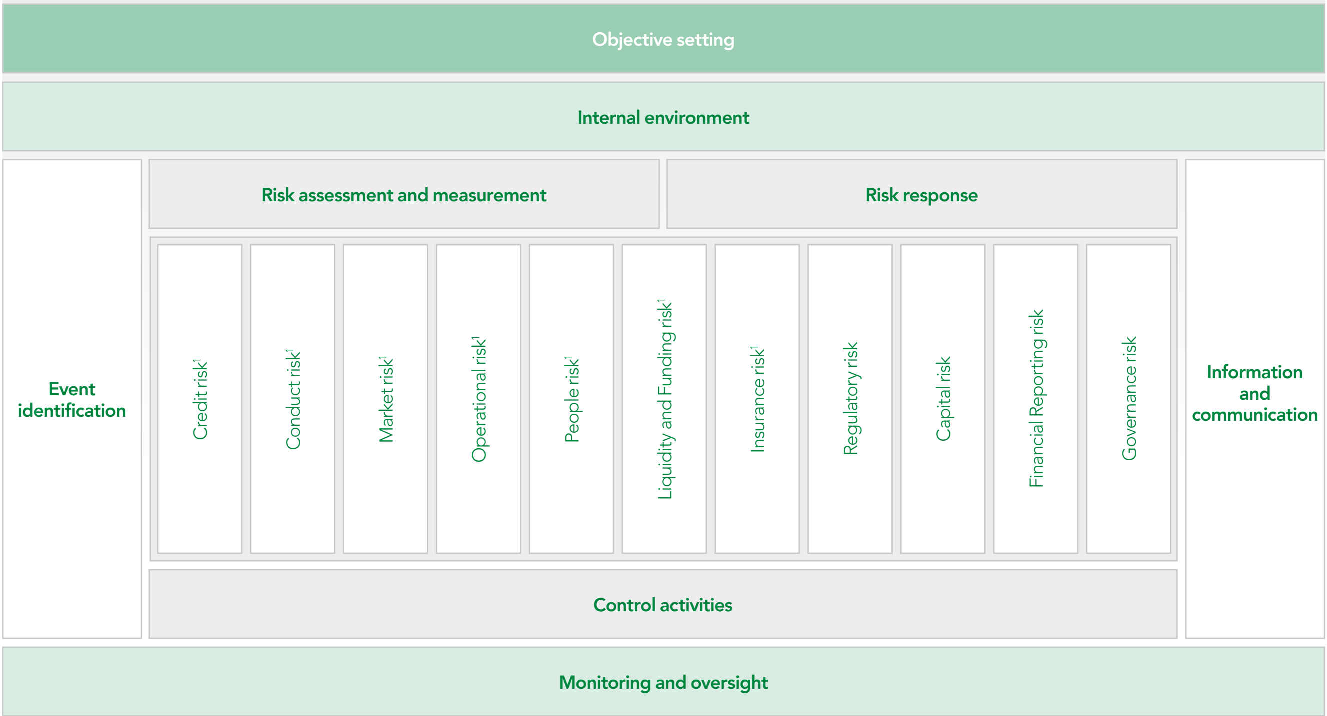
Risk management strategy and risk appetite are developed and reviewed in tandem with Group strategy. The Group uses an Enterprise Risk Management (ERM) framework to ensure a robust and consistent approach to risk management is applied across all business areas and all risk types in order to drive improvements in its risk profile in line with risk appetite.

The framework is designed to ensure that policies and controls can be adapted to reflect adjustments to business strategy and risk appetite which are made in response to changing market conditions. By providing a structured approach to identify and assess the impact of emerging risks, agree tolerances and develop mitigating strategies the framework also supports the Group's aim of maximising shareholder value over time.

A key component of the ERM Framework is the common risk language, which categorises the risks to which the Group is exposed into eleven categories which are used consistently to support risk aggregation and standardised reporting. The Framework (table 1.3) outlines the key risk management activities undertaken consistently across the Group for all types of risk. These activities map to the components of the internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

RISK MANAGEMENT

Table 1.3: **Risk management framework**



[1] The Group considers these to be principal risks. See pages 118 to 124 for further details.

Objective setting – the Group's high level risk appetite is derived from its business strategy of achieving strong, stable and sustainable growth. The risk management strategy and objectives are set to support the business in operating in line with the agreed risk appetite.

The risk appetite is proposed by the Group Chief Executive following review by the Group Risk Committee and Group Asset and Liability Committee, and is approved by the Board. The approved high level appetite and limits are delegated to the Group Chief Executive and then cascaded in consultation with the Group Risk Committee and Group Asset and Liability Committee to members of the Group Executive Committee and the business.

Internal environment – the Group's risk culture ensures that colleague capability is developed, individual accountabilities and limits are understood, and policies and procedures are adhered to. Colleagues are expected to be aware of, and to comply with, the policies and procedures which apply to them and their work. Line management in each business area has primary responsibility for ensuring that they do so.

Event identification – incidents occurring internally or externally that could affect achievement of the Group's objectives are identified, differentiating between risks and opportunities. Group wide risk tools and methodologies are used to help identify risks across the different risk types including external horizon scanning by Risk Division.

Risk assessment and measurement – risks are defined and categorised using a common risk language (see page 131). The impact of risks and issues is determined through effective risk measurement; including modelling, stress testing and scenario analysis to assess financial, reputational and regulatory capital implications (both qualitative and quantitative).

Risk response – actions to mitigate each risk are aligned to the Group's risk appetite and tolerances, managing future uncertainty and responding in a manner which reduces the likelihood of downside outcomes and increases the upside.

Information and communication – risk reporting consolidates and escalates key risks and management information internally through the Group's committee structure and reports these externally to regulators. Risk reporting is reviewed by the business executive sitting as a risk committee, to ensure that senior management is satisfied with the overall risk profile, risk accountabilities and progress on any necessary action plans and tracking. Information is provided to Risk Division for review and aggregation to feed into regular reporting on risk exposures and material issues.

At Group level a consolidated risk report and risk appetite dashboard are produced, which are reviewed and debated by the Group Risk Committee, Board Risk Committee and the Board to ensure that they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The report and dashboard provide a monthly assessment of the aggregate residual risk for the risk drivers, comparing the assessment with the previous periods and providing a forecast for the next twelve months, including an assessment of emerging risks, which could impact the Group over the next five years.

Control activities – robust frameworks are established across the Group covering policies, accountabilities and governance. Proportionate control activities mitigate or transfer risk where appropriate. The outcomes of independent reviews (including internal and external audit and regulatory reviews) are reflected in risk management activities and action plans. Risk and control assessments including the annual control effectiveness review assess the effectiveness of mitigating actions and whether risk exposures are consistent with the Group's risk appetite.

Monitoring and oversight – regular checks are carried out to ensure the Group's risk management approach and controls are effective with sufficient oversight in place. Risk Division oversees the effective implementation of policy, and Group Audit provides independent assurance to the Board about the effectiveness of the Group's internal control framework and adherence to policy. Monitoring processes are in place supporting the reporting and escalation of significant issues or losses to appropriate levels of management. Business areas monitor and report on their risk levels against risk appetite and their performance against relevant limits or policies.

The overall effectiveness of the risk management framework depends on the people undertaking these activities and the quality of the supporting systems and tools. The risk transformation programme is progressing significant investment in risk infrastructure to strengthen the Group's risk management capability of which the Group policy framework is a key element.

The Group policy framework has four component parts:

- Group Principles – statements aligned to the Group's risk drivers which set the foundation for the Group's behaviours and decision making;
- Group Policies – documents which translate a specific component of risk appetite into mandatory requirements, key measures and controls;
- Group Procedures – operational standards required to implement Policy across the Group; and
- Business Processes – activity, or set of activities, which detail how local businesses will comply with Group Policies and Procedures.

All Policy Framework documents are actively managed and maintained to ensure that they remain effective and aligned to the Group's risk appetite and changing business needs. Management of the Policy life cycle includes:

- Policy setting – development and formal approval of Policy documents to address the Group's material risk areas;
- Policy embedding – ensuring all colleagues are aware of the Policies which impact them, and the required processes are in place in business units to implement the Policy requirements;
- Policy assurance – monitoring and oversight activity to confirm adherence to Policy requirements and ensure any non-compliance is identified and managed; and
- Policy review – review of each Policy at least once a year in light of any changes to the internal or external environment in order to identify any amendments needed to ensure effective management of the risk within the Group's appetite.

Full analysis of risk drivers

The Group's risk framework covers all types of risk which affect the Group and could impact on the achievement of its strategic objectives. Following a review in 2012 the Group has moved from six to eleven risk categories to provide greater focus over significant areas of risk. A detailed description of each category is included below.

Primary Risk Drivers

Credit risk[1]	Conduct risk[1]	Market risk[1]	Operational risk[1]	People risk[1]	Liquidity and Funding risk[1]	Insurance risk[1]	Regulatory risk	Capital risk	Financial Reporting risk	Governance risk
Page 132	Page 169	Page 170	Page 174	Page 176	Page 177	Page 185	Page 186	Page 187	Page 201	Page 202

[1] The Group considers these to be principal risks. See pages 118 to 124 for further details.

Secondary Risk Drivers

Concentration Risk Counterparty Risk	Customer Risk Product Risk Product Distribution/ Advice Business Standards	Equity Risk Foreign Exchange Risk Interest Rate Risk Credit Spread	Regulatory Customer Treatment People Supplier Management Customer Processes Financial Crime Anti-Money Laundering and Sanctions Security IT Systems Change Organisational Infrastructure	Regulatory People Risk	Funding Risk Liquidity Risk	Mortality Longevity Morbidity Persistency Property Expenses Unemployment	Prudential Risk Compliance Risk Regulatory Development Risk	Capital Sufficiency Capital Efficiency	Financial and Prudential Regulatory Reporting Tax Disclosure	Governance

RISK MANAGEMENT

Credit risk

Definition

Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their obligations (both on and off balance sheet).

Risk appetite

Credit risk appetite is set at Board level and is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio performance measures, which may include the use of various credit risk rating systems as inputs. These metrics are supported by more detailed appetite metrics at Divisional and business level and by a comprehensive suite of policies, sector caps, product and country limits to manage concentration risk and exposures within the Group's approved risk appetite.

This statement of the Group's overall appetite for credit risk is reviewed and approved annually. With the support of the Group Risk Committee, the Group Chief Executive allocates this risk appetite across the Group.

Our prudent credit risk appetite and strong risk management controls have supported a lower impairment charge in 2012, and the continued improvement in the credit quality of our portfolios.

Exposures

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions, sovereigns and corporate clients. The credit risk exposures of the Group are set out in note 55 on page 319. Credit risk exposures are categorised as 'retail', arising primarily in the Retail and Wealth, Asset Finance and International Divisions, 'commercial' and 'corporate', 'financial institutions' or 'Sovereigns' arising in the Commercial Banking and Wealth, Asset Finance and International Divisions.

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially also exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail term commitments to extend credit can be cancelled without notice and the creditworthiness of customers is monitored frequently. In addition, most corporate commitments to extend credit are contingent upon customers maintaining specific credit standards, which are monitored regularly.

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 18 on page 247 shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2012. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 55 on page 319.

Credit risk exposures in the Insurance business arise primarily from holding investments and from exposure to reinsurers. A significant proportion of the investments are held in unit-linked and with-profits funds where the shareholder risk is limited, subject to any guarantees given.

Note 2(H) on page 219 provides details of the Group's approach to the impairment of financial assets.

Measurement

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components: (i) the 'probability of default' by the counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

For regulatory capital purposes the Group's rating systems assess probability of default and if permitted, exposure at default and loss given default, in order to derive an expected loss. If not permitted, regulatory prescribed exposure at default and loss given default values are used in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes.

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and subject matter expert judgement. Each rating model is subject to a validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. The most material rating models are approved by the Group Risk Committee. Responsibility for the approval of the remaining material rating models, and the governance framework in place around all Group models, is delegated to the Group Model Governance Committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities (details of these rating scales are published in the Group's Pillar III disclosure). Exposures migrate between rating grades if the assessment of the counterparty probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale (Note 55 on page 320 provides an analysis of the portfolio and page 137 provides details of our Credit risk portfolio).

The quality definition of both retail and non-retail counterparties/exposures is largely based on the outcomes of credit risk (probability of default – PD) models. The Group operates a significant number of different rating models, typically developed internally using statistical analysis and may use management judgement – retail models rely more on the former; non-retail models include more of the latter, especially in the larger corporate and more specialised lending portfolios. Internal data is supplemented with external data in model development, where appropriate.

The models vary, inter alia, in the extent to which they are point in time versus through the cycle. The models are subject to rigorous validation and oversight/governance, including where appropriate, benchmarking to external information.

In non-retail portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties/exposures migrate between rating grades if the assessment of the PD changes. The modelled PDs 'map' to a (non-retail) master scale which enables the consolidation of credit risk information, and it is this that forms the basis for the IFRS credit quality characterisation.

In retail, for reporting purposes, counterparties are also segmented into a number of rating grades, each representing a defined range of default probabilities and exposures migrate between rating grades if the assessment of the counterparty probability of default changes.

The nature, construction and calibration of retail and non-retail models are very different and so too are their respective master scales (not least in their graduality). The distribution of probabilities of default is also different, which precludes reporting on a single consolidated basis.

Mitigation

The Group uses a range of approaches to mitigate credit risk.

Internal control

Credit principles and policy: Risk Division sets out the credit principles and policy according to which credit risk is managed. Principles and policies are reviewed at least annually, and any changes are subject to a review and approval process. Policies, where appropriate, include lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. These policies and procedures define chosen target market and risk acceptance criteria. These have been and will continue to be fine-tuned as appropriate and include the use of early warning indicators to help anticipate future areas of concern and allow us to take early and proactive mitigating actions. Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators.

Controls over rating systems: The Group has established an independent team in the Risk Division that sets common minimum standards, designed to ensure risk models and associated rating systems are developed consistently, and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating systems are developed and owned by the Risk Division. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by an independent specialist group function.

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual limit guidelines. Credit policy is aligned to the Group's risk appetite and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 20 on page 251, provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk and single name concentrations. In addition correlated concentration risks to sectors and movements in such concentrations are monitored regularly to guide risk appetite and limit setting, identify unwanted concentrations, and provide an early warning indicator for potential excesses. These concentration risk controls are not necessarily in the form of a maximum limit on lending, but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.

Cross-border and cross-currency exposures: The Board sets country risk appetite. Within these, country limits are authorised by the country limits committee, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support the approved business and strategic plans of the Group.

Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control (see Intensive care of customers in financial difficulty); security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.

Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis. Events are modelled at a Group wide level, at divisional and business unit level and by rating model and portfolio.

Credit risk assurance and review: Group Credit Risk Assurance, a team within Group Audit comprising experienced credit professionals, is also in place. In conjunction with Risk senior management, this team carries out independent risk based credit reviews, providing individual business unit assessment of the effectiveness of risk management practices and adherence to risk controls across the diverse range of the Group's wholesale businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical ('standard') credit reviews, non-standard reviews, and bespoke assignments, including impairment adequacy reviews as required. The work of Group Credit Risk Assurance continues to provide executive and senior management (and Audit Committee) with assurance and guidance on credit quality, effectiveness of credit risk controls and Business Support Unit work out strategies as well as accuracy of impairments.

Retail Assets (lending to individuals in Retail and Wealth, Asset Finance and International divisions)

The Group uses a variety of lending criteria when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant's previous credit history using information held by credit reference agencies (CRA). The Group also assesses the affordability of the borrowings to the borrower under stressed scenarios including increased interest rates. In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are hard limits above which the Group will

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reject the application. The Group also has certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

The Group's lending practices within Retail have changed since 2009 in several ways: the Group has lowered its maximum loan-to-value thresholds, which have been reduced across all mortgage product types; the Group has withdrawn from 'specialist' secured lending since early 2009 (self-certificated and sub-prime lending) and increased credit scorecard cut-offs for both secured and unsecured lending; the Group has tightened its assessments and the maximum limit for affordability of borrowings for both secured and unsecured lending. In addition, the number of properties permitted in buy-to-let portfolios has been reduced.

For UK mortgages, the Group's policy is to reject all standard applications with a loan-to-value (LTV) greater than 90 per cent. For mainstream mortgages the Group has maximum per cent LTV limits which depend upon the loan size. These limits are currently:

Table 1.4: **Loan to value analysis (unaudited)**

Loan size From	To	Maximum LTV
£1	£750,000	90% LTV
£750,001	£1,000,000	85% LTV
£1,000,001	£2,000,000	80% LTV
£2,000,001	£5,000,000	70% LTV

For mainstream mortgages greater than £5,000,000 the maximum LTV is 50 per cent. Buy-to-let mortgages are limited to a maximum of £1,000,000 and 75 per cent LTV. All mortgage applications above £500,000 are subject to manual underwriting.

The Group's approach to underwriting applications for unsecured products in Retail takes into account the total unsecured debt held by a customer and their affordability. The Group rejects any application for an unsecured product where a customer is registered as bankrupt or insolvent, or has a County Court Judgment registered at a CRA used by the Group. In addition, for credit cards the Group rejects any applicant with total unsecured debt greater than £50,000 registered at the CRA; or revolving debt-to-income ratio greater than 75 per cent; or total unsecured debt-to-income ratio greater than 100 per cent. For unsecured personal loan applications, we reject any applicant with total unsecured debt greater than £50,000 registered at the CRA. Rules around refinancing of debt have also been made more stringent since 2009 as a result of the application of rules relating to the total unsecured debt held by a customer and the Group's approach in assessing affordability. This has resulted in fewer customers being eligible to refinance unsecured debt.

Credit scoring: In its principal retail portfolios, the Group uses statistically based decisioning techniques (primarily credit scoring models). The Risk Division reviews model effectiveness, while new models and model changes are referred by them to the appropriate Model Governance Committees for approval. The most material changes are approved in accordance with the governance framework set by the Group Model Governance Committee.

Commercial customers

Individual credit assessment and sanction with the exception of smaller SME names: Credit risk in commercial customers portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities and limit guidelines. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting is generally the same as that for assets intended to be held over the period to maturity.

Counterparty limits: Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.

Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.

Collateral

The principal collateral types for loans and advances are:

- mortgages over residential and commercial real estate;
- charges over business assets such as premises, inventory and accounts receivables;
- charges over financial instruments such as debt securities and equities; and
- guarantees received from third parties.

The Group maintains guidelines on the acceptability of specific classes of collateral.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement.

It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. Collateral is reviewed on a regular basis in accordance with business unit credit policy, which will vary according to the type of lending and collateral involved. For residential mortgages, the Group adjusts open market property values to take account of the costs of realisation and any discount associated with the realisation of the collateral. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are identified for the relevant individual loans and advances.

The Group considers risk concentrations by collateral providers and collateral type, as appropriate, with a view to ensuring that any potential undue concentrations of risk are identified and suitably managed by changes to strategy, policy and/or business plans.

Master netting agreements

Where it is appropriate and likely to be effective, the Group seeks to enter into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since it is affected by each transaction subject to the agreement.

Other credit risk transfers

The Group also undertakes asset sales and credit derivative based transactions as a means of mitigating or reducing credit risk, taking into account the nature of assets and the prevailing market conditions.

Monitoring

In conjunction with Risk, businesses identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Risk Division in turn produces an aggregated review of credit risk throughout the Group, including reports on significant credit exposures, which are presented to the Group Risk Committee and the Board Risk Committee.

The performance of all rating models is monitored on a regular basis, in order to seek to ensure that models provide appropriate risk differentiation capability, the generated ratings remain as accurate and robust as practical, and the models assign appropriate risk estimates to grades/pools. All models are monitored against a series of agreed key performance indicators. In the event that the monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated in accordance with the governance framework set by the Group Model Governance Committee.

Intensive care of customers in financial difficulty

The Group operates a number of schemes to assist borrowers who are experiencing financial stress. The material elements of these schemes through which the Group has granted a concession, whether temporarily or permanently, are set out below and in note 55 on page 329.

Retail Customers

The Group's aim in offering forbearance and other assistance to retail customers in financial distress is to benefit both the customer and the Group by: discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests; and bringing customer facilities back into a sustainable position which, for residential mortgages, also means keeping customers in their homes.

The Group offers a range of tools and assistance to support retail customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework; controls around the execution of policy; regular review of the different treatments to confirm that they remain appropriate; monitoring of customers' performance and the level of payments received; and management visibility of the nature and extent of assistance provided and the associated risk.

Assistance is provided through trained colleagues in branches and dedicated telephony units, and via online guidance material. For those customers requiring more intensive help, assistance is provided through dedicated support units where tailored repayment programmes can be agreed. Customers are actively supported and referred to free money advice agencies when they have multiple credit facilities, including those at other lenders, that require restructuring. Within the Collections and Recoveries functions, the sharing of best practice and alignment of policies across the Group has helped to drive more effective customer outcomes and achieve operational efficiencies.

One component of our relationship management approach is to contact customers showing signs of financial difficulty, discussing with them their circumstances and offering solutions to prevent their accounts falling into arrears.

The specific tools available to assist customers vary by territory and product and the customer's status. In defining the treatments offered to customers who have experienced financial distress, the Group distinguishes between the following three categories:

- Reduced contractual monthly payment – a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments, for example capital payment breaks and payment assistance breaks. Any arrears existing at the commencement of the arrangement are retained;
- Financial distress assistance – an arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay and term extensions; and
- Repair – an account change used to repair a customer's position when they have emerged from financial difficulty, for example capitalisation of arrears.

To assist customers in financial distress, the Group also participates in, or benefits from, the following UK Government sponsored programmes for households:

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- Income Support for Mortgage Interest – This is a Government medium-term initiative that provides certain defined categories of customers, principally those who are unemployed, access to a benefit scheme, paid for by the Government, which covers all or part of the interest on the mortgage. Qualifying customers are able to claim for mortgage interest on up to £200,000 of the mortgage. All decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the Government. Payments are made directly to the Group by the appropriate Government department.
- Homeowner Mortgage Support Scheme – This is a Government medium-term initiative that enables borrowers affected by temporary reductions in income to access reduced payments for a period of up to two years. The Government provides a partial guarantee to the Group whilst a customer participates in the plan. Decisions on eligibility, principally whether the Group expects the borrower's earnings to recover fully, initially rest with the Group and must be made on the basis of detailed information received from an independent fee-free advisor. After a year, the customer must undergo a further full assessment made by the advice agency. The customer must pay at least 30 per cent of the interest due. Any shortfall in payments made during the period covered by the scheme is collected through increased payments over the remaining term. The scheme was closed to new customer applications in April 2011 by the Department of Communities and Local Government.
- Mortgage Rescue Scheme – This is a Government short-term initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full.

Commercial Customers

Wholesale credit facilities are reviewed on a regular basis and more frequently where required. When financial stress is exhibited, the customer would be transferred at an early stage to one of the Group's specialist BSUs or Customer Support teams.

In order to support commercial customers that encounter difficulties during the current economic downturn, the Group increased the size of its dedicated Business Support Unit (BSU) to cover all its UK and International portfolios.

The over-arching aim of BSU is to work with each customer to try and resolve the issues, to restore the business to a financially viable position and facilitate a business turnaround. This could be through a number of channels, including providing advice on how to develop and implement turnaround strategies, and considering potential restructuring of debt and forbearance.

BSU Relationship Managers are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and ongoing close scrutiny by senior management. Exposure is minimised through a combination of appropriate forbearance, asset sales, restructuring and work-out strategies.

The determination of cash flows for cases in the BSUs is undertaken by a specialist risk team who gather a range of information from various sources including the customer, professional advisers and the Group's own credit teams to fully understand and appraise the customer's business and circumstances. A more detailed assessment is undertaken to assist in reducing risk exposure and highlighting potential strategic options. This often involves the Group, in addition to using its own internal experts, engaging professional advisers to perform Independent Business Reviews and, where relevant, independently value collateral held. In more complex cases, such as those involving work-out strategies, the review may also involve:

- critically assessing customer's ability to successfully manage the business effectively in a distressed situation where turnaround is required;
- analysis of market sector factors, i.e. products, customers, suppliers, pricing and margin issues;
- performance review of operational areas that should be considered in terms of current effectiveness and efficiency and scope for improvements;
- financial analysis to model plans and factor in potential sensitivities, vulnerabilities and upsides; and
- determining the most appropriate corporate and capital structure suitable for the work-out strategy concerned.

The above assessment, monitoring and control processes continue throughout the period the case is managed within the BSU. All the analysis performed around cash flows is used to determine appropriate impairment provisions.

Customer Support provides intensive care and support to smaller Commercial small and medium-sized enterprises (SME) customers in difficulty. Whilst the customer relationship remains with the Relationship Manager, they are supported by a Customer Support Manager to oversee and manage identified risk.

It is Group policy that where forbearance has been granted for a commercial customer it must be managed either within the Group's good book watchlist Credit Risk Classification framework or within a BSU. Whilst the Group treats all impaired assets to commercial customers as having been granted some form of forbearance in the past, granting forbearance does not necessarily mean that it is expected that future cashflows will fall, or that the asset is impaired. Depending on circumstances and within robust parameters and controls, the Group believes forbearance can help support the customer in the medium term.

Multiple types of forbearance concessions may occur and each case is treated depending on its own specific circumstances, as the Group's strategy and offer of forbearance is largely dependent on the individual situation. Early identification, control and monitoring are key in order to support the customer and protect the Group.

The Group's forbearance actions for its commercial customers experiencing financial difficulties fall into the following three main categories:

- Amendments – Waiver or amendment of covenants or interest rate to a level considered outside of market or the Group's risk appetite;
- Extensions – Extension/alteration of repayment terms to a level outside of market or the Group's risk appetite due to the customer's inability to make existing contractual repayment terms; and
- Forgiveness – Debt for equity swaps or partial debt forgiveness. This type of forbearance will always give rise to impairment.

Following a forbearance event, should the customer show a sustained period of stabilisation on their new terms and conditions or where the forbearance has reversed or cured, the customer would likely be returned to the mainstream good classification, at which point they may no longer be considered forborne. Such a decision can be made only by the independent Risk Division.

The Group recognises that forbearance alone is not necessarily an indicator of impairment but is a trigger point for it to review the customer's credit profile.

One of the components of the approach to forbearance and early identification of issues used for commercial customers is the Group's Credit Risk Classification Policy. This complements the Group's risk rating tools and is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. This policy includes the Group's good book/mainstream early warning watchlist process identifying 'Special Mention' and 'Sub Standard' cases. This process seeks to ensure that Relationship Managers act promptly to identify, and highlight to senior management, customers that have the possibility to become higher risk in the future. Customers classified as Special Mention/ Sub Standard are subject to additional controls and regular monitoring routines, including oversight by BSU and the independent Risk function.

Concessions granted under forbearance would be classified in the Group's Credit Risk Classification system according to the severity of the customer's financial distress. Management information is produced which gives a high level view of asset quality, with clearly defined parameters and features. Trends and warning signs are reported and advised to senior management promptly, which include issues not yet identified by rating models. A robust review and challenge process is applied to each credit if asset quality declines, initiating an appropriate and measured response. As the financial stress of a credit deteriorates the Credit Risk Classification helps to determine the route and management of the customer. Repeat transgressions of forbearance would be reflected in the strategy to manage the customer and an objective reassessment of any impairment will be undertaken on a regular basis. This is subject to independent review and sanctioning.

The Group's accounting policy for loan renegotiations and forbearance is set out in note 2(H) on page 219.

In addition, the Group, through its banking businesses, participates in a number of initiatives designed to assist small and medium-sized enterprises. These include:

- The Lending Code: A voluntary code of practice covering its subscribers' dealings with consumers, micro-enterprises and charities with an income of less than £1 million, in respect of current account overdrafts, loans, credit cards and lending. It sets standards for financial institutions to follow in order to ensure that firms act fairly and reasonably in all dealings with UK customers. In addition to providing protection for customers, it also gives guidance as to how firms should treat them on both a day to day basis, and when they suffer times of financial difficulty.
- Business Finance Taskforce: The Group, through its banking businesses, has taken a leading role in the Business Finance Taskforce, which committed to a number of key actions in three broad areas: (i) improving customer relationships; (ii) ensuring better access to finance (for example, through regular in-depth surveys of SME customers, including Ethnic Minority Businesses and Female Led Businesses); and (iii) providing better information and promoting customer understanding (including sponsorship of the Enterprise Research Centre).
- The lending appeals process: If a lending application is declined, customers have the right to appeal that decision. The Group has committed to go beyond industry agreed standards in this area and has pledged to respond to 90 per cent of appeals with a decision within 15 working days. In addition to this, customers will receive a goodwill payment for each overturned decline. The appeals process is overseen by the Independent External Reviewer of Appeals.
- Business mentoring: Businesses may benefit from the support of a business mentor. A free online service, offered by 'mentorsme' enables businesses to locate local independent mentoring organisations that suit their specific business needs. The Group has committed to having 400 trained mentors across the UK available to businesses free of charge through a network of not for profit mentoring agencies. We also partner several mentoring initiatives to support SME including the EDA (Enterprise Diversity Alliance), young enterprise through our Enterprise Awards and social enterprise through work with Business in the Community and the School of Social Entrepreneurs.
- The Government's National Loan Guarantee Scheme (NLGS) through which the Group will provide discounted funding to SMEs with a turnover of up to £250 million over the next five years. The Group issued its full allocation of funding for the scheme and is continuing to market these facilities in order to ensure that the full benefit of the scheme is passed on to SME customers.
- 2013 SME Charter: The 2013 SME Charter details the Group's commitment to supporting UK business and, amongst others, includes pledges that:
  - The Group will deliver net lending that is positive and ahead of the industry as a whole.
  - As part of its participation in the Funding for Lending Scheme, the Group will continue to offer interest rate reductions of 1 per cent on all approved business loan, commercial mortgage and hire purchase applications for the whole life of these loans.
  - The Group will do everything possible to support business customers that are facing financial difficulties through its customer support specialists.

The Group credit risk portfolio in 2012

Overview

- The Group's impairment charge decreased by 42 per cent to £5,697 million in 2012, due to significant reductions in both the core and non-core portfolios and an improving overall credit quality.
- The lower charges were supported by the continued application of the Group's prudent risk appetite and strong risk management controls. The portfolio also benefited from continued low interest rates, and broadly stable UK retail property prices, partly offset by subdued UK and global economic growth, high unemployment and a weak commercial real estate market.
- The Group's core impairment charge of £1,919 million in 2012 was 34 per cent lower compared to 2011, driven by better performance in all divisions.
- The Group's non-core impairment charge of £3,778 million in 2012 was 45 per cent lower compared to 2011. This is primarily driven by lower impairment from the non-core Irish and Australasian portfolios as the Group works through legacy issues.
- The Group's exposures which are higher risk are being successfully managed by the Business and Customer Support Units in Commercial Banking and Ireland wholesale and Collection and Recovery Units in Retail.
- The Group continues to proactively manage down sovereign as well as banking and trading book exposure to selected Eurozone countries.
- The Group's divestment strategy remains focused on reducing non-core assets and on the disposal of higher risk positions.

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Table 1.5: **Impairment charge by Division (audited)**

	2012 £m	2011 £m	Change %
Retail	**1,270**	1,970	36
Commercial Banking	**2,946**	4,210	30
Wealth, Asset Finance and International	**1,480**	3,604	59
Central items	**1**	3	67
Total impairment charge	**5,697**	9,787	42
Impairment charge as a % of average advances	**1.02%**	1.62%	(60)bp

Total impairment charge comprises:

Table 1.6: **Total impairment charge (audited)**

	2012 £m	2011 £m	Change %
Loans and advances to customers	**5,654**	9,712	42
Debt securities classified as loans and receivables	**15**	49	69
Available-for-sale financial assets	**37**	81	54
Other credit risk provisions	**(9)**	(55)	(84)
Total impairment charge	**5,697**	9,787	42

Table 1.7: **Impairments on loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2012					
Retail	**346,560**	**8,320**	**2.4**	**2,335**	**32.5**
Commercial Banking	**144,770**	**23,965**	**16.6**	**9,984**	**41.7**
Wealth, Asset Finance and International	**42,927**	**14,008**	**32.6**	**9,453**	**67.5**
Reverse repos and other items	**5,814**	**–**		**–**	
	540,071	**46,293**	**8.6**	**21,772**	**48.2**
Impairment provisions	**(21,772)**				
Fair value adjustments[3]	**(1,074)**				
Total Group	**517,225**				
At 31 December 2011					
Retail	356,907	8,822	2.5	2,718	35.4
Commercial Banking	169,964	33,117	19.5	13,693	41.3
Wealth, Asset Finance and International	51,506	18,330	35.6	11,307	61.7
Reverse repos and other items	17,066	–		–	
	595,443	60,269	10.1	27,718	46.9
Impairment provisions	(27,718)				
Fair value adjustments[3]	(2,087)				
Total Group	565,638				

[1] Includes collective unimpaired provisions.

[2] Provisions as a percentage of impaired loans are calculated excluding Retail unsecured loans in recoveries (2012: £1,129 million; 2011: £1,137 million).

[3] The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Group's consolidated financial records at their fair value and took into account both the expected future impairment losses and market liquidity at the date of acquisition. The unwind relating to future impairment losses requires significant management judgement to determine its timing which includes an assessment of whether the losses incurred in the current period were expected at the date of the acquisition and assessing whether the remaining losses expected at the date of the acquisition will still be incurred. The element relating to market liquidity unwinds to the income statement over the estimated useful lives of the related assets (until 2014 for wholesale loans and 2018 for retail loans) although if an asset is written off or suffers previously unexpected impairment then this element of the fair value will no longer be considered a timing difference (liquidity) but permanent (impairment). The fair value unwind in respect of impairment losses incurred was £868 million for 2012 (2011: £1,693 million). The fair value unwind in respect of loans and advances is expected to continue to decrease in future years as fixed-rate periods on mortgages expire, loans are repaid or written off, and will reduce to zero over time.

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Table 1.8: Core impairment charge – Group (unaudited)

	2012 £m	2011 £m	Change %
Retail	1,192	1,796	34
Commercial Banking	704	1,055	33
Wealth, Asset Finance and International	22	33	33
Central items	1	3	67
Core impairment charge	1,919	2,887	34
Impairment charge as a % of average advances	0.44%	0.64%	(20)pp

Table 1.9: Core impairments on loans and advances (unaudited)

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2012					
Retail	320,058	6,693	2.1	1,957	34.7
Commercial Banking	104,867	5,907	5.6	2,866	48.5
Wealth, Asset Finance and International	5,415	351	6.5	85	24.2
Reverse repos and other items	5,814	–		–	
	436,154	12,951	3.0	4,908	41.2
Impairment provisions	(4,908)				
Fair value adjustments	(778)				
Total core	430,468				
At 31 December 2011					
Retail	328,524	7,151	2.2	2,310	37.9
Commercial Banking	109,809	6,714	6.1	3,175	47.3
Wealth, Asset Finance and International	5,243	340	6.5	103	30.3
Reverse repos and other items	17,066	–		–	
	460,642	14,205	3.1	5,588	42.5
Impairment provisions	(5,588)				
Fair value adjustments	(1,171)				
Total core	453,883				

[1] Includes collective unimpaired provisions.

[2] Provisions as a percentage of impaired loans are calculated excluding Retail unsecured loans in recoveries (2012: £1,047 million; 2011: £1,054 million).

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Table 1.10: **Non-core impairment charge (unaudited)**

	2012 £m	2011 £m	Change %
Retail	**78**	174	55
Commercial Banking	**2,242**	3,155	29
Wealth, Asset Finance and International	**1,458**	3,571	59
Non-core impairment charge	**3,778**	6,900	45
Impairment charge as a % of average advances	**3.08%**	4.60%	(1.52)pp

Table 1.11: **Non-core impairments on loans and advances (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2012					
Retail	**26,502**	**1,627**	**6.1**	**378**	**24.5**
Commercial Banking	**39,903**	**18,058**	**45.3**	**7,118**	**39.4**
Wealth, Asset Finance and International	**37,512**	**13,657**	**36.4**	**9,368**	**68.6**
Reverse repos and other items	**–**	**–**		**–**	
	103,917	**33,342**	**32.1**	**16,864**	**50.7**
Impairment provisions	**(16,864)**				
Fair value adjustments	**(296)**				
Total non-core	**86,757**				
At 31 December 2011					
Retail	28,383	1,671	5.9	408	25.7
Commercial Banking	60,155	26,403	43.9	10,518	39.8
Wealth, Asset Finance and International	46,263	17,990	38.9	11,204	62.3
Reverse repos and other items	–	–		–	
	134,801	46,064	34.2	22,130	48.1
Impairment provisions	(22,130)				
Fair value adjustments	(916)				
Total non-core	111,755				

[1] Includes collective unimpaired provisions.

[2] Provisions as a percentage of impaired loans are calculated excluding Retail unsecured loans in recoveries (2012: £82 million; 2011: £83 million).

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Credit Risk – Retail

Overview

- The Retail impairment charge was £1,270 million in 2012, a decrease of 36 per cent, against 2011 primarily driven by the unsecured portfolio as a result of the Group's sustainable risk appetite and ongoing effective portfolio management.
- The Retail impairment charge, as an annualised percentage of average loans and advances to customers decreased to 0.36 per cent in 2012 from 0.54 per cent in 2011.
- The overall value of assets entering arrears in 2012 was lower in both unsecured and secured lending compared to 2011.
- Non-core represents 8 per cent of total Retail assets at 31 December 2012 and is primarily specialist mortgages which is closed to new business and has been in run-off since 2009.

Table 1.12: **Retail impairment charge**

(audited)	**2012 £m**	2011 £m	Change %
Secured	**377**	463	19
Unsecured	**893**	1,507	41
Total impairment charge	**1,270**	1,970	36
(unaudited)	**2012 £m**	2011 £m	Change %
Core:			
Secured	**304**	330	8
Unsecured	**888**	1,466	39
	1,192	1,796	34
Non-core:			
Secured	**73**	133	45
Unsecured	**5**	41	88
	78	174	55
Total impairment charge	**1,270**	1,970	36
(unaudited)			
Core impairment charge as a % of average advances	**0.37%**	0.54%	(17)bp
Non-core impairment charge as a % of average advances	**0.29%**	0.59%	(30)bp
Impairment charge as a % of average advances	**0.36%**	0.54%	(18)bp

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Impaired loans and provisions

Retail impaired loans decreased by £502 million to £8,320 million compared with 31 December 2011 and, as a percentage of closing loans and advances to customers, decreased to 2.4 per cent from 2.5 per cent at 31 December 2011. Impairment provisions as a percentage of impaired loans (excluding unsecured loans in recoveries) decreased to 32.5 per cent from 35.4 per cent at 31 December 2011 driven by the reduction in unsecured impaired loans.

Table 1.13: **Impairments on Retail loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[3] %
At 31 December 2012					
Secured	**323,862**	**6,321**	**2.0**	**1,616**	**25.6**
Unsecured:					
Collections		**870**		**719**	**82.6**
Recoveries[2]		**1,129**		**–**	
	22,698	**1,999**	**8.8**	**719**	
Total gross lending	**346,560**	**8,320**	**2.4**	**2,335**	**32.5**
Impairment provisions	**(2,335)**				
Fair value adjustments	**(915)**				
Total	**343,310**				
At 31 December 2011					
Secured	332,143	6,452	1.9	1,651	25.6
Unsecured:					
Collections		1,233		1,067	86.5
Recoveries[2]		1,137		–	
	24,764	2,370	9.6	1,067	
Total gross lending	356,907	8,822	2.5	2,718	35.4
Impairment provisions	(2,718)				
Fair value adjustments	(1,377)				
Total	352,812				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

[3] Impairment provisions as a percentage of impaired loans are calculated excluding unsecured loans in recoveries.

The Retail division's loans and advances to customers are analysed in the following table:

Table 1.14: **Retail loans and advances to customers (audited)**

	2012 £m	2011 £m
Secured:		
Mainstream	**248,735**	256,518
Buy to let	**49,568**	48,276
Specialist	**25,559**	27,349
	323,862	332,143
Unsecured:		
Credit cards	**9,465**	10,192
Personal loans	**10,523**	11,970
Bank accounts	**2,710**	2,602
	22,698	24,764
Total gross lending	**346,560**	356,907

Table 1.15: **Impairments on Retail loans and advances – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[3] %
At 31 December 2012					
Secured	**297,902**	**4,793**	**1.6**	**1,251**	**26.1**
Unsecured:					
Collections		**853**		**706**	**82.8**
Recoveries[2]		**1,047**		**–**	
	22,156	**1,900**	**8.6**	**706**	
Total gross lending	**320,058**	**6,693**	**2.1**	**1,957**	**34.7**
Impairment provisions	**(1,957)**				
Fair value adjustments	**(778)**				
Total core	**317,323**				
At 31 December 2011					
Secured	304,589	4,895	1.6	1,265	25.8
Unsecured:					
Collections		1,202		1,045	86.9
Recoveries[2]		1,054		–	
	23,935	2,256	9.4	1,045	
Total gross lending	328,524	7,151	2.2	2,310	37.9
Impairment provisions	(2,310)				
Fair value adjustments	(1,111)				
Total core	325,103				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

[3] Impairment provisions as a percentage of impaired loans are calculated excluding unsecured loans in recoveries.

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Table 1.16: **Impairments on Retail loans and advances – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[3] %
At 31 December 2012					
Secured	**25,960**	**1,528**	**5.9**	**365**	**23.9**
Unsecured:					
Collections		**17**		**13**	**76.5**
Recoveries[2]		**82**		**–**	
	542	**99**	**18.3**	**13**	
Total gross lending	**26,502**	**1,627**	**6.1**	**378**	**24.5**
Impairment provisions	**(378)**				
Fair value adjustments	**(137)**				
Total non-core	**25,987**				
At 31 December 2011					
Secured	27,554	1,557	5.7	386	24.8
Unsecured:					
Collections		31		22	71.0
Recoveries[2]		83		–	
	829	114	13.8	22	
Total gross lending	28,383	1,671	5.9	408	25.7
Impairment provisions	(408)				
Fair value adjustments	(266)				
Total non-core	27,709				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

[3] Impairment provisions as a percentage of impaired loans are calculated excluding unsecured loans in recoveries.

Secured

The secured impairment charge decreased to £377 million from £463 million in 2011 reflecting further reductions in impaired loans. The annualised impairment charge, as a percentage of average loans and advances to customers, decreased to 0.12 per cent in 2012 from 0.14 per cent in 2011. Provision coverage has remained stable at 25.6 per cent compared to 31 December 2011.

The impairment provisions held against secured assets reflect the Group's view of appropriate allowance for incurred losses. The Group holds appropriate impairment provisions for customers who are experiencing financial difficulty, either on a forbearance arrangement or who may be able to maintain their repayments only whilst interest rates remain low.

The value of mortgages greater than three months in arrears (excluding repossessions) increased to £9,637 million at 31 December 2012 compared to £9,560 million at 31 December 2011. The value of mortgages subject to forbearance (reduced contractual monthly payment treatment) reduced from £3,923 million (1.2 per cent) at 31 December 2011 to £2,706 million (0.8 per cent) at 31 December 2012.

The number of customers entering into arrears was 7 per cent lower in 2012 in comparison with 2011.

Table 1.17: **Mortgages greater than three months in arrears (excluding repossessions) (unaudited)**

	Number of cases		Total mortgage accounts %		Value of debt[1]		Total mortgage balances %	
At 31 December	**2012 Cases**	2011 Cases	**2012 %**	2011 %	**2012 £m**	2011 £m	**2012 %**	2011 %
Mainstream	**55,905**	53,734	**2.2**	2.0	**6,287**	5,988	**2.5**	2.3
Buy to let	**7,306**	7,805	**1.6**	1.8	**1,033**	1,145	**2.1**	2.4
Specialist	**13,262**	13,677	**7.6**	7.5	**2,317**	2,427	**9.1**	8.9
Total	**76,473**	75,216	**2.4**	2.3	**9,637**	9,560	**3.0**	2.9

[1] Value of debt represents total book value of mortgages in arrears.

The stock of repossessions decreased to 2,438 cases at 31 December 2012 compared to 3,054 cases at 31 December 2011.

Secured loan to value analysis

The average indexed loan to value (LTV) on the mortgage portfolio at 31 December 2012 increased to 56.4 per cent compared with 55.9 per cent at 31 December 2011. The average LTV for new mortgages and further advances written in 2012 was 62.6 per cent compared with 62.1 per cent for 2011.

The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent decreased to 11.7 per cent (£37,811 million) at 31 December 2012, compared with 12.0 per cent (£39,729 million) at 31 December 2011. The tables below show LTVs across the principal mortgage portfolios.

Table 1.18: **Actual and average LTVs across the Retail mortgage portfolios (audited)**

	Mainstream %	Buy to let %	Specialist[1] %	Total %
At 31 December 2012				
Less than 60%	**31.9**	**12.8**	**14.7**	**27.6**
60% to 70%	**12.8**	**12.9**	**9.7**	**12.6**
70% to 80%	**18.3**	**26.2**	**17.2**	**19.4**
80% to 90%	**16.6**	**16.5**	**19.1**	**16.8**
90% to 100%	**10.5**	**15.4**	**18.5**	**11.9**
Greater than 100%	**9.9**	**16.2**	**20.8**	**11.7**
Total	**100.0**	**100.0**	**100.0**	**100.0**
Average loan to value:[2]				
Stock of residential mortgages	**52.7**	**73.6**	**72.6**	**56.4**
New residential lending	**62.3**	**64.5**	**n/a**	**62.6**
Impaired mortgages	**72.2**	**99.3**	**88.1**	**78.3**
At 31 December 2011				
Less than 60%	32.5	12.7	14.6	28.1
60% to 70%	12.7	13.0	10.1	12.5
70% to 80%	17.2	24.1	17.2	18.2
80% to 90%	16.0	17.3	19.3	16.5
90% to 100%	11.2	17.1	19.0	12.7
Greater than 100%	10.4	15.8	19.8	12.0
Total	100.0	100.0	100.0	100.0
Average loan to value:[2]				
Stock of residential mortgages	52.2	74.0	72.6	55.9
New residential lending	61.4	65.8	n/a	62.1
Impaired mortgages	72.0	99.8	88.0	78.4

[1] Specialist lending is closed to new business and is in run-off.

[2] Average loan to value is calculated as total loans and advances as a percentage of the total collateral of these loans and advances.

Unsecured

The impairment charge on unsecured loans and advances to customers reduced by £614 million in 2012 to £893 million compared with 2011. The impairment charge as a percentage of annualised average loans and advances to customers decreased to 3.74 per cent in 2012 from 5.65 per cent in 2011.

A combination of reduced demand from customers for new unsecured borrowing and existing customers continuing to reduce their personal indebtedness contributed to loans and advances to customers reducing by £2,066 million since 31 December 2011 to £22,698 million at 31 December 2012.

Impaired loans decreased by £371 million since 31 December 2011 to £1,999 million at 31 December 2012 which represented 8.8 per cent of closing loans and advances to customers, compared with 9.6 per cent at 31 December 2011. The reduction in impaired loans is a result of the Group's sustainable risk appetite and ongoing effective portfolio management. Retail's exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers' changing financial circumstances.

Impairment provisions decreased by £348 million, compared with 31 December 2011. This reduction was driven by fewer assets entering arrears and recoveries assets being written down to the present value of future expected cash flows. Impairment provisions as a percentage of impaired loans in collections decreased to 82.6 per cent at 31 December 2012 from 86.5 per cent at 31 December 2011.

RISK MANAGEMENT

Credit Risk – Commercial Banking

Overview

- Impairment charges were £2,946 million in 2012, down from £4,210 million in 2011. The decrease in the underlying impairment charge was primarily driven by lower charges in Australasia and in Acquisition Finance. The reduction was partly offset by further deterioration in the Shipping portfolio as a result of weak markets.
- The fall in the impairment charge reflects generally stable obligor credit quality overall, with the low interest rate environment helping to maintain defaults at a lower level, despite weaker consumer confidence in a number of sectors. The credit risk appetite approach is through the cycle helping to ensure that new business written is of good quality.
- Core impairment charges as an annualised percentage of average loans and advances to customers reduced to 0.67 per cent compared to 0.95 per cent at 31 December 2011.
- Forbearance is well controlled and managed, and any such cases are quickly identified and managed appropriately under the Group's Credit Risk Classification framework. The value of assets transferring into the Business Support Unit (BSU) has reduced by 37 per cent during 2012.
- As a percentage of total loans and advances to customers, non-core loans and advances reduced to 28 per cent at 31 December 2012 (2011: 35 per cent). As a percentage of total impaired loans, non-core impaired loans reduced to 75 per cent (2011: 80 per cent).

Table 1.19: **Commercial Banking impairment charge (unaudited)**

	2012 £m	2011 £m	Change during 2012 %
Core	704	1,055	33
Non-core	2,242	3,155	29
Total impairment charge	2,946	4,210	30
(unaudited)			
Core impairment charge as a % of average advances	0.67%	0.95%	(28)bp
Non-core impairment charge as a % of average advances	4.28%	4.60%	(32)bp
Impairment charge as a % of average advances	1.85%	2.32%	(47)bp

Impairment charges have decreased 30 per cent compared with 2011 driven by lower charges in Australasia and leveraged lending in Acquisition Finance, which was partly offset by further deterioration in the Shipping portfolio as a result of weak markets. The low interest rate environment is helping to maintain defaults at a lower level.

Core impairments in 2012 were 33 per cent lower compared to 2011. This is primarily attributable to lower impairments in some core portfolios, including in Mid Markets, Corporate and SME. In Mid Markets and Corporate, there were specific large impairments in 2011, which were not repeated in 2012.

As a result, core impairment charges as an annualised percentage of average loans and advances to customers reduced to 0.67 per cent compared to 2011 (0.95 per cent).

Non-core impairments were also lower, driven mainly by lower charges on non-core Acquisition Finance and Australasian exposures, partially offset by further deterioration in the Shipping portfolio due to a weak market. There was a significant deterioration in the leveraged market during the first half of 2011 which has not been repeated during 2012. A significant portion of the Australasian impaired portfolio was disposed of in 2011 and 2012, and the residual portfolio is considered better quality.

Impaired loans and provisions

The overall quality of the Commercial Banking portfolio continues to improve. Despite a reducing portfolio, as a percentage of closing loans and advances to customers, impaired loans decreased to 16.6 per cent from 19.5 per cent at 31 December 2011.

Commercial Banking's impaired loans reduced by £9,152 million to £23,965 million compared with 31 December 2011. The reduction is due to write-offs on irrecoverable assets, the sale of previously impaired assets, net repayments and transfers out of Business Support Unit more than offsetting the flow of newly impaired assets into Business Support Unit. Furthermore, the flow of assets into impaired status was lower during 2012 compared to 2011.

Impairment provisions as a percentage of impaired loans increased to 41.7 per cent from 41.3 per cent at 31 December 2011 as Business Support Unit was successful in selling a number of impaired assets which generally had lower coverage levels. The Business Support Unit portfolio continues to reduce as a result of robust and proactive risk management.

Core impaired loans reduced by £807 million to £5,907 million compared with 31 December 2011. This arose from a number of factors, including the sale of previously impaired assets. An increase in the core coverage ratio to 48.5 per cent from 47.3 per cent at 31 December 2011 was seen as a result of a few specific cases. As a percentage of closing core advances, core impaired loans reduced to 5.6 per cent compared to 6.1 per cent at 31 December 2011.

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Non-core impaired loans reduced by £8,345 million to £18,058 million compared with 31 December 2011. The reduction reflects write offs and asset sales of previously impaired assets partly offset by new to impaired loans, especially in Corporate Real Estate Business Support Unit as a result of the Group's proactive stance to ensure its secondary real estate portfolio is appropriately managed. Non-core impairment provisions as a percentage of non-core impaired loans reduced marginally to 39.4 per cent from 39.8 per cent at 31 December 2011. A reduction was also seen in Corporate Real Estate BSU (36.7 per cent compared to 37.0 per cent at 31 December 2011), due to the high level of provision coverage on previously impaired assets which were either sold or written-off during 2012, and a lower impairment rate on newly impaired assets, although this was offset partially by additional charges on previously impaired assets. As a percentage of closing non-core advances, impaired loans increased to 45.3 per cent from 43.9 per cent at 31 December 2011. The increase was driven by Corporate Real Estate BSU, with weak market conditions resulting in existing Corporate Real Estate BSU managed unimpaired connections transferring to impaired status.

Non-core impairment provisions as a percentage of non-core impaired assets are lower than core, mainly a factor of the asset mix, where the non-core portfolios are heavily weighted towards real estate and real estate related portfolios with higher collateral levels against lending.

Table 1.20: **Impairments on loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Commercial	**30,443**	**2,713**	**8.9**	**826**	**30.4**
Wholesale	**114,327**	**21,252**	**18.6**	**9,158**	**43.1**
Total Commercial Banking	**144,770**	**23,965**	**16.6**	**9,984**	**41.7**
Reverse repos	**5,087**				
Impairment provisions	**(9,984)**				
Fair value adjustments	**(131)**				
Total	**139,742**				
Loans and advances to banks	**7,580**				
Debt securities	**5,261**				
Available-for-sale financial assets	**4,345**				
At 31 December 2011					
Commercial	29,681	2,915	9.8	880	30.2
Wholesale	140,283	30,202	21.5	12,813	42.4
Total Commercial Banking	169,964	33,117	19.5	13,693	41.3
Reverse repos	16,836				
Impairment provisions	(13,693)				
Fair value adjustments	(668)				
Total	172,439				
Loans and advances to banks	8,461				
Debt securities	12,490				
Available-for-sale financial assets	12,554				

[1] Includes collective unimpaired provisions of £894 million (2011: £1,213 million).

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Table 1.21: **Impairments on loans and advances – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Commercial	**29,357**	**2,680**	**9.1**	**814**	**30.4**
Wholesale	**75,510**	**3,227**	**4.3**	**2,052**	**63.6**
Total Commercial Banking	**104,867**	**5,907**	**5.6**	**2,866**	**48.5**
Reverse repos	**5,087**				
Impairment provisions	**(2,866)**				
Fair value adjustments	**–**				
Total core	**107,088**				
Loans and advances to banks	**7,132**				
Debt securities	**536**				
Available-for-sale financial assets	**1,818**				
At 31 December 2011					
Commercial	28,289	2,885	10.2	858	29.7
Wholesale	81,520	3,829	4.7	2,317	60.5
Total Commercial Banking	109,809	6,714	6.1	3,175	47.3
Reverse repos	16,836				
Impairment provisions	(3,175)				
Fair value adjustments	(60)				
Total core	123,410				
Loans and advances to banks	8,161				
Debt securities	190				
Available-for-sale financial assets	3,154				

[1] Includes collective unimpaired provisions of £545 million (31 December 2011: £637 million).

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Table 1.22: **Impairments on loans and advances – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Corporate Real Estate BSU[1]	**15,701**	**12,060**	**76.8**	**4,424**	**36.7**
Specialised Lending	**15,018**	**2,679**	**17.8**	**1,135**	**42.4**
Other	**9,184**	**3,319**	**36.1**	**1,559**	**47.0**
Total Commercial Banking[2]	**39,903**	**18,058**	**45.3**	**7,118**	**39.4**
Reverse repos	**–**				
Impairment provisions	**(7,118)**				
Fair value adjustments	**(131)**				
Total non-core	**32,654**				
Loans and advances to banks	**448**				
Debt securities	**4,725**				
Available-for-sale financial assets	**2,527**				
At 31 December 2011					
Corporate Real Estate BSU[1]	21,055	15,069	71.6	5,579	37.0
Specialised Lending	20,387	4,822	23.7	1,615	33.5
Other	18,713	6,512	34.8	3,324	51.0
Total Commercial Banking	60,155	26,403	43.9	10,518	39.8
Reverse repos	–				
Impairment provisions	(10,518)				
Fair value adjustments	(608)				
Total non-core	49,029				
Loans and advances to banks	300				
Debt securities	12,300				
Available-for-sale financial assets	9,400				

[1] Corporate Real Estate BSU includes direct real estate and other real estate related sectors (such as hotels, care homes and housebuilders).

[2] Includes collective unimpaired provisions of £349 million (2011: £576 million).

Core

Commercial

The Commercial portfolio credit quality remains stable and impairment charges have fallen over the last 12 months to £252 million in 2012 from £296 million in 2011. The decrease reflects the continued benefits of the low interest rate environment, which has helped to maintain defaults at a lower level, and the continued application of the Group's prudent risk appetite and through the cycle credit policy that has proven itself appropriate for both customers and the Group.

Supporting its clients through the cycle remains a key aim and the Group continues to operate control and monitoring activities which play an important role in identifying customers showing early signs of financial stress and bringing them into the Group's support model so prompt and supporting actions can be taken.

Wholesale

Overall obligor quality remains stable, and impairment charges reduced over the last 12 months to £452 million in 2012 from £759 million in 2011.

The £75,510 million of gross loans and advances to customers in the Wholesale core portfolio is structured across a number of different coverage segments delivered via a suite of core banking products from Lending and Transaction Banking to Financial Markets and Capital Markets. These include:

Mid Markets – The businesses are predominantly UK focused and several sectors have continued to face challenging trading conditions in the face of domestic economic performance, weak consumer sentiment and public sector austerity measures. The Retail, Leisure, Construction and Care sectors have shown the most evident stress, although there is wide disparity between the performance of the stronger and weaker businesses in each of these areas. The Group's through the cycle risk appetite has helped ensure that the portfolio quality has remained relatively stable.

RISK MANAGEMENT

Global Corporates – The core portfolio continues to be predominantly investment grade focused, the overall portfolio asset quality remains strong and Major Corporate balance sheets continue to de-lever. This year has seen a limited number of mergers and acquisitions. These are being selectively targeted by Corporates, with conservative structuring approaches being adopted, and subsequent focus on rapid de-leveraging. The Group continues to see softness in sectors such as Media, Retail, Leisure and Construction across the UK and Continental Europe. Public sector austerity continues to impact on recovery prospects, although the long lead-in times to these cuts have allowed Corporates to adjust their own structures and cost bases.

Financial Institutions (FIs) – Commercial Banking maintains relationships with many major financial institutions throughout the world. These relationships are either client focused or held to support the Group's funding, liquidity and general hedging requirements. Trading exposures continue to be predominantly short-term and/or collateralised with inter bank activity mainly undertaken with strong investment grade counterparties. The Eurozone crisis continued during 2012 and continues to require very close portfolio scrutiny and oversight. Detailed contingency plans are in place and continuously refined, whilst exposures to FIs domiciled in peripheral Eurozone countries in particular have been further reduced and are being managed within tight risk parameters.

Acquisition Finance (leveraged lending) – The Group's core portfolio is performing in line with expectations given the economic environment. Many customers are prepaying facilities ahead of schedule. The portfolio is predominantly within the good book business and all such loans are performing. The Group continues to write new business within its through the cycle credit risk appetite parameters.

Project Finance – Principally focuses on lending to large scale UK Infrastructure. The good book accounts for over 95 per cent of the portfolio which is representative of the quasi government cashflow or monopolistic nature of the assets. Good book assets are performing well and have shown resilience to economic cyclicality.

Sales and Trading – Acts as the link between the wholesale markets and the Group's balance sheet management activities providing pricing and risk management solutions to both internal and external clients. The portfolio comprises £5.8 billion of loans and advances to banks, £1.7 billion of available-for-sale debt securities and £2.8 billion of loans and advances to customers (excluding reverse repos). Sales and Trading actively manages the government bond portfolio which is now almost solely AAA/AA rated. Exposure to the weaker Eurozone sovereigns has been managed down to a de minimis level given continued concerns over market conditions across the Eurozone.

The majority of Sales and Trading's funding and risk management activity is transacted with investment grade counterparties including Sovereign central banks and much of it is on a collateralised basis, such as repos facing a Central Counterparty (CCP). Derivative transactions with FI counterparties are typically collateralised under a credit support annex in conjunction with the International Swaps and Derivatives Association Master Agreement. During 2012 the Group continued to consolidate its counterparty risk via CCPs as part of an ongoing move to reduce counterparty risk by clearing standardised derivative contracts.

Non-core

Corporate Real Estate Business Support Unit (BSU)

Strong progress has been maintained in reducing the non-core Corporate Real Estate BSU portfolio with the gross loans and advances falling to £15.7 billion (2011: £21.1 billion) which is ahead of expectations. This is primarily due to the momentum on asset disposals which totalled around £4 billion (net cash proceeds) in the year despite the declining volume of transactions in the regional markets. There has been a material reduction in the level of gross loans and advances through disposals (including write-offs) since 30 June 2009. The full year non-core Corporate Real Estate BSU impairment charge has continued its downward trend to £1.2 billion (2011: £1.3 billion) despite the difficult market conditions.

Over 75 per cent of the non-core Corporate Real Estate BSU portfolio consists of distressed or sub standard direct real estate loans. The remainder relates to loans to other real estate related sectors, supported by trading activities (such as housebuilders, hotels and care homes), with assets managed by specialist teams.

The portfolio remains regionally focused with real estate asset quality that is largely secondary and tertiary in nature. However, these assets have been the subject of significant and frequent review, and have been impaired to appropriate levels.

The profile of the Group's portfolio allows the Group flexibility to consider asset disposal, loan sales or repayments through the now embedded property asset management platforms and has allowed the Group to attract liquidity from different counterparties in a demanding environment. Over the last three years Corporate Real Estate BSU has reduced non-core gross loan exposure by approximately £21 billion. In 2012, disposals outside London accounted for over 70 per cent of Corporate Real Estate BSU's disposals by value and over 90 per cent by number. This is higher than the general market experience.

Corporate Real Estate BSU has continued to execute its active asset management programme of this complex portfolio making strong progress in a difficult real estate market. The principal aim is to minimise losses for the Group and to support the Group's clients through difficult periods. This activity can involve the restructuring of loans, seeking deleverage through asset sales and other sale initiatives. A consensual route with its clients is always the Group's preferred option.

Values in the Commercial Real Estate market have trended downwards over the last 12 months, falling on average by 4.2 per cent on the same period last year. Investment volumes have by and large been steady, though investor appetite has been concentrated on London. Although values in London continue to climb and are 39 per cent above their 2009 trough, non-London asset values are struggling and are now only 5 per cent above their 2009 trough. With a continuing high level of loan maturities due over the next few years, refinancing risk remains a market wide risk, although loans in non-core BSU are predominantly bilateral. In assessing the Group's impairment provisions, allowance is taken for the Group's greater proportion of secondary real estate assets. Consequently a steeper fall in real estate prices, compared to the general market index expectations, is used to calculate impairment provisions.

Specialised Lending

Loans and advances to customers of £15.0 billion largely comprise balances in the Structured Corporate Finance portfolio, which includes the portion of the Acquisition Finance (leveraged lending) portfolio which falls into non-core since it is outside the Group's risk appetite, and the non-core Asset Based Finance portfolios (Ship Finance, Aircraft Finance and Rail Capital). While the effects of subdued UK economic conditions and refinancing risk continues to be felt in this portion of the Acquisition Finance portfolio, the non-core portfolio is now smaller in size and has a generally lower risk profile than in previous reporting periods which led to a significantly lower impairment charge during 2012 compared to 2011.

The non-core Acquisition Finance portfolio is approximately 75 per cent managed in Business Support Unit reflecting its relatively high risk parameters, with significant loan maturities due in the next few years. In Ship Finance, the tankers, dry bulk and containers sectors remained challenging in 2012. The Ship Finance portfolio is non-core and as such projects have been successfully completed to accelerate exits when deemed in the best interest of the Group with further planning at an advanced stage to facilitate early exits where opportunities arise during 2013. In December 2012, the Group sold its Rail Finance rolling stock operating lease businesses and made a managed disposal of some of its US aircraft exposure. These reduced the Group's non-core assets and eliminated the operational and residual value risk related to these assets.

Specialised Lending also includes a small non-core equity business and a significantly reduced Treasury Assets portfolio. Following a number of material disposals during 2012, the non-core drawn assets representing equity risk now only totals £0.7 billion. The Treasury Asset legacy investment portfolio mainly encompasses a portfolio of asset-backed securities and financial institution Covered Bond positions. This portfolio size continues to be actively reduced through asset sales and from bond maturities. Further details of Commercial Banking's asset-backed securities portfolio is provided in note 55 on page 334.

Other

Loans and advances to customers of £9.2 billion largely comprise balances in non-core Australian Corporate (£2.3 billion), Wholesale Europe (£2.2 billion) and Entrepreneurs (£2.0 billion) businesses. The Group significantly reduced its exposure and impaired assets in its Australasian business by £3.4 billion and £2.2 billion respectively during 2012, largely due to asset sales including the successful disposal of a £0.8 billion portfolio of impaired Australasian real estate loans. Net Corporate Real Estate exposure in Australia now only totals £0.1 billion as at 31 December 2012 (2011: £1.3 billion). The Group was also successful in reducing its Wholesale Europe non-core exposure during 2012, with disposals of £0.4 billion in the period.

Secured loan to value analysis for UK Direct Real Estate lending in Commercial Banking

The Group classifies Direct Real Estate as exposure which is directly supported by cashflows from property activities, as opposed to trading activities (such as hotels, care homes and housebuilders). The Group manages its exposures to Direct Real Estate in a number of different business units.

UK Direct Real Estate in the Good Book – The Group's good book exposure incorporates core and non-core, and totalled £18.0 billion at 31 December 2012. Approximately three quarters related to commercial real estate with the remainder mostly residential real estate. A large element of the residential exposure is to professional landlords in the Group's SME business, where performance has been good. The entire good book portfolio has been fully reviewed and is performing acceptably. Approximately two thirds of the core commercial real estate portfolio was originated under heritage Lloyds TSB credit risk criteria. The Group's risk appetite requires it to look first at the underlying cashflows as part of credit assessment, alongside key requirements for good quality counterparties and a well spread tenant profile. The Group considers the value in security taken as a secondary repayment source, although its origination parameters for LTVs (based on heritage Lloyds TSB risk appetite) are considered through the cycle.

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UK Direct Real Estate in Business Support Units – The Group's Business Support Unit portfolios consist of £12.7 billion gross (£8.8 billion net of impairment) of UK Direct Real Estate loan exposure at 31 December 2012. This incorporates both core and non-core UK direct real estate exposure.

Loan to value ratios (indexed or actual if within last 12 months) for the Group's largest transactions (over £5 million) are detailed in the table below. The Group considers this portfolio to be appropriately provided for after taking into account the provisions held for each transaction and the value of the collateral held. In the case of impaired UK Direct Real Estate exposures (over £5 million) there is a net property collateral shortfall of approximately £0.2 billion. This figure excludes benefits of credit mitigants such as cross collateralisation and cross guarantees. For the good book, unsecured and over 100 per cent LTV lending mainly comprises lending supported by either the strength of the obligors' balance sheet or a strong parent. The Group makes use of a variety of methodologies to assess the value of property collateral, where external valuations are not available. These include use of market indexes, models and subject matter expert judgement.

Table 1.23: **LTV – UK Direct Real Estate (unaudited)**

	Good Book Loans and advances (gross)		Business Support Loans and advances (gross)	
	2012 £m	2012 %	2012 £m	2012 %
Exposures > £5 million:				
Less than 60%	3,536	42	402	4
61% to 70%	1,891	22	308	3
71% to 80%	1,738	21	495	5
81% to 100%	351	4	2,690	26
101% to 125%	229	3	1,546	15
More than 125%	23	–	4,362	43
Unsecured	677	8	431	4
	8,445	100	10,234	100
Exposures < £5 million	9,591		2,474	
Total	18,036		12,708	

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Credit Risk – Wealth, Asset Finance and International

Overview

- In 2012 Wealth, Asset Finance and International impairment charges fell significantly compared to 2011 predominantly reflecting reductions in the Ireland (wholesale and retail) portfolio.
- In the Irish wholesale portfolio, 85.2 per cent (2011: 84.3 per cent) is now impaired with a coverage ratio of 68.0 per cent (2011: 61.1 per cent), primarily reflecting continued deterioration in the Irish commercial property market. Net exposure in Ireland wholesale has reduced to £5.4 billion (2011: £8.6 billion).
- In the Irish retail mortgage portfolio, impairment provisions as a percentage of impaired loans increased to 71.2 per cent (2011: 70.4 per cent).

Table 1.24: **Impairment charge (audited)**

	2012 £m	2011 £m	Change %
Wealth	**23**	33	30
International:			
Ireland retail	**108**	511	79
Ireland wholesale	**1,137**	2,676	58
Spain retail	**51**	59	14
Netherlands retail	**23**	21	(10)
Asia retail	**35**	7	
Latin America and Middle East	**(33)**	65	
	1,321	3,339	60
Asset Finance:			
United Kingdom	**121**	200	40
Australia	**15**	32	53
	136	232	41
Total impairment charge	**1,480**	3,604	59
Impairment charge as a % of average advances	3.12%	6.48%	(3.36)pp

Table 1.25: **Impairment charge – core (unaudited)**

	2012 £m	2011 £m	Change %
Wealth	**23**	33	30
International	**–**	–	
Asset Finance	**(1)**	–	
Core impairment charge	**22**	33	33
Core impairment charge as a % of average advances	0.45%	0.60%	(15)bp

Table 1.26: **Impairment charge – non-core (unaudited)**

	2012 £m	2011 £m	Change %
Wealth	**–**	–	
International	**1,321**	3,339	60
Asset Finance	**137**	232	41
Non-core impairment charge	**1,458**	3,571	59
Non-core impairment charge as a % of average advances	3.42%	7.11%	(3.69)pp

RISK MANAGEMENT

Impaired loans and provisions

Total impaired loans decreased by £4,322 million to £14,008 million compared with £18,330 million at 31 December 2011 and as a percentage of closing loans and advances to customers decreased to 32.6 per cent from 35.6 per cent at 31 December 2011. This is primarily driven by reductions in Ireland wholesale.

Impairment provisions as a percentage of impaired loans increased to 67.5 per cent from 61.7 per cent at 31 December 2011. The increase was driven by the International portfolios.

Table 1.27: **Impairments on loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Wealth	**4,325**	**284**	**6.6**	**73**	**25.7**
International:					
Ireland retail	**6,656**	**1,534**	**23.0**	**1,111**	**72.4**
Ireland wholesale	**12,875**	**10,967**	**85.2**	**7,463**	**68.0**
Spain retail	**1,458**	**104**	**7.1**	**94**	**90.4**
Netherlands retail	**5,689**	**79**	**1.4**	**41**	**51.9**
Asia retail	**1,978**	**80**	**4.0**	**46**	**57.5**
Latin America and Middle East	**46**	**36**	**78.3**	**31**	**86.1**
	28,702	**12,800**	**44.6**	**8,786**	**68.6**
Asset Finance:					
United Kingdom	**5,848**	**885**	**15.1**	**541**	**61.1**
Australia	**4,052**	**39**	**1.0**	**53**	
	9,900	**924**	**9.3**	**594**	**64.3**
	42,927	**14,008**	**32.6**	**9,453**	**67.5**
Impairment provisions	**(9,453)**				
Fair value adjustments	**(28)**				
Total	**33,446**				
At 31 December 2011					
Wealth	4,865	231	4.7	74	32.0
International:					
Ireland retail	7,036	1,415	20.1	1,034	73.1
Ireland wholesale	17,737	14,945	84.3	9,133	61.1
Spain retail	1,604	99	6.2	63	63.6
Netherlands retail	6,259	62	1.0	30	48.4
Asia retail	2,180	55	2.5	18	32.7
Latin America and Middle East	612	211	34.5	144	68.2
	35,428	16,787	47.4	10,422	62.1
Asset Finance:					
United Kingdom	7,162	1,217	17.0	746	61.3
Australia	4,051	95	2.3	65	68.4
	11,213	1,312	11.7	811	61.8
	51,506	18,330	35.6	11,307	61.7
Impairment provisions	(11,307)				
Fair value adjustments	(42)				
Total	40,157				

[1] Impairment provisions include collective unimpaired provisions.

Table 1.28: **Impairments on loans and advances – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Wealth	**4,325**	**284**	**6.6**	**73**	**25.7**
International	**–**	**–**		**–**	
Asset Finance	**1,090**	**67**	**6.1**	**12**	**17.9**
	5,415	**351**	**6.5**	**85**	**24.2**
Impairment provisions	**(85)**				
Fair value adjustments	**–**				
Total core	**5,330**				
At 31 December 2011					
Wealth	4,865	231	4.7	74	32.0
International	133	14	10.5	4	28.6
Asset Finance	245	95	38.8	25	26.3
	5,243	340	6.5	103	30.3
Impairment provisions	(103)				
Fair value adjustments	–				
Total core	5,140				

[1] Impairment provisions include collective unimpaired provisions.

Table 1.29: **Impairments on loans and advances – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Wealth	**–**	**–**		**–**	
International	**28,702**	**12,800**	**44.6**	**8,786**	**68.6**
Asset Finance	**8,810**	**857**	**9.7**	**582**	**67.9**
	37,512	**13,657**	**36.4**	**9,368**	**68.6**
Impairment provisions	**(9,368)**				
Fair value adjustments	**(28)**				
Total non-core	**28,116**				
At 31 December 2011					
Wealth	–	–		–	
International	35,295	16,773	47.5	10,418	62.1
Asset Finance	10,968	1,217	11.1	786	64.6
	46,263	17,990	38.9	11,204	62.3
Impairment provisions	(11,204)				
Fair value adjustments	(42)				
Total non-core	35,017				

[1] Impairment provisions include collective unimpaired provisions.

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Wealth

Total impaired loans increased by £53 million to £284 million compared with £231 million at 31 December 2011. Impairment provisions as a percentage of closing loans and advances decreased to 25.7 per cent from 32.0 per cent at 31 December 2011. The impairment charge for 2012 was £23 million. The impairment charge, as an annualised percentage of average loans and advances to customers, decreased to 0.51 per cent compared with 0.67 per cent in 2011.

International

Ireland

Total impaired loans decreased by £3,859 million, or 24 per cent to £12,501 million compared with £16,360 million at 31 December 2011. The reduction is driven primarily by Commercial Real Estate and Corporate loans. Impaired loans as a percentage of closing loans and advances decreased to 64.0 per cent from 66.0 per cent at 31 December 2011. Continuing weakness in the Irish real estate markets resulted in a further increase in Ireland wholesale coverage in 2012 to 68.0 per cent from 61.1 per cent.

Impairment charges decreased by £1,942 million to £1,245 million compared to 2011 as the rate of increase in newly impaired loans fell during 2012. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 5.53 per cent from 11.93 per cent in 2011.

Table 1.30: **Impairments on Ireland loans and advances (audited)**

	2012			2011		
	Loans and advances to customers £m	Impaired loans £m	Provisions £m	Loans and advances to customers £m	Impaired loans £m	Provisions £m
Commercial Real Estate	**7,408**	**6,720**	**4,695**	10,872	9,807	6,194
Corporate	**5,467**	**4,247**	**2,768**	6,865	5,138	2,939
Retail	**6,656**	**1,534**	**1,111**	7,036	1,415	1,034
Total Ireland	**19,531**	**12,501**	**8,574**	24,773	16,360	10,167

The most significant contribution to impairment in Ireland is the Commercial Real Estate portfolio. Within the Commercial Real Estate portfolio, 90.7 per cent of the portfolio is now impaired (compared to 90.2 per cent at 31 December 2011). The average impairment coverage ratio has increased in the year to 69.9 per cent (63.2 per cent at 31 December 2011) reflecting the continued deterioration in the Irish commercial property market. Mortgage lending at 31 December 2012 comprised 99.5 per cent of the retail portfolio with impairment coverage on the mortgage portfolio at 71.2 per cent (2011: 70.4 per cent). Impaired loans on the retail portfolio increased by £119 million in 2012 compared to a £545 million increase in 2011. The reduction in growth of impaired loans is primarily due to a less uncertain economic environment.

The Group continued to reduce its exposure to Ireland. Gross loans and advances reduced by £5,242 million during 2012 mainly due to write-offs of £2.5 billion, disposals of £1.4 billion and net repayments of £0.7 billion.

£1,413 million of gross wholesale lending within the Commercial Real Estate and Corporate portfolios relates to sterling loans secured on UK property.

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Secured loan to value analysis for Commercial Real Estate lending in Ireland Wholesale

Loan to value ratios (indexed or actual if within last 18 months) for the Group's largest transactions (over €5 million) are detailed in the table below. The Group considers this portfolio to be appropriately provided for after taking into account the provisions held for each transaction and the value of the collateral held. In the case of impaired Ireland commercial real estate exposures (over €5 million) there is a net property collateral shortfall of approximately £0.3 billion. This figure excludes benefits of credit mitigants such as cross collateralisation and cross guarantees. As a result of the market environment, market-based information on valuations is limited. The Group therefore makes use of a variety of methodologies to assess the value of property collateral. These include use of market indexes, models and subject matter expert judgement.

Table 1.31: **LTV – Ireland Wholesale Commercial Real Estate**

	Loans and advances (gross)	
	2012 £m	2012 %
Exposures > €5 million:		
Less than 60%	119	2
61% to 70%	20	–
71% to 80%	27	–
81% to 100%	165	3
101% to 125%	182	3
More than 125%	4,927	81
Unsecured	674	11
	6,114	100
Exposures < €5 million	1,294	
Total	7,408	

Other International

Total impaired loans decreased by £128 million to £299 million compared with £427 million at 31 December 2011 and as a percentage of closing loans and advances decreased to 3.3 per cent from 4.0 per cent at 31 December 2011. The reduction in impaired loans is driven by Latin America and Middle East. Impairment provisions as a percentage of impaired loans have increased in Spain Retail, Netherlands Retail and Asia Retail, against a backdrop of falling residential property prices.

Asset Finance

United Kingdom – the UK Asset Finance impairment charge reduced by 40 per cent to £121 million (of which 100 per cent related to non-core assets) driven by strong credit management and improving credit quality. The retail portfolio saw more customers meeting their payment arrangements resulting in a lower proportion of people falling into arrears. The retail impairments also benefited from debt sale activity during the course of the year. The number of defaults in all areas of the commercial and corporate lending book was low relative to the last three years, reflecting effective previous and ongoing credit risk management actions.

Australia – Impaired loans decreased by £56 million to £39 million compared with £95 million at 31 December 2011 and as a percentage of closing loans and advances decreased to 1.0 per cent from 2.3 per cent at 31 December 2011. The impairment charge has also reduced materially by 53 per cent to £15 million. The Asset Finance business continues to benefit from strong credit management and improving credit quality supported by a resilient Australian economy.

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Exposures to Eurozone countries

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2012. The exposures comprise on-balance sheet exposures based on their balance sheet carrying values and off-balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

The Group manages its exposures to individual countries through authorised country limits which take into account economic, financial, political and social factors. In addition, the Group manages its direct risks to the selected countries by establishing and monitoring risk limits for individual banks, financial institutions, corporates and individuals.

Identified indirect exposure information is also taken into account when setting limits and determining credit risk appetite for individual counterparties. This forms part of the Group's credit analysis undertaken at least annually for counterparty and sector reviews, with interim updates performed as necessary. Interim updates would usually be triggered by specific credit events such as rating downgrades, sovereign events or other developments such as spread widening. Examples of indirect risk which have been identified are: European banking groups with lending and other exposures to certain Eurozone countries; corporate customers with operations or significant trade in certain European jurisdictions; major travel operators known to operate in certain Eurozone countries; and international banks with custodian operations based in certain European locations.

The Group Financial Stability Forum has been established in order to monitor developments within the Eurozone, carry out stress testing through detailed scenario analysis and complete appropriate due diligence on the Group's exposures.

The Group Financial Stability Forum has carried out a number of scenario analyses and rehearsals to test the Group's resilience in the event of further instability in certain Eurozone countries. The Group has developed and refined pre-determined action plans that would be executed in such scenarios. The plans set out governance requirements and responsibilities for the key actions which would be carried out and cover risk areas such as payments, liquidity and capital, communications, suppliers and systems, legal, credit, delivery channels and products, employees and the impact on customers.

The Group has included certain amounts on a net basis to better reflect the overall risk to which the Group is exposed. The gross IFRS reported values for the exposures to Ireland, Spain, Portugal, Greece and Italy are detailed in the following tables. Derivative balances are included within exposures to financial institutions or corporates, as appropriate, at fair value adjusted for master netting agreements at obligor level and net of cash collateral in line with legal agreements. Exposures in respect of reverse repurchase agreements are included on a gross IFRS basis and are disclosed based on the counterparty rather than the collateral (repos and stock lending are excluded); reverse repurchase exposures are not, therefore, reduced as a result of collateral held. Exposures to central clearing counterparties are shown net.

For multi-country asset backed securities exposures, the Group has reported exposures based on the largest country exposure. The country of exposure for asset backed securities is based on the location of the underlying assets, which are predominantly residential mortgages, not on the domicile of the issuer.

During the year, the Group drew €13.5 billion (the Sterling equivalent of which at the date of drawdown was £11.2 billion) under the European Central Bank's Long-Term Refinancing Operation facility for an initial term of three years, to part fund a pool of non-core euro denominated assets.

Exposures to Ireland, Spain, Portugal, Greece and Italy

The Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries.

Table 1.32: **Eurozone exposures (unaudited)**

	Sovereign debt		Financial Institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance assets £m	Total £m
At 31 December 2012									
Ireland	**–**	**–**	**115**	**644**	**305**	**5,972**	**5,559**	**111**	**12,706**
Spain	**5**	**14**	**1,170**	**7**	**132**	**2,110**	**1,472**	**25**	**4,935**
Portugal	**–**	**–**	**118**	**–**	**224**	**187**	**10**	**–**	**539**
Greece	**–**	**–**	**–**	**–**	**–**	**277**	**–**	**–**	**277**
Italy	**5**	**–**	**44**	**–**	**10**	**150**	**–**	**37**	**246**
	10	**14**	**1,447**	**651**	**671**	**8,696**	**7,041**	**173**	**18,703**
At 31 December 2011									
Ireland	–	–	207	272	376	8,894	6,027	68	15,844
Spain	17	35	1,692	7	375	2,955	1,649	39	6,769
Portugal	–	–	142	8	341	309	11	–	811
Greece	–	–	–	–	55	431	–	–	486
Italy	16	–	433	17	39	152	–	47	704
	33	35	2,474	304	1,186	12,741	7,687	154	24,614

Derivatives with sovereigns and sovereign referenced credit default swaps are insignificant. Included within exposures to banks, and treated as available-for-sale assets, are covered bonds of £1.1 billion (2011: £1.7 billion). The covered bonds are ultimately secured on a pool of mortgage assets in the countries concerned and benefit from over-collateralisation, with an overall weighted maturity of approximately four years. Exposures to other financial institutions relate primarily to balances held within insurance companies and funds. No impairments are held against these exposures.

At 31 December 2012, the Group's total gross derivative asset exposure to counterparties registered in the above countries was £754 million (2011: £775 million), offset by derivative liabilities of £278 million (2011: £204 million) and cash collateral held of £152 million (2011: £191 million). Within the following detailed tables, derivative assets are included within the carrying value column, and derivative liabilities and cash collateral are included within the netting column.

Assets held by the Insurance business are shareholder assets and are held outside the with-profits and unit-linked funds. Approximately £106 million (2011: £127 million) of these exposures relate to direct investments where the issuer is resident in Ireland, Spain, Portugal, Greece or Italy and the credit rating is consistent with the tight credit criteria defined under the appropriate investment mandate. The remaining exposures relate to interests in two funds domiciled in Ireland and administered by Scottish Widows Investment Partnership (the Global Liquidity Fund and the Short-Term Fund) where in line with the investment mandates, cash is invested in the money markets. For these funds, the exposure is analysed on a look through basis to the underlying assets held and the Insurance business' pro rata share of these assets rather than treating all the holding in the fund as exposure to Ireland. Within the above exposures there are no sovereign exposures.

The Group continued to reduce its exposure to these countries and exposures have been proactively managed down in line with its risk appetite. The Group's total exposure has reduced 24 per cent from £24,614 million to £18,703 million.

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Table 1.33: **Ireland exposures (unaudited)**

	31 December 2012			31 December 2011		
	Carrying value £m	Netting £m	Net £m	Carrying value £m	Netting £m	Net £m
Sovereign debt	–	–	–	–	–	–
Financial institutions – banks:						
Amortised cost	47	–	47	46	–	46
Net trading assets	7	–	7	–	–	–
Available-for-sale	53	–	53	136	–	136
Derivatives	188	(180)	8	216	(191)	25
	295	(180)	115	398	(191)	207
Financial institutions – other:						
Amortised cost	557	–	557	255	–	255
Net trading assets	86	–	86	5	–	5
Derivatives	4	(3)	1	12	–	12
	647	(3)	644	272	–	272
Asset backed securities:						
Amortised cost	216	–	216	221	–	221
Available-for-sale	89	–	89	155	–	155
	305	–	305	376	–	376
Corporate:						
Amortised cost	5,400	–	5,400	7,949	–	7,949
Derivatives	39	(1)	38	32	(1)	31
Off balance sheet exposures	534	–	534	914	–	914
	5,973	(1)	5,972	8,895	(1)	8,894
Personal:						
Amortised cost	5,559	–	5,559	6,027	–	6,027
Insurance assets	111	–	111	68	–	68
Total	12,890	(184)	12,706	16,036	(192)	15,844

The Group held impairment provisions of £6,597 million (2011: £7,961 million) against corporate amortised cost exposures and £1,111 million (2011: £1,034 million) against personal amortised cost exposures. £34 million (2011: £170 million) was included in reserves in respect of available-for-sale securities included in the table above.

The Group has exposures to a structured vehicle incorporated in Ireland. In accordance with the reporting protocol outlined above, the exposures classified as Bonds have been reported on the basis of the underlying country of risk, while other exposures have been reported against the country of registration of the structured vehicle.

The movement in the period within exposures to financial institutions is primarily due to reverse repurchase transactions secured primarily on UK gilts.

See page 153 for further details on Irish corporate and personal exposures. The off-balance sheet exposures to corporates are principally undrawn facilities.

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Table 1.34: **Spain exposures (unaudited)**

	31 December 2012			31 December 2011		
	Carrying value £m	Netting £m	Net £m	Carrying value £m	Netting £m	Net £m
Sovereign debt:						
Direct sovereign exposures	5	–	5	17	–	17
Central bank balances	14	–	14	35	–	35
	19	–	19	52	–	52
Financial institutions – banks:						
Amortised cost	32	–	32	33	–	33
Available-for-sale	1,055	–	1,055	1,548	–	1,548
Net trading assets	64	–	64	59	–	59
Derivatives	197	(178)	19	175	(123)	52
	1,348	(178)	1,170	1,815	(123)	1,692
Financial institutions – other:						
Net trading assets	7	–	7	7	–	7
Asset backed securities:						
Amortised cost	31	–	31	211	–	211
Available-for-sale	101	–	101	164	–	164
	132	–	132	375	–	375
Corporate:						
Amortised cost	1,427	–	1,427	2,043	–	2,043
Net trading assets	1	–	1	20	–	20
Derivatives	197	(5)	192	174	(7)	167
Off balance sheet exposures	490	–	490	725	–	725
	2,115	(5)	2,110	2,962	(7)	2,955
Personal:						
Amortised cost	1,414	–	1,414	1,615	–	1,615
Off balance sheet exposures	58	–	58	34	–	34
	1,472	–	1,472	1,649	–	1,649
Insurance assets	25	–	25	39	–	39
Total	5,118	(183)	4,935	6,899	(130)	6,769

The Group held impairment provisions of £112 million (2011: £149 million) against corporate amortised cost exposures and £105 million (2011: £70 million) against personal amortised cost exposures. £220 million (2011: £349 million) was included in reserves in respect of available-for-sale securities included in the table above.

Included within exposures to banks, and treated as available-for-sale assets are covered bonds of £1.1 billion (2011: £1.4 billion), which are ultimately secured on a pool of mortgage assets in the countries concerned and benefit from over-collateralisation and have an overall weighted maturity of approximately four years. The Group has credit default swap positions referenced to banking groups domiciled in Spain (net short of £4.1 million), which are included in the balances detailed above, and unutilised and uncommitted money market lines and repo facilities of approximately £1.0 billion (2011: £1.1 billion) in respect of Spanish banks. Bank limits have been closely monitored with amounts and tenors reduced where appropriate.

The corporate exposure in Spain is mainly local lending (82 per cent of the total Spanish exposures) comprising corporate loans and project finance facilities (86 per cent) and commercial real estate portfolio (14 per cent).

Personal exposures within Spain are predominantly secured residential mortgages, where about half of the borrowers are expatriates. Impaired lending represented 7 per cent (2011: 6 per cent) of the portfolio, with a coverage ratio of 90 per cent (2011: 64 per cent).

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Table 1.35: **Portugal exposures (unaudited)**

	31 December 2012			31 December 2011		
	Carrying value £m	Netting £m	Net £m	Carrying value £m	Netting £m	Net £m
Sovereign debt	–	–	–	–	–	–
Financial institutions – banks:						
Amortised cost	14	–	14	17	–	17
Net trading assets	20	–	20	–	–	–
Available-for-sale	83	–	83	124	–	124
Derivatives	5	(4)	1	7	(6)	1
	122	(4)	118	148	(6)	142
Financial institutions – other:						
Net trading assets	–	–	–	8	–	8
Asset backed securities:						
Amortised cost	119	–	119	208	–	208
Available-for-sale	105	–	105	133	–	133
	224	–	224	341	–	341
Corporate:						
Amortised cost	86	–	86	100	–	100
Derivatives	–	–	–	13	–	13
Off balance sheet exposures	101	–	101	196	–	196
	187	–	187	309	–	309
Personal:						
Amortised cost	10	–	10	11	–	11
Insurance assets	–	–	–	–	–	–
Total	543	(4)	539	817	(6)	811

The Group held impairment provisions of £21 million (2011: £25 million) against corporate amortised cost exposures. £55 million (2011: £160 million) was included in reserves in respect of available-for-sale securities included in the table above.

Exposures comprise lending to corporates, including a small amount of commercial real estate exposure.

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Table 1.36: **Greece exposures (unaudited)**

	31 December 2012			31 December 2011		
	Carrying value £m	**Netting £m**	**Net £m**	Carrying value £m	Netting £m	Net £m
Sovereign debt	**–**	**–**	**–**	–	–	–
Financial institutions – banks	**–**	**–**	**–**	–	–	–
Financial institutions – other	**–**	**–**	**–**	–	–	–
Asset backed securities:						
Amortised cost	**–**	**–**	**–**	32	–	32
Available-for-sale	**–**	**–**	**–**	23	–	23
	–	**–**	**–**	55	–	55
Corporate:						
Amortised cost	**249**	**–**	**249**	364	–	364
Derivatives	**12**	**–**	**12**	19	–	19
Off balance sheet exposures	**16**	**–**	**16**	48	–	48
	277	**–**	**277**	431	–	431
Personal	**–**	**–**	**–**	–	–	–
Insurance assets	**–**	**–**	**–**	–	–	–
Total	**277**	**–**	**277**	486	–	486

The Group held impairment provisions of £40 million (2011: £43 million) against corporate amortised cost exposures. In 2011, £21 million was included in reserves in respect of available-for-sale securities included in the table above.

The exposures in Greece principally relate to shipping loans to Greek shipping companies where the assets are generally secured and the vessels operate in international waters; repayment is mainly dependent on international trade and the industry is less sensitive to the Greek economy.

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Table 1.37: **Italy exposures (unaudited)**

	31 December 2012			31 December 2011		
	Carrying value £m	Netting £m	Net £m	Carrying value £m	Netting £m	Net £m
Sovereign debt:						
Direct sovereign exposures	5	–	5	16	–	16
Financial institutions – banks:						
Amortised cost	22	–	22	41	–	41
Available-for-sale	–	–	–	180	–	180
Net trading assets	19	–	19	188	–	188
Derivatives	58	(55)	3	91	(67)	24
	99	(55)	44	500	(67)	433
Financial institutions – other:						
Net trading assets	–	–	–	17	–	17
Asset backed securities:						
Amortised cost	–	–	–	26	–	26
Available-for-sale	10	–	10	13	–	13
	10	–	10	39	–	39
Corporate:						
Amortised cost	76	–	76	86	–	86
Net trading assets	4	–	4	17	–	17
Derivatives	54	(4)	50	36	–	36
Off balance sheet exposures	20	–	20	13	–	13
	154	(4)	150	152	–	152
Personal	–	–	–	–	–	–
Insurance assets	37	–	37	47	–	47
Total	305	(59)	246	771	(67)	704

The Group held impairment provisions of £2 million (2011: £1 million) against corporate amortised cost exposures. £nil (2011: £17 million) was included in reserves in respect of available-for-sale securities included in the table above.

In addition to the above balances there are unutilised and uncommitted money market lines and repo facilities of approximately £0.2 billion (2011: £0.6 billion) predominantly in respect of Italian banks. Bank limits have been closely monitored with amounts and tenors reduced where appropriate.

Exposures comprise lending to corporates, including a small amount of commercial real estate exposure.

Exposures to Eurozone countries

In addition to the exposures detailed above, the Group has the following exposures to sovereign, financial institutions, asset backed securities, corporates and personal customers in the following Eurozone countries:

Table 1.38: **Other Eurozone exposures (unaudited)**

	Sovereign debt		Financial Institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance assets £m	Total £m
At 31 December 2012									
Netherlands	**1**	**33,232**	**478**	**2**	**268**	**2,207**	**5,649**	**977**	**42,814**
France	**6**	**–**	**853**	**–**	**77**	**3,226**	**312**	**1,457**	**5,931**
Germany	**284**	**1,809**	**389**	**414**	**400**	**2,117**	**–**	**977**	**6,390**
Luxembourg	**–**	**2**	**–**	**834**	**–**	**1,841**	**–**	**71**	**2,748**
Belgium	**–**	**–**	**309**	**25**	**–**	**568**	**–**	**64**	**966**
Finland	**–**	**–**	**16**	**–**	**–**	**43**	**–**	**214**	**273**
Malta	**–**	**–**	**–**	**–**	**–**	**218**	**–**	**–**	**218**
Cyprus	**–**	**–**	**2**	**–**	**–**	**102**	**–**	**–**	**104**
Austria	**–**	**–**	**3**	**–**	**–**	**73**	**–**	**–**	**76**
Slovenia	**–**	**–**	**35**	**–**	**–**	**–**	**–**	**–**	**35**
Estonia	**–**	**–**	**–**	**–**	**–**	**2**	**–**	**–**	**2**
Slovakia	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	291	**35,043**	**2,085**	**1,275**	**745**	**10,397**	**5,961**	**3,760**	**59,557**
At 31 December 2011									
Netherlands	–	9,594	712	173	176	4,105	6,226	960	21,946
France	217	–	1,517	143	525	3,796	295	1,841	8,334
Germany	656	203	1,291	100	703	2,532	1	1,263	6,749
Luxembourg	2	3	4	442	–	2,828	–	568	3,847
Belgium	74	4	404	11	–	1,617	–	57	2,167
Finland	–	–	60	–	–	56	–	147	263
Malta	–	–	2	–	–	305	–	–	307
Cyprus	–	–	6	–	–	204	–	–	210
Austria	2	–	202	5	–	97	–	–	306
Slovenia	–	–	56	–	–	–	–	–	56
Estonia	–	–	–	–	–	2	–	–	2
Slovakia	–	–	–	–	–	–	–	–	–
	951	9,804	4,254	874	1,404	15,542	6,522	4,836	44,187

Total balances with other Eurozone countries have increased from £44,187 million to £59,557 million. This is due to an increase in sovereign debt balances held, which primarily relate to central bank balances held for regulatory liquidity purposes. Excluding cash at central banks, the remaining overall exposures have reduced by 29 per cent from £34,383 million to £24,514 million. Derivatives with sovereigns and sovereign referenced credit default swaps are insignificant.

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Eurozone redenomination risk

Redenomination risk arises from the uncertainty over how an exiting member state would deal with pre-incurred euro contractual liabilities and, in particular, whether it (or a competent European body) legislates to re-denominate such liabilities into a post-euro currency. It is generally expected that an exiting member state would introduce a new national currency and determine an opening rate of exchange, which would then change when trading commences in the new currency, exposing the holders of the new currency to the risk of changes in the value of the new currency against the Euro. Although considered less likely, multiple member exits may also take place, and in the case of a total dissolution of the Eurozone, the Euro may cease to be a valid currency, with the possibility of all states re-introducing their own currencies.

The Group has considered redenomination risk in respect of its exposures to Ireland, Spain, Portugal, Greece and Italy and in the event of a member exit believes that the risks can be broadly classified as follows:

- The Group is not significantly exposed to the redenomination impact of a Greek exit from the Euro as Greek-related exposures are very limited and are in any case predominantly ship finance facilities denominated in US dollar or Sterling with contracts subject to English law. The Group's exposures to Italy, Ireland, Portugal and Spain are considered to be at potential risk of redenomination. Redenomination of contractual liabilities depends on, amongst other things, the terms of relevant contracts, the contents of the legislation passed by the exiting member state, the governing law and jurisdiction of the contract and the nationality of the parties of the contracts.
- The Group has undertaken actions to mitigate redenomination risk for both assets and liabilities where possible, but it is not clear that such mitigation will be effective in the event of a member exit.
- The introduction of one or more new currencies would be likely to lead to significant operational issues for clearing and payment systems. The Group continues to work actively with central banks, regulators and with the main clearing and payment systems to better understand and mitigate the impact of these risks on the Group and its customers.

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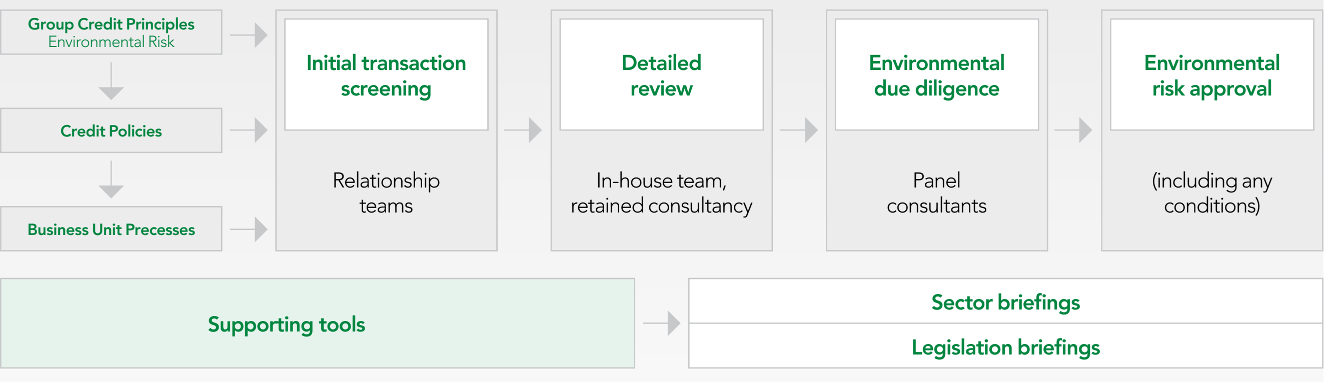
Environmental risk management

The Group's policies and procedures ensure it manages the environmental impact of its lending activities. The Group wide Credit Risk Principles require all credit risk to be incurred with due regard to environmental legislation and the Group's Code of Business Responsibility.

Since 2011, an electronic environmental risk screening system has been the primary mechanism for assessing environmental risk in Commercial Banking. This provides real time screening of location specific and sector based risks that may be present in a transaction. Where a risk is identified, the transaction is referred to the Group's expert in-house Environmental Risk team for further review and assessment, as outlined below. Additional support is provided by the Group's panel of environmental consultants as required.

Table 1.39: **Environmental risk management approach**



Colleagues are trained in environmental risk management as part of the Group's standard credit risk training course, and bespoke training can be provided upon request. Supporting this training, a range of documents are provided to all colleagues online including environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

Project Finance: Equator Principles

The Group has been a signatory to the Equator Principles since 2006. The Equator Principles support the Group's approach to assessing and managing environmental and social issues in project finance. Project finance is often used to fund the development and construction of major infrastructure and industrial projects. The Equator Principles are applicable to project finance transactions above US$10 million and provide a framework to support responsible decision making.

The Group has a robust, Group wide approach to assess, monitor and report Equator Principle transactions. It also provides ongoing training for lending officers and more in-depth training for colleagues working in project finance is offered.

Projects are categorised depending on the level of perceived environmental and social risk and magnitude of impact they pose. The categories are as follows:

Category A – Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented;

Category B – Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; and

Category C – Projects with minimal or no social or environmental impacts.

Lending officers are responsible for undertaking initial classification of transactions that qualify under the Equator Principles. Their assessments are subject to further review by the in-house Environmental Risk team and retained consultant, and for higher risk transactions by the Equator Principles Review Group, comprising experts from both the Risk and Project Finance teams. This ensures that each transaction is compliant and is consistent with the Group's environmental risk policy. A range of training and support materials are provided to risk and transactional colleagues to ensure that they are familiar with the requirements of the Principles.

Since 2011, the Group has participated in the Equator Principles Strategic Review process ('Equator Principles III') which is examining the scope of application, transparency, implementation and governance of the Principles. The process is nearing completion, and it is envisaged that the final version of Equator Principles III will be published in 2013. The Group is currently reviewing its approach to the Equator Principles to ensure that it fully complies with the new requirements once introduced.

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Table 1.40: **Status of Categorised Projects (unaudited)**

	A	B	C	Total
Completed	2	13	5	20
In progress	–	3	–	3
Not completed	–	–	–	–
	2	16	5	23

Table 1.41: **Status of Projects by Industry (unaudited)**

	Renewables	Infrastructure	Energy and Utilities	Total
Completed	9	11	–	20
In progress	2	1	–	3
Not completed	–	–	–	–
	11	12	–	23

2012 has seen a continuation of the Group's involvement in the development of low carbon electricity generation with significant lending in support of Government targets for decarbonisation of the power sector. The Group's commitments to renewable energy now support over 1700MW of capacity, sufficient to power around 2 million homes. In addition, the Group continues to be the largest provider of finance after the European Investment Bank to the offshore transmission ownership scheme designed by the Government to encourage investment in large scale offshore wind farms and helping create significant investment and jobs in UK energy infrastructure.

Table 1.42: **Industry of Completed Transactions (unaudited)**

	No.	£m
Renewables	9	254
Infrastructure	11	651
Energy and utilities	–	–
	20	905

Table 1.43: **Geography of Completed Transactions (unaudited)**

	A	B	C	Total
UK	–	5	4	9
Americas	–	7	–	7
Europe	–	1	–	1
Australasia	2	–	1	3
	2	13	5	20

During 2012, no transaction was declined on environmental or social risk grounds, nor approved with exceptions.

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Conduct risk

Definition

Conduct risk is defined as the risk of customer detriment or censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

A more customer-centric culture where we do the right things.

Risk appetite

The Group has zero risk appetite for systemic unfair customer outcomes arising from product design, sales or other after sales processes. This appetite is reviewed and approved annually by the Board. To achieve this, the Group has policies, processes and standards which provide the framework for businesses and colleagues to operate in accordance with the laws, regulations and voluntary codes which apply to the Group and its activities.

Exposures

Conduct risk affects all aspects of the Group's operations, all types of customers and other stakeholders. There is currently a high level of scrutiny regarding conduct risk and treatment of customers by financial institutions from the press, politicians and regulatory bodies. The Group has been actively managing conduct issues as part of its conduct strategy and has undertaken a range of actions in respect of both front and back book of business. Work continues to close back book issues such as payment protection insurance and drive down complaint volumes. An ongoing focus on the delivery of fair outcomes, business standards and the implementation of the conduct strategy, which will make greater use of technology and metrics to determine inherent conduct risks, will facilitate earlier detection and mitigation of conduct issues.

Measurement

Conduct risks are measured against a set of risk appetite measures, with appropriate limits and triggers, which have been approved by the Board. Metrics include assessments of products, sales, aftersales and fair outcomes for customers.

These appetites and metrics are tracked within the Group's three lines of defence control framework. Business areas track and report the conduct risks in their business. These reports are challenged by Risk Division and contribute to reporting on conduct risk provided to the Group Compliance and Conduct Committee, the Group Risk Committee and the Board Risk Committee.

Mitigation

Mitigation is undertaken across the Group and consists of the following components:

- Risks are assessed by the business and controls put in place to mitigate them.
- Oversight and assurance of conduct risks within the business.
- Theme reviews to assess customer treatment and fair outcomes.
- Senior business leaders monitor the progress of these assessments and mitigations.
- Material risks and issues are escalated to Group-level bodies which challenge the business on its management of risks and issues.
- Mandated policies and processes require minimum control frameworks, management information and standards to be implemented.

Monitoring

Business unit risk exposure is reported to Risk Division where it is aggregated and reported at Group level. The report forms the basis of challenge to the business at the monthly Group Compliance and Conduct Risk Committee. This committee may escalate matters to the Chief Risk Officer, or higher committees. The report also forms the basis of the regulatory sections in the Group's consolidated risk reporting.

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Market risk

Definition

Market risk is defined as the risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments), lead to reductions in earnings and/or value.

Risk appetite

The Group's overall appetite for market risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee, the Group Chief Executive allocates this risk appetite across the Group. Individual members of the Group Executive Committee ensure that market risk appetite is further cascaded to an appropriate level within their areas of responsibility.

> The Group's trading activity is small relative to its peers and the Group does not have a programme of proprietary trading activities.

Exposures

Trading portfolios

The Group's trading activity is small relative to its peers and the Group does not have a programme of proprietary trading activities. The average 95 per cent 1-day trading Value at Risk (VaR) was £7.0 million for the year to 31 December 2012 (2011: £6 million). Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products.

Banking activities

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets and liabilities. Interest rate risk arises predominantly from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets.

Risk also arises from the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restricts the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Foreign currency risk also arises from the Group's investment in its overseas operations. Net investment exposures are disclosed (see note 55 on page 319) and it is Group policy to hedge non-functional currency exposures.

Insurance portfolios

The Group's insurance activities also expose it to market risk, encompassing interest rate, exchange rate, property, credit spreads and equity risk:

- With Profit Funds are managed with the aim of generating rates of return consistent with policyholders' expectations and this involves the mismatch of assets and liabilities.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in-force business, see note 29 on page 256).
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch. Further, in assessing the current value of these future cashflows, it is not always possible to achieve equally resilient levels of matching between the different capital measures that are used to assess regulatory solvency.
- Surplus assets are held primarily in four portfolios: (a) in the long-term funds within the life insurance companies; (b) in the corresponding shareholder funds; (c) in investment portfolios within the general insurance business; and (d) within the main fund of Heidelberger Lebensversicherung AG.

Defined benefit pension schemes

The Group's defined benefit pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on defined benefit pension scheme assets and liabilities please refer to note 42 on page 271.

Measurement

Market risk is managed within a Board approved framework and risk appetite. A variety of risk measures are used such as:

- Sensitivity based measures (e.g. sensitivity to 1 basis point move in interest rates).
- Percentile based measures (e.g. VaR).
- Scenario/stress based measures (e.g. single factor stresses, macroeconomic scenarios).

In addition, profit and loss triggers are used in the Trading Books in order to ensure that mitigating action is considered if profit and loss becomes volatile. Both VaR and standard stress measures are used in setting divisional market risk appetite limits and triggers.

Although an important market standard measure of risk, VaR has limitations. These arise from the use of limited historical data, an assumed distribution, defined holding periods, set confidence intervals and frequency of calculation. The exposure level at the confidence interval does not convey any information about potential losses which may arise if this level is exceeded. A 95 per cent confidence interval with a 1-day holding period is equivalent to an expected 1 in 20 day loss.

The Group recognises these limitations and supplements the use of VaR with a variety of other techniques more suited to the nature of the business activity. These include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at Group level, to simulate the impact of extreme conditions and to understand more fully the interdependence of different parts of the balance sheet. These measures are reviewed regularly by senior management to inform effective decision making.

Trading portfolios

Based on the 1-day 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2012 and 2011 based on the Group's global trading positions is detailed in table 1.44.

The risk of loss measured by the VaR model is the potential loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR does not assume any diversification benefit across the five risk types, which now include inflation. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The Group internally uses VaR as the primary measure for all trading book positions arising from short term market facing activity. Trading book VaR (1-day 99 per cent) is compared daily against both forecast and actual profit and loss.

Table 1.44: **Trading portfolios: VaR 1-day 95 per cent confidence level (audited)**

Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products.

	Close £m	Average £m	Maximum £m	Minimum £m
At 31 December 2012				
Interest rate risk	**2.8**	**4.2**	**7.4**	**1.9**
Foreign exchange risk	**0.3**	**0.4**	**1.0**	**0.02**
Equity risk	**–**	**–**	**–**	**–**
Credit spread risk	**0.8**	**1.9**	**3.6**	**0.7**
Inflation risk	**0.5**	**0.5**	**1.3**	**0.1**
Total VaR	**4.4**	**7.0**	**11.4**	**4.1**

	Close £m	Average £m	Maximum £m	Minimum £m
At 31 December 2011				
Interest rate risk	2.6	3.0	5.9	1.8
Foreign exchange risk	0.4	0.5	1.6	0.2
Equity risk	–	–	–	–
Credit spread risk	3.1	2.3	4.5	1.0
Inflation risk	0.2	0.2	0.5	0.1
Total VaR	6.3	6.0	9.7	4.1

Open market risk for the trading operations continues to be low with respect to the size of the Group and similar institutions, reflecting the fact that the Group's trading operations are customer-centric, focusing on hedging and recycling client risks.

Banking activities

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates including the margin between interbank and central bank rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets; or when, if rates rise, assets cannot be re-priced as quickly or by as much as liabilities.

Risk exposure is monitored monthly using, primarily, market value sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks. Where re-pricing maturity is based on assumptions about customer behaviour these assumptions are also reviewed monthly. A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

The following table shows, split by material currency, the Group's sensitivities at 31 December 2012 to an immediate up and down 25 basis points change to all interest rates.

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Table 1.45: **Banking activities: Market Value sensitivity (audited)**

	2012		2011	
	Up 25bps £m	Down 25bps £m	Up 25bps £m	Down 25bps £m
Sterling	**104.9**	**(108.3)**	(53.1)	54.7
US Dollar	**14.9**	**(16.7)**	(0.4)	0.3
Euro	**14.5**	**(8.5)**	(15.7)	15.9
Australian Dollar	**1.0**	**(1.0)**	(1.8)	1.8
Other	**(0.1)**	**0.1**	(1.4)	1.3
Total	**135.2**	**(134.4)**	(72.4)	74.0

The Group always seeks to maintain minimal interest rate re-pricing mismatch in its banking books. At any point in time, however, some small level of transitory risk will always exist pending, for example, contrary offsetting customer flows and the efficient hedging of the net position with the external market. In addition, during 2012, a number of risks to income have been managed. These include the potential risk of LIBOR rising relative to the Bank of England Base Rate and the risk to Net Interest Margin of all interest rates remaining lower for longer than is implied by current market prices. Such strategic hedges are executed only with the explicit approval of the Group Asset and Liability Committee. Overall this hedge portfolio has varied during 2012 as the Group Asset and Liability Committee, in response to changing economic conditions, has periodically reviewed and revised its opinion as to which of these various risks is the most likely to crystallise.

Base case market value is calculated on the basis of the Group's balance sheet with re-pricing dates adjusted according to behavioural assumptions. The above sensitivities show how this projected market value would change in response to an immediate parallel shift to all relevant interest rates – market and administered.

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio. The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

Insurance portfolios

Market risks within the Insurance business are measured using a variety of techniques including stress and scenario testing and, where appropriate, stochastic modelling. Current and potential future market risk exposures are assessed and aggregated using risk measures based on 1-in-200 year stresses for Insurance's Individual Capital Assessment (ICA) and other supporting measures, including, profit before tax, where appropriate. The stresses include sensitivities on the risk-free rate, equity investment volatility, widening of credit default spreads on corporate bonds and an increase in illiquidity premia, as applied to profit before tax and set out in note 38 on page 269.

Defined benefit pension schemes

Management of the assets of the Group's defined benefit pension schemes is the responsibility of the Scheme Trustees, who also appoint the Scheme Actuaries to perform the triennial valuations. The Group monitors its defined benefit pension exposure holistically using a variety of metrics including accounting and economic deficits and contribution rates. These and other measures are regularly reviewed by the Group Asset and Liability Committee and the Group Market Risk Committee and used in discussions with the Trustees, through whom any risk management and mitigation activity must be conducted.

The schemes' main exposures are to equity risk, real rate risk and credit spread risk. Accounting for the defined benefit pension schemes under International Accounting Standard (IAS) 19 spreads any adverse impacts of these risks over time.

Mitigation

Various mitigation activities are undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits.

Trading portfolios and Banking activities

Management of the balance sheet is centralised and overseen by the Group Asset and Liability Committee. Interest rate risk arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive assets and interest rate sensitive liabilities, is managed centrally. Matching assets and liabilities are offset against each other and interest rate swaps are also used to manage the residual exposure to within the non-traded market risk appetite.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled within the trading risk appetite and any residual risk is hedged in the market.

Insurance portfolios

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

Monitoring

The Group Asset and Liability Committee and the Group Market Risk Committee regularly review high level market risk exposure, as part of the wider risk management framework. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits and triggers are monitored by Risk Division and where appropriate, escalation procedures are in place.

Trading portfolios and Banking activities

Trading is restricted to a number of specialist centres, the most important centre being the treasury and trading business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed centrally within triggers defined in the Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

Insurance portfolios

Market risk exposures from the Insurance business are controlled via approved investment policies and triggers set with reference to the Group's overall risk appetite and regularly reviewed by the Group Market Risk Committee:

- The With Profit Funds are managed in accordance with the relevant fund's principles and practices of financial management and legal requirements.
- The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.
- Investment strategy for surplus assets held in excess of liabilities takes account of the legal, regulatory and internal business requirements for capital to be held to support the business now and in the future.

Defined benefit pension schemes

The Group agrees strategies for the overall mix of pension assets with the defined benefit pension scheme Trustees.

RISK MANAGEMENT

Operational risk

Definition

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The Group has implemented an Operational Risk Framework which embraces the risk life-cycle of identification; measurement and assessment; management via appropriate mitigants and controls; and monitoring and reporting. To ensure the rigour of the Operational Risk Framework, the Group defines operational risks in the form of a number of discrete categories, the principal ones being:

Customer Processes – The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor externally facing business processes. Customer process risk includes customer transaction and processing errors due to incorrect capturing of customer information and/or system failure.

Security – The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Group's assets, the loss, corruption, misuse or theft of the Group's information assets or threats or actual harm to the Group's people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

IT Systems and resilience – The risk of reductions in earnings and/or value through financial or reputational loss resulting from the failure to develop, deliver or maintain effective IT solutions. This includes the resilience of the Group's IT infrastructure and systems, rigorous change control processes to minimise the risk of incidents impacting their availability, and formal business continuity and recovery arrangements which are designed and tested to evidence the recoverability of key services within prescribed timescales. Significant business-wide incidents are managed via an incident management process, which is subject to frequent testing.

Supplier Management – The risk of reductions in earnings and/or value through financial or reputational loss from services with outsourced partners or third-party suppliers.

The Group continues to operate a robust control environment with regular review and investment.

Risk Appetite

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty.

In setting operational risk appetite, the Group looks at both impact on solvency and the Group's reputation. Appetite is defined and monitored relative to a number of key indicators, including the size and numbers of material events, and the amounts of operational risk losses that have arisen.

Exposures

The Group's success depends on its ability to attract, retain and develop high calibre talent. Achievement of this aim cannot be guaranteed, particularly in light of ongoing regulatory and public interest in remuneration practices. Macroeconomic conditions and negative media attention on the financial services industry may also adversely impact employee retention, colleague sentiment and engagement.

The continuing structural consolidation and the sale of part of the branch network under Project Verde may result in disruption of senior management's ability to lead and manage the Group effectively. The level and impact of change is managed via robust change management governance and a consolidated Strategic Change Plan. There are separate Governance arrangements in place in Project Verde to oversee the impacts of the divestment on the retained business customers, operations and controls.

The Group's businesses are dependent on processing and reporting accurately and efficiently a high volume of complex transactions across numerous and diverse products and services, in different currencies and subject to a number of different legal and regulatory regimes. The complexity of these operations presents potential risks. In addition, any breach in security of the Group's systems could disrupt its business, result in the disclosure of confidential information and create significant financial and legal exposure.

Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events and responses to those acts/events may create economic and political uncertainties, which could have a material adverse effect on UK and international macroeconomic conditions generally, and more specifically on the Group's results of operations, financial condition or prospects in ways that cannot necessarily be predicted.

Measurement

The Group manages its operational risks via a risk framework which includes definition, monitoring and measurement against appetite targets and thresholds. Appetites are defined with limits and triggers which are approved by the Board and which are regularly reviewed and monitored by the Group Operational Risk Committee. The Group monitors events and losses by size, business unit and internal risk categories. The table below shows high level loss and event trends using Basel II categories.

Table 1.46: **Operational risk events by risk category (unaudited)**

	% of total volume		% of total losses	
	2012	2011	**2012**	2011
Business disruption and system failures	**1.08**	1.03	**1.46**	1.63
Clients, products and business practices	**15.27**	18.89	**58.65**	54.40
Damage to physical assets	**0.32**	0.16	**0.24**	0.26
Employee practices and workplace safety	**0.14**	0.68	**0.10**	0.23
Execution, delivery and process management	**24.90**	29.67	**27.19**	28.65
External fraud	**58.02**	48.89	**11.99**	12.98
Internal fraud	**0.27**	0.68	**0.37**	1.85
Total	**100.00**	100.00	**100.00**	100.00

In 2012, the highest frequency of events occurred in External Fraud (58.0 per cent) and Execution, Delivery and Process Management (24.9 per cent). Clients, Products and Business Practices accounted for 58.7 per cent of losses (54.4 per cent in 2011). The continued high proportion of losses in this category is driven by legacy issues.

The operational risk profile of the Group as a whole and of individual business areas is regularly reviewed within the overarching three lines of defence control framework. Business area reports are reviewed and challenged at Risk Division level, whilst audit and assurance teams ensure that all levels of reporting are subject to rigorous scrutiny.

Operational risk appetites and actual exposures are used by the Group to calculate the appropriate holding of operational risk regulatory capital under the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its operational risk capital requirements using the Standardised Approach (TSA), which the Basel Committee states as being appropriate for an "internationally active" bank.

Mitigation

Operational risk is relevant to every aspect of the Group's business and activities. The Group's operational risk framework consists of the following key components:

- Identification and categorisation of the key operational risks facing a business area, including defining risk appetite;
- Risk assessment, including impact assessment of financial and non-financial impacts (e.g. reputational risk) for each of the key risks to which the business area is exposed;
- Control assessment, evaluating the effectiveness of the control framework covering each of the key risks to which the business area is exposed;
- Loss and incident management, capturing actions to manage any losses facing a business area;
- The development of key risk indicators for management reporting, including the monitoring of risk appetite;
- Oversight and assurance of the risk management framework in businesses; and
- Scenarios for estimation of potential loss exposures for material risks.

The Group purchases insurance to mitigate certain operational risk events.

Monitoring

Monitoring and reporting is undertaken at Board, Group and business area committee levels, in accordance with delegated limits of authority which are themselves regularly reviewed and refreshed. Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. The report is discussed at the monthly Group Operational Risk Committee, and matters can be escalated to the Chief Risk Officer, or higher committees, if appropriate. A combination of systems, monthly reports from business areas, and oversight and challenge from the Risk Division ensures that key risk measures are presented and debated on a monthly basis to an Executive audience.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.

RISK MANAGEMENT

People risk

Definition

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to reductions in earnings and/or value.

Risk appetite

The Group's appetite for people risk is reviewed and approved annually by the Board. The high level appetite is described as: The Group leads responsibly and proficiently, manages people resource effectively, supports and develops colleague talent, and meets legal and regulatory obligations related to its people.

To achieve this, the Group has developed and implemented policies and processes that provide a framework where the Group's businesses and colleagues can operate in accordance with the laws, regulations and voluntary codes that apply to the Group and its activities.

> The quality, effectiveness and engagement of colleagues are fundamental to the Group's successful delivery of its strategy.

Exposures

The major sources of people risk over the course of the next year can be grouped into four key areas;

- The ongoing divestment of the bank's branch network under project Verde continues to stretch resources in parts of the Group and increase operational complexity.
- Increased regulatory scrutiny of incentive and remuneration practices, and Approved Persons following recent changes to domestic and international regulatory structures.
- Colleague engagement, in the context of macroeconomic conditions, Group restructuring, and continued media scrutiny.
- Political and regulatory scrutiny of sales practices, culture and ethical behaviours within the financial services industry will remain a key risk to the Group's strategic direction for the foreseeable future.

Measurement

People risk is measured through a series of quantitative and qualitative indicators, calibrated against the Group's risk appetite and monitored on a monthly basis via the Group's risk reporting structure.

Mitigation

The Group undertakes a variety of programmes which aim to manage its people risks; there are currently four key areas of activity;

- The Group focuses on leadership and colleague retention, including initiatives and strategies to attract, develop and retain high-calibre colleagues and that cross-Group succession planning is well implemented.
- The Group places considerable emphasis on its responsibilities arising from the FSA's Approved Persons regime, Remuneration Code and other people-focused regulatory requirements; this includes dedicating resources across the Group, and the provision of training, guidance and oversight of senior management's knowledge and delivery of their accountabilities.
- The Group continues to develop colleagues' awareness of their responsibilities in managing risk in their role through the embedding of Codes of Personal and Business Responsibility which ensure a strong focus on fair customer outcomes and support the effective management of the Group's overall risk profile.
- Finally, the Group takes a proactive approach in fostering an ethical banking model and enforcing against lapses in ethical behaviour, through strong management of staff incentive adjustments, effective people risk and performance management, and promoting strong risk-based behaviours within its culture.

Monitoring

People risks from across the Group are reported through the first line of defence. Key people risks are then escalated to the relevant operational or regulatory oversight committees. Key people risks are assessed in the context of the Group's wider risk profile, and tracked to remediation.

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Liquidity and funding risk

We have significantly strengthened our liquidity and funding position, leaving the Group well positioned for growth.

Definition

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

Risk appetite

Liquidity and funding risk appetite for the banking businesses is set by the Board and this statement of the Group's overall appetite for liquidity risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee (GALCO), the Group Chief Executive allocates this risk appetite across the Group. Risk is reported against appetite through various metrics that enable the Group to manage liquidity and funding constraints. The Group Chief Executive, assisted by GALCO regularly reviews performance against risk appetite.

Exposure

Liquidity exposure represents the amount of potential outflows in any future period less expected inflows. Liquidity is considered from both an internal and regulatory perspective.

Measurement

A series of measures are used across the Group to monitor both short and long-term liquidity including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. The Board approved liquidity risk appetite covers a range of metrics considered key to maintaining a strong liquidity and funding position, with regular reporting to GALCO and the Board. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Details of contractual maturities for assets and liabilities form an important source of information for the management of liquidity risk. Note 55 on page 336 sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. Divisional teams form a view of customer behaviour based on quantitative and qualitative analysis and these assumptions are subject to governance via divisional asset and liability committees. This also forms the foundation of the Group's stress testing framework on which the Group's liquidity controls are based.

Mitigation

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and through the life of the funding plan. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term wholesale funding. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise interbank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's appetite for short-term money market funding is based on a qualitative analysis of the market's capacity for the Group's credit. The Group has developed strong relationships with certain wholesale market segments, and also has access to corporate customers to supplement its retail deposit base.

The Group actively manages its balance sheet and contingent liabilities by ensuring that the internal pricing mechanism for funds within the Group fully incorporates liquidity costs. This transfer pricing mechanism ensures that liquidity risk is reflected in product pricing and supports the overall Group balance sheet strategy and that the correct behaviours and decisions are rewarded.

The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group's banking businesses. The Group holds sizeable balances of high grade marketable debt securities as set out in Table 1.48 which can be sold to provide, or used to secure, additional short term funding should the need arise from either market counterparties or central bank facilities (Bank of England, European Central Bank, Federal Reserve and Reserve Bank of Australia).

Monitoring

Liquidity is actively monitored at business unit and Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular GALCO which meets monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent internal oversight.

RISK MANAGEMENT

Daily monitoring and control processes are in place to address regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group. These are a mixture of quantitative and qualitative measures including daily variation of customer balances, changes in maturity profiles, cash outflows, funding concentration, primary liquidity portfolio, credit default swap (CDS) spreads and changing funding costs.

In addition, the framework has two other important components:

- Firstly, the Group carries out stress testing of its liquidity and potential cash flow mismatch position over both short (up to two weeks) and longer term (up to three months) horizons against a range of scenarios, including those prescribed by the FSA, on an ongoing basis. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

  Scenarios cover both Group specific and market wide difficulties. The Group calculates the stressed cash flow mismatch under the prescribed FSA scenarios, which include the effect of credit rating agency downgrades; the idiosyncratic, market wide and combined stresses. The Group also calculates the stressed cash flow position under a range of the Group's own scenarios reflecting possible future liquidity risks. These scenarios cover US market disruption, market counterparty failure, UK sovereign rating downgrade and a Eurozone stress. The key risk driver assumptions applied to the scenarios are:

Liquidity risk driver	Market wide and Group specific stresses
Wholesale funding	Outflows calculated based on contractual maturity of wholesale funding with limited roll over.
Marketable asset	Haircut widening and repos assumed not to roll on contractual maturity.
Retail and commercial funding	Substantial outflows on customer deposit base.
Intra-day liquidity	Liquidity required for clearing and payment systems under stressed conditions.
Intra group liquidity	Requirements from the stressed position of subsidiaries.
Off balance sheet	Stressed cash outflows from commitments granted. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities.
Downgrade	Contractual outflows resulting from short and long-term rating downgrades.
Franchise viability	Actions that need to be taken to maintain the Group's core business franchise and reputation.

  Liquidity stress tests are applied to the Group's funding plan to project possible future stressed positions. The funding plan is also stressed against a range of macroeconomic scenarios, including those prescribed by the FSA under the Pillar II 'anchor' scenario. The Group applies its own macroeconomic stress scenarios, covering a stagnation and a recession.

- Secondly, the Group has a contingency funding plan embedded within the Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing. Contingency funding plan invocation and escalation processes are based on analysis of five major quantitative and qualitative components, comprising assessment of: early warning indicators, prudential and regulatory liquidity risk limits and triggers, stress testing results, event and systemic indicators and market intelligence.

The planned introduction of the Liquidity Coverage Ratio (LCR – minimum requirement will begin at 60 per cent in January 2015 rising in equal annual steps of 10 per cent to reach 100 per cent in January 2019) and the introduction of the Net Stable Funding Ratio (NSFR – January 2018) contained within CRD IV are intended to raise the resilience of banks to potential liquidity shocks and provide the basis for a harmonised approach to liquidity risk management. The guidance issued by the Basel Committee is still subject to final ratification by the EU and the methodology is likely to be refined on the basis of feedback from banks and regulators during the observation period. The Group has invested considerable resource to ensure that it satisfies the governance, reporting and stress testing requirements of the FSA's Individual Liquidity Adequacy Standards liquidity regime and will satisfy the agreed final NSFR and LCR requirements. The Group monitors and forecasts the Group's NSFR and LCR. The actions already announced to right size the balance sheet are expected to ensure compliance with the future minimum standards. These standards are expected to be 100 per cent for both ratios by their respective effective dates.

During the year, the individual entities within the Group, and the Group, complied with all of the external regulatory liquidity and funding requirements to which they are subject.

Liquidity and funding management in 2012

Liquidity and funding continues to remain a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and long-term wholesale funding markets. Should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding, its ability to fund its financial obligations could be impacted.

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During the first half of 2012 the Group accelerated term funding initiatives and the run down of certain non-core asset portfolios allowing a further reduction in money market funding and total government and central bank facilities. This has significantly reduced exposure to wholesale outflows and rating agency downgrades. The Group repaid its remaining drawings under the Government's Credit Guarantee Scheme in full, in line with its contractual maturities.

Despite difficult funding markets during much of 2012 as investor confidence was impacted by concerns over Eurozone sovereign debt levels, downgrades and possible defaults and the potential downside effects from financial market volatility, the Group continued to fund adequately, maintaining a broadly stable stock of primary liquid assets during the year and meeting its regulatory liquidity requirements at all times.

The key dependencies on successfully funding the Group's balance sheet include the continued functioning of the money and capital markets; successful right-sizing of the Group's balance sheet; limited further deterioration in the UK's and the Group's credit rating; and no significant or sudden withdrawal of customer deposits. Additionally, the Group has entered into a number of EU State Aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. These are assumed within the Group's funding plan. The Group has achieved the asset reduction commitment, two years ahead of the mandated completion date, and is currently working with the European Commission to achieve formal release from the commitment. Until release is obtained from the European Commission the Group may have to continue with these asset reductions and or/disposals and may receive a lower price upon disposal.

The combination of right-sizing the balance sheet and continued development of the customer deposit base has seen the Group's wholesale funding requirement reduce materially in recent years. The progress the Group has made to date in diversifying its funding sources has further strengthened its funding base. Funding concentration is not considered significant by the Group but where such concentrations do exist (at the customer or industry level) they are not deemed material at Group level.

Group funding sources

Total wholesale funding reduced by £81.6 billion to £169.6 billion, with the volume with a residual maturity less than one year falling £62.7 billion to £50.6 billion. The Group term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) improved to 70 per cent (55 per cent at 31 December 2011) due to good progress in new term issuance and a significant reduction in short term money market funding (2012: £31 billion; 2011: £69.1 billion). Term wholesale issuance for the year totalled £20.1 billion.

Table 1.47: **Group funding by type (audited)**

	2012 £bn	**2012 %**	2011 £bn	2011 %
Total wholesale funding[1]	**169.6**	**28.6**	251.2	38.2
Customer deposits	**422.5**	**71.4**	405.9	61.8
Total Group funding[2]	**592.1**	**100.0**	657.1	100.0

[1] The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

[2] Excluding repos and total equity.

Total wholesale funding by type and expected residual maturity is detailed below.

Table 1.48: **Analysis of 2012 total wholesale funding by residual maturity (audited)**

	Less than one month £bn	**One to three months £bn**	**Three to six months £bn**	**Six to nine months £bn**	**Nine months to one year £bn**	**One to two years £bn**	**Two to five years £bn**	**More than five years £bn**	**Total at 31 Dec 2012 £bn**	Total at 31 Dec 2011 £bn
Deposits from banks[1]	**8.7**	**2.7**	**1.1**	**–**	**0.1**	**0.7**	**0.5**	**1.3**	**15.1**	25.4
Debt securities in issue:[1]										
Certificates of deposit	**1.9**	**5.1**	**1.9**	**0.5**	**1.1**	**0.2**	**–**	**–**	**10.7**	28.0
Commercial paper	**–**	**6.2**	**1.3**	**0.2**	**0.2**	**–**	**–**	**–**	**7.9**	18.0
Medium-term notes[2]	**–**	**1.3**	**2.7**	**0.5**	**1.5**	**6.2**	**13.0**	**9.4**	**34.6**	69.8
Covered bonds	**–**	**1.6**	**1.0**	**–**	**1.8**	**6.9**	**13.7**	**13.7**	**38.7**	36.6
Securitisation	**1.3**	**1.7**	**1.2**	**0.3**	**3.8**	**7.0**	**12.8**	**0.4**	**28.5**	37.5
	3.2	**15.9**	**8.1**	**1.5**	**8.4**	**20.3**	**39.5**	**23.5**	**120.4**	189.9
Subordinated liabilities[1]	**–**	**0.3**	**0.6**	**–**	**–**	**1.0**	**5.2**	**27.0**	**34.1**	35.9
Total wholesale funding[3]	**11.9**	**18.9**	**9.8**	**1.5**	**8.5**	**22.0**	**45.2**	**51.8**	**169.6**	251.2

[1] A reconciliation to the Group's balance sheet is provided on page 182.

[2] Medium-term notes include funding from the Credit Guarantee Scheme (2012: £nil; 2011: £23.5 billion) and from the National Loan Guarantee Scheme (2012: £1.4 billion; 2011: £nil).

[3] The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

RISK MANAGEMENT

Total wholesale funding in 2011 was £251.2 billion of which £113.3 billion had a residual maturity of less than one year.

Table 1.49: **Total Wholesale funding by currency (audited)**

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
31 December 2012	**54.3**	**41.6**	**60.2**	**13.5**	**169.6**
31 December 2011	61.8	76.0	91.6	21.8	251.2

The table below summarises the Group's wholesale term issuance during 2012. The Group's 2012 issuance plan was successfully completed in the first half of 2012 through the ability of the Group to access a diverse range of markets and currencies, both in unsecured and secured form.

Table 1.50: **Analysis of 2012 term issuance (audited)**

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	**1.0**	**1.6**	**1.2**	**0.5**	**4.3**
Medium-term notes	**1.4**	**0.9**	**1.3**	**0.5**	**4.1**
Covered bonds	**2.5**	**–**	**1.0**	**–**	**3.5**
Private placements[1]	**3.8**	**1.2**	**1.1**	**2.1**	**8.2**
Total issuance	**8.7**	**3.7**	**4.6**	**3.1**	**20.1**

[1] Private placements include structured bonds and term repurchase agreements (repos).

The Group has now fully repaid all debt issued under the UK Government's legacy Credit Guarantee Scheme. In August the Group announced its support for the Government's Funding for Lending Scheme (FLS) and confirmed its intention to participate in the scheme. The FLS represents a further source of cost effective secured term funding available to the Group. The initiative supports the Group's customers and provides businesses with cheaper finance to invest and grow. The Group was the first UK bank to draw on the scheme in September 2012, drawing down £3 billion in total in 2012.

Excluding reverse repos and repos, loans and advances reduced by £36.7 billion; customer deposits increased by £16.6 billion, representing growth of 4 per cent in 2012. Over the year the Group has seen above market growth in customer deposits (2012: £422.5 billion, 2011: £405.9 billion) and a continued reduction in non-core assets (2012: £98.4 billion, 2011: £140.7 billion).

On the same basis, the Group loan to deposit ratio has improved to 121 per cent compared with 135 per cent at 31 December 2011, driven by strong deposit growth and non-core asset reduction. The core loan to deposit ratio also improved to 101 per cent from 109 per cent at 31 December 2011, close to the Group's long-term target of 100 per cent for the core, which the Group continues to expect to reach in the first quarter of 2013, at the same time as achieving a 120 per cent ratio in the Group.

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Table 1.51: **Group funding position (audited)**

	2012 £bn	2011 £bn	Change %
At 31 December			
Funding requirement			
Loans and advances to customers[1]	512.1	548.8	(7)
Loans and advances to banks[2]	9.1	10.3	(12)
Debt securities	5.3	12.5	(58)
Available-for-sale financial assets – secondary[3]	5.3	12.0	(56)
Cash balances[4]	3.5	4.1	(15)
Funded assets	535.3	587.7	(9)
Other assets[5]	295.9	286.1	3
	831.2	873.8	(5)
On balance sheet primary liquidity assets:[6]			
Reverse repurchase agreements	5.8	17.3	(66)
Balances at central banks – primary[4]	76.8	56.6	36
Available-for-sale financial assets – primary	26.1	25.4	(3)
Held to maturity	–	8.1	
Trading and fair value through profit or loss	(9.4)	(3.5)	
Repurchase agreements	(5.9)	(7.2)	18
	93.4	96.7	(3)
Total Group assets	924.6	970.5	(5)
Less: other liabilities[5]	(266.0)	(251.6)	(6)
Funding requirement	658.6	718.9	(8)
Funded by			
Customer deposits[7]	422.5	405.9	4
Wholesale funding	169.6	251.2	(32)
	592.1	657.1	(10)
Repurchase agreements	21.8	15.2	43
Total equity	44.7	46.6	(4)
Total funding	658.6	718.9	(8)

[1] Excludes £5.1 billion (2011: £16.8 billion) of reverse repurchase agreements.

[2] Excludes £19.6 billion (2011: £21.8 billion) of loans and advances to banks within the Insurance business and £0.7 billion (2011: £0.5 billion) of reverse repurchase agreements.

[3] Secondary liquidity assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

[4] Cash balances and balances at central banks – primary are combined in the Group's balance sheet.

[5] Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

[6] Primary liquidity assets are FSA eligible liquid assets including UK Gilts, US Treasuries, Euro AAA government debt and unencumbered cash balances held at central banks.

[7] Excluding repurchase agreements of £4.4 billion (2011: £8.0 billion).

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Table 1.52: **Reconciliation of Group funding figure to the balance sheet (audited)**

	Included in funding analysis (table 1.48) £bn	Repos £bn	Fair value and other accounting methods £bn	Balance Sheet £bn
At 31 December 2012				
Deposits from banks	**15.1**	**23.3**	**–**	**38.4**
Debt securities in issue	**120.4**	**–**	**(3.0)**	**117.4**
Subordinated liabilities	**34.1**	**–**	**–**	**34.1**
Total wholesale funding	**169.6**	**23.3**		
Customer deposits	**422.5**	**4.4**	**–**	**426.9**
Total	**592.1**	**27.7**		
At 31 December 2011				
Deposits from banks	25.4	14.4	–	39.8
Debt securities in issue	189.9	–	(4.8)	185.1
Subordinated liabilities	35.9	–	(0.8)	35.1
Total wholesale funding	251.2	14.4		
Customer deposits	405.9	8.0	–	413.9
Total	657.1	22.4		

Liquidity Portfolio

At 31 December 2012, the Group had £87.6 billion (2011: £94.8 billion) of highly liquid unencumbered assets in its primary liquidity portfolio which are available to meet cash and collateral outflows, as illustrated in the table below. In addition the Group had £117.1 billion (2011: £107.4 billion) of secondary liquidity covering a range of ratings but all investment grade and central bank eligible. This liquidity is managed as a single pool in the centre under the control of the function charged with managing the liquidity of the Group. It is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of the Group's liquidity management process.

Table 1.53: **Liquidity portfolio (unaudited)**

Primary liquidity	**2012 £bn**	2011 £bn	**Average 2012 £bn**	Average 2011 £bn
Central bank cash deposits	**76.8**	56.6	**78.3**	51.4
Government bonds	**10.8**	38.2	**21.1**	48.4
Total	**87.6**	94.8	**99.4**	99.8
Secondary liquidity	**2012 £bn**	2011 £bn	**Average 2012 £bn**	Average 2011 £bn
High-quality ABS/covered bonds[1]	**2.8**	1.4	**2.1**	8.0
Credit institution bonds[1]	**3.4**	2.1	**2.8**	3.7
Corporate bonds[1]	**0.1**	0.3	**0.1**	0.6
Own securities (retained issuance)	**44.9**	81.6	**50.2**	76.8
Other securities	**5.0**	8.6	**8.3**	9.2
Other[2]	**60.9**	13.4	**49.8**	6.4
Total	**117.1**	107.4	**113.3**	104.7
Total liquidity	**204.7**	202.2		

[1] Assets rated A- or above.

[2] Includes other central bank eligible assets.

Table 1.54: **Liquidity portfolio: currency (unaudited)**

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2012					
Primary Liquidity	**42.2**	**7.2**	**36.5**	**1.7**	**87.6**
Secondary Liquidity	**109.2**	**1.6**	**4.7**	**1.6**	**117.1**
Total	**151.4**	**8.8**	**41.2**	**3.3**	**204.7**
At 31 December 2011					
Primary Liquidity	65.6	13.8	14.8	0.6	94.8
Secondary Liquidity	93.9	5.0	6.9	1.6	107.4
Total	159.5	18.8	21.7	2.2	202.2

Following the introduction of the FSA's individual liquidity guidance under ILAS, the Group now manages its liquidity position as a coverage ratio (proportion of stressed outflows covered by primary liquid assets) rather than by reference to a quantum of liquid assets; the liquidity position reflects a buffer over the regulatory minimum.

Primary liquid assets of £87.6 billion represent approximately 260 per cent (133 per cent at 31 December 2011) of the Group's money market funding positions and are approximately 173 per cent (84 per cent at 31 December 2011) of all wholesale funding with a maturity of less than one year, and thus provides substantial buffer in the event of continued market dislocation.

In addition to primary liquidity holdings the Group has significant secondary liquidity holdings providing access to open market operations at a number of central banks which the Group routinely makes use of as part of its normal liquidity management practices. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions.

During 2012, the GALCO mandated Group Corporate Treasury to establish a new core Liquidity and Collateral asset portfolio. The portfolio is subject to defined risk appetite with tight controls over eligible assets, which must also be diversified across geography, currency, markets and tenor.

Stress testing results

Internal stress testing results at 31 December 2012 show that the Group has liquidity resources representing 128 per cent of modelled outflows from all wholesale funding sources, retail and corporate deposits, intra-day requirements and rating dependent contracts under the Group's most severe liquidity stress scenario (the three month combined (market wide and Group specific) scenario).

The Group's stress testing assumes that further credit rating downgrades may reduce investor appetite for some of the Group's liability classes and therefore funding capacity. In June 2012 the Group experienced a one notch downgrade in its long-term rating from Moody's, following the agency's review of 114 European banks. The impact that the Group experienced following the downgrade was not material and was consistent with the modelled outcomes based on the stress testing framework. A hypothetical idiosyncratic two notch downgrade of the Group's current long-term debt rating and accompanying short-term downgrade, implemented instantaneously by all major rating agencies could result in an outflow of £11.5 billion of cash over a period of up to one year, £3.5 billion of collateral posting related to customer financial contracts and £18.0 billion of collateral posting associated with secured funding. The Group's internal liquidity risk appetite includes such a stress scenario. The stress scenario modelling demonstrates the Group has available liquidity resources to manage such an event.

Encumbered assets

During 2012 the Group was a consistent issuer in a number of secured funding markets, in particular residential mortgage-backed securities and covered bonds. The table below summarises the assets encumbered through the Group's external issuance transactions.

Table 1.55: **Secured external issuance transactions (audited)**

	Notes issued £bn	Assets encumbered[3] £bn
At 31 December 2012		
Securitisations[1]	**28.1**	**40.0**
Covered bonds[2]	**40.7**	**56.7**
Total	**68.8**	**96.7**
At 31 December 2011		
Securitisations[1]	37.4	50.0
Covered bonds[2]	38.2	52.0
Total	75.6	102.0

[1] In addition the Group retained internally £58.7 billion (2011: £86.6 billion) of notes secured with £78.2 billion (2011: £114.6 billion) of assets. For details on the Group's securitisation programme refer to note 21 on page 252.

[2] In addition the Group retained internally £26.3 billion (2011: £31.9 billion) of notes secured with £37.6 billion (2011: £42.4 billion) of assets. For details on the Group's covered bond programme refer to note 21 on page 252.

[3] Pro-rated by programme asset type.

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The Board monitors and manages total balance sheet encumbrance via a risk appetite metric. The Group's level of encumbrance arising from external issuance of securitisation and covered bonds has remained broadly constant, reflecting the maturity and stability of the Group's utilisation of this form of term funding, and the established cycle of redemptions and new issuance. Total notes issued externally from secured programmes (asset-backed securities (ABS) and covered bonds) have fallen from £75.6 billion at 31 December 2011 to £68.8 billion, reflecting a reduction in the number of outstanding programmes as well as lower issued balances. A total of £85.1 billion (2011: £118.5 billion) of notes issued under securitisation and covered bond programmes have also been retained internally, most of which are held to provide a pool of collateral eligible for use with central bank liquidity facilities. This reduction in retained notes partially reflects the Group's increased use of whole loans as eligible collateral at central banks.

The Group uses secured transactions to manage short-term cash and collateral needs. At 31 December 2012, the fair value of collateral pledged as security in repo transactions was £48.1 billion (2011: £39.7 billion). Internally held notes encumbered through repo activity or assets pledged are included in these disclosure amounts. Note 55 on page 329 sets out further information on assets pledged as security. Within asset-backed commercial paper (ABCP) conduits, assets pledged as security for ABCP investors totalled £6.4 billion (2011: £8.8 billion). Note 22 on page 253 sets out the assets held within the ABCP conduits.

Group borrowing costs

The Group's borrowing costs and issuance in the capital markets are dependent on a number of factors, and increased cost or reduction of capacity could materially adversely affect the Group's results of operations, financial condition and prospects. In particular, reduction in the credit rating of the Group or deterioration in the capital markets' perception of the Group's financial resilience could significantly increase its borrowing costs and limit its issuance capacity in the capital markets. As an indicator over the last 12 months the spread between an index of A rated long term senior unsecured bank debt and an index of similar BBB rated bank debt, both of which are publicly available, averaged 134 basis points. The applicability to and implications for the Group's funding cost would depend on the type of issuance, and prevailing market conditions. The impact on the Group's funding cost is subject to a number of assumptions and uncertainties and is therefore impossible to quantify precisely.

The rating changes that the Group has experienced since the fourth quarter of 2011 did not significantly change its borrowing costs, reduce its issuance capacity or require significant collateral posting. In November 2012 Standard & Poor's revised its outlook on the Group's long-term rating to negative from stable. However, even if a two notch long-term downgrade and a simultaneous short-term downgrade occurred, the Group would remain investment grade.

Hybrid capital securities coupon payments

The discretionary payments on Tier 1 hybrid capital securities which are expected to be paid in 2013, subject to their terms and conditions, are estimated to amount to approximately £350 million. In the context of on-going macro prudential policy discussions, the Board of Lloyds Banking Group has decided to issue new Lloyds Banking Group ordinary shares to raise this amount. The Group has entered into an agreement with a third-party financial institution in connection with the issue of these new ordinary shares. Such ordinary shares are expected to be issued, subject to market conditions, by the end of April 2013 at a price determined by reference to the volume weighted average price of our ordinary shares in a period prior to their date of issue.

Insurance risk

Definition

Insurance risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

Risk appetite

Insurance risk appetite is defined with regard to the quantum and composition of insurance risk that exists currently in the Group and the Group's risk preferences. It takes account of the need for each entity in the Group to maintain solvency in excess of the minimum level required by the entity's jurisdictional legal or regulatory requirements. The Group's appetite for Insurance solvency and earnings is reviewed and approved annually by the Board.

Protecting today,
securing tomorrow.

Exposures

The major sources of insurance risk within the Group are the Insurance business and the Group's defined benefit pension schemes. The nature of Insurance business involves the accepting of insurance risks which relate primarily to mortality, longevity, morbidity, persistency, expenses, property and unemployment. The prime insurance risk of the Group's defined benefit pension schemes is related to longevity.

Measurement

Insurance risks are measured using a variety of techniques including stress and scenario testing, and where appropriate, stochastic modelling. Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-200 year stresses (Group defined benefit pension schemes utilise 1-in-20 year stresses) and other supporting measures where appropriate, including those set out in notes 37 and 38 to the financial statements.

Mitigation

A key element of the control framework is the consideration of insurance risk by an appropriate combination of high level committees and Boards. For the Insurance business the ultimate control body is the Board of Scottish Widows Group Limited with significant risks also reviewed by the Group Executive and Group Risk Committees and/or Board. All Group defined benefit pension schemes issues are covered by the Group Asset and Liability Committee and the Group Risk Committee.

Insurance risk is mitigated through pooling and through diversification across large numbers of individuals, geographical areas, and different types of risk exposure. A number of processes are used to control insurance risk including: Underwriting (the process to ensure that new insurance proposals are properly assessed); Pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products); Claims management; Product design and management; Policy wording; Reinsurance and Cost controls and efficiencies.

In addition, exposure limits by risk type are assessed through the business planning process and used as a control mechanism to ensure risks are taken within risk appetite. At all times, close attention is paid to the adequacy of reserves, solvency management and regulatory requirements.

The most significant insurance risks within the Insurance business are longevity risk, persistency risk and expenses. The merits of longevity risk transfer and hedging solutions are regularly reviewed. It is not possible to hedge persistency risk.

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to the Group's chosen reinsurers.

In respect of insurance risks in the defined benefit pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees to assist with the management of risk in line with the Group's risk appetite.

Monitoring

Ongoing monitoring is in place to track the progression of insurance risks. This involves monitoring relevant experiences against expectations (for example claims experience, persistency experience, expenses and non-disclosure at the point of sale) as well as tracking the progression of insurance risk capital against limits. As part of this, the effectiveness of controls put in place to manage insurance risk are evaluated and any significant divergences from experience or movements in risk exposures are investigated and remedial action taken.

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Regulatory risk

Definition

Regulatory risk is defined as the risk that the Group is exposed to fines, censure, or legal or enforcement action due to failing to comply with applicable laws, regulations, codes of conduct or legal obligations.

Risk appetite

The Group has zero risk appetite for material regulatory breaches. This appetite is reviewed and approved annually by the Board. To achieve this, the Group has policies, processes and standards which provide the framework for businesses and colleagues to operate in accordance with the laws, regulations and voluntary codes which apply to the Group and its activities.

Maintaining an effective relationship with our regulators remains a key focus for the Group.

Exposures

Regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be interpreted, implemented and embedded into day-to-day operational and business practices across the Group. This is particularly the case currently: the industry is witnessing increased levels of government and regulatory intervention in the banking sector.

There are a number of regulatory issues and challenges across the broader regulatory environment such as changes in the investment advice regulations when the Retail Distribution Review (RDR) came into force on 1 January 2013; ongoing focus on changes in the anti-bribery and sanctions controls; and being dual regulated by two new regulators (the Prudential Regulation Authority and Financial Conduct Authority). This is expected to happen from April 2013. At a European and US level, significant regulatory initiatives and new directives or changes to existing directives will impact the Group in the next 12 to 24 months. This includes the enactment of the Dodd-Frank Act, a revised Markets in Financial Instruments Directive and development of the Single Supervisory Mechanism.

Measurement

Regulatory risks are measured against a set of risk appetite metrics, with appropriate limits and triggers, which have been approved by the Board and which are regularly reviewed and monitored at the Group Conduct and Compliance Committee. Metrics include assessments of control and material regulatory rule breaches.

Mitigation

Mitigation is undertaken across the Group and comprises the following key components:

- Risks are assessed by the business and controls put in place to mitigate them.
- Oversight and assurance of the regulatory risks within the business.
- Theme reviews to assess compliance with rules, regulations and policies.
- Senior business leaders monitor the progress of these assessments and mitigations.
- Material risks and issues are escalated to Group-level bodies which challenge the business on its management of risks and issues.
- Mandated policies and processes require minimum control frameworks, management information and standards to be implemented.
- The Group takes very seriously its responsibilities for complying with legal and regulatory sanctions requirements in all the jurisdictions in which it operates. In order to assist adherence to relevant economic Sanctions legislation, the Group has enhanced its internal compliance processes including those associated with customer and payment screening. The Group has continued the delivery of a programme of staff training regarding policies and procedures for detecting and preventing economic sanctions non-compliance.

Monitoring

Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. The report forms the basis of challenge to the business at the monthly Group Compliance and Conduct Risk Committee. This committee may escalate matters to the Chief Risk Officer, or higher committees. The report also forms the basis of the regulatory sections in the Group's consolidated risk reporting.

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Capital risk

Definition

Capital risk is defined as the risk that the Group has a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Risk Appetite

Capital risk appetite is set by the Board, reflecting the Group's strategic plans, regulatory capital constraints and market expectations, and includes a number of minimum capital ratios and target buffers. The Board and the Group Chief Executive, assisted by the Group Asset and Liability Committee, regularly review performance against the risk appetite. A key metric is the Group's core tier 1 capital ratio which the Group currently aims to maintain prudently in excess of 10 per cent.

> We have made significant progress and continue to deliver on our strategy of strengthening the balance sheet to improve the resilience of the Group.

Exposure

A capital exposure arises where the Group has insufficient capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures while optimising value for shareholders.

Measurement

The Group measures the amount of capital it holds using the FSA's definitions. Until the Basel III reforms for an enhanced global capital accord are introduced in the EU through the implementation of the new Capital Requirements Directive and Regulation (CRD IV), the regulatory minimum and buffer amounts of capital continue to be based upon the Basel II framework.

The regulatory minimum amounts of capital, under Pillar I of the Basel framework, are determined as percentages of the aggregate risk-weighted assets calculated for credit risk, operational risk and market risk (Trading Book), which are predominately calculated using internal models that are prudently calibrated based on internal loss experience. The models are subject to a number of internal controls and external scrutiny from the FSA.

The minimum requirement for total capital is supplemented, under Pillar II of the framework, through the issuance of bank specific Individual Capital Guidance (ICG) which adjusts the Pillar I minimum for those risks not covered or not fully covered under Pillar I. A key input into the FSA's ICG setting process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process. The Group has been set an ICG by the FSA and maintains capital at a level which exceeds this requirement.

As part of the capital planning process, capital positions are subjected to an extensive stress analysis to determine the adequacy of the Group's capital resources against the minimum requirements, including ICG, over the forecast period. The outputs from some of these stress analyses are used by the FSA to set a Capital Planning Buffer (CPB) for the Group. This comprises minimum levels of capital buffers over and above the minimum regulatory requirements for core tier 1 and total capital that should be maintained in non-stressed conditions as mitigation against potential future periods of stress.

The FSA requires ICG and CPB to remain confidential matters between a bank and the FSA.

Mitigation

The Group has developed procedures to ensure that it complies with current requirements, is positioned to meet anticipated future requirements and that policies and risk appetite are aligned to them.

The Group is able to accumulate additional capital through profit retention, by raising equity via, for example, a rights issue or debt exchange and by raising tier 1 and tier 2 capital by issuing subordinated liabilities, taking account of the potential capital eligibility requirements under CRD IV. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time.

The Group has in issue, as part of tier 2 capital resources, Enhanced Capital Notes which will convert to core tier 1 capital in the event that the Group's published core tier 1 ratio (as defined by the FSA in May 2009) falls below 5 per cent.

Additional measures to manage the Group's capital position include seeking to strike an appropriate balance of capital held within its insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises.

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Monitoring

Capital is actively managed and regulatory ratios are a key factor in the Group's budgeting and planning processes.

Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios, including those that could occur under CRD IV and in stressed scenarios, is submitted to the Senior Asset and Liability Committee (a sub-committee of the Group Asset and Liability Committee), the Group Asset and Liability Committee, the Group Risk Committee and the Board.

The regulatory framework within which the Group operates continues to be enhanced as part of the global banking reforms. The Group monitors these developments very closely, participates actively in the regulatory consultation processes and analyses the potential financial impacts, ensuring that the Group continues to have a strong loss absorption capacity exceeding regulatory requirements.

Over the course of 2012 some of the key developments were:

- In October, the UK Government published the draft Financial Services (Banking Reform) Bill which will give effect to the recommendations of the Independent Commission on Banking covering banking structural reforms ('ring-fencing' of retail banking activities), bail-in of senior debt and depositor preference. In December, the Parliamentary Commission on Banking Standards published its first report commenting upon the draft Bill.
- In November the Financial Stability Board published an updated list of Global Systemically Important Banks (G-SIBs) which no longer included the Group. The Group remains, however, a Domestic Systemically Important Bank (D-SIB) within the UK.
- The implementation of CRD IV has been delayed beyond the original proposed date of 1 January 2013 to an as yet unknown implementation date while certain parts of the draft directive and regulation continue to be refined.

Generally, the reforms are developed and phased in over long periods which allows time for the Group to further strengthen its capital position as necessary through business performance and mitigating actions.

Capital management in 2012

The Group actively manages its capital position, closely monitoring the changing market and regulatory environments. The Group further strengthened its capital ratios in 2012. This was principally driven by management profit and a reduction in risk-weighted assets, reflecting asset reductions and the substantial decrease in risk, partly offset by statutory items and tax costs. The core business remains strongly capital generative and there is continued progress in simultaneously reducing risk and creating capital through the disposal of non-core assets.

Capital position at 31 December 2012

The Group's capital position, at 31 December 2012 and applying the existing regulatory framework, is set out in the following section. Additionally, estimated pro forma information about the Group's capital position on a CRD IV basis is set out on page 192.

Table 1.56: **Capital resources (audited)**

	2012 £m	2011 £m
Core tier 1		
Shareholders' equity per balance sheet	**43,999**	45,920
Non-controlling interests per balance sheet	**685**	674
Regulatory adjustments:		
Regulatory adjustments to non-controlling interests	**(628)**	(577)
Adjustment for own credit	**217**	(136)
Defined benefit pension adjustment	**(1,438)**	(1,004)
Unrealised reserve on available-for-sale debt securities	**(343)**	(940)
Unrealised reserve on available-for-sale equity investments	**(56)**	(386)
Cash flow hedging reserve	**(350)**	(325)
Other items	**33**	(36)
	42,119	43,190
Less: deductions from core tier 1		
Goodwill	**(2,016)**	(2,016)
Intangible assets	**(2,091)**	(2,310)
50% excess of expected losses over impairment provisions (unaudited)	**(636)**	(720)
50% of securitisation positions	**(183)**	(153)
Core tier 1 capital	**37,193**	37,991
Non-controlling preference shares[1]	**1,568**	1,613
Preferred securities[1]	**4,039**	4,487
Less: deductions from tier 1		
50% of material holdings	**(46)**	(94)
Total tier 1 capital	**42,754**	43,997
Tier 2		
Undated subordinated debt	**1,828**	1,859
Dated subordinated debt	**19,886**	21,229
Unrealised gains on available-for-sale equity investments	**56**	386
Eligible provisions	**977**	1,259
Less: deductions from tier 2		
50% excess of expected losses over impairment provisions (unaudited)	**(636)**	(720)
50% of securitisation positions	**(183)**	(153)
50% of material holdings	**(46)**	(94)
Total tier 2 capital	**21,882**	23,766
Supervisory deductions		
Unconsolidated investments – life	**(10,104)**	(10,107)
Unconsolidated investments – general insurance and other	**(929)**	(2,660)
Total supervisory deductions	**(11,033)**	(12,767)
Total capital resources	**53,603**	54,996

[1] Covered by grandfathering provisions issued by FSA.

Table 1.57: **Risk Weighted Assets and Capital Ratios (unaudited)**

	2012 £m	2011 £m
Risk-weighted assets	**310,299**	352,341
Ratios		
Core tier 1 capital ratio	**12.0%**	10.8%
Tier 1 capital ratio	**13.8%**	12.5%
Total capital ratio	**17.3%**	15.6%

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Core tier 1 capital

Core tier 1 capital has reduced by £798 million during 2012 primarily due to the attributable loss for the period and the deduction of the increase to the pension scheme asset balances, which have been partially offset by a decrease in the deductions of intangibles, the adjustment for own credit, the excess of expected losses over impairment provisions and share issuance.

The movements in core tier 1, tier 1, tier 2 and total capital in the period are shown below:

Table 1.58: **Movements in capital (unaudited)**

	Core tier 1 £m	Tier 1 £m	Tier 2 £m	Total £m
At 31 December 2011	37,991	6,006	23,766	54,996
Loss attributable to ordinary shareholders	(1,427)	–	–	(1,427)
Regulatory post-retirement benefit adjustments	(434)	–	–	(434)
Adjustment for own credit	353	–	–	353
Goodwill and intangible assets deductions	219	–	–	219
Excess of expected losses over impairment	84	–	84	168
Material holdings deduction	–	48	48	96
Eligible provisions	–	–	(282)	(282)
Subordinated debt movements:				
Foreign exchange	–	(194)	(1,186)	(1,380)
New issuances	–	–	128	128
Repurchases, redemptions and other	–	(299)	(316)	(615)
Supervisory deductions from total capital	–	–	–	1,734
Other movements	407	–	(360)	47
At 31 December 2012	**37,193**	**5,561**	**21,882**	**53,603**

Tier 1 capital

Tier 1 capital has decreased in the period by £445 million mainly as a result of a debt exchange undertaken in February 2012 and foreign exchange movements.

Tier 2 capital

Tier 2 capital has decreased in the period by £1,884 million largely arising from a decrease in dated subordinated debt, principally due to amortisation, foreign exchange movements and fair value movements in Enhanced Capital Notes. Unrealised gains on available-for-sale equity investments have also decreased in the year.

Supervisory deductions

Supervisory deductions principally consist of investments in subsidiary undertakings that are not within the banking group for regulatory purposes. These investments are primarily the Scottish Widows and Clerical Medical life and pensions businesses together with the Group’s general insurance business and the investment in St. James’s Place.

At 31 December 2011 deductions for other unconsolidated investments also included private equity investments in non-financial entities. At 31 December 2012, revised regulatory rules have been applied to these investments which are now risk-weighted rather than being deducted from total capital.

Table 1.59: **Risk-weighted assets (unaudited)**

	2012 £m	2011 £m
Divisional analysis of risk-weighted assets		
Retail	95,470	103,237
Commercial Banking	165,209	192,885
Wealth, Asset Finance and International	36,167	43,593
Group Operations and Central items	13,453	12,626
	310,299	352,341
Risk type analysis of risk-weighted assets		
Foundation IRB	80,612	90,450
Retail IRB	91,445	98,823
Other IRB	12,396	9,433
IRB Approach	184,453	198,706
Standardised Approach	73,665	103,525
Credit risk	258,118	302,231
Operational risk	27,939	30,589
Market and counterparty risk	24,242	19,521
Total risk-weighted assets	310,299	352,341

Risk-weighted assets reduced by £42,042 million to £310,299 million, a decrease of 12 per cent. This reflects a combination of balance sheet reductions of non-core assets, lower core lending balances and strong management of risk.

Retail risk-weighted assets reduced by £7,767 million mainly due to lower lending volumes.

The reduction of Commercial Banking risk-weighted assets of £27,676 million primarily reflects further balance sheet reductions of non-core assets.

Risk-weighted assets within Wealth, Asset Finance and International have reduced by £7,426 million as a result of the run down of non-core asset portfolios and foreign exchange movements.

Operational risk-weighted assets are determined under the standardised approach, which uses income as the basis of calculation. The decrease in the risk-weighted assets is a result of a reduction in three year rolling-average income.

During 2012 equity portfolios and investments previously measured on the standardised approach were transferred to the internal ratings based approach (Other IRB). The Group anticipates moving further portfolios that are currently measured on the standardised approach over to an IRB methodology during 2013.

Pro forma CRD IV capital and leverage information

CRD IV capital and leverage estimates will be incorporated in the Group's Pillar III report in detailed templates. The data in the following tables represent a summary of the information that will be published as part of the Group's Pillar III report. These estimates reflect the Group's current interpretation of the draft rules. The actual impact of CRD IV on capital ratios may be materially different as the requirements and related technical standards have not yet been finalised. The actual impact will also be dependent on required regulatory approvals and the extent to which further management action is taken prior to implementation.

Capital position on CRD IV basis

The Group's capital position at 31 December 2012 calculated on current regulatory rules and also estimated on a pro forma basis, applying the CRD IV rules and assuming existing FSA waivers still apply, is shown in the table below.

The pro forma CRD IV capital resources shown reflect estimates of the impact of the rules laid out in the draft of CRD IV published by the European Commission in July 2011 (July 2011 draft) on both a transitional basis as if 2012 had been the first year of transition and on a fully loaded basis (referred to as CRD IV 'end-point definition' in FSA documentation). The transitional position shown is consistent with FSA's statement 'CRD IV transitional provisions on capital resources' published on 26 October 2012 on the FSA website.

The estimates of pro forma CRD IV risk-weighted assets shown are also based upon July 2011 draft rules updated to reflect the Group's current view of the most likely application of the final rules.

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Table 1.60: **Capital position on CRD IV basis (unaudited)**

		Pro forma CRD IV rules	
	Current Rules £m	Transitional estimate £m	Fully loaded estimate £m
31 December 2012			
Core/common equity tier 1 (CET1)			
Shareholders equity per balance sheet	43,999	43,999	43,999
Regulatory adjustments:			
Non-controlling interests	57	57	–
Unrealised reserves on available for sale assets	(399)	(399)	–
Other adjustments	(1,538)	(1,675)	(1,675)
	42,119	41,982	42,324
less: deductions from core/common equity tier 1			
Goodwill and other intangible assets	(4,107)	–	(4,107)
Excess of expected losses over impairment provisions	(636)	–	(1,272)
Securitisation deductions	(183)	(366)	(366)
Significant investments	–	–	(5,066)
Deferred tax assets	–	(511)	(5,655)
Excess AT1 deductions reallocated to CET1	–	(3,720)	–
Core/common equity tier 1 Capital	37,193	37,385	25,858
Additional tier 1 (AT1)			
Additional tier 1 instruments	5,607	5,009	–
less: deductions from tier 1			
Goodwill and other intangible assets	–	(4,107)	–
Excess of expected losses over impairment provisions	–	(636)	–
Significant investments	(46)	(3,986)	–
Reallocated excess AT1 deductions to CET1	–	3,720	–
Total tier 1 capital	42,754	37,385	25,858
Tier 2			
Tier 2 instruments	21,714	20,990	13,571
Unrealised gain on available for sale equity investments	56	56	–
Eligible provisions	977	–	–
less: deductions from tier 2			
Excess of expected losses over impairment provisions	(636)	(636)	–
Securitisation deductions	(183)	–	–
Significant investments	(46)	(3,986)	(2,907)
Subsidiary surplus tier 2	–	–	(371)
less: deductions from total capital			
Significant investments	(11,033)	–	–
Total capital resources	53,603	53,809	36,151
Risk-weighted assets	310,299	322,468	321,097
Core/common equity tier 1 capital ratio	12.0%	11.6%	8.1%
Tier 1 Capital ratio	13.8%	11.6%	8.1%
Total Capital ratio	17.3%	16.7%	11.3%

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At 31 December 2012, on a pro forma CRD IV transitional basis the Group's estimated common equity tier 1 (CET1-CRD IV equivalent of core tier 1) ratio would have been 11.6 per cent, and on a pro forma CRD IV fully loaded basis it would have been 8.1 per cent.

The key impacts on capital resources of the transitional rules are that:

- The deductions for goodwill and other intangible assets and excess of expected losses over impairment provisions that are made from core tier 1 under the current rules are made from additional tier 1;
- A part of the deduction that would otherwise be made for significant investments is risk-weighted instead. The residual deduction is made 50 per cent from tier 1 and 50 per cent from tier 2 rather than from total capital;
- The deduction made for securitisations is made fully from CET1 rather than 50 per cent from core tier 1 and 50 per cent from tier 2 capital as under the current rules;
- A proportion of the deferred tax asset is deducted from CET1;
- A proportion of the additional tier 1 and tier 2 instruments become ineligible under the grandfathering rules;
- Eligible provisions are nil as collectively assessed impairment provisions for the standardised portfolios can no longer be included under tier 2 capital (instead a corresponding reduction is made to standardised risk-weighted assets); and
- The deductions to be made from additional tier 1 exceed the amount of available additional tier 1 capital instruments. The excess is deducted from CET1.

The impact of the fully loaded rules on capital resources is that:

- Non-controlling interests are no longer eligible for inclusion;
- The amount of unrealised reserves on available for sale assets are included in full rather than being deducted;
- Excess of expected losses over impairment provisions and the deduction made for securitisations are deducted fully from CET1 instead of 50 per cent from core tier 1 and 50 per cent from tier 2 under the current rules;
- The amount of significant investments that is not risk-weighted is fully deducted following a corresponding deduction approach;
- Deferred tax assets are deducted from CET1;
- Existing additional tier 1 and a proportion of tier 2 instruments become ineligible and are excluded. The Group would expect to accumulate additional tier 1 and tier 2 capital as required through the issuance of subordinated liabilities, taking account of the potential capital eligibility requirements under CRD IV. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time;
- Eligible provisions are nil as collectively assessed impairment provisions for the standardised portfolios can no longer be included under tier 2 capital (instead a corresponding reduction is made to standardised risk-weighted assets); and
- Subsidiary surplus within tier 2 relates to the restriction of capital instruments of a subsidiary that can be recognised as capital at the consolidated group level.

The CRD IV impact on risk-weighted assets includes estimates for credit valuation adjustment (CVA) volatility and risk-weighting of the available elements of the deferred tax asset and the investment in the Group's Insurance businesses. It is assumed that EU corporates are exempt from the CVA volatility charge and that the national discretion over 180 day default remains for UK retail mortgages.

The Group's capital position may be different should alternative text be agreed. There are potential changes that could result in increases to risk-weighted assets including, for example, the application of a 90 day definition of default for retail assets and the EU corporate exemption from the CVA not applying. Conversely, if the FSA were to apply the more favourable treatment allowed in relation to insurance holdings (rather than the less favourable treatment that has been assumed will apply), this would increase the estimated fully loaded CET1 ratio by a further 1.0 per cent.

The pro forma fully loaded CRD IV CET1 ratio of 8.1 per cent comfortably exceeds the 4.5 per cent minimum and the additional 2.5 per cent conservation buffer that are required under the draft rules from 2019. Nevertheless, the Group will continue to monitor closely the emergence of the final rules and their impact upon its ratios. Moreover, through transition to the new rules, the Group is aiming to build the ratio to an amount prudently in excess of 10 per cent by continuing to run down its non-core portfolios and by profit generation.

Leverage ratio on CRD IV basis

The Basel III reforms include the introduction of a capital leverage measure defined as the ratio of tier 1 capital to total exposure. This is intended to reinforce the risk based capital requirements with a simple, non-risk based backstop measure. The Basel Committee have proposed that final adjustments to the definition and calibration of the leverage ratio be carried out in 2017, with a view to migrating to a Pillar I treatment in 2018.

In the interim, the FSA has asked the Group to publish the estimated leverage ratio on a fully loaded CRD IV basis, with and without ineligible tier 1 instruments, to indicate the approximate leverage ratio that the Group would have now were the CRD IV rules fully implemented.

The Group's estimates of its leverage ratio at 31 December 2012 are shown in the table below on three different bases:

- The 'CRD IV Transitional' basis uses the tier 1 capital calculated by applying the rules laid out in the July 2011 draft publication of CRD IV on a transitional basis as if 2012 had been the first year of transition. The tier 1 capital amount corresponds to that shown in the second column of table 1.61.
- The 'CRD IV fully loaded' basis uses the tier 1 capital calculated by applying the rules laid out in the July 2011 draft publication of CRD IV, without applying any transitional provisions and corresponds to the amount shown in the third column in table 1.61.
- The 'CRD IV fully loaded with ineligible tier 1 instruments grandfathered' basis uses the tier 1 capital calculated by applying the rules laid out in the July 2011 draft publication of CRD IV, without transition, with the exception that tier 1 instruments which will be ineligible once the transitional phase has elapsed are counted in full.

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Table 1.61: **Leverage ratio on CRD IV basis (unaudited)**

	Pro forma CRD IV rules		
	CRD IV Transitional estimate £m	CRD IV Fully loaded estimate £m	CRD IV Fully loaded estimate (with ineligible T1 instruments grandfathered) £m
At 31 December 2012			
Total tier 1 capital for leverage ratio			
Common equity tier 1	37,385	25,858	25,858
Tier 1 subordinated debt allowable for leverage	5,009	–	5,607
Tier 1 deductions	(5,009)	–	–
	37,385	25,858	31,465
Exposures for leverage ratio			
Total statutory balance sheet assets	924,552	924,552	924,552
Remove accounting value of derivatives and securities finance transactions	(76,731)	(76,731)	(76,731)
Adjustment for insurance assets	(99,464)	(109,786)	(109,786)
Derivatives	20,174	20,174	20,174
Securities finance transactions	7,936	7,936	7,936
Off-balance sheet including unconditionally cancellable	76,899	76,899	76,899
Other regulatory adjustments	(6,781)	(12,619)	(12,619)
Total exposures	846,585	830,425	830,425
Leverage ratio	4.4%	3.1%	3.8%

Derivatives and securities financing transactions have been calculated by applying the accounting measure of exposure (plus, for derivatives, an add-on for potential future exposure) and the regulatory netting rules based on the Basel II Framework.

To ensure that the capital and exposure components of the ratio are measured consistently, the assets of the insurance entities included in the accounting consolidation have been excluded from the exposure measure in proportion to the capital that is excluded in tier 1.

The Group's estimated fully loaded leverage ratio (with ineligible tier 1 instruments grandfathered) is 3.8 per cent and the Group's estimated fully loaded leverage ratio, excluding the tier 1 instruments is 3.1 per cent. These would both be in excess of the Basel Committee's minimum ratio of 3 per cent which is proposed should become a Pillar I requirement by 1 January 2018. The Group will continue to monitor closely the leverage ratio against the emerging rules and minimum calibration and will aim to increase the ratio further by continuing to run down its non-core portfolios and by profit generation.

Life insurance businesses

The business transacted by the life insurance companies within the Group comprises unit-linked business, non-profit business and with-profits business. Several companies transact either unit-linked and/or non-profit business, but Scottish Widows plc (Scottish Widows) and Clerical Medical Investment Group Limited (Clerical Medical) hold the only large With-Profit Funds managed by the Group.

Basis of determining regulatory capital of the life insurance businesses

Available capital resources

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the FSA.

Statutory basis: Assets are generally valued on a basis consistent with that used for accounting purposes (with the exception that, in certain cases, the value attributed to assets is limited) and which follows a market value approach where possible. If the market is not active, the Group establishes a fair value by using valuation techniques. Liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets in accordance with the FSA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

Regulatory capital requirements

Each life insurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the FSA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows and Clerical Medical, the regulatory capital requirement is a combination of amounts held in respect of actuarial reserves, sums at risk and maintenance expenses (the Long-Term Insurance Capital Requirement) and amounts required to cover various stress tests (the Resilience Capital Requirement). The regulatory capital requirement is deducted from the available capital resources to give statutory excess capital.

For Scottish Widows and Clerical Medical, no Resilience Capital Requirement is required. However, a further test is required in respect of the With-Profit Funds. This involves comparing the statutory basis of assessment with a realistic basis of assessment as described below.

Realistic basis: The FSA requires each life insurance company which contains a With-Profit Fund in excess of £500 million to also carry out a realistic valuation of that fund. The Group has two such funds; one within Scottish Widows and one within Clerical Medical. The word realistic in this context reflects the fact that assumptions are best-estimate as opposed to prudent. This realistic valuation is an assessment of the financial position of a With-Profit Fund calculated under a methodology prescribed by the FSA.

The valuation of with-profits assets in a With-Profit Fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profit business written therein, it includes the present value of the anticipated future release of the prudent margins for adverse deviation. In addition, the realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above.

The realistic valuation of liabilities includes an allowance for future bonuses. Options and guarantees are valued using a stochastic simulation model which values these liabilities on a basis consistent with tradable market option contracts (a market-consistent basis). The model takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given in the section entitled Options and guarantees on page 199.

The realistic excess capital is calculated as the difference between realistic assets and realistic liabilities of the With-Profit Fund with a further deduction to cover various stress tests (the Risk Capital Margin). In circumstances where the realistic excess capital position is less than the statutory excess capital, the company is required to hold additional capital to cover the shortfall. Any additional capital requirement under this test is referred to as the With-Profits Insurance Capital Component.

The determination of realistic liabilities of the With-Profit Funds includes the value of internal transfers expected to be made from each With-Profit Fund to the Non-Profit Fund held within the same life insurance entity. These internal transfers may include charges on policies where the associated costs are borne by the Non-Profit Fund.

Capital statement

The following table provides more detail regarding the capital resources available to meet regulatory capital requirements in the life insurance businesses. The figures quoted are based on management's current expectations pending completion of the annual financial returns to the FSA.

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Table 1.62: **Capital resources (unaudited)**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Fund £m	UK Life Shareholder Fund £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2012 (statutory basis)						
Shareholders' funds:						
Held outside the long-term funds	**–**	**–**	**6**	**1,791**	**562**	**2,359**
Held within the long-term funds	**–**	**–**	**6,259**	**–**	**225**	**6,484**
Total shareholders' funds	**–**	**–**	**6,265**	**1,791**	**787**	**8,843**
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	**205**	**62**	**–**	**–**	**–**	**267**
Value of in-force business	**–**	**–**	**(5,056)**	**–**	**(718)**	**(5,774)**
Other differences between IFRS and regulatory valuation of assets and liabilities	**–**	**–**	**101**	**(175)**	**152**	**78**
Estimated share of realistic liabilities consistent with the FSA reporting treatment	**(305)**	**(62)**	**–**	**–**	**–**	**(367)**
Qualifying loan capital	**–**	**–**	**–**	**2,238**	**–**	**2,238**
Support arrangement assets	**190**	**–**	**(190)**	**–**	**–**	**–**
Available capital resources	**90**	**–**	**1,120**	**3,854**	**221**	**5,285**
At 31 December 2011 (statutory basis)						
Shareholders' funds:						
Held outside the long-term funds	–	–	–	1,843	632	2,475
Held within the long-term funds	–	–	6,592	–	312	6,904
Total shareholders' funds	–	–	6,592	1,843	944	9,379
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	242	58	–	–	–	300
Value of in-force business	–	–	(5,491)	–	(818)	(6,309)
Other differences between IFRS and regulatory valuation of assets and liabilities	–	–	107	(163)	124	68
Estimated share of realistic liabilities consistent with the FSA reporting treatment	(341)	(58)	–	–	–	(399)
Qualifying loan capital	–	–	–	1,997	–	1,997
Support arrangement assets	184	–	(184)	–	–	–
Available capital resources	85	–	1,024	3,677	250	5,036

Available capital resources for With-Profit Funds are presented in the table on a realistic basis as this is more onerous than on a regulatory basis.

Formal intra-group capital arrangements

Scottish Widows has a formal arrangement with one of its subsidiary undertakings, Scottish Widows Unit Funds Limited, whereby the subsidiary company can draw down capital from Scottish Widows to finance new business which is reinsured from the parent to its subsidiary. Scottish Widows has also provided subordinated loans to its fellow group undertaking Scottish Widows Bank plc. No such arrangement exists for Clerical Medical.

Constraints over available capital resources

Scottish Widows

Scottish Widows was created following the demutualisation of Scottish Widows Fund and Life Assurance Society in 2000. The terms of the demutualisation are governed by a Court-approved Scheme of Transfer (the 'Scheme') which, inter alia, created a With-Profits Fund and a Non-Participating Fund and established protected capital support for the with-profits policyholders in existence at the date of demutualisation. Much of that capital support is held in the Non-Participating Fund and, as such, the capital held in that fund is subject to the constraints noted below. The requirements of the Scheme sit alongside Scottish Widows' published Principles and Practices of Financial Management of With-Profit business.

Requirement to maintain a Support Account: The Scheme requires the maintenance of a Support Account within the Non-Participating Fund. The quantum of the Support Account is calculated with reference to the value of assets backing current with-profits policies which also existed at the date of demutualisation. Under the Scheme assets can only be transferred from the Non-Participating Fund if the value of the remaining assets in the fund exceeds the value of the Support Account. Scottish Widows has obtained from the FSA permission to include the value of the Support Account or, if greater, the excess of realistic liabilities for business written before demutualisation over the relevant assets (subject to the Non-Participating Fund being able to cover this amount by its surplus admissible assets) in assessing the realistic value of assets available to the With-Profit Fund. At 31 December 2012 the estimated value of surplus admissible assets in the Non-Participating Fund was £1,430 million (2011: £1,198 million) and the estimated value of the Support Account was £nil (2011: £nil). However, at 31 December 2012, the excess of realistic liabilities of with-profits business written before demutualisation over the relevant assets was £62 million (2011: £67 million) which, in accordance with the FSA's permission, has been used to assess the estimated value of realistic assets available to the With-Profit Fund (and has therefore reduced the value of the Non-Participating Fund's surplus admissible assets by that amount).

Further Support Account: The Further Support Account is an extra tier of capital support for the with-profits policies in existence at the date of demutualisation. The Scheme requires that assets can only be transferred from the Non-Participating Fund if the economic value of the remaining assets in the fund exceeds the aggregate of the Support Account and Further Support Account. Unlike the Support Account test, the economic value used for this test includes both admissible assets and the present value of future profits of business written in the Non-Participating Fund or by any subsidiaries of that fund. The balance of the Further Support Account is expected to reduce to nil by the year 2030. At 31 December 2012, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £5,647 million (2011: £5,494 million) and the estimated combined value of the Support Account and Further Support Account was £2,171 million (2011: £2,291 million).

Other restrictions in the Non-Participating Fund: In addition to the policies which existed at the date of demutualisation, the With-Profit Fund includes policies which have been written since that date. As a result of statements made to policyholders that investment policy will usually be the same for both types of business, there is an implicit requirement to hold additional regulatory assets in respect of the business written after demutualisation. The estimated amount required to provide such support at 31 December 2012 is £128 million (2011: £117 million). Scottish Widows has obtained from the FSA permission to include the value of this support in assessing the realistic value of assets available to the With-Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long-Term Fund to meet both policyholders' reasonable expectations in light of liabilities in force at a year-end and the new business expected to be written over the following year.

Clerical Medical

The surplus held in the Clerical Medical With-Profit Fund can only be applied to meet the requirements of the fund itself or distributed according to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses on traditional with-profits business. The use of capital within the fund is also subject to the terms of the Scheme of Demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. In extreme circumstances capital within the Clerical Medical Non-Profit Fund may be made available to support the With-Profit Fund.

Other life insurance businesses

Except as described above capital held in UK Non-Profit Funds is potentially transferable to other parts of the Group, subject to meeting the regulatory requirements of these businesses. There are no prior arrangements in place to allow capital to move freely between life insurance entities or other parts of the Group.

Overseas life business includes several life companies outside the UK, including Germany and Ireland. In all cases the available capital resources are subject to local regulatory requirements, and transfer to other parts of the Group is subject to additional complexity surrounding the transfer of capital from one country to another.

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Movements in regulatory capital

The movements in the Group's available capital resources in the life business can be analysed as follows:

Table 1.63: **Movements in available capital resources (unaudited)**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Fund £m	UK Life Shareholder Fund £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2011	85	–	1,024	3,677	250	5,036
Changes in estimations and in demographic assumptions used to measure life assurance liabilities	**(11)**	**4**	**81**	**–**	**(6)**	**68**
Dividends and capital transactions	**–**	**–**	**205**	**215**	**(74)**	**346**
Change in support arrangements	**6**	**–**	**(6)**	**–**	**–**	**–**
New business and other factors	**10**	**(4)**	**(184)**	**(38)**	**51**	**(165)**
At 31 December 2012	**90**	**–**	**1,120**	**3,854**	**221**	**5,285**

With-Profit Funds

Available capital in the Scottish Widows With-Profit Fund has increased from £85 million at 31 December 2011 to an estimated £90 million at 31 December 2012. Available capital in the Clerical Medical With-Profit Fund is estimated to be zero at 31 December 2012 (no change from 31 December 2011). This is because the fund is in the process of distributing the free estate and all surplus will ultimately be distributed to policyholders.

UK Non-Profit Funds

Available capital in the UK Non-Profit Funds has increased from £1,024 million at 31 December 2011 to an estimated £1,120 million at 31 December 2012. This is mainly due to income on existing business offset by the impact of writing new business, positive investment returns, one-off transfers and an increase in provisions.

UK Life Shareholder Funds

Available capital in the UK Life Shareholder Funds has increased from £3,677 million at 31 December 2011 to an estimated £3,854 million at 31 December 2012. The increase is mainly due to dividend receipts and transfers between funds offset by the issue of and payments on subordinated debt.

Overseas life business

Available capital has decreased during 2012 due to a dividend payment which was partially offset by profits emerging on new and in force business. Analysis of policyholder liabilities reported in the balance sheet in respect of the Group's life insurance business is as follows. With-Profit Fund liabilities are valued in accordance with FRS 27.

Table 1.64: **Analysis of policyholder liabilities (unaudited)**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Funds £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2012					
With-Profit Fund liabilities	**13,779**	**8,248**	**2**	**–**	**22,029**
Unit-linked business (excluding that accounted for as non-participating investment contracts)	**–**	**–**	**38,756**	**8,429**	**47,185**
Other life insurance business	**–**	**–**	**12,923**	**2**	**12,925**
Insurance and participating investment contract liabilities	**13,779**	**8,248**	**51,681**	**8,431**	**82,139**
Non-participating investment contract liabilities	**–**	**–**	**49,929**	**4,443**	**54,372**
Total policyholder liabilities	**13,779**	**8,248**	**101,610**	**12,874**	**136,511**
At 31 December 2011					
With-Profit Fund liabilities	13,651	9,300	4	–	22,955
Unit-linked business (excluding that accounted for as non-participating investment contracts)	–	–	34,660	7,801	42,461
Other life insurance business	–	–	12,559	55	12,614
Insurance and participating investment contract liabilities	13,651	9,300	47,223	7,856	78,030
Non-participating investment contract liabilities	–	–	45,469	4,167	49,636
Total policyholder liabilities	13,651	9,300	92,692	12,023	127,666

Capital sensitivities

Shareholders' funds

Shareholders' funds outside the long-term business fund are invested in readily tradable assets (e.g. equities and fixed interest securities), cash and a range of less liquid fixed interest instruments, at levels consistent with the liquidity risk appetite of the Insurance business.

With-Profit Funds

The with-profits realistic liabilities and the available capital for the With-Profit Funds are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund. The available capital resources (and capital requirements) are sensitive to the level of the stock market, with the position worsening at low stock market levels as a result of the guarantees to policyholders increasing in value. However, the exposure to guaranteed annuity options increases under rising stock market levels. An increase in the level of equity volatility implied by the market cost of equity put options also increases the market consistent value of the options given to policyholders and worsens the capital position. Various hedging strategies are used to manage these exposures.

The most critical non-economic assumptions are the level of take-up of options inherent in the contracts (higher take-up rates are more onerous), mortality rates (lower mortality rates are generally more onerous) and lapses prior to dates at which a guarantee would apply (lower lapse rates are generally more onerous where guarantees are in the money). The sensitivity of the capital position and capital requirements of the With-Profit Funds is partly mitigated by the actions that can be taken by management.

Other long-term funds

Outside the With-Profit Funds, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower mortality rates are more onerous). Assumptions relating to future expenses are also significant with increases in the expected level of future costs leading to increases in the value of the liabilities and consequently leading to a reduction in available capital. Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of non-annuity life insurance contracts such that assured life mortality is a less significant assumption. For Clerical Medical, assumptions relating to the provision in relation to German insurance business litigation are also significant.

Assets held in excess of those backing reserves are invested in readily tradable assets (e.g. equities and fixed interest securities), cash and a range of less liquid fixed interest instruments, at levels consistent with the risk appetite of the Insurance business.

Options and guarantees

The Group has sold insurance products that contain options and guarantees, both within the With-Profit Funds and in other funds.

Options and guarantees within the With-Profit Funds

The most significant options and guarantees provided from within the With-Profit Funds are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies.

For those policies written in Scottish Widows pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up within the With-Profit Fund of Scottish Widows called the Additional Account which is available, inter alia, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2012 of £2.1 billion (2011: £2.0 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the FSA, the liabilities of both the Clerical Medical and Scottish Widows With-Profit Funds are valued using a market-consistent stochastic simulation model. This model is used in order to place a value on the options and guarantees which captures both their intrinsic value and their time value.

The most significant economic assumptions included in the model are:

- Risk-free yield. The risk-free yield is defined as spot yields derived from the government bond yield curve.
- Investment volatility. The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, at 31 December 2012, the 10 year equity-implied at-the-money assumption was set at 26.3 per cent (2011: 27.2 per cent). The assumption for property volatility was 15 per cent (2011: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 18 per cent (2011: 19 per cent).

The model includes a matrix of the correlations between each of the underlying modelled asset types. The correlations used are consistent with long-term historical returns. The most significant non-economic assumptions included in the model are management actions (in respect of investment policy and bonus rates), guaranteed annuity option take-up rates and assumptions regarding persistency (both of which are based on recent actual experience and include an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities), and assumptions regarding mortality (which are based on recent actual experience and industry tables).

RISK MANAGEMENT

Options and guarantees outside the With-Profit Funds

A number of typical guarantees are provided outside the With-Profit Funds such as guaranteed payments on death (e.g. term assurance) or guaranteed income for life (e.g. annuities). In addition, certain personal pension policyholders in Scottish Widows, for whom reinstatement to their occupational pension scheme was not an option, have been given a guarantee that their pension and other benefits will correspond in value to the benefits of the relevant occupational pension scheme. The key assumptions affecting the ultimate value of the guarantee are future salary growth, gilt yields at retirement, annuitant mortality at retirement, marital status at retirement and future investment returns. There is currently a provision, calculated on a deterministic basis, of £56 million (2011: £61 million) in respect of those guarantees. If future salary growth were 0.5 per cent per annum greater than assumed, the liability would increase by approximately £2 million. If yields were 0.5 per cent lower than assumed, the liability would increase by approximately £8 million.

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Financial reporting risk

Definition

Financial reporting risk is defined as the risk that the Group suffers reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate and timely information.

Risk Appetite

The risk appetite is set by the Board and reviewed on an annual basis or more frequently. It includes complying with statutory and regulatory reporting requirements, compliance with tax legislation in the jurisdictions in which the Group operates.

Through a system of internal controls we deliver meaningful, transparent and timely disclosures.

Exposure

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate systems, processes and controls to support statutory, prudential regulatory and tax reporting, to prevent and detect financial reporting fraud, to manage the Group's tax position and to support market disclosures.

Measurement

Financial reporting risk is measured by the adequacy of and compliance with a number of key controls. Identification of potential financial reporting risk also forms a part of the Group's Operational Risk management framework.

Mitigation

The Group maintains a system of internal controls, which is designed to:

- ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded;
- enable the calculation, preparation and reporting of financial, prudential regulatory and tax outcomes in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements;
- ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements and as far as possible are consistent with best practice and in compliance with the British Bankers' Association Code for Financial Reporting Disclosure.

Monitoring

Financial reporting risk is actively monitored at business unit and Group levels. There are specific programmes of work undertaken across the Group to support:

- annual assessments of (1) the effectiveness of internal controls over financial reporting; and (2) the effectiveness of the Group's disclosure controls and procedures, both in accordance with the requirements of the US Sarbanes Oxley Act;
- annual certifications by the Senior Accounting Officer with respect to the maintenance of appropriate tax accounting arrangements, in accordance with the requirements of the 2009 Finance Act.

The Group also has in place an assurance process to support its prudential regulatory reporting and monitoring activities designed to identify and review tax exposures on a regular basis. There is ongoing monitoring to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

The Group has a Disclosure Committee which assists the Group Chief Executive and Group Finance Director in fulfilling their disclosure responsibilities under relevant listing requirements. In addition, the Audit Committee reviews the quality and acceptability of the Group's financial disclosures. For further information on the Audit Committee's responsibilities relating to financial reporting see page 94.

RISK MANAGEMENT

Governance risk

Definition

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

Risk Appetite

Governance risk appetite is defined and embedded through the Group's Governance Policy which is reviewed and approved by the Board on an annual basis.

Exposure

The internal governance arrangements of major financial institutions are currently subject to a high level of regulatory and public scrutiny. The Group's exposure to governance risk is also reflective of the significant volume of existing and proposed legislation and regulation within the UK and overseas with which it must comply.

The Group's internal governance framework is actively managed to ensure it remains appropriate and aligned to the Group's risk appetite and changing business needs.

Measurement

The Group's governance arrangements are assessed against new or proposed legislation and regulation in order to identify any areas of enhancement required.

Mitigation

The Group's internal governance framework consists of the following key components:

- clearly defined authorities and accountabilities delegated to business management, which ultimately derive from the Board;
- core principles established to ensure consistent and effective internal governance and decision-making arrangements at business level;
- a Group Policy framework which defines clear control requirements for the business and supports effective risk management; and
- a risk management model based on three Lines of Defence, with clear allocation of responsibilities for risk management, oversight and independent challenge.

The Ethics Policy and supporting Codes of Personal Responsibility and Business Responsibility embody the Group's values and reflect its commitment to operating responsibly and ethically both at a business and an individual level. All colleagues are required to adhere to the Codes in all aspects of their roles.

Monitoring

A review of the Group's governance and internal control framework, including the status of the Group's Principles and Policy Framework, and the design and operational effectiveness of key governance committees, is undertaken on an annual basis and the findings reported to the Group Risk Committee, Board Risk Committee and the Board.

For further information on Corporate Governance see pages 86 to 97.

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REPORT OF THE INDEPENDENT AUDITORS ON THE CONSOLIDATED FINANCIAL STATEMENTS

Independent auditors' report to the members of Lloyds Banking Group plc

We have audited the group financial statements of Lloyds Banking Group plc for the year ended 31 December 2012 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated balance sheet, the consolidated statement of changes in equity, the consolidated cash flow statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of directors' responsibilities on page 84, the directors are responsible for the preparation of the group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the group financial statements:

- give a true and fair view of the state of the Group's affairs at 31 December 2012 and of its loss and cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the group financial statements are prepared is consistent with the group financial statements.

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Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, on page 82, in relation to going concern;
- the part of the Corporate Governance Report relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and
- certain elements of the report to shareholders by the Board on directors' remuneration.

Other matter

We have reported separately on the parent company financial statements of Lloyds Banking Group plc for the year ended 31 December 2012 and on the information in the Directors' Remuneration Report that is described as having been audited.

Philip Rivett
Senior Statutory Auditor
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
1 March 2013

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December

	Note	2012 £ million	2011 £ million	2010 £ million
Interest and similar income		**23,535**	26,316	29,340
Interest and similar expense		**(14,460)**	(13,618)	(16,794)
Net interest income	5	**9,075**	12,698	12,546
Fee and commission income		**4,731**	4,935	4,992
Fee and commission expense		**(1,438)**	(1,391)	(1,682)
Net fee and commission income	6	**3,293**	3,544	3,310
Net trading income	7	**13,554**	(368)	15,724
Insurance premium income	8	**8,284**	8,170	8,148
Other operating income	9	**4,700**	2,799	4,228
Other income		**29,831**	14,145	31,410
Total income		**38,906**	26,843	43,956
Insurance claims	10	**(18,396)**	(6,041)	(19,088)
Total income, net of insurance claims		**20,510**	20,802	24,868
Regulatory provisions		**(4,175)**	(3,375)	(500)
Other operating expenses		**(11,756)**	(12,875)	(12,770)
Total operating expenses	11	**(15,931)**	(16,250)	(13,270)
Trading surplus		**4,579**	4,552	11,598
Impairment	12	**(5,149)**	(8,094)	(10,952)
Loss on disposal of businesses	14	**–**	–	(365)
(Loss) profit before tax		**(570)**	(3,542)	281
Taxation	15	**(773)**	828	(539)
Loss for the year		**(1,343)**	(2,714)	(258)
Profit attributable to non-controlling interests		**84**	73	62
Loss attributable to equity shareholders		**(1,427)**	(2,787)	(320)
Loss for the year		**(1,343)**	(2,714)	(258)
Basic earnings per share	16	**(2.0)p**	(4.1)p	(0.5)p
Diluted earnings per share	16	**(2.0)p**	(4.1)p	(0.5)p

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December

	2012 **£ million**	2011 £ million	2010 £ million
Loss for the year	**(1,343)**	(2,714)	(258)
Other comprehensive income			
Movements in revaluation reserve in respect of available-for-sale financial assets:			
Adjustment on transfers from held-to-maturity portfolio	**1,168**	–	–
Change in fair value	**779**	2,603	1,231
Income statement transfers in respect of disposals	**(3,547)**	(343)	(399)
Income statement transfers in respect of impairment	**42**	80	114
Other income statement transfers	**290**	(155)	(110)
Taxation	**339**	(575)	(343)
	(929)	1,610	493
Movement in cash flow hedging reserve:			
Effective portion of changes in fair value taken to other comprehensive income	**116**	916	(1,048)
Net income statement transfers	**(92)**	70	932
Taxation	**1**	(270)	30
	25	716	(86)
Currency translation differences (tax: nil)	**(14)**	(84)	(129)
Other comprehensive income for the year, net of tax	**(918)**	2,242	278
Total comprehensive income for the year	**(2,261)**	(472)	20
Total comprehensive income attributable to non-controlling interests	**82**	72	57
Total comprehensive income attributable to equity shareholders	**(2,343)**	(544)	(37)
Total comprehensive income for the year	**(2,261)**	(472)	20

CONSOLIDATED BALANCE SHEET

at 31 December

	Note	2012 £ million	2011 £ million
Assets			
Cash and balances at central banks		**80,298**	60,722
Items in the course of collection from banks		**1,256**	1,408
Trading and other financial assets at fair value through profit or loss	17	**153,990**	139,510
Derivative financial instruments	18	**56,550**	66,013
Loans and receivables:			
Loans and advances to banks	19	**29,417**	32,606
Loans and advances to customers	20	**517,225**	565,638
Debt securities	23	**5,273**	12,470
		551,915	610,714
Available-for-sale financial assets	25	**31,374**	37,406
Held-to-maturity investments	26	**–**	8,098
Investment properties	27	**5,405**	6,122
Goodwill	28	**2,016**	2,016
Value of in-force business	29	**6,800**	6,638
Other intangible assets	30	**2,792**	3,196
Tangible fixed assets	31	**7,342**	7,673
Current tax recoverable		**354**	434
Deferred tax assets	43	**4,285**	4,496
Retirement benefit assets	42	**1,867**	1,338
Other assets	32	**18,308**	14,762
Total assets		**924,552**	970,546

The accompanying notes are an integral part of the consolidated financial statements.

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Equity and liabilities	Note	2012 £ million	2011 £ million
Liabilities			
Deposits from banks	33	**38,405**	39,810
Customer deposits	34	**426,912**	413,906
Items in course of transmission to banks		**996**	844
Trading and other financial liabilities at fair value through profit or loss	35	**35,972**	24,955
Derivative financial instruments	18	**48,665**	58,212
Notes in circulation		**1,198**	1,145
Debt securities in issue	36	**117,369**	185,059
Liabilities arising from insurance contracts and participating investment contracts	37	**82,953**	78,991
Liabilities arising from non-participating investment contracts	39	**54,372**	49,636
Unallocated surplus within insurance businesses	40	**267**	300
Other liabilities	41	**33,941**	32,041
Retirement benefit obligations	42	**300**	381
Current tax liabilities		**138**	103
Deferred tax liabilities	43	**327**	314
Other provisions	44	**3,961**	3,166
Subordinated liabilities	45	**34,092**	35,089
Total liabilities		**879,868**	923,952
Equity			
Share capital	46	**7,042**	6,881
Share premium account	47	**16,872**	16,541
Other reserves	48	**12,902**	13,818
Retained profits	49	**7,183**	8,680
Shareholders' equity		**43,999**	45,920
Non-controlling interests		**685**	674
Total equity		**44,684**	46,594
Total equity and liabilities		**924,552**	970,546

The accompanying notes are an integral part of the consolidated financial statements.

The directors approved the consolidated financial statements on 1 March 2013.

Sir Winfried Bischoff
Chairman

António Horta-Osório
Group Chief Executive

George Culmer
Group Finance Director

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2012	23,422	13,818	8,680	45,920	674	46,594
Comprehensive income						
(Loss) profit for the year	–	–	(1,427)	(1,427)	84	(1,343)
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(927)	–	(927)	(2)	(929)
Movements in cash flow hedging reserve, net of tax	–	25	–	25	–	25
Currency translation differences (tax: £nil)	–	(14)	–	(14)	–	(14)
Total other comprehensive income	–	(916)	–	(916)	(2)	(918)
Total comprehensive income	–	(916)	(1,427)	(2,343)	82	(2,261)
Transactions with owners						
Dividends	–	–	–	–	(56)	(56)
Issue of ordinary shares	492	–	–	492	–	492
Movement in treasury shares	–	–	(407)	(407)	–	(407)
Value of employee services:						
Share option schemes	–	–	81	81	–	81
Other employee award schemes	–	–	256	256	–	256
Change in non-controlling interests	–	–	–	–	(15)	(15)
Total transactions with owners	492	–	(70)	422	(71)	351
Balance at 31 December 2012	23,914	12,902	7,183	43,999	685	44,684

Further details of movements in the Group's share capital and reserves are provided in notes 46, 47, 48 and 49.

The accompanying notes are an integral part of the consolidated financial statements.

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	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2011	23,106	11,575	11,380	46,061	841	46,902
Comprehensive income						
(Loss) profit for the year	–	–	(2,787)	(2,787)	73	(2,714)
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,611	–	1,611	(1)	1,610
Movements in cash flow hedging reserve, net of tax	–	716	–	716	–	716
Currency translation differences (tax: nil)	–	(84)	–	(84)	–	(84)
Total other comprehensive income	–	2,243	–	2,243	(1)	2,242
Total comprehensive income	–	2,243	(2,787)	(544)	72	(472)
Transactions with owners						
Dividends	–	–	–	–	(50)	(50)
Issue of ordinary shares	316	–	–	316	–	316
Movement in treasury shares	–	–	(276)	(276)	–	(276)
Value of employee services:						
Share option schemes	–	–	125	125	–	125
Other employee award schemes	–	–	238	238	–	238
Change in non-controlling interests	–	–	–	–	(189)	(189)
Total transactions with owners	316	–	87	403	(239)	164
Balance at 31 December 2011	23,422	13,818	8,680	45,920	674	46,594

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2010	24,944	7,217	11,117	43,278	829	44,107
Comprehensive income						
(Loss) profit for the year	–	–	(320)	(320)	62	(258)
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	498	–	498	(5)	493
Movements in cash flow hedging reserve, net of tax	–	(86)	–	(86)	–	(86)
Currency translation differences (tax: nil)	–	(129)	–	(129)	–	(129)
Total other comprehensive income	–	283	–	283	(5)	278
Total comprehensive income	–	283	(320)	(37)	57	20
Transactions with owners						
Dividends	–	–	–	–	(47)	(47)
Issue of ordinary shares	2,237	–	–	2,237	–	2,237
Redemption of preference shares	11	(11)	–	–	–	–
Cancellation of deferred shares	(4,086)	4,086	–	–	–	–
Movement in treasury shares	–	–	20	20	–	20
Value of employee services:						
Share option schemes	–	–	154	154	–	154
Other employee award schemes	–	–	409	409	–	409
Change in non-controlling interests	–	–	–	–	2	2
Total transactions with owners	(1,838)	4,075	583	2,820	(45)	2,775
Balance at 31 December 2010	23,106	11,575	11,380	46,061	841	46,902

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CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December

	Note	**2012** **£ million**	2011 £ million	2010 £ million
(Loss) profit before tax		**(570)**	(3,542)	281
Adjustments for:				
Change in operating assets	56(A)	**48,333**	44,097	31,860
Change in operating liabilities	56(B)	**(46,681)**	(19,187)	(45,683)
Non-cash and other items	56(C)	**2,045**	(1,339)	11,173
Tax (paid) received		**(78)**	(136)	332
Net cash provided by (used in) operating activities		**3,049**	19,893	(2,037)
Cash flows from investing activities				
Purchase of financial assets		**(22,050)**	(28,995)	(46,890)
Proceeds from sale and maturity of financial assets		**37,664**	36,523	45,999
Purchase of fixed assets		**(3,003)**	(3,095)	(3,216)
Proceeds from sale of fixed assets		**2,595**	2,214	1,354
Acquisition of businesses, net of cash acquired	56(E)	**(11)**	(13)	(73)
Disposal of businesses, net of cash disposed	56(F)	**37**	298	428
Net cash provided by (used in) investing activities		**15,232**	6,932	(2,398)
Cash flows from financing activities				
Dividends paid to non-controlling interests		**(56)**	(50)	(47)
Interest paid on subordinated liabilities		**(2,577)**	(2,126)	(1,942)
Proceeds from issue of subordinated liabilities		**–**	–	3,237
Proceeds from issue of ordinary shares		**170**	–	–
Repayment of subordinated liabilities		**(664)**	(1,074)	(684)
Change in non-controlling interests		**23**	8	2
Net cash (used in) provided by financing activities		**(3,104)**	(3,242)	566
Effects of exchange rate changes on cash and cash equivalents		**(8)**	6	479
Change in cash and cash equivalents		**15,169**	23,589	(3,390)
Cash and cash equivalents at beginning of year		**85,889**	62,300	65,690
Cash and cash equivalents at end of year	56(D)	**101,058**	85,889	62,300

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of preparation

The consolidated financial statements of Lloyds Banking Group plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts. As stated on page 82, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

The Group has reviewed its holding of government securities classified as held-to-maturity; since it is no longer the Group's intention to hold these to maturity, they have been reclassified as available-for-sale. In addition, as the Group's share of results of joint ventures and associates is no longer significant, this is now included within other operating income and the related asset reported within other assets; comparatives have been re-presented on a consistent basis.

The Group has adopted the following amendments to standards which became effective for financial years beginning on or after 1 January 2012. Neither of these amendments has had a material impact on these financial statements.

(i) *Disclosures – Transfers of Financial Assets (Amendments to IFRS 7).* Requires disclosures in respect of all transferred financial assets that are not derecognised in their entirety and transferred assets that are derecognised in their entirety but with which there is continuing involvement. Disclosures in connection with such transfers can be found in note 54.

(ii) *Deferred Tax: Recovery of Underlying Assets (Amendment to IAS 12).* Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property is recognised on that basis.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2012 and which have not been applied in preparing these financial statements are given in note 57.

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Note 2: Accounting policies

The Group's accounting policies are set out below. These accounting policies have been applied consistently.

(A) Consolidation

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures.

(1) Subsidiaries

Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 9 to the parent company financial statements.

Investment vehicles, such as Open Ended Investment Companies (OEICs), where the Group has control are consolidated. Control arises when the Group manages the funds and also has a majority beneficial interest. In circumstances where the Group holds a majority beneficial interest, but is not the fund manager, the Group does not consolidate the entity as it does not have the fund manager's decision-making powers over the investment activities of the OEIC necessary to establish control. The interests of parties other than the Group are reported in other liabilities.

Special purpose entities (SPEs) are consolidated if, in substance, the Group controls the entity. A key indicator of such control, amongst others, is where the Group is exposed to the risks and benefits of the SPE.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see (E)(5) below) or share capital (see (R)(1) below). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) Joint ventures and associates

Joint ventures are entities over which the Group has joint control under a contractual arrangement with other parties. Associates are entities over which the Group has significant influence, but not control or joint control, over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity and is normally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting and are initially recorded at cost and adjusted each year to reflect the Group's share of the post-acquisition results of the joint venture or associate based on audited accounts which are coterminous with the Group or made up to a date which is not more than three months before the Group's reporting date. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

(B) Goodwill

Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates; goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. Goodwill arising on acquisitions of associates and joint ventures is included in the Group's investment in joint ventures and associates. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

(C) Other intangible assets

Other intangible assets include brands, core deposit intangible, purchased credit card relationships, customer-related intangibles and both internally and externally generated capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 7 years
Brands (which have been assessed as having finite lives)	10-15 years
Customer-related intangibles	up to 10 years
Core deposit intangible	up to 8 years
Purchased credit card relationships	5 years

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

(D) Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the effective interest method, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group including expected early redemption fees and related penalties and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account in the calculation. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see (H) below).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to life insurance and general insurance business are detailed below (see (O) below); those relating to leases are set out in (K)(2) below.

(E) Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. Purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either:

– substantially all of the risks and rewards of ownership have been transferred; or

– the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

(1) Financial instruments at fair value through profit or loss

Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see (F) below).

Trading securities are debt securities and equity shares acquired principally for the purpose of selling in the short term or which are part of a portfolio which is managed for short-term gains. Such securities are classified as trading securities and recognised in the balance sheet at their fair value. Gains and losses arising from changes in their fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

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Note 2: Accounting policies (continued)

Other financial assets and liabilities at fair value through profit or loss are designated as such by management upon initial recognition. Such assets and liabilities are carried in the balance sheet at their fair value and gains and losses arising from changes in fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur. Financial assets and liabilities are designated at fair value through profit or loss on acquisition in the following circumstances:

- it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases. The main type of financial assets designated by the Group at fair value through profit or loss are assets backing insurance contracts and investment contracts issued by the Group's life insurance businesses. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available-for-sale financial assets.
- the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis. As noted in (A)(2) above certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.
- where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 54(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

The Group is permitted to reclassify, at fair value at the date of transfer, non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the trading category if they are no longer held for the purpose of being sold or repurchased in the near term, as follows:

- if the financial assets would have met the definition of loans and receivables (but for the fact that they had to be classified as held for trading at initial recognition), they may be reclassified into loans and receivables where the Group has the intention and ability to hold the assets for the foreseeable future or until maturity; or
- if the financial assets would not have met the definition of loans and receivables, they may be reclassified out of the held for trading category into available-for-sale financial assets in 'rare circumstances'.

(2) Available-for-sale financial assets

Debt securities and equity shares that are not classified as trading securities, at fair value through profit or loss, held-to-maturity investments or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Available-for-sale financial assets are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

(3) Loans and receivables

Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see (D) above) less provision for impairment (see (H) below).

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. In cases where the securitisation vehicles are funded by the issue of debt, on terms whereby the majority of the risks and rewards of the portfolio of securitised

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

lending are retained by the Group, these loans and advances continue to be recognised by the Group, together with a corresponding liability for the funding.

(4) Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity other than:

– those that the Group designates upon initial recognition as at fair value through profit or loss;

– those that the Group designates as available-for-sale; and

– those that meet the definition of loans and receivables.

These are initially recognised at fair value including direct and incremental transaction costs and measured subsequently at amortised cost, using the effective interest method, less any provision for impairment.

A sale or reclassification of a more than insignificant amount of held-to-maturity investments would result in the reclassification of all held-to-maturity investments to available-for-sale financial assets.

(5) Borrowings

Borrowings (which include deposits from banks, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense.

An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss together with any related costs or fees incurred.

(6) Sale and repurchase agreements

Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities lent to counterparties are retained in the financial statements. Securities borrowed are not recognised in the financial statements, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability.

(F) Derivative financial instruments and hedge accounting

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 54(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

Changes in the fair value of any derivative instrument that is not part of a hedging relationship are recognised immediately in the income statement.

Derivatives embedded in financial instruments and insurance contracts (unless the embedded derivative is itself an insurance contract) are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement. In accordance with IFRS 4 *Insurance Contracts*, a policyholder's option to surrender an insurance contract for a fixed amount is not treated as an embedded derivative.

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

The Group designates certain derivatives as either: (1) hedges of the fair value of the particular risks inherent in recognised assets or liabilities (fair value hedges); (2) hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges); or (3) hedges of net investments in foreign operations (net investment hedges). These are accounted for as follows:

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Note 2: Accounting policies (continued)

(1) Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as an available-for-sale financial asset. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

(2) Cash flow hedges

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedge reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

(3) Net investment hedges

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instrument used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

(G) Offset

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

(H) Impairment of financial assets

(1) Assets accounted for at amortised cost

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition of the financial asset and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

Where such an event has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's wholesale lending portfolios in the Commercial Banking and Wealth, Asset Finance and International divisions. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances in the Group's retail portfolios in both the Retail and Wealth, Asset Finance and International divisions that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

Individual assessment

In respect of individually significant financial assets in the Group's wholesale lending portfolios, assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watch list where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that would lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower; (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate; (iii) disappearance of an active market because of financial difficulties; or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable.

For impaired debt instruments which are held at amortised cost, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows. A reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment.

Collective assessment

Impairment is assessed on a collective basis for (1) homogenous groups of loans that are not considered individually impaired; and (2) to cover losses which have been incurred but have not yet been identified on loans subject to individual impairment.

Homogenous groups of loans

In respect of portfolios of smaller balance, homogenous loans, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower’s ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group’s secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data about economic and credit conditions (including unemployment rates and borrowers’ behaviour) to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

Incurred but not yet identified impairment

The collective provision also includes provision for inherent losses, that is losses that have been incurred but have not been separately identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. Risk drivers for secured retail lending include the current indexed loan-to-value, previous mortgage arrears, internal cross-product delinquency data and external credit bureau data; for unsecured retail lending they include whether the account is up-to-date and, if not, the number of payments that have been missed; and for wholesale lending they include factors such as observed default rates and loss given default. An assessment is made of the likelihood of each account becoming recognised as impaired within the loss emergence period, with the economic loss that each portfolio is likely to generate were it to become impaired. The loss emergence period is determined by local management for each portfolio and the Group has a range of loss emergence periods which are dependent upon the characteristics of the portfolios. Loss emergence periods are reviewed regularly and updated when appropriate. In general the periods used across the Group vary between one month and twelve months based on historical experience. Unsecured portfolios tend to have shorter loss emergence periods than secured portfolios.

Loan renegotiations and forbearance

In certain circumstances, the Group will renegotiate the original terms of a customer’s loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

Write offs

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. For both secured and unsecured retail balances, the write-off takes place only once an extensive set of collections processes has been completed, or the status of the account reaches a point where policy dictates that forbearance is no longer appropriate. For wholesale lending, a write-off occurs if the loan facility with the customer is restructured, the asset is under administration and the only monies that can be received are the amounts estimated by the administrator, the underlying assets are disposed and a decision is made that no further settlement monies will be received, or external evidence (for example, third party valuations) is available that there has been an irreversible decline in expected cash flows.

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Note 2: Accounting policies (continued)

Debt for equity exchanges

Equity securities acquired in exchange for loans in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of equity securities, held as available-for-sale. Where control is obtained over an entity as a result of the transaction, the entity is consolidated; where the Group has significant influence over an entity as a result of the transaction, the investment is accounted for by the equity method of accounting (see (A) above). Any subsequent impairment of the assets or business acquired is treated as an impairment of the relevant asset or business and not as an impairment of the original instrument.

(2) Available-for-sale financial assets

The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer, assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(I) Investment property

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital appreciation or both. The Group's investment property primarily relates to property held for long-term rental yields and capital appreciation within the life insurance funds. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income.

(J) Tangible fixed assets

Tangible fixed assets are included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

- Freehold/long and short leasehold premises: shorter of 50 years and the remaining period of the lease.
- Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease.

Equipment:

- Fixtures and furnishings: 10-20 years.
- Other equipment and motor vehicles: 2-8 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

(K) Leases

(1) As lessee

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

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

(2) As lessor

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

Operating lease assets are included within tangible fixed assets at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

The Group evaluates non-lease arrangements such as outsourcing and similar contracts to determine if they contain a lease which is then accounted for separately.

(L) Pensions and other post-retirement benefits

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Full actuarial valuations of the Group's principal defined benefit schemes are carried out every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries, or in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

The Group's income statement charge includes the current service cost of providing pension benefits, the expected return on the schemes' assets, net of expected administration costs, and the interest cost on the schemes' liabilities. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10 per cent of the scheme assets or liabilities ('the corridor approach'). In these circumstances the excess is charged or credited to the income statement over the employees' expected average remaining working lives. Past service costs are charged immediately to the income statement, unless the charges are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date adjusted for any cumulative unrecognised actuarial gains or losses. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

The Group recognises the effect of material changes to the terms of its defined benefit pension plans which reduce future benefits as curtailments; gains and losses are recognised in the income statement when the curtailments occur.

The costs of the Group's defined contribution plans are charged to the income statement in the period in which they fall due.

(M) Share-based compensation

The Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments, with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model or a Monte Carlo simulation. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

(N) Taxation

Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

For the Group's long-term insurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on shareholders' returns. This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules.

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

Note 2: Accounting policies (continued)

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the gain or loss.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

(O) Insurance

The Group undertakes both life insurance and general insurance business. Insurance and participating investment contracts are accounted for under IFRS 4 *Insurance Contracts*, which permits (with certain exceptions) the continuation of accounting practices for measuring insurance and participating investment contracts that applied prior to the adoption of IFRS. The Group, therefore, continues to account for these products using UK GAAP, including FRS 27 *Life Assurance*, and UK established practice.

Products sold by the life insurance business are classified into three categories:

- Insurance contracts – these contracts transfer significant insurance risk and may also transfer financial risk. The Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. These contracts may or may not include discretionary participation features.
- Investment contracts containing a discretionary participation feature (participating investment contracts) – these contracts do not transfer significant insurance risk, but contain a contractual right which gives the holder the right to receive, in addition to the guaranteed benefits, further additional discretionary benefits or bonuses that are likely to be a significant proportion of the total contractual benefits and the amount and timing of which is at the discretion of the Group, within the constraints of the terms and conditions of the instrument and based upon the performance of specified assets.
- Non-participating investment contracts – these contracts do not transfer significant insurance risk or contain a discretionary participation feature.

The general insurance business issues only insurance contracts.

(1) Life insurance business

(i) Accounting for insurance and participating investment contracts

Premiums and claims

Premiums received in respect of insurance and participating investment contracts are recognised as revenue when due except for unit-linked contracts on which premiums are recognised as revenue when received. Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified.

Liabilities

- *Insurance and participating investment contracts in the Group's with-profit funds*

  Liabilities of the Group's with-profit funds, including guarantees and options embedded within products written by these funds, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in the unallocated surplus (see below). Further details on the realistic capital regime are given on page 195. Changes in the value of these liabilities are recognised in the income statement through insurance claims.

- *Insurance and participating investment contracts which are not unit-linked or in the Group's with-profit funds*

  A liability for contractual benefits that are expected to be incurred in the future is recorded when the premiums are recognised. The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date allowing for probabilities of occurrence. The liability will vary with movements in interest rates and with the cost of life insurance and annuity benefits where future mortality is uncertain.

  Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs.

  Changes in the value of these liabilities are recognised in the income statement through insurance claims.

- *Insurance and participating investment contracts which are unit-linked*

  Liabilities for unit-linked insurance contracts and participating investment contracts are stated at the bid value of units plus an additional allowance where appropriate (such as for any excess of future expenses over charges). The liability is increased or reduced by the change in the unit prices and is reduced by policy administration fees, mortality and surrender charges and any withdrawals. Changes in the value of the liability are recognised in the income statement through insurance claims. Benefit claims in excess of the account balances incurred in the period are also charged through insurance claims. Revenue consists of fees deducted for mortality, policy administration and surrender charges.

Unallocated surplus

Any amounts in the with-profit funds not yet determined as being due to policyholders or shareholders are recognised as an unallocated surplus which is shown separately from liabilities arising from insurance contracts and participating investment contracts.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

(ii) Accounting for non-participating investment contracts

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment returns (including movements in fair value and investment income) allocated to those contracts are recognised in the income statement through insurance claims.

Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the non-participating investment contract liability.

The Group receives investment management fees in the form of an initial adjustment or charge to the amount invested. These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them over the estimated lives of the contracts, in line with the provision of investment management services.

Costs which are directly attributable and incremental to securing new non-participating investment contracts are deferred. This asset is subsequently amortised over the period of the provision of investment management services and is reviewed for impairment in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately through fee and commission expense in the income statement. All other costs are recognised as expenses when incurred.

(iii) Value of in-force business

The Group recognises as an asset the value of in-force business in respect of insurance contracts and participating investment contracts. The asset represents the present value of the shareholders' interest in the profits expected to emerge from those contracts written at the balance sheet date. This is determined after making appropriate assumptions about future economic and operating conditions such as future mortality and persistency rates and includes allowances for both non-market risk and for the realistic value of financial options and guarantees. Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. The asset in the consolidated balance sheet is presented gross of attributable tax and movements in the asset are reflected within other operating income in the income statement.

The Group's contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers are measured at fair value at the date of acquisition. The resulting asset is amortised over the estimated lives of the contracts. At each reporting date an assessment is made to determine if there is any indication of impairment. Where impairment exists, the carrying value of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement.

(2) General insurance business

The Group both underwrites and acts as intermediary in the sale of general insurance products. Underwriting premiums are included in insurance premium income, net of refunds, in the period in which insurance cover is provided to the customer; premiums received relating to future periods are deferred in the balance sheet within liabilities arising from insurance contracts and participating investment contracts and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

The underwriting business makes provision for the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The provision for the cost of claims notified but not settled is based upon a best estimate of the cost of settling the outstanding claims after taking into account all known facts. In those cases where there is insufficient information to determine the required provision, statistical techniques are used which take into account the cost of claims that have recently been settled and make assumptions about the future development of the outstanding cases. Similar statistical techniques are used to determine the provision for claims incurred but not reported at the balance sheet date. Claims liabilities are not discounted.

(3) Liability adequacy test

At each balance sheet date liability adequacy tests are performed to ensure the adequacy of insurance and participating investment contract liabilities net of related deferred cost assets and value of in-force business. In performing these tests current best estimates of discounted future contractual cash flows and claims handling and policy administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to the income statement, initially by writing off the relevant assets and subsequently by establishing a provision for losses arising from liability adequacy tests.

(4) Reinsurance

Contracts entered into by the Group with reinsurers under which the Group is compensated for benefits payable on one or more contracts issued by the Group are recognised as assets arising from reinsurance contracts held. Where the underlying contracts issued by the Group are classified as insurance contracts and the reinsurance contract transfers significant insurance risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the underlying contracts issued by the Group are classified as non-participating investment contracts and the reinsurance contract transfers financial risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as non-participating investment contracts.

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Note 2: Accounting policies (continued)

Assets arising from reinsurance contracts held – Classified as insurance contracts
Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Premiums payable for reinsurance contracts are recognised as an expense when due within insurance premium income. Changes in the reinsurance recoverable assets are recognised in the income statement through insurance claims.

Assets arising from reinsurance contracts held – Classified as non-participating investment contracts
These contracts are accounted for as financial assets whose value is contractually linked to the fair values of financial assets within the reinsurers' investment funds. Investment returns (including movements in fair value and investment income) allocated to these contracts are recognised in insurance claims. Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the assets arising from reinsurance contracts held.

(P) Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The consolidated financial statements are presented in sterling, which is the Company's functional and presentation currency.

Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.
- The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see (F)(3) above). On disposal of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal.

(Q) Provisions and contingent liabilities

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

The Group recognises provisions in respect of vacant leasehold property where the unavoidable costs of the present obligations exceed anticipated rental income.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

(R) Share capital

(1) Share issue costs

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

(2) Dividends

Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

(3) Treasury shares

Where the Company or any member of the Group purchases the Company's share capital, the consideration paid is deducted from shareholders' equity as treasury shares until they are cancelled. Where such shares are subsequently sold or reissued, any consideration received is included in shareholders' equity.

(S) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 3: Critical accounting estimates and judgements

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows.

Allowance for impairment losses on loans and receivables

At 31 December 2012 gross loans and receivables totalled £567,374 million (2011: £629,736 million) against which impairment allowances of £15,459 million (2011: £19,022 million) had been made (see note 24). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2(H)(1); this note also provides an overview of the methodologies applied.

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's wholesale lending portfolios. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in the current economic environment in assessing the borrower's cash flows and debt servicing capability together with the realisable value of collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the retail portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were ten per cent lower than those estimated at 31 December 2012, the impairment charge would increase by approximately £330 million in respect of UK mortgages and a further £55 million in respect of Irish mortgages.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the Commercial Banking division, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £130 million (at 31 December 2011, a one month increase in the loss emergence period would have increased the collective unimpaired provision by an estimated £181 million).

Unwind of HBOS acquisition fair value adjustments

The acquisition of HBOS in January 2009 required the Group to recognise the identifiable assets acquired and liabilities assumed at their acquisition-date fair values. The overall effect was to increase the book value of HBOS's net assets by £1,241 million primarily reflecting a reduction in the value of HBOS's debt securities and subordinated liabilities of £15,439 million, partially offset by a reduction in the carrying value of HBOS's loans and receivables of £14,880 million, including loans and advances to customers of £13,512 million.

In the periods subsequent to the acquisition, all of the fair value adjustments unwind. The fair value adjustments made to debt securities and subordinated liabilities unwind over the expected remaining life of the related securities except in the event that the liability is extinguished, in which case the remaining unamortised fair value adjustment is recognised in the income statement immediately. The timing of the unwind of the fair value adjustment relating to loans and receivables requires significant management judgement. This includes the identification of losses which were expected at the date of acquisition and assessing whether anticipated losses will still be incurred. In 2012, there was a benefit of £1,339 million (2011: £1,943 million) to the income statement either from the reversal of a fair value adjustment being credited to the income statement or through a lower impairment charge as a result of the initial HBOS acquisition fair value adjustments.

Fair value of financial instruments

In accordance with IFRS 7 *Financial Instruments: Disclosure*, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques including discounted cash flow analysis and valuation models. These valuation techniques involve management judgement and estimates the extent of which depends on the complexity of the instrument and the availability of market observable information.

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Note 3: Critical accounting estimates and judgements (continued)

Valuation techniques for level 2 financial instruments use inputs that are largely based on observable market data. Level 3 financial instruments are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Determining the appropriate assumptions to be used for level 3 financial instruments requires significant management judgement.

At 31 December 2012, the Group classified £6,231 million of financial assets and £591 million of financial liabilities as level 3. Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out in note 54. Details about sensitivities to market risk arising from trading assets and other treasury positions can be found in the Risk Management section on page 170.

Recoverability of deferred tax assets

At 31 December 2012 the Group carried deferred tax assets on its balance sheet of £4,285 million (2011: £4,496 million) and deferred tax liabilities of £327 million (2011: £314 million) (note 43). This presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 43 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward.

The recoverability of the Group's deferred tax assets in respect of carry forward losses is based on an assessment of future levels of taxable profit expected to arise that can be offset against these losses. The Group's expectations as to the level of future taxable profits take into account the Group's long-term financial and strategic plans, and anticipated future tax adjusting items.

In making this assessment account is taken of business plans, the five year board approved operating plan and the following future risk factors:

– The expected future economic outlook as set out in the Group Chief Executive's Review;

– The retail banking business disposal as required by the European Commission; and

– Future regulatory change.

The Group's total deferred tax asset includes £7,034 million (2011: £5,862 million) in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc and Lloyds TSB Bank plc.

The deferred tax asset is expected to be utilised over different time periods in each of the entities in which the losses arise. Under current UK tax law there is no expiry date for unused tax losses. The assessment of the likely rate of recoverability of the deferred tax is expected to be slower than previously anticipated due to the more subdued and uncertain macroeconomic environment and the further provisions for legacy issues. However, the losses are still expected to be fully utilised by 2019.

As disclosed in note 43; deferred tax assets totalling £1,311 million (2011: £1,288 million) have not been recognised in respect of certain capital losses carried forward, trading losses carried forward and unrelieved foreign tax credits as there are no predicted future capital or taxable profits against which these losses can be recognised.

Retirement benefit obligations

The net asset recognised in the balance sheet at 31 December 2012 in respect of the Group's retirement benefit obligations was £1,567 million (comprising an asset of £1,867 million and a liability of £300 million) (2011: a net asset of £957 million) of which an asset of £1,748 million (2011: £1,131 million) related to defined benefit pension schemes. As explained in note 2(L), the Group adopts the corridor approach to the recognition of actuarial gains and losses in respect of its pension schemes and as a consequence has not recognised actuarial losses of £2,705 million (2011: £539 million). After allowing for this, the defined benefit pension schemes' net accounting deficit totalled £957 million (2011: surplus of £592 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The value of the Group's defined benefit pension schemes' liabilities requires management to make a number of assumptions. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The accounting surplus or deficit is sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variation. The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience and extrapolate the improving trend, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience.

The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in note 42.

Valuation of assets and liabilities arising from life insurance business

At 31 December 2012, the Group recognised a value of in-force business asset of £5,488 million (2011: £5,247 million) and an acquired value of in-force business asset of £1,312 million (2011: £1,391 million). The value of in-force business asset represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. The acquired value of in-force business asset represents the contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers. The methodology used to value these assets is set out in note 2(O)(1). The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to these assets. The key assumptions that have been made in determining the carrying value of the value of in-force business assets at 31 December 2012 are set out in note 29.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 3: Critical accounting estimates and judgements (continued)

At 31 December 2012, the Group carried liabilities arising from insurance contracts and participating investment contracts of £82,953 million (2011: £78,991 million). The methodology used to value these liabilities is described in note 2(O)(1). Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The key assumptions that have been made in determining the carrying value of these liabilities are set out in note 37.

The effect on the Group's profit before tax and shareholders' equity of changes in key assumptions used in determining the life insurance assets and liabilities is set out in note 38.

Payment protection insurance and other regulatory provisions

At 31 December 2012, the Group carried provisions of £3,366 million (2011: £2,499 million) against the cost of making redress payments to customers and the related administration costs in connection with historic regulatory breaches, principally the misselling of payment protection insurance. Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the number of future complaints, the extent to which they will be upheld and the average cost of redress. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

Note 44 contains more detail on the nature of the assumptions that have been made and key sensitivities.

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Note 4: Segmental analysis

Lloyds Banking Group provides a wide range of banking and financial services in the UK and in certain locations overseas.

The Group Executive Committee has been determined to be the chief operating decision maker for the Group. The Group's operating segments reflect its organisational and management structures. The Group Executive Committee reviews the Group's internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment's net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

The segmental results and comparatives are presented on a management basis, the basis reviewed by the chief operating decision maker. Previously the results of the Group's segments had been reviewed on a combined businesses basis and the Group's segmental analysis was presented accordingly. Profit on the management basis is equivalent to profit before tax on a combined businesses basis. However, the effects of asset sales, volatile items and liability management are shown on a separate line in the management basis income statements whereas they were previously included in the relevant line items on a combined businesses basis; in addition the results of asset sales are now reported net of the related fair value unwind whereas this was previously included on the separate fair value unwind line.

Following a reorganisation during 2012, the Group's activities are now organised into four financial reporting segments: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance. The impact of this reorganisation was as follows:

- The Group's Wholesale and Commercial divisions have been combined to form Commercial Banking.
- The Asset Finance business unit, previously reported within Wholesale, is now reported within the Wealth, Asset Finance and International segment; the Asset Finance business recorded a management basis profit before tax of £319 million in the year ended 31 December 2012 (2011: £275 million; 2010: £380 million).
- The Group's Continental European wholesale business and the wholesale Australian business have been transferred from Wealth, Asset Finance and International to Commercial Banking; during the year ended 31 December 2012 these transferred businesses recorded a management basis loss before tax of £432 million (2011: £1,050 million; 2010: £1,327 million).

In addition, asset sales now include sales of centrally held government bonds, following an increase in activity in the first half of 2012.

Comparative figures have been restated accordingly for all of the above changes.

Retail offers a broad range of retail financial service products in the UK, including current accounts, savings, personal loans, credit cards and mortgages. It is also a major general insurance and bancassurance distributor, selling a wide range of long-term savings, investment and general insurance products.

Commercial Banking provides banking and related services for all UK and multinational business clients, from small and medium-sized enterprises to major corporate and financial institutions.

Wealth, Asset Finance and International gives increased focus and momentum to the Group's private banking and asset management activities, closely co-ordinates the management of its international businesses and now also encompasses the Asset Finance business in the UK and Australia. Wealth comprises the Group's private banking, wealth and asset management businesses in the UK and overseas. International comprises retail businesses, principally in Continental Europe.

Insurance provides long-term savings, protection and investment products distributed through the bancassurance, intermediary and direct channels in the UK. It is also a distributor of home insurance in the UK with products sold through the retail branch network, direct channels and strategic corporate partners. The business consists of Life, Pensions and Investments UK; Life, Pensions and Investments Europe; and General Insurance.

Other includes the costs of managing the Group's technology platforms, branch and head office property estate, operations (including payments, banking operations and collections) and sourcing, the costs of which are predominantly recharged to the other divisions. It also reflects other items not recharged to the divisions, including hedge ineffectiveness, UK bank levy, Financial Services Compensation Scheme costs, gains on liability management, volatile items such as hedge accounting volatility managed centrally, and other gains from the structural hedging of interest rate risk.

Inter-segment services are generally recharged at cost, with the exception of the internal commission arrangements between the UK branch and other distribution networks and the insurance product manufacturing businesses within the Group, where a profit margin is also charged. Inter-segment lending and deposits are generally entered into at market rates, except that non-interest bearing balances are priced at a rate that reflects the external yield that could be earned on such funds.

For the majority of those derivative contracts entered into by business units for risk management purposes, the business unit recognises the net interest income or expense on an accrual accounting basis and transfers the remainder of the movement in the fair value of the derivative to the central group segment where the resulting accounting volatility is managed where possible through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the swap and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results and leads to accounting volatility in the central group segment where it is managed.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Other £m	Reported basis total £m
Year ended 31 December 2012						
Net interest income	7,195	2,206	799	(78)	213	10,335
Other income (net of fee and commission expense)	1,462	2,932	2,043	2,294	(315)	8,416
Insurance claims	–	–	–	(365)	–	(365)
Total underlying income, net of insurance claims	8,657	5,138	2,842	1,851	(102)	18,386
Total costs	(4,199)	(2,516)	(2,291)	(744)	(332)	(10,082)
Impairment	(1,270)	(2,946)	(1,480)	–	(1)	(5,697)
Underlying profit (loss)	3,188	(324)	(929)	1,107	(435)	2,607
Asset sales	–	(464)	(196)	–	3,207	2,547
Volatile items	–	138	–	–	(886)	(748)
Liability management	–	–	–	–	(229)	(229)
Fair value unwind	482	888	(51)	(42)	(627)	650
Management basis profit (loss)	3,670	238	(1,176)	1,065	1,030	4,827
External revenue	10,951	4,070	2,835	2,497	(1,967)	18,386
Inter-segment revenue	(2,294)	1,068	7	(646)	1,865	–
Segment revenue	8,657	5,138	2,842	1,851	(102)	18,386
Segment external assets	346,030	314,090	76,449	143,851	44,132	924,552
Segment customer deposits	260,838	114,115	51,885	–	74	426,912
Segment external liabilities	287,631	249,097	91,251	134,963	116,926	879,868
Other segment items reflected in income statement above:						
Depreciation and amortisation	345	219	815	95	90	1,564
(Decrease) increase in value of in-force business	–	–	(4)	273	–	269
Defined benefit scheme charges	103	54	36	23	(148)	68
Other segment items:						
Additions to tangible fixed assets	143	67	1,732	378	683	3,003
Investments in joint ventures and associates at end of year	185	113	6	–	9	313

Note 4: Segmental analysis (continued)

	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Other £m	Reported basis total £m
Year ended 31 December 2011[1]						
Net interest income	7,497	3,192	1,003	(67)	585	12,210
Other income (net of fee and commission expense)	1,660	2,806	2,230	2,687	(204)	9,179
Insurance claims	–	–	–	(343)	–	(343)
Total underlying income, net of insurance claims	9,157	5,998	3,233	2,277	381	21,046
Total costs	(4,438)	(2,600)	(2,414)	(812)	(357)	(10,621)
Impairment	(1,970)	(4,210)	(3,604)	–	(3)	(9,787)
Underlying profit (loss)	2,749	(812)	(2,785)	1,465	21	638
Asset sales	48	61	(21)	–	196	284
Volatile items	–	(736)	–	–	(2)	(738)
Liability management	–	–	–	–	1,295	1,295
Fair value unwind	839	1,562	122	(43)	(1,274)	1,206
Management basis profit (loss)	3,636	75	(2,684)	1,422	236	2,685
External revenue	12,230	3,889	3,863	2,910	(1,846)	21,046
Inter-segment revenue	(3,073)	2,109	(630)	(633)	2,227	–
Segment revenue	9,157	5,998	3,233	2,277	381	21,046
Segment external assets	356,295	350,711	73,345	140,754	49,441	970,546
Segment customer deposits	247,088	123,822	41,661	–	1,335	413,906
Segment external liabilities	279,162	294,088	73,635	129,350	147,717	923,952
Other segment items reflected in income statement above:						
Depreciation and amortisation	364	244	836	91	67	1,602
Increase (decrease) in value of in-force business	–	–	3	(625)	–	(622)
Defined benefit scheme charges	121	54	37	23	(36)	199
Other segment items:						
Additions to tangible fixed assets	189	197	1,452	451	806	3,095
Investments in joint ventures and associates at end of year	147	155	29	–	3	334

[1] Restated as explained on page 229.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Other £m	Reported basis total £m
Year ended 31 December 2010[1]						
Net interest income	8,648	3,820	1,204	(39)	510	14,143
Other income (net of fee and commission expense)	1,624	3,009	2,397	2,789	(62)	9,757
Insurance claims	–	–	–	(542)	–	(542)
Total underlying income, net of insurance claims	10,272	6,829	3,601	2,208	448	23,358
Total costs	(4,644)	(2,897)	(2,533)	(854)	(150)	(11,078)
Impairment	(2,747)	(5,714)	(4,720)	–	–	(13,181)
Underlying profit (loss)	2,881	(1,782)	(3,652)	1,354	298	(901)
Asset sales	–	401	37	15	43	496
Volatile items	–	3	–	–	(273)	(270)
Liability management	–	–	–	–	423	423
Fair value unwind	1,105	2,476	372	(43)	(1,446)	2,464
Management basis profit (loss)	3,986	1,098	(3,243)	1,326	(955)	2,212
External revenue	13,620	3,297	5,102	2,613	(1,274)	23,358
Inter-segment revenue	(3,348)	3,532	(1,501)	(405)	1,722	–
Segment revenue	10,272	6,829	3,601	2,208	448	23,358
Other segment items reflected in income statement above:						
Depreciation and amortisation	384	290	930	135	64	1,803
Increase in value of in-force business	–	–	2	787	–	789
Defined benefit scheme charges	176	70	55	28	126	455
Other segment items:						
Additions to tangible fixed assets	126	496	1,232	585	777	3,216
Investments in joint ventures and associates at end of year	139	127	158	–	5	429

[1] Restated as explained on page 229.

Note 4: Segmental analysis (continued)

Reconciliation of reported basis to statutory results

The reported basis is the basis on which financial information is presented to the chief operating decision maker which excludes certain items included in the statutory results. The table below reconciles the statutory results to the reported basis.

		Removal of:					
	Lloyds Banking Group statutory £m	Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Regulatory provisions[2] £m	Fair value unwind £m	Reported basis £m
Year ended 31 December 2012							
Net interest income	**9,075**	**(199)**	**(8)**	**1,230**	**–**	**237**	**10,335**
Other income	**29,831**	**(1,691)**	**(298)**	**(19,433)**	**50**	**(43)**	**8,416**
Insurance claims	**(18,396)**	**–**	**–**	**18,031**	**–**	**–**	**(365)**
Total underlying income, net of insurance claims	**20,510**	**(1,890)**	**(306)**	**(172)**	**50**	**194**	**18,386**
Operating expenses	**(15,931)**	**1,478**	**–**	**172**	**4,175**	**24**	**(10,082)**
Impairment	**(5,149)**	**320**	**–**	**–**	**–**	**(868)**	**(5,697)**
Underlying (loss) profit	**(570)**	**(92)**	**(306)**	**–**	**4,225**	**(650)**	**2,607**
Asset sales		**2,547**	**–**	**–**	**–**	**–**	**2,547**
Volatile items		**(748)**	**–**	**–**	**–**	**–**	**(748)**
Liability management		**(229)**	**–**	**–**	**–**	**–**	**(229)**
Fair value unwind		**–**	**–**	**–**	**–**	**650**	**650**
(Loss) profit	**(570)**	**1,478**	**(306)**	**–**	**4,225**	**–**	**4,827**

[1] Comprises the effects of asset sales (gain of £2,547 million), volatile items (loss of £748 million), liability management (loss of £229 million), Simplification costs related to severance, IT and business costs of implementation (£676 million), EC mandated retail business disposal costs (£570 million), the amortisation of purchased intangibles (£482 million) and the past service pensions credit (£250 million, see note 11).

[2] Comprises the payment protection insurance provision (£3,575 million) and other regulatory provisions (£650 million).

		Removal of:					
	Lloyds Banking Group statutory £m	Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Regulatory provisions[2] £m	Fair value unwind £m	Reported basis £m
Year ended 31 December 2011							
Net interest income	12,698	(843)	(19)	(336)	–	710	12,210
Other income	14,145	2	857	(5,530)	–	(295)	9,179
Insurance claims	(6,041)	–	–	5,698	–	–	(343)
Total underlying income, net of insurance claims	20,802	(841)	838	(168)	–	415	21,046
Operating expenses	(16,250)	2,014	–	168	3,375	72	(10,621)
Impairment	(8,094)	–	–	–	–	(1,693)	(9,787)
Underlying (loss) profit	(3,542)	1,173	838	–	3,375	(1,206)	638
Asset sales		284	–	–	–	–	284
Volatile items		(738)	–	–	–	–	(738)
Liability management		1,295	–	–	–	–	1,295
Fair value unwind		-	–	–	–	1,206	1,206
(Loss) profit	(3,542)	2,014	838	–	3,375	–	2,685

[1] Comprises the effects of asset sales (gain of £284 million), volatile items (loss of £738 million), liability management (gain of £1,295 million), integration and Simplification costs related to severance, IT and business costs of implementation (£1,282 million), EC mandated retail business disposal costs (£170 million) and the amortisation of purchased intangibles (£562 million).

[2] Comprises the payment protection insurance provision (£3,200 million) and other regulatory provisions (£175 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

		Removal of:					
	Lloyds Banking Group statutory £m	Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Regulatory provisions and loss on disposal of businesses[2] £m	Fair value unwind £m	Reported basis £m
Year ended 31 December 2010							
Net interest income	12,546	321	26	949	–	301	14,143
Other income	31,410	(970)	(332)	(19,739)	–	(612)	9,757
Insurance claims	(19,088)	–	–	18,544	–	2	(542)
Total underlying income, net of insurance claims	24,868	(649)	(306)	(246)	–	(309)	23,358
Operating expenses	(13,270)	1,372	–	246	500	74	(11,078)
Impairment	(10,952)	–	–	–	–	(2,229)	(13,181)
Loss on disposal of businesses	(365)	–	–	–	365	–	–
Underlying profit (loss)	281	723	(306)	–	865	(2,464)	(901)
Asset sales		496	–	–	–	–	496
Volatile items		(270)	–	–	–	–	(270)
Liability management		423	–	–	–	–	423
Fair value unwind		–	–	–	–	2,464	2,464
Profit (loss)	281	1,372	(306)	–	865	–	2,212

[1] Comprises the effects of asset sales (gain of £496 million), volatile items (loss of £270 million), liability management (gain of £423 million), the pension curtailment gain (£910 million, see note 11), integration costs related to severance, IT and business costs of implementation (£1,653 million) and the amortisation of purchased intangibles (£629 million).

[2] Comprises regulatory provisions (£500 million) and the loss on disposal of businesses (£365 million).

Geographical areas

The Group's activities are focused in the UK and the analyses of income and assets below are based on the location of the branch or entity recording the income or assets.

	2012			2011			2010		
	UK £m	**Non-UK £m**	**Total £m**	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
Total income	**36,646**	**2,260**	**38,906**	24,417	2,426	26,843	39,754	4,202	43,956
Total assets	**823,664**	**100,888**	**924,552**	875,918	94,628	970,546	873,138	118,436	991,574

There was no individual non-UK country contributing more than 5 per cent of total income or total assets.

Note 5: Net interest income

	Weighted average effective interest rate					
	2012 %	2011 %	2010 %	**2012 £m**	2011 £m	2010 £m
Interest and similar income:						
Loans and advances to customers, excluding lease and hire purchase receivables	**3.91**	4.00	4.37	**20,928**	23,208	25,459
Loans and advances to banks	**0.53**	0.78	0.72	**590**	628	512
Debt securities held as loans and receivables	**4.77**	3.17	4.41	**433**	590	1,377
Lease and hire purchase receivables	**5.35**	5.13	6.74	**672**	742	626
Interest receivable on loans and receivables	**3.39**	3.63	4.03	**22,623**	25,168	27,974
Available-for-sale financial assets	**1.99**	2.58	2.88	**624**	886	1,311
Held-to-maturity investments	**2.80**	3.29	2.51	**288**	262	55
Total interest and similar income	**3.32**	3.58	3.95	**23,535**	26,316	29,340
Interest and similar expense:						
Deposits from banks, excluding liabilities under sale and repurchase transactions	**1.14**	0.80	0.78	**(324)**	(222)	(319)
Customer deposits, excluding liabilities under sale and repurchase transactions	**1.69**	1.66	1.56	**(6,637)**	(6,080)	(5,381)
Debt securities in issue	**2.04**	2.22	2.49	**(3,043)**	(5,045)	(5,833)
Subordinated liabilities	**7.41**	6.35	10.98	**(2,783)**	(2,155)	(3,619)
Liabilities under sale and repurchase agreements	**1.47**	1.39	1.18	**(245)**	(335)	(744)
Interest payable on liabilities held at amortised cost	**2.08**	2.04	2.22	**(13,032)**	(13,837)	(15,896)
Other	**7.40**	(1.14)	6.97	**(1,428)**	219	(898)
Total interest and similar expense	**2.24**	1.95	2.31	**(14,460)**	(13,618)	(16,794)
Net interest income				**9,075**	12,698	12,546

Included within interest and similar income is £1,133 million (2011: £1,405 million; 2010: £1,288 million) in respect of impaired financial assets. Net interest income also includes a credit of £92 million (2011: charge of £70 million; 2010: charge of £932 million) transferred from the cash flow hedging reserve (see note 48).

During February 2012, the Group completed the exchange of certain subordinated debt securities issued by the HBOS group for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call during 2012. As part of the exchange, the Group announced that all decisions to exercise calls on those original securities that remained outstanding following the exchange offer would be made with reference to the prevailing regulatory, economic and market conditions at the time. These securities will not, therefore, be called at their first available call date which will lead to coupons continuing to be being paid until possibly the final redemption date of the securities. Consequently, the Group is required to adjust the carrying amount of these securities to reflect the revised estimated cash flows over their revised life and to recognise this change in carrying value in interest expense. Included within net interest income in the year ended 31 December 2012 is a credit of £109 million in respect of the securities that remained outstanding following the exchange offer (2011: gain following a similar adjustment to carrying value of £570 million; 2010: £nil).

In December 2011, the Group decided to defer payment of non-mandatory coupons on certain securities and, instead, settle them using an Alternative Coupon Satisfaction Mechanism on their contractual terms. This change in expected cash flows resulted in a gain of £126 million in net interest income in the year ended 31 December 2011 from the recalculation of the carrying value of these securities.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 6: Net fee and commission income

	2012 £m	2011 £m	2010 £m
Fee and commission income:			
Current accounts	**1,008**	1,053	1,086
Credit and debit card fees	**941**	877	812
Other	**2,782**	3,005	3,094
Total fee and commission income	**4,731**	4,935	4,992
Fee and commission expense	**(1,438)**	(1,391)	(1,682)
Net fee and commission income	**3,293**	3,544	3,310

As discussed in note 2, fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

Note 7: Net trading income

	2012 £m	2011 £m	2010 £m
Foreign exchange translation (losses) gains	**(167)**	317	70
Gains on foreign exchange trading transactions	**502**	341	377
Total foreign exchange	**335**	658	447
Investment property (losses) gains (note 27)	**(264)**	(107)	434
Securities and other gains (losses) (see below)	**13,483**	(919)	14,843
Net trading income (expense)	**13,554**	(368)	15,724

Securities and other gains (losses) comprise net gains (losses) arising on assets and liabilities held at fair value through profit or loss and for trading as follows:

	2012 £m	2011 £m	2010 £m
Net income (expense) arising on assets held at fair value through profit or loss:			
Debt securities, loans and advances	**3,616**	5,293	2,292
Equity shares	**10,099**	(4,917)	10,333
Total net income arising on assets held at fair value through profit or loss	**13,715**	376	12,625
Net expense arising on liabilities held at fair value through profit or loss – debt securities in issue	**(576)**	(230)	(231)
Total net gains arising on assets and liabilities held at fair value through profit or loss	**13,139**	146	12,394
Net gains (losses) on financial instruments held for trading	**344**	(1,065)	2,449
Securities and other gains (losses)	**13,483**	(919)	14,843

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Note 8: Insurance premium income

	2012 £m	2011 £m	2010 £m
Life insurance			
Gross premiums	**7,391**	7,276	7,026
Ceded reinsurance premiums	**(222)**	(322)	(253)
Net earned premiums	**7,169**	6,954	6,773
Non-life insurance			
Gross written premiums	**1,081**	1,198	1,332
Ceded reinsurance premiums	**(31)**	(52)	(104)
Net written premiums	**1,050**	1,146	1,228
Change in provision for unearned premiums (note 37(2))	**72**	70	156
Change in provision for ceded unearned premiums (note 37(2))	**(7)**	–	(9)
Net earned premiums	**1,115**	1,216	1,375
Total net earned premiums	**8,284**	8,170	8,148

Life insurance gross premiums can be further analysed as follows:

	2012 £m	2011 £m	2010 £m
Life and pensions	**6,755**	6,737	6,428
Annuities	**630**	529	583
Other	**6**	10	15
Gross premiums	**7,391**	7,276	7,026

Non-life insurance gross written premiums can be further analysed as follows:

	2012 £m	2011 £m	2010 £m
Credit protection	**173**	231	363
Home	**904**	963	964
Health	**4**	4	5
Gross written premiums	**1,081**	1,198	1,332

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Note 9: Other operating income

	2012 £m	2011 £m	2010 £m
Operating lease rental income	**1,145**	1,268	1,410
Rental income from investment properties (note 27)	**389**	388	337
Other rents receivable	**27**	34	41
Gains less losses on disposal of available-for-sale financial assets (note 48)	**3,547**	343	399
Movement in value of in-force business (note 29)	**269**	(622)	789
Liability management (see below)	**(338)**	599	423
Share of results of joint ventures and associates (note 13)	**28**	31	(88)
Other	**(367)**	758	917
Total other operating income	**4,700**	2,799	4,228

Liability management

During February 2012, the Group completed the exchange of certain subordinated debt securities issued by the HBOS group for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call during 2012. This exchange resulted in a gain on the extinguishment of the existing securities of £59 million being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs. Additionally, during the second half of 2012 losses totalling £397 million arose on the buy-back of other debt securities.

During December 2011, the Group completed the exchange of certain subordinated debt securities which resulted in a gain on extinguishment of the existing securities of £599 million.

During 2010, Lloyds Banking Group plc issued ordinary shares in exchange for certain existing securities, resulting in total gains of £403 million. Also during 2010 the Group entered into a bilateral exchange in respect of certain Enhanced Capital Notes on which a profit of £20 million arose.

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Note 10: Insurance claims

Insurance claims comprise:

	2012 £m	2011 £m	2010 £m
Life insurance and participating investment contracts			
Claims and surrenders:			
Gross	**(8,719)**	(8,622)	(9,397)
Reinsurers' share	**185**	230	159
	(8,534)	(8,392)	(9,238)
Change in insurance and participating investment contracts (note 37(1)):			
Change in gross liabilities	**(4,284)**	1,383	(4,622)
Change in assets arising from reinsurance contracts held	**(186)**	451	256
	(4,470)	1,834	(4,366)
Change in non-participating investment contracts:			
Change in gross liabilities	**(5,058)**	520	(5,449)
Change in assets arising from reinsurance contracts held	**–**	–	65
	(5,058)	520	(5,384)
Change in unallocated surplus (note 40)	**31**	340	439
Total life insurance and participating investment contracts	**(18,031)**	(5,698)	(18,549)
Non-life insurance			
Claims and claims paid:			
Gross	**(439)**	(521)	(470)
Reinsurers' share	**1**	4	11
	(438)	(517)	(459)
Change in liabilities (note 37(2)):			
Gross	**74**	186	(82)
Reinsurers' share	**(1)**	(12)	2
	73	174	(80)
Total non-life insurance	**(365)**	(343)	(539)
Total insurance claims	**(18,396)**	(6,041)	(19,088)
Life insurance and participating investment contracts gross claims can also be analysed as follows:			
Deaths	**(618)**	(625)	(662)
Maturities	**(2,238)**	(1,861)	(1,763)
Surrenders	**(4,795)**	(5,041)	(5,904)
Annuities	**(789)**	(764)	(741)
Other	**(279)**	(331)	(327)
Total life insurance gross claims	**(8,719)**	(8,622)	(9,397)

A non-life insurance claims development table is included in note 37.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11: Operating expenses

	2012 £m	2011 £m	2010 £m
Staff costs:			
Salaries	**3,411**	3,784	3,787
Performance-based compensation	**395**	361	533
Social security costs	**383**	432	396
Pensions and other post-retirement benefit schemes (note 42):			
Past service credits and curtailment gains[1]	**(250)**	–	(910)
Other	**547**	401	628
	297	401	(282)
Restructuring costs	**217**	124	119
Other staff costs	**746**	1,064	1,069
	5,449	6,166	5,622
Premises and equipment:			
Rent and rates	**488**	547	602
Hire of equipment	**17**	22	18
Repairs and maintenance	**174**	188	199
Other	**270**	294	358
	949	1,051	1,177
Other expenses:			
Communications and data processing	**1,082**	954	1,126
Advertising and promotion	**314**	398	362
Professional fees	**550**	576	742
UK bank levy	**179**	189	–
Financial services compensation scheme levy (note 53)	**175**	179	46
Other	**932**	1,122	1,061
	3,232	3,418	3,337
Depreciation and amortisation:			
Depreciation of tangible fixed assets (note 31)	**1,431**	1,434	1,635
Amortisation of acquired value of in-force non-participating investment contracts (note 29)	**79**	78	76
Amortisation of other intangible assets (note 30)	**616**	663	721
	2,126	2,175	2,432
Impairment of tangible fixed assets (note 31)	**–**	65	202
Total operating expenses, excluding regulatory provisions	**11,756**	12,875	12,770
Regulatory provisions:			
Payment protection insurance provision (note 44)	**3,575**	3,200	–
Other regulatory provisions (note 44)[2]	**600**	175	500
	4,175	3,375	500
Total operating expenses	**15,931**	16,250	13,270

[1] Following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change is a reduction in the Group's defined benefit obligation of £258 million, recognised in the Group's income statement in 2012, net of a charge of £8 million resulting from a change to the commutation factors in one of the Group's smaller schemes.

Following changes by the Group to the terms of its defined benefit pension schemes in 2010, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee's actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of 2010 there was a change in commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group's defined benefit obligation of £1,081 million and a reduction in the Group's unrecognised actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement in 2010 and a reduction in the balance sheet liability.

[2] In addition, regulatory provisions of £50 million (2011: £nil; 2010: £nil) have been charged against income.

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Note 11: Operating expenses (continued)

Performance-based compensation

The table below analyses the Group's performance-based compensation costs (excluding branch-based sales incentives) between those relating to the current performance year and those relating to earlier years.

	2012 £m	2011 £m	2010 £m
Performance-based compensation expense comprises:			
Awards made in respect of the year ended 31 December	**362**	363	505
Awards made in respect of earlier years	**33**	(2)	28
	395	361	533
Performance-based compensation expense deferred until later years comprises:			
Awards made in respect of the year ended 31 December	**37**	43	39
Awards made in respect of earlier years	**15**	29	39
	52	72	78

Performance-based awards expensed in 2012 include cash awards amounting to £128 million (2011: £160 million; 2010: £163 million).

Average headcount

The average number of persons on a headcount basis employed by the Group during the year was as follows:

	2012	2011	2010
UK	**110,295**	116,371	118,149
Overseas	**3,322**	4,078	4,830
Total	**113,617**	120,449	122,979

Fees payable to the auditors

Fees payable to the Company's auditors by the Group are as follows:

	2012 £m	2011 £m	2010 £m
Fees payable for the audit of the Company's current year annual report	**1.6**	1.7	1.9
Fees payable for other services:			
Audit of the Company's subsidiaries pursuant to legislation	**15.7**	16.9	17.9
Other services supplied pursuant to legislation	**4.5**	4.8	6.2
Total audit fees	**21.8**	23.4	26.0
Other services – audit related fees	**1.7**	2.9	1.8
Total audit and audit related fees	**23.5**	26.3	27.8
Services relating to taxation:			
Taxation compliance services	**0.2**	0.2	0.3
All other taxation advisory services	**0.6**	0.9	0.7
	0.8	1.1	1.0
Other non-audit fees:			
Services relating to corporate finance transactions	**0.5**	6.3	1.9
Other services	**2.2**	2.6	9.7
Total other non-audit fees	**2.7**	8.9	11.6
Total fees payable to the Company's auditors by the Group	**27.0**	36.3	40.4

The following types of services are included in the categories listed above:

Audit fees: This category includes fees in respect of the audit of the Group's annual financial statements and other services in connection with regulatory filings. Other services supplied pursuant to legislation relate primarily to the costs associated with the Sarbanes-Oxley Act audit requirements together with the cost of the audit of the Group's Form 20-F filing.

Audit related fees: This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements, for example acting as reporting accountants in respect of prospectuses and circulars required by the UKLA listing rules.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11: Operating expenses (continued)

Services relating to taxation: This category includes tax compliance and tax advisory services.

Other non-audit fees: This category includes due diligence relating to corporate finance, including venture capital transactions and other assurance and advisory services.

It is the Group's policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants. Such assignments typically relate to the provision of advice on tax issues, assistance in transactions involving the acquisition and disposal of businesses and accounting advice.

The Group has procedures that are designed to ensure auditor independence, including that fees for audit and non-audit services are approved in advance. This approval can be obtained either on an individual engagement basis or, for certain types of non-audit services, particularly those of a recurring nature, through the approval of a fee cap covering all engagements of that type provided the fee is below that cap. All statutory audit work as well as non-audit assignments where the fee is expected to exceed the relevant fee cap must be pre-approved by the Audit Committee on an individual engagement basis. On a quarterly basis, the Audit Committee receives a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

During the year, the auditors also earned fees payable by entities outside the consolidated Lloyds Banking Group in respect of the following:

	2012 £m	2011 £m	2010 £m
Audits of Group pension schemes	0.4	0.4	0.3
Audits of the unconsolidated Open Ended Investment Companies managed by the Group	0.8	0.6	0.8
Reviews of the financial position of corporate and other borrowers	5.4	11.0	17.2
Acquisition due diligence and other work performed in respect of potential venture capital investments	0.7	1.0	1.2

Note 12: Impairment

	2012 £m	2011 £m	2010 £m
Impairment losses on loans and receivables:			
Loans and advances to banks	–	–	(13)
Loans and advances to customers	5,125	8,020	10,727
Debt securities classified as loans and receivables	(4)	49	57
Total impairment losses on loans and receivables (note 24)	5,121	8,069	10,771
Impairment of available-for-sale financial assets	37	80	106
Other credit risk provisions (note 44)	(9)	(55)	75
Total impairment charged to the income statement	5,149	8,094	10,952

Note 13: Investments in joint ventures and associates

The Group's share of results of and investments in joint ventures and associates comprises:

	Joint ventures			Associates			Total		
	2012 £m	2011 £m	2010 £m	**2012 £m**	2011 £m	2010 £m	**2012 £m**	2011 £m	2010 £m
Share of income statement amounts:									
Income	**278**	316	318	**63**	160	135	**341**	476	453
Expenses	**(229)**	(261)	(209)	**(68)**	(161)	(91)	**(297)**	(422)	(300)
Impairment	**(6)**	(20)	(126)	**(1)**	1	(92)	**(7)**	(19)	(218)
Profit (loss) before tax	**43**	35	(17)	**(6)**	–	(48)	**37**	35	(65)
Tax	**(9)**	(4)	(22)	**–**	–	(1)	**(9)**	(4)	(23)
Share of post-tax results	**34**	31	(39)	**(6)**	–	(49)	**28**	31	(88)
Share of balance sheet amounts:									
Current assets	**3,103**	3,346	3,370	**127**	246	378	**3,230**	3,592	3,748
Non-current assets	**1,596**	2,148	2,868	**581**	976	1,184	**2,177**	3,124	4,052
Current liabilities	**(729)**	(714)	(588)	**(128)**	(293)	(433)	**(857)**	(1,007)	(1,021)
Non-current liabilities	**(3,672)**	(4,471)	(5,324)	**(565)**	(904)	(1,026)	**(4,237)**	(5,375)	(6,350)
Share of net assets at 31 December	**298**	309	326	**15**	25	103	**313**	334	429
Movement in investments over the year:									
At 1 January	**309**	326	370	**25**	103	109	**334**	429	479
Exchange and other adjustments	**2**	(3)	(8)	**1**	(1)	40	**3**	(4)	32
Additional investments	**10**	7	71	**1**	3	6	**11**	10	77
Disposals	**(44)**	(47)	(68)	**(6)**	(79)	(2)	**(50)**	(126)	(70)
Share of post-tax results	**34**	31	(39)	**(6)**	–	(49)	**28**	31	(88)
Dividends paid	**(13)**	(5)	–	**–**	(1)	(1)	**(13)**	(6)	(1)
Share of net assets at 31 December	**298**	309	326	**15**	25	103	**313**	334	429

During 2012, the Group recognised a net £10 million (2011: £8 million) of losses of associates not previously recognised. The Group's unrecognised share of losses of associates during 2010 was £8 million and of joint ventures is £126 million in 2012 (2011: £85 million; 2010: £180 million). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £31 million (2011: £56 million; 2010: £104 million) and of joint ventures is £330 million (2011: £299 million; 2010: £339 million).

The Group's principal joint venture investment at 31 December 2012 was in Sainsbury's Bank plc; the Group owns 50 per cent of the ordinary share capital of Sainsbury's Bank plc, whose business is banking and principal area of operation is the UK. Sainsbury's Bank plc is incorporated in the UK and the Group's interest is held by a subsidiary.

Where entities have statutory accounts drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

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Note 14: Loss on disposal of businesses in 2010

During 2009, the Group acquired an oil drilling rig construction business through a previous lending relationship and consolidated the results and net assets of the business from the date it exercised control.

In the first half of 2010, as a result of a deteriorating market, the Group impaired the oil drilling rigs under construction held by the business by £150 million to reflect their reduced value in use.

In the second half of 2010, the Group reached agreement to dispose of its interests in the two wholly-owned subsidiary companies through which this business operates; the sale was completed in January 2011. These companies, which had gross assets of £860 million, were sold to Seadrill Limited; a loss of £365 million arose on disposal.

The Group extended vendor financing, on normal commercial terms and negotiated on an arms length basis, to Seadrill to facilitate the acquisition of the rig holding companies. The loan is not contingent on the performance of the oil rigs under construction. Accordingly, at 31 December 2010, the subsidiaries were derecognised.

Note 15: Taxation

(A) Analysis of tax (charge) credit for the year

	2012 **£m**	2011 £m	2010 £m
UK corporation tax:			
Current tax on profit for the year	**(175)**	(93)	(146)
Adjustments in respect of prior years	**58**	(146)	310
	(117)	(239)	164
Double taxation relief	**–**	–	1
	(117)	(239)	165
Foreign tax:			
Current tax on profit for the year	**(86)**	(90)	(82)
Adjustments in respect of prior years	**(8)**	36	49
	(94)	(54)	(33)
Current tax (charge) credit	**(211)**	(293)	132
Deferred tax (note 43):			
Origination and reversal of temporary differences	**(339)**	1,621	(393)
Reduction in UK corporation tax rate	**(308)**	(404)	(137)
Adjustments in respect of prior years	**85**	(96)	(141)
	(562)	1,121	(671)
Tax (charge) credit	**(773)**	828	(539)

The charge for tax on the profit for 2012 is based on a UK corporation tax rate of 24.5 per cent (2011: 26.5 per cent; 2010: 28.0 per cent).

The income tax charge is made up as follows:

	2012 **£m**	2011 £m	2010 £m
Tax (charge) credit attributable to policyholders	**(944)**	72	(315)
Shareholder tax credit (charge)	**171**	756	(224)
Tax (charge) credit	**(773)**	828	(539)

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15 Taxation (continued)

(B) Factors affecting the tax credit (charge) for the year

A reconciliation of the credit (charge) that would result from applying the standard UK corporation tax rate to the (loss) profit before tax to the actual tax (charge) credit for the year is given below:

	2012 £m	2011 £m	2010 £m
(Loss) profit before tax	(570)	(3,542)	281
Tax credit (charge) thereon at UK corporation tax rate of 24.5 per cent (2011: 26.5 per cent; 2010: 28.0 per cent)	140	939	(79)
Factors affecting credit (charge):			
UK corporation tax rate change	(308)	(404)	(137)
Disallowed and non-taxable items	54	277	5
Overseas tax rate differences	75	17	134
Gains exempted or covered by capital losses	36	106	65
Policyholder tax	(139)	160	(227)
Further factors affecting the life business[1]:			
Derecognition of deferred tax on policyholder tax credit	(583)	(146)	–
Taxation of certain insurance assets arising on transition to new tax regime	(221)	–	–
Changes to the taxation of pension business:			
Policyholder tax cost	(182)	–	–
Shareholder tax benefit	206	–	–
Tax losses where no deferred tax recognised	(13)	(261)	(487)
Deferred tax on tax losses not previously recognised	–	332	–
Adjustments in respect of previous years	135	(206)	218
Effect of results of joint ventures and associates	23	8	(25)
Other items	4	6	(6)
Tax (charge) credit on (loss) profit on ordinary activities	(773)	828	(539)

[1] The Finance Act 2012 introduced a new UK tax regime for the taxation of life insurance companies which takes effect from 1 January 2013. The new regime, combined with current economic forecasts, has had a number of impacts on the tax charge.

Note 16: Earnings per share

	2012 £m	2011 £m	2010 £m
Loss attributable to equity shareholders – basic and diluted	(1,427)	(2,787)	(320)
	2012 million	2011 million	2010 million
Weighted average number of ordinary shares in issue – basic	69,841	68,470	67,117
Adjustment for share options and awards	–	–	–
Weighted average number of ordinary shares in issue – diluted	69,841	68,470	67,117
Basic loss per share	(2.0)p	(4.1)p	(0.5)p
Diluted loss per share	(2.0)p	(4.1)p	(0.5)p

Basic earnings per share are calculated by dividing the net profit attributable to equity shareholders by the weighted average number of ordinary shares in issue during the year, which has been calculated after deducting 13 million (2011: 10 million; 2010: 8 million) ordinary shares representing the Group's holdings of own shares in respect of employee share schemes.

For the calculation of diluted earnings per share the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares, if any, that arise in respect of share options and awards granted to employees. The number of shares that could have been acquired at the average annual share price of the Company's shares based on the monetary value of the subscription rights attached to outstanding share options and awards is determined. This is deducted from the number of shares issuable under such options and awards to leave a residual bonus amount of shares which are added to the weighted-average number of ordinary shares in issue, but no adjustment is made to the profit attributable to equity shareholders.

The weighted-average number of anti-dilutive share options and awards excluded from the calculation of diluted earnings per share was 37 million at 31 December 2012 (2011: 619 million; 2010: 92 million).

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Note 17: Trading and other financial assets at fair value through profit or loss

These assets are comprised as follows:

	2012			2011		
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m
Loans and advances to customers	13,598	34	13,632	9,642	124	9,766
Loans and advances to banks	919	–	919	1,355	–	1,355
Debt securities:						
Government securities	3,965	16,766	20,731	2,000	21,367	23,367
Other public sector securities	–	1,056	1,056	–	1,183	1,183
Bank and building society certificates of deposit	3,166	228	3,394	2,863	385	3,248
Asset-backed securities:						
Mortgage-backed securities	130	708	838	99	612	711
Other asset-backed securities	21	1,802	1,823	222	1,764	1,986
Corporate and other debt securities	1,172	23,686	24,858	1,576	20,282	21,858
	8,454	44,246	52,700	6,760	45,593	52,353
Equity shares	–	86,309	86,309	–	75,737	75,737
Treasury and other bills	374	56	430	299	–	299
Total	23,345	130,645	153,990	18,056	121,454	139,510

Other financial assets at fair value through profit or loss include the following assets designated into that category:

(i) financial assets backing insurance contracts and investment contracts of £127,907 million (2011: £118,890 million) which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise;

(ii) loans and advances to customers of £34 million (2011: £124 million) which are economically hedged by interest rate derivatives which are not in hedge accounting relationships and where significant measurement inconsistencies would otherwise arise if the related derivatives were treated as trading liabilities and the loans and advances were carried at amortised cost; and

(iii) private equity investments of £2,110 million (2011: £1,850 million) that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The maximum exposure to credit risk at 31 December 2012 of the loans and advances to banks and customers designated at fair value through profit or loss was £34 million (2011: £124 million); the Group does not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk which is determined by reference to the publicly available credit ratings of the instruments involved.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £14,433 million (2011: £10,990 million). Collateral is held with a fair value of £19,629 million (2011: £15,765 million), all of which the Group is able to repledge. At 31 December 2012, £15,640 million had been repledged (2011: £3,740 million).

For amounts included above which are subject to repurchase agreements see note 55.

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Note 18: Derivative financial instruments

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 55; and
- Derivatives held in policyholder funds as permitted by the investment strategies of those funds.

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 54.

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.
- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place. The Group also uses credit default swaps to securitise, in combination with external funding, £2,829 million (2011: £3,436 million) of corporate and commercial banking loans.
- Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

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Note 18: Derivative financial instruments (continued)

The fair values and notional amounts of derivative instruments are set out in the following table:

	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
At 31 December 2012			
Trading and other			
Exchange rate contracts:			
Spot, forwards and futures	815,759	1,432	1,599
Currency swaps	107,217	1,689	1,683
Options purchased	330,843	591	–
Options written	21,757	–	605
	1,275,576	3,712	3,887
Interest rate contracts:			
Interest rate swaps	2,071,103	32,819	31,880
Forward rate agreements	1,836,186	494	593
Options purchased	105,245	4,463	–
Options written	115,516	–	4,051
Futures	53,529	2	2
	4,181,579	37,778	36,526
Credit derivatives	6,167	94	343
Embedded equity conversion feature	–	1,421	–
Equity and other contracts	23,714	1,974	1,311
Total derivative assets/liabilities – trading and other	5,487,036	44,979	42,067
Hedging			
Derivatives designated as fair value hedges:			
Currency swaps	56,188	817	356
Interest rate swaps	135,516	6,018	1,772
Options written	68	68	–
	191,772	6,903	2,128
Derivatives designated as cash flow hedges:			
Interest rate swaps	86,190	4,653	4,438
Futures	49,527	1	–
Currency swaps	2,395	14	32
	138,112	4,668	4,470
Total derivative assets/liabilities – hedging	329,884	11,571	6,598
Total recognised derivative assets/liabilities	5,816,920	56,550	48,665

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 55 Credit risk.

The embedded equity conversion feature of £1,421 million (2011: £1,172 million) reflects the value of the equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009; the gain of £249 million arising from the change in fair value over 2012 (2011: loss of £5 million; 2010: loss of £620 million) is included within net gains on financial instruments held for trading within net trading income (note 7).

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Note 18: Derivative financial instruments (continued)

	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
At 31 December 2011			
Trading and other			
Exchange rate contracts:			
Spot, forwards and futures	204,629	2,542	2,780
Currency swaps	138,120	3,498	2,027
Options purchased	17,992	610	–
Options written	18,924	–	616
	379,665	6,650	5,423
Interest rate contracts:			
Interest rate swaps	1,627,013	38,806	39,899
Forward rate agreements	1,311,811	586	606
Options purchased	69,554	3,693	–
Options written	67,858	–	3,524
Futures	118,921	1	2
	3,195,157	43,086	44,031
Credit derivatives	9,980	238	328
Embedded equity conversion feature	–	1,172	–
Equity and other contracts	23,032	2,017	1,184
Total derivative assets/liabilities – trading and other	3,607,834	53,163	50,966
Hedging			
Derivatives designated as fair value hedges:			
Currency swaps	19,130	708	302
Interest rate swaps	93,215	6,720	1,236
Options written	657	–	9
	113,002	7,428	1,547
Derivatives designated as cash flow hedges:			
Interest rate swaps	152,314	5,250	5,608
Futures	103,467	–	–
Currency swaps	16,582	172	90
	272,363	5,422	5,698
Derivatives designated as net investment hedges:			
Cross currency swaps	49	–	1
Total derivative assets/liabilities – hedging	385,414	12,850	7,246
Total recognised derivative assets/liabilities	3,993,248	66,013	58,212

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Note 18: Derivative financial instruments (continued)

Hedged cash flows

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

2012	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	214	241	271	139	67	163	37	33	1,165
Forecast payable cash flows	(168)	(126)	(36)	(40)	(148)	(960)	(1,682)	(442)	(3,602)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	254	287	256	95	51	157	32	33	1,165
Forecast payable cash flows	(190)	(120)	(41)	(42)	(154)	(963)	(1,694)	(398)	(3,602)

2011	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	140	239	475	208	35	355	191	66	1,709
Forecast payable cash flows	(178)	(181)	(63)	(81)	(78)	(1,394)	(1,163)	(354)	(3,492)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	234	232	388	208	47	383	163	54	1,709
Forecast payable cash flows	(224)	(154)	(53)	(81)	(145)	(1,475)	(1,110)	(250)	(3,492)

There were no transactions for which cash flow hedge accounting had to be ceased in 2012 or 2011 as a result of the highly probable cash flows no longer being expected to occur.

Note 19: Loans and advances to banks

	2012 £m	2011 £m
Lending to banks	591	1,810
Money market placements with banks	28,829	30,810
Total loans and advances to banks before allowance for impairment losses	29,420	32,620
Allowance for impairment losses (note 24)	(3)	(14)
Total loans and advances to banks	29,417	32,606

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £662 million (2011: £508 million). Collateral is held with a fair value of £662 million (2011: £511 million), all of which the Group is able to repledge.

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Note 20: Loans and advances to customers

	2012 £m	2011 £m
Agriculture, forestry and fishing	**5,531**	5,198
Energy and water supply	**3,321**	4,013
Manufacturing	**8,530**	10,061
Construction	**7,526**	9,722
Transport, distribution and hotels	**26,568**	32,882
Postal and telecommunications	**1,397**	1,896
Property companies	**52,388**	64,752
Financial, business and other services	**49,190**	64,046
Personal:		
Mortgages	**337,879**	348,210
Other	**28,334**	30,014
Lease financing	**6,477**	7,800
Hire purchase	**5,334**	5,776
Total loans and advances to customers before allowance for impairment losses	**532,475**	584,370
Allowance for impairment losses (note 24)	**(15,250)**	(18,732)
Total loans and advances to customers	**517,225**	565,638

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £5,087 million (2011: £16,835 million). Collateral is held with a fair value of £4,916 million (2011: £16,936 million), all of which the Group is able to repledge. Included within this are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £2 million (2011: £34 million).

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

	2012 £m	2011 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**1,271**	1,287
Later than 1 year and not later than 5 years	**2,049**	3,126
Later than 5 years	**6,232**	7,067
	9,552	11,480
Unearned future finance income on finance leases	**(3,027)**	(3,594)
Rentals received in advance	**(30)**	(56)
Commitments for expenditure in respect of equipment to be leased	**(18)**	(30)
Net investment in finance leases	**6,477**	7,800

The net investment in finance leases represents amounts recoverable as follows:

	2012 £m	2011 £m
Not later than 1 year	**835**	724
Later than 1 year and not later than 5 years	**1,491**	2,307
Later than 5 years	**4,151**	4,769
Net investment in finance leases	**6,477**	7,800

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2012 and 2011 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £33 million (2011: £92 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 20: Loans and advances to customers (continued)

The unguaranteed residual values included in finance lease receivables were as follows:

	2012 £m	2011 £m
Not later than 1 year	49	56
Later than 1 year and not later than 5 years	126	137
Later than 5 years	14	20
Total unguaranteed residual values	**189**	**213**

Note 21: Securitisations and covered bonds

Securitisation programmes

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the SPEs are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue. In addition to the SPEs described below, the Group sponsors three conduit programmes, Argento, Cancara and Grampian.

Covered bond programmes

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in note 36.

	2012		2011	
	Loans and advances securitised £m	Notes in issue £m	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes[1]				
UK residential mortgages	80,125	57,285	129,764	94,080
US residential mortgage-backed securities	185	221	398	398
Commercial loans	15,024	14,110	13,313	11,342
Irish residential mortgages	5,189	3,509	5,497	5,661
Credit card receivables	6,974	3,794	6,763	4,810
Dutch residential mortgages	4,547	4,682	4,933	4,777
Personal loans	4,412	2,000	–	–
PFI/PPP and project finance loans	688	104	767	110
Motor vehicle loans	1,039	1,086	3,124	2,871
	118,183	86,791	164,559	124,049
Less held by the Group		(58,732)		(86,637)
Total securitisation programmes (note 36)		**28,059**		**37,412**
Covered bond programmes				
Residential mortgage-backed	91,420	64,593	91,023	67,456
Social housing loan-backed	2,927	2,400	3,363	2,605
	94,347	66,993	94,386	70,061
Less held by the Group		(26,320)		(31,865)
Total covered bond programmes (note 36)		**40,673**		**38,196**
Total securitisation and covered bond programmes		**68,732**		**75,608**

[1] Includes securitisations utilising a combination of external funding and credit default swaps.

Cash deposits of £19,691 million (2011: £20,435 million) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs, the term advances relating to covered bonds and other legal obligations.

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Note 22: Special purpose entities

In addition to the special purpose entities discussed in note 21, which are used for securitisation and covered bond programmes, the Group sponsors three asset-backed conduits, Argento, Cancara and Grampian, which invest in debt securities and client receivables. All the external assets in these conduits are consolidated in the Group's financial statements and are included in the credit market exposures set out in note 55. The total consolidated exposures in these conduits are set out in the table below:

	Argento £m	Cancara £m	Grampian £m	Total £m
At 31 December 2012				
Loans and advances	**140**	**4,342**	**58**	**4,540**
Debt securities classified as loans and receivables:				
Asset-backed securities	**603**	**367**	**358**	**1,328**
Debt securities classified as available-for-sale financial assets:				
Asset-backed securities	**396**	**–**	**143**	**539**
Total assets	**1,139**	**4,709**	**559**	**6,407**
At 31 December 2011				
Loans and advances	130	3,962	73	4,165
Debt securities classified as loans and receivables:				
Asset-backed securities	1,022	–	2,004	3,026
Debt securities classified as available-for-sale financial assets:				
Asset-backed securities	733	21	796	1,550
Corporate and other debt securities	73	–	–	73
	806	21	796	1,623
Total assets	1,958	3,983	2,873	8,814

Other special purpose entities

During 2009, the Group established Lloyds TSB Pension ABCS (No 1) LLP and Lloyds TSB Pension ABCS (No 2) LLP and transferred approximately £5 billion of assets, primarily comprising notes in certain of the Group's securitisation programmes, in aggregate to these entities. Further details are provided in note 42.

Note 23: Debt securities classified as loans and receivables

Debt securities accounted for as loans and receivables comprise:

	2012 £m	2011 £m
Asset-backed securities:		
Mortgage-backed securities	**3,927**	7,179
Other asset-backed securities	**1,150**	5,030
Corporate and other debt securities	**402**	537
Total debt securities classified as loans and receivables before allowance for impairment losses	**5,479**	12,746
Allowance for impairment losses (note 24)	**(206)**	(276)
Total debt securities classified as loans and receivables	**5,273**	12,470

For amounts included above which are subject to repurchase agreements see note 55.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 24: Allowance for impairment losses on loans and receivables

	Loans and advances to customers £m	Loans and advances to banks £m	Debt securities £m	Total £m
At 1 January 2011	18,373	20	558	18,951
Exchange and other adjustments	(369)	–	2	(367)
Advances written off	(7,487)	(6)	(341)	(7,834)
Recoveries of advances written off in previous years	421	–	8	429
Unwinding of discount	(226)	–	–	(226)
Charge to the income statement (note 12)	8,020	–	49	8,069
At 31 December 2011	18,732	14	276	19,022
Exchange and other adjustments	**(379)**	**(1)**	**(8)**	**(388)**
Advances written off	**(8,697)**	**(10)**	**(73)**	**(8,780)**
Recoveries of advances written off in previous years	**843**	**–**	**15**	**858**
Unwinding of discount	**(374)**	**–**	**–**	**(374)**
Charge (release) to the income statement (note 12)	**5,125**	**–**	**(4)**	**5,121**
At 31 December 2012	**15,250**	**3**	**206**	**15,459**

Of the total allowance in respect of loans and advances to customers, £13,936 million (2011: £17,021 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £3,309 million (2011: £3,832 million) was assessed on a collective basis.

Note 25: Available-for-sale financial assets

	2012			2011		
	Conduits £m	Other £m	Total £m	Conduits £m	Other £m	Total £m
Debt securities:						
Government securities	**–**	**25,555**	**25,555**	–	25,236	25,236
Other public sector securities	**–**	**–**	**–**	–	27	27
Bank and building society certificates of deposit	**–**	**188**	**188**	–	366	366
Asset-backed securities:						
Mortgage-backed securities	**277**	**1,247**	**1,524**	1,255	548	1,803
Other asset-backed securities	**262**	**498**	**760**	295	769	1,064
Corporate and other debt securities	**–**	**1,848**	**1,848**	73	5,172	5,245
	539	**29,336**	**29,875**	1,623	32,118	33,741
Equity shares	**–**	**528**	**528**	–	1,938	1,938
Treasury and other bills	**–**	**971**	**971**	–	1,727	1,727
Total available-for-sale financial assets	**539**	**30,835**	**31,374**	1,623	35,783	37,406

Details of the Group's asset-backed conduits shown in the table above are included in note 22.

Included within asset-backed securities are £2,284 million (31 December 2011: £2,867 million) managed by the Commercial Banking division and at the Group's centre. Further information on these exposures is provided in note 55.

For amounts included above which are subject to repurchase agreements see note 55.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2(H).

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Note 26: Held-to-maturity investments

	2012 £m	2011 £m
Debt securities: government securities	**–**	8,098

During 2012 the Group has reviewed its holding of government securities classified as held-to-maturity. Since it is no longer the Group's intention to hold these to maturity, they have been reclassified as available-for-sale (note 25). Details of the impact of this reclassification are provided in note 54.

Note 27: Investment properties

	2012 £m	2011 £m
At 1 January	**6,122**	5,997
Exchange and other adjustments	**22**	(16)
Additions:		
Acquisitions of new properties	**428**	396
Consolidation of new subsidiary undertakings	**411**	922
Additional expenditure on existing properties	**89**	81
Total additions	**928**	1,399
Disposals	**(1,403)**	(1,151)
Changes in fair value (note 7)	**(264)**	(107)
At 31 December	**5,405**	6,122

The investment properties are valued at least annually at open-market value, by independent, professionally qualified valuers, who have recent experience in the location and categories of the investment properties being valued.

In addition, the following amounts have been recognised in the income statement:

	2012 £m	2011 £m
Rental income (note 9)	**389**	388
Direct operating expenses arising from investment properties that generate rental income	**42**	50

Capital expenditure in respect of investment properties:

	2012 £m	2011 £m
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	**24**	33

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Note 28: Goodwill

	2012 £m	2011 £m
At 1 January and 31 December	**2,016**	2,016
Cost[1]	**2,362**	2,362
Accumulated impairment losses	**(346)**	(346)
At 31 December	**2,016**	2,016

[1] For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is included net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,016 million (2011: £2,016 million), £1,836 million, or 91 per cent of the total (2011: £1,836 million, 91 per cent of the total) has been allocated to Scottish Widows in the Group's Insurance division and £170 million, or 8 per cent of the total (2011: £170 million, 8 per cent of the total) to Asset Finance in the Group's Wealth, Asset Finance and International division.

The recoverable amount of Scottish Widows has been based on a value-in-use calculation. The calculation uses post-tax projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 12 per cent (net of tax). The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady 3 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of Asset Finance has also been based on a value-in-use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 14 per cent (gross of tax). The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Asset Finance participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Asset Finance to fall below the balance sheet carrying value.

Note 29: Value of in-force business

The gross value of in-force business asset in the consolidated balance sheet is as follows:

	2012 £m	2011 £m
Acquired value of in-force non-participating investment contracts	**1,312**	1,391
Value of in-force insurance and participating investment contracts	**5,488**	5,247
Total value of in-force business	**6,800**	6,638

The movement in the acquired value of in-force non-participating investment contracts over the year is as follows:

	2012 £m	2011 £m
At 1 January	**1,391**	1,469
Amortisation taken to income statement (note 11)	**(79)**	(78)
At 31 December	**1,312**	1,391

The acquired value of in-force non-participating investment contracts includes £303 million (2011: £329 million) in relation to OEIC business.

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Note 29: Value of in-force business (continued)

The movement in the value of in-force insurance and participating investment contracts over the year is as follows:

	2012 £m	2011 £m
At 1 January	**5,247**	5,898
Exchange and other adjustments	**(28)**	(29)
Movements in the year:		
New business	**570**	552
Existing business:		
Expected return	**(471)**	(437)
Experience variances	**52**	117
Assumption changes	**(90)**	(576)
Economic variance	**208**	(278)
Movement in the value of in-force business taken to income statement (note 9)	**269**	(622)
At 31 December	**5,488**	5,247

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown contributes to profit before tax. This will also contain changes in the other assets and liabilities, including the effects of changes in assumptions used to value the liabilities, of the relevant businesses. The presentation of economic variance includes the impact of financial market conditions being different at the end of the reporting period from those included in assumptions used to calculate new and existing business returns.

The principal features of the methodology and process used for determining key assumptions used in the calculation of the value of in-force business are set out below:

Economic assumptions

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn a risk-free rate and all cash flows are discounted at a risk-free rate.

A market-consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date. The risk-free rate used for the value of financial options and guarantees is defined as the spot yield derived from the relevant government bond yield curve. Further information on options and guarantees can be found on page 199.

The liabilities in respect of the Group's UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds and, since late 2012, illiquid loan assets. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings and relevant illiquid loan assets. The illiquidity premium is estimated to be 73 basis points at 31 December 2012 (2011: 119 basis points). The effect of including illiquid loan assets in the calculation of the market premium for illiquidity has been to increase the value of in-force business by £44 million at 31 December 2012. This is included as an assumption change in the table below. The effect of this change on profit before tax, after also including the impacts of movements in liabilities, is given in note 37.

The risk-free rate assumed in valuing the non-annuity in-force business is the 15 year government bond yield for the appropriate territory. The risk-free rate assumed in valuing the in-force asset for the UK annuity business is presented as a single risk-free rate to allow a better comparison to the rate used for other business. That single risk-free rate has been derived to give the equivalent value to the UK annuity book, had that book been valued using the UK gilt yield curve increased to reflect the illiquidity premium described above.

The table below shows the resulting range of yields and other key assumptions at 31 December for UK business:

	2012 %	2011 %
Risk-free rate (value of in-force non-annuity business)	**2.32**	2.48
Risk-free rate (value of in-force annuity business)	**3.25**	3.76
Risk-free rate (financial options and guarantees)	**0.22 to 3.56**	0.22 to 3.36
Retail price inflation	**3.13**	3.35
Expense inflation	**3.61**	4.01

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Note 29: Value of in-force business (continued)

Non-market risk

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk, reinsurer default and the with-profit funds these can be asymmetric in the range of potential outcomes for which an explicit allowance is made.

Non-economic assumptions

Future mortality, morbidity, expenses, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and on management's view of future experience.

Mortality and morbidity

The mortality and morbidity assumptions, including allowances for improvements in longevity, are set with regard to the Group's actual experience where this provides a reliable basis and relevant industry data otherwise. For German business, appropriate industry tables have been considered.

Lapse (persistency) and paid-up rates

Lapse and paid up rates assumptions are reviewed each year. The most recent experience is considered along with the results of previous analyses and management's views on future experience. In determining this best estimate view, a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration and any known or expected trends in underlying data.

Maintenance expenses

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

These assumptions are intended to represent a best estimate of future experience, and further information about the effect of changes in key assumptions is given in note 38.

Note 30: Other intangible assets

	Brands £m	Core deposit intangible £m	Purchased credit card relationships £m	Customer-related intangibles £m	Capitalised software enhancements £m	Total £m
Cost:						
At 1 January 2011	596	2,770	300	877	610	5,153
Exchange and other adjustments	–	–	–	–	5	5
Additions	–	–	–	4	369	373
Disposals	–	–	–	–	(25)	(25)
At 31 December 2011	596	2,770	300	881	959	5,506
Exchange and other adjustments	**–**	**–**	**–**	**–**	**27**	**27**
Additions	**–**	**–**	**–**	**–**	**236**	**236**
Disposals	**–**	**–**	**–**	**–**	**(89)**	**(89)**
At 31 December 2012	**596**	**2,770**	**300**	**881**	**1,133**	**5,680**
Accumulated amortisation:						
At 1 January 2011	46	793	118	398	302	1,657
Exchange and other adjustments	–	–	–	–	2	2
Charge for the year	19	399	60	88	97	663
Disposals	–	–	–	–	(12)	(12)
At 31 December 2011	65	1,192	178	486	389	2,310
Exchange and other adjustments	**–**	**–**	**–**	**–**	**25**	**25**
Charge for the year	**21**	**368**	**60**	**40**	**127**	**616**
Disposals	**–**	**–**	**–**	**–**	**(63)**	**(63)**
At 31 December 2012	**86**	**1,560**	**238**	**526**	**478**	**2,888**
Balance sheet amount at 31 December 2012	**510**	**1,210**	**62**	**355**	**655**	**2,792**
Balance sheet amount at 31 December 2011	531	1,578	122	395	570	3,196

Included within brands above are assets of £380 million (31 December 2011: £380 million) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not have an indefinite useful life.

The core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates, and the balance sheet amount at 31 December 2012 shown above will be amortised, in accordance with the Group's accounting policy, on a straight line basis over its remaining useful life of four years (see note 2(C)).

The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased.

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income.

Capitalised software enhancements principally comprise identifiable and directly associated internal staff and other costs.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 31: Tangible fixed assets

	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:				
At 1 January 2011	2,440	4,579	6,287	13,306
Exchange and other adjustments	–	(45)	(22)	(67)
Additions	149	660	1,436	2,245
Disposals	(121)	(395)	(1,852)	(2,368)
Disposal of businesses	(14)	(7)	(330)	(351)
At 31 December 2011	2,454	4,792	5,519	12,765
Exchange and other adjustments	**2**	**(82)**	**(11)**	**(91)**
Additions	**225**	**711**	**1,314**	**2,250**
Disposals	**(65)**	**(306)**	**(1,924)**	**(2,295)**
Write-offs	**–**	**(1,562)**	**–**	**(1,562)**
At 31 December 2012	**2,616**	**3,553**	**4,898**	**11,067**
Accumulated depreciation and impairment:				
At 1 January 2011	1,001	2,845	1,270	5,116
Exchange and other adjustments	–	17	18	35
Impairment charged to the income statement	–	65	–	65
Depreciation charge for the year	137	411	886	1,434
Disposals	(38)	(349)	(967)	(1,354)
Disposal of businesses	(3)	(6)	(195)	(204)
At 31 December 2011	1,097	2,983	1,012	5,092
Exchange and other adjustments	**(8)**	**(77)**	**52**	**(33)**
Depreciation charge for the year	**130**	**432**	**869**	**1,431**
Disposals	**(28)**	**(266)**	**(909)**	**(1,203)**
Write-offs	**–**	**(1,562)**	**–**	**(1,562)**
At 31 December 2012	**1,191**	**1,510**	**1,024**	**3,725**
Balance sheet amount at 31 December 2012	**1,425**	**2,043**	**3,874**	**7,342**
Balance sheet amount at 31 December 2011	1,357	1,809	4,507	7,673

At 31 December the future minimum rentals receivable under non-cancellable operating leases were as follows:

	2012 £m	2011 £m
Receivable within 1 year	**1,039**	987
1 to 5 years	**1,291**	1,389
Over 5 years	**435**	628
Total future minimum rentals receivable	**2,765**	3,004

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2012 and 2011 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £30 million at 31 December 2012 (£40 million at 31 December 2011) is expected to be received under non-cancellable sub-leases of the Group's premises.

The impairment charge in 2011 related to integration activities.

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Note 32: Other assets

	2012 £m	2011 £m
Assets arising from reinsurance contracts held (note 37 and note 39)	2,320	2,534
Deferred acquisition and origination costs (see below)	774	693
Settlement balances	1,332	1,193
Corporate pension asset	6,353	3,873
Investments in joint ventures and associates (note 13)	313	334
Other assets and prepayments	7,216	6,135
Total other assets	18,308	14,762

Deferred acquisition and origination costs:

	2012 £m	2011 £m
At 1 January	693	602
Costs deferred, net of amounts amortised to the income statement	80	92
Exchange and other adjustments	1	(1)
At 31 December	774	693

Note 33: Deposits from banks

	2012 £m	2011 £m
Liabilities in respect of securities sold under repurchase agreements	23,368	14,389
Other deposits from banks	15,037	25,421
Deposits from banks	38,405	39,810

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £23,078 million (2011: £13,933 million) and a fair value of £25,682 million (2011: £14,258 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £4 million (2011: £nil).

Note 34: Customer deposits

	2012 £m	2011 £m
Non-interest bearing current accounts	30,633	29,468
Interest bearing current accounts	71,478	72,562
Savings and investment accounts	261,573	238,132
Liabilities in respect of securities sold under repurchase agreements	4,433	7,996
Other customer deposits	58,795	65,748
Customer deposits	426,912	413,906

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £4,429 million (2011: £7,987 million) and a fair value of £4,552 million (2011: £8,088 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £192 million (2011: £323 million).

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Note 35: Trading and other financial liabilities at fair value through profit or loss

	2012 £m	2011 £m
Liabilities held at fair value through profit or loss (debt securities)	5,700	5,339
Trading liabilities:		
Liabilities in respect of securities sold under repurchase agreements	24,553	12,378
Short positions in securities	2,200	3,701
Other	3,519	3,537
	30,272	19,616
Trading and other financial liabilities at fair value through profit or loss	35,972	24,955

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2012 was £6,553 million, which was £853 million higher than the balance sheet carrying value (2011: £5,487 million, which was £148 million higher than the balance sheet carrying value). At 31 December 2012 there was a cumulative £254 million increase in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of Lloyds TSB Bank plc, the issuing entity within the Group. Of the cumulative amount an increase of £437 million arose in 2012 and a decrease of £194 million arose in 2011.

Liabilities designated at fair value through profit or loss represent debt securities in issue which either contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities, or which are accounted for at fair value to significantly reduce an accounting mismatch.

Note 36: Debt securities in issue

	2012 £m	2011 £m
Medium-term notes issued	29,537	63,366
Covered bonds (note 21)	40,673	38,196
Certificates of deposit issued	11,087	27,994
Securitisation notes (note 21)	28,059	37,412
Commercial paper	8,013	18,091
Total debt securities in issue	117,369	185,059

Note 37: Liabilities arising from insurance contracts and participating investment contracts

Insurance contract and participating investment contract liabilities are comprised as follows:

	2012			2011		
	Gross £m	Reinsurance[1] £m	Net £m	Gross £m	Reinsurance[1] £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	65,650	(2,257)	63,393	62,399	(2,452)	59,947
Participating investment contracts	16,489	–	16,489	15,631	–	15,631
	82,139	(2,257)	79,882	78,030	(2,452)	75,578
Non-life insurance contracts (see (2) below):						
Unearned premiums	494	(16)	478	566	(23)	543
Claims outstanding	320	(1)	319	395	(2)	393
	814	(17)	797	961	(25)	936
Total	82,953	(2,274)	80,679	78,991	(2,477)	76,514

[1] Reinsurance balances are reported within other assets (note 32).

Note 37: Liabilities arising from insurance contracts and participating investment contracts (continued)

(1) Life insurance

The movement in life insurance contract and participating investment contract liabilities over the year can be analysed as follows:

	Insurance contracts £m	Participating investment contracts £m	Gross £m	Reinsurance £m	Net £m
At 1 January 2011	61,871	17,642	79,513	(2,044)	77,469
New business	4,340	86	4,426	(156)	4,270
Changes in existing business	(3,713)	(2,096)	(5,809)	(295)	(6,104)
Change in liabilities charged to the income statement (note 10)	627	(2,010)	(1,383)	(451)	(1,834)
Exchange and other adjustments	(99)	(1)	(100)	43	(57)
At 31 December 2011	62,399	15,631	78,030	(2,452)	75,578
New business	2,757	65	2,822	(67)	2,755
Changes in existing business	668	794	1,462	253	1,715
Change in liabilities charged to the income statement (note 10)	3,425	859	4,284	186	4,470
Exchange and other adjustments	(174)	(1)	(175)	9	(166)
At 31 December 2012	**65,650**	**16,489**	**82,139**	**(2,257)**	**79,882**

Liabilities for insurance contracts and participating investment contracts can be split into with-profit fund liabilities, accounted for using the FSA's realistic capital regime (realistic liabilities) and non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

	2012			2011		
	With-profit fund £m	Non-profit fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	12,383	53,267	65,650	13,467	48,932	62,399
Participating investment contracts	9,646	6,843	16,489	9,488	6,143	15,631
Total	22,029	60,110	82,139	22,955	55,075	78,030

With-profit fund realistic liabilities

(i) Business description

The Group has with-profit funds within Scottish Widows plc and Clerical Medical Investment Group Limited containing both insurance contracts and participating investment contracts.

The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a smoothed investment vehicle to policyholders, protecting them against short-term market fluctuations. Payouts may be subject to a guaranteed minimum payout if certain policy conditions are met. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at retirement.

(ii) Method of calculation of liabilities

With-profit liabilities are stated at their realistic value, the main components of which are:

– With-profit benefit reserve, the total asset shares for with-profit policies;

– Cost of options and guarantees (including guaranteed annuity options);

– Deductions levied against asset shares;

– Planned enhancements to with-profits benefits reserve; and

– Impact of the smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market-consistent basis. The calculation of realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 29.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 37: Liabilities arising from insurance contracts and participating investment contracts (continued)

(iii) Assumptions
Key assumptions used in the calculation of with-profit liabilities, and the processes for determining these, are:

Investment returns and discount rates
The realistic capital regime dictates that with-profit fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant government bond yield curve. Further information on significant options and guarantees is given on page 199.

Guaranteed annuity option take-up rates
Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract. For contracts that contain such options, key assumptions in determining the cost of options are economic conditions in which the option has value, mortality rates and take up rates of other options. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

Investment volatility
The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical volatility where it is not possible to observe meaningful prices.

Mortality
The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.

Lapse rates (persistency)
Lapse rates refer to the rate of policy termination or the rate at which policyholders stop paying regular premiums due under the contract.

Historical persistency experience is analysed using statistical techniques. As experience can vary considerably between different product types and for contracts that have been in force for different periods, the data is broken down into broadly homogenous groups for the purposes of this analysis.

The most recent experience is considered along with the results of previous analyses and management's views on future experience, taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions, in order to determine a 'best estimate' view of what persistency will be. In determining this best estimate view a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration, any known or expected trends in underlying data and relevant published market data.

Non-profit fund liabilities

(i) Business description
The Group principally writes the following types of life insurance contracts within its non-profit funds. Shareholder profits on these types of business arise from management fees and other policy charges.

Unit-linked business – This includes unit-linked pensions and unit-linked bonds, the primary purpose of which is to provide an investment vehicle where the policyholder is also insured against death.

Life insurance – The policyholder is insured against death or permanent disability, usually for predetermined amounts. Such business includes whole of life and term assurance and long-term creditor policies.

Annuities – The policyholder is entitled to payments for the duration of their life and is therefore insured against surviving longer than expected.

German insurance business is written through the Group's subsidiary Heidelberger Leben and comprises policies similar to the UK definitions above, except that there is participation by the policyholder in the investment, insurance and expense profits of Heidelberger Leben. A minimum level of policyholder participation is prescribed by German law. The following types of life insurance contracts are written:

– Traditional and unit linked endowment or pensions business; and

– Life insurance business.

(ii) Method of calculation of liabilities
The non-profit fund liabilities are determined on the basis of recognised actuarial methods and consistent with the approach required by regulatory rules. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting the cash flows back to the valuation date allowing for probabilities of occurrence.

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Note 37: Liabilities arising from insurance contracts and participating investment contracts (continued)

(iii) Assumptions

Generally, assumptions used to value non-profit fund liabilities are prudent in nature and therefore contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgement and reflects management's views on the inherent level of uncertainty. The key assumptions used in the measurement of non-profit fund liabilities are:

Interest rates

The rates used are derived in accordance with the guidelines set by local regulatory bodies. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the guidelines set by local regulatory bodies, including reductions made to the available yields to allow for default risk based upon the credit rating of the securities allocated to the insurance liability.

Mortality and morbidity

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and include a margin for adverse deviation. For German business appropriate industry tables have been considered.

Lapse rates (persistency)

Lapse rates are allowed for on some non-profit fund contracts. The process for setting these rates is as described for with-profit liabilities, however a prudent scenario is assumed by the inclusion of a margin for adverse deviation within the non-profit fund liabilities.

Maintenance expenses

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

Key changes in assumptions

A detailed review of the Group's assumptions in 2012 resulted in the following key impacts on profit before tax:

– Change in persistency assumptions (£124 million decrease).

– Change in the assumption in respect of current and future mortality rates (£4 million increase).

– Change in expenses assumptions (£81 million increase).

– Inclusion of illiquid loan assets in the valuation of the annuity portfolio (£44 million increase).

– Reduction of assumed future bonus rate and move to yield curve valuation of annuities (£19 million increase).

– Addition of an allowance for the time value cost of interest rate options on traditional with-profits business (£10 million decrease).

These amounts include the impacts of movements in liabilities and value of the in-force business in respect of insurance contracts and participating investment contracts.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 37: Liabilities arising from insurance contracts and participating investment contracts (continued)

(2) Non-life insurance

Gross non-life insurance contract liabilities are analysed by line of business as follows:

	2012 £m	2011 £m
Credit protection	**94**	206
Home	**718**	753
Health	**2**	2
Total gross non-life insurance contract liabilities	**814**	961

For non-life insurance contracts, the methodology and assumptions used in relation to determining the bases of the earned premium and claims provisioning levels are derived for each individual underwritten product. Assumptions are intended to be neutral estimates of the most likely or expected outcome. There has been no significant change in the assumptions and methodologies used for setting reserves.

The reserving methodology and associated assumptions are set out below:

The unearned premium reserve is determined on a basis that reflects the length of time for which contracts have been in force and the projected incidence of risk over the term of each contract.

Claims outstanding comprise those claims that have been notified and those that have been incurred but not reported. Claims incurred but not reported are determined based on the historical emergence of claims and their average cost. The notified claims element represents the best estimate of the cost of claims reported using projections and estimates based on historical experience.

The movements in non-life insurance contract liabilities and reinsurance assets over the year have been as follows:

	Gross £m	Reinsurance £m	Net £m
Provisions for unearned premiums			
At 1 January 2011	632	(22)	610
Increase in the year	1,082	(52)	1,030
Release in the year	(1,152)	52	(1,100)
Change in provision for unearned premiums charged to income statement (note 8)	(70)	–	(70)
Exchange and other adjustments	4	(1)	3
At 31 December 2011	566	(23)	543
Increase in the year	**1,081**	**(31)**	**1,050**
Release in the year	**(1,153)**	**38**	**(1,115)**
Change in provision for unearned premiums charged to income statement (note 8)	**(72)**	**7**	**(65)**
At 31 December 2012	**494**	**(16)**	**478**

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Note 37: Liabilities arising from insurance contracts and participating investment contracts (continued)

These provisions represent the liability for short-term insurance contracts for which the Group's obligations are not expired at the year end.

	Gross £m	Reinsurance £m	Net £m
Claims outstanding			
Notified claims	420	(4)	416
Incurred but not reported	164	(11)	153
At 1 January 2011	584	(15)	569
Cash paid for claims settled in the year	(485)	–	(485)
Increase (decrease) in liabilities:			
Arising from current year claims	470	–	470
Arising from prior year claims	(171)	12	(159)
Change in liabilities charged to income statement (note 10)	(186)	12	(174)
Exchange and over adjustments	(3)	1	(2)
At 31 December 2011	395	(2)	393
Cash paid for claims settled in the year	**(455)**	**1**	**(454)**
Increase (decrease) in liabilities:			
Arising from current year claims	**492**	**–**	**492**
Arising from prior year claims	**(111)**	**–**	**(111)**
Change in liabilities charged to income statement (note 10)	**(74)**	**1**	**(73)**
Exchange and other adjustments	**(1)**	**–**	**(1)**
At 31 December 2012	**320**	**(1)**	**319**
Notified claims	**280**	**–**	**280**
Incurred but not reported	**40**	**(1)**	**39**
At 31 December 2012	**320**	**(1)**	**319**
Notified claims	313	(1)	312
Incurred but not reported	82	(1)	81
At 31 December 2011	395	(2)	393

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Note 37: Liabilities arising from insurance contracts and participating investment contracts (continued)

Non-life insurance claims development table

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year shown has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

Non-life insurance all risks – gross

	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	**2012 £m**	**Total £m**
Accident year									
Estimate of ultimate claims costs:									
At end of accident year	211	208	317	205	639	609	446	**421**	**3,056**
One year later	207	206	311	199	539	517	366		
Two years later	204	204	299	195	494	497			
Three years later	202	204	292	187	487				
Four years later	201	205	285	186					
Five years later	201	203	286						
Six years later	201	202							
Seven years later	200								
Current estimate in respect of above claims	200	202	286	186	487	497	366	**421**	**2,645**
Current estimate of claims relating to general insurance business acquired in 2009	272	315	388	256	–	–	–	**–**	**1,231**
Current estimate of cumulative claims	472	517	674	442	487	497	366	**421**	**3,876**
Cumulative payments to date	(471)	(515)	(671)	(437)	(476)	(469)	(315)	**(227)**	**(3,581)**
Liability recognised in the balance sheet	1	2	3	5	11	28	51	**194**	**295**
Liability in respect of earlier years									**1**
Total liability included in the balance sheet									**296**

The liability of £296 million shown in the above table excludes £13 million of unallocated claims handling expenses and £11 million of unexpired risk reserve.

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Note 38: Life insurance sensitivity analysis

The following table demonstrates the effect of reasonably possible changes in key assumptions on profit before tax and equity disclosed in these financial statements assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated. These amounts include movements in assets, liabilities and the value of the in-force business in respect of insurance contracts and participating investment contracts. The impact is shown in one direction but can be assumed to be reasonably symmetrical.

	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
At 31 December 2012			
Non-annuitant mortality[1]	**5% reduction**	**43**	**33**
Annuitant mortality[2]	**5% reduction**	**(170)**	**(131)**
Lapse rates[3]	**10% reduction**	**117**	**90**
Future maintenance and investment expenses[4]	**10% reduction**	**199**	**153**
Risk-free rate[5]	**0.25% reduction**	**26**	**20**
Guaranteed annuity option take up[6]	**5% addition**	**(9)**	**(7)**
Equity investment volatility[7]	**1% addition**	**(7)**	**(5)**
Widening of credit default spreads on corporate bonds[8]	**0.25% addition**	**(239)**	**(184)**
Increase in illiquidity premia[9]	**0.10% addition**	**93**	**72**

	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
At 31 December 2011			
Non-annuitant mortality[1]	5% reduction	48	36
Annuitant mortality[2]	5% reduction	(154)	(115)
Lapse rates[3]	10% reduction	123	92
Future maintenance and investment expenses[4]	10% reduction	207	156
Risk-free rate[5]	0.25% reduction	55	41
Guaranteed annuity option take up[6]	5% addition	(4)	(3)
Equity investment volatility[7]	1% addition	(9)	(7)
Widening of credit default spreads on corporate bonds[8]	0.25% addition	(164)	(123)
Increase in illiquidity premia[9]	0.10% addition	87	66

Assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and statutory reserving bases.

[1] This sensitivity shows the impact of reducing mortality and morbidity rates on non-annuity business to 95 per cent of the expected rate.

[2] This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

[3] This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

[4] This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

[5] This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

[6] This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

[7] This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

[8] This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Government bond yields, the risk-free rate and illiquidity premia are all assumed to be unchanged.

[9] This sensitivity shows the impact of a 10 basis point increase in the allowance for illiquidity premia. It assumes the overall spreads on assets are unchanged and hence market values are unchanged. Government bond yields and the non-annuity risk-free rate are both assumed to be unchanged. The increased illiquidity premium increases the annuity risk-free rate.

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Note 39: Liabilities arising from non-participating investment contracts

The movement in liabilities arising from non-participating investment contracts may be analysed as follows:

	Gross £m	Reinsurance £m	Net £m
At 1 January 2011	51,363	(65)	51,298
New business	4,194	(3)	4,191
Changes in existing business	(5,922)	11	(5,911)
Exchange and other adjustments	1	–	1
At 31 December 2011	49,636	(57)	49,579
New business	**4,236**	**(1)**	**4,235**
Changes in existing business	**526**	**12**	**538**
Exchange and other adjustments	**(26)**	**–**	**(26)**
At 31 December 2012	**54,372**	**(46)**	**54,326**

Note 40: Unallocated surplus within insurance businesses

The movement in the unallocated surplus within long-term insurance businesses over the year can be analysed as follows:

	2012 £m	2011 £m
At 1 January	**300**	643
Change in unallocated surplus recognised in the income statement (note 10)	**(31)**	(340)
Exchange and other adjustments	**(2)**	(3)
At 31 December	**267**	300

Note 41: Other liabilities

	2012 £m	2011 £m
Settlement balances	**2,006**	1,937
Unitholders' interest in Open Ended Investment Companies	**20,935**	18,249
Other creditors and accruals	**11,000**	11,855
Total other liabilities	**33,941**	32,041

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Note 42: Retirement benefit obligations

	2012 £m	2011 £m	2010 £m
Charge (credit) to the income statement			
Past service credits and curtailment gains[1]	(250)	–	(910)
Other	307	186	443
Defined benefit pension schemes	57	186	(467)
Other post-retirement benefit schemes	11	13	12
Total defined benefit schemes	68	199	(455)
Defined contribution pension schemes	229	202	173
Total charge (credit) to the income statement	**297**	**401**	**(282)**

[1] In 2012, there was a net credit of £250 million following a decision to link discretionary pension increases in certain schemes to the Consumer Price Index; and in 2010, there was a credit of £910 million following the Group's decision to cap all future increases to pensionable salary in its principal UK defined benefit pension schemes, together with a change in commutation factors in certain schemes (note 11).

	2012 £m	2011 £m
Amounts recognised in the balance sheet		
Retirement benefit assets	1,867	1,338
Retirement benefit obligations	(300)	(381)
Total amounts recognised in the balance sheet	**1,567**	**957**

The total amount recognised in the balance sheet relates to:

	2012 £m	2011 £m
Defined benefit pension schemes	1,748	1,131
Other post-retirement benefit schemes	(181)	(174)
Total amounts recognised in the balance sheet	**1,567**	**957**

Pension schemes

Defined benefit schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas, the three most significant being the defined benefit sections of the Lloyds TSB Group Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme. These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2012 was generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The latest full valuations of the three main schemes were carried out as at 30 June 2011; the results have been updated to 31 December 2012 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates; these have been updated to 31 December 2012 by qualified independent actuaries or, in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows.

The Group's obligations in respect of its defined benefit schemes are funded.

During 2009, the Group made one-off contributions to the Lloyds TSB Group Pension Scheme No 1 and Lloyds TSB Group Pension Scheme No 2 of approximately £1 billion in aggregate. These contributions took the form of interests in limited liability partnerships for each of the two schemes which contained assets of approximately £5 billion in aggregate entitling the schemes to annual payments of approximately £215 million in aggregate until 31 December 2014. Thereafter, assuming that all distributions have been made, the value of the partnership interests will equate to a nominal amount. At 31 December 2012, the limited liability partnerships held assets of approximately £4.7 billion; cash payments of £215 million were made to the pension schemes during the year (2011: £215 million). The limited liability partnerships are fully consolidated in the Group's balance sheet (see note 22).

The Group currently expects to pay contributions of approximately £1,025 million to its defined benefit schemes in 2013.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 42: Retirement benefit obligations (continued)

	2012 £m	2011 £m
Amount included in the balance sheet		
Present value of funded obligations	(31,324)	(28,236)
Fair value of scheme assets	30,367	28,828
	(957)	592
Unrecognised actuarial losses	2,705	539
Net amount recognised in the balance sheet	1,748	1,131

	2012 £m	2011 £m
Movements in the defined benefit obligation		
At 1 January	(28,236)	(26,862)
Current service cost	(360)	(380)
Employee contributions	(3)	(1)
Interest cost	(1,373)	(1,423)
Actuarial losses	(2,607)	(514)
Benefits paid	995	912
Past service cost	(16)	(20)
Curtailments	250	25
Settlements	12	15
Exchange and other adjustments	14	12
At 31 December	(31,324)	(28,236)

	2012 £m	2011 £m
Changes in the fair value of scheme assets		
At 1 January	28,828	26,382
Expected return	1,446	1,627
Employer contributions	667	833
Employee contributions	3	1
Actuarial gains	442	926
Benefits paid	(993)	(912)
Settlements	(16)	(23)
Exchange and other adjustments	(10)	(6)
At 31 December	30,367	28,828
Actual return on scheme assets	1,888	2,553

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Note 42: Retirement benefit obligations (continued)

Assumptions

The principal actuarial and financial assumptions used in valuations of the defined benefit pension schemes were as follows:

	2012 %	2011 %
Discount rate	**4.60**	5.00
Rate of inflation:		
Retail Prices Index	**2.90**	3.00
Consumer Price Index	**2.00**	2.00
Rate of salary increases	**2.00**	2.00
Rate of increase for pensions in payment	**2.70**	2.80
	2012 Years	2011 Years
Life expectancy for member aged 60, on the valuation date:		
Men	**27.4**	27.3
Women	**29.7**	28.4
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**28.5**	28.8
Women	**30.9**	30.0

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 at 31 December 2012 is assumed to live for, on average, 27.4 years for a male and 29.7 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

Sensitivity analysis

The effect of changes in key assumptions on the pension charge in the Group's income statement and on the net defined benefit pension scheme asset or liability is set out below:

	Increase (decrease) in the income statement charge		Increase (decrease) in the net defined benefit pension scheme asset	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Inflation:[1]				
Increase of 0.2 per cent	**50**	12	**(884)**	(798)
Decrease of 0.2 per cent	**(45)**	(6)	**815**	783
Discount rate:[2]				
Increase of 0.2 per cent	**(54)**	(10)	**1,056**	909
Decrease of 0.2 per cent	**54**	17	**(1,102)**	(957)
Expected life expectancy of members:				
Increase of one year	**74**	38	**(697)**	(655)
Decrease of one year	**(73)**	(40)	**686**	667

[1] At 31 December 2012, the assumed rate of inflation is 2.90 per cent (2011: 3.00 per cent).

[2] At 31 December 2012, the assumed discount rate is 4.60 per cent (2011: 5.00 per cent).

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Note 42: Retirement benefit obligations (continued)

The expected return on scheme assets has been calculated using the following assumptions:

	2012 %	2011 %
Equities and alternative assets	**7.3**	8.3
Fixed interest gilts	**3.0**	4.0
Index linked gilts	**2.8**	3.9
Non-government bonds	**4.9**	4.9
Property	**6.6**	7.3
Money market instruments and cash	**2.6**	3.9

The expected return on scheme assets in 2013 will be calculated using the following assumptions:

	2013 %
Equities and alternative assets	**6.8**
Fixed interest gilts	**2.3**
Index linked gilts	**2.8**
Non-government bonds	**3.1**
Property	**6.8**
Money market instruments and cash	**2.4**

With effect from 1 January 2013 the Group will adopt amendments to IAS 19 *Employee Benefits*. These amendments will change the calculation of the Group's defined benefit schemes' income statement expense, replacing expected return on scheme assets and interest cost with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset) (see note 57 on page 342). The above expected return on scheme assets will be used in determining the effect of this new accounting policy on the Group's 2013 income statement expense.

Composition of scheme assets:

	2012 £m	2011 £m
Equities	**12,364**	10,728
Fixed interest gilts	**771**	995
Index linked gilts	**6,429**	6,211
Non-government bonds	**5,014**	4,250
Property	**1,528**	1,708
Money market instruments, cash and other assets and liabilities	**4,261**	4,936
At 31 December	**30,367**	28,828

The assets of all the funded schemes are held independently of the Group's assets in separate trustee administered funds.

The expected return on scheme assets was determined by considering the expected returns available on the assets underlying the current investment policy. Expected yields on fixed interest investments are based on gross redemption yields at the balance sheet date at a term and credit rating broadly appropriate for the bonds held. Expected returns on equity and property investments are long-term rates based on the views of the plan's independent investment consultants. The expected return on equities allows for the different expected returns from the private equity, infrastructure and hedge fund investments held by some of the funded schemes. Some of the funded schemes also invest in certain money market instruments and the expected return on these investments has been assumed to be the same as cash.

Experience adjustments history:

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Present value of defined benefit obligation	**(31,324)**	(28,236)	(26,862)	(27,073)	(15,617)	(16,795)	(17,378)
Fair value of scheme assets	**30,367**	28,828	26,382	23,518	13,693	16,112	15,279
(Deficit) surplus	**(957)**	592	(480)	(3,555)	(1,924)	(683)	(2,099)
Experience (losses) gains on scheme liabilities	**(501)**	(277)	496	31	(39)	(185)	(50)
Experience gains (losses) on scheme assets	**442**	926	1,624	886	(3,520)	139	314

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Note 42: Retirement benefit obligations (continued)

The expense recognised in the income statement for the year ended 31 December comprises:

	2012 £m	2011 £m	2010 £m
Current service cost	360	380	384
Interest cost	1,373	1,423	1,474
Expected return on scheme assets	(1,446)	(1,627)	(1,507)
Net actuarial losses recognised in year	–	7	43
Past service credits and curtailments (see below)	(250)	(25)	(910)
Settlements	4	8	3
Past service cost	16	20	46
Total defined benefit pension expense (credit)	57	186	(467)

Following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change is a reduction in the Group's defined benefit obligation of £258 million, recognised in the Group's income statement in 2012, net of a charge of £8 million resulting from a change to the commutation factors in one of the Group's smaller schemes.

In 2010 the Group made changes to the terms of its principal UK defined benefit pension schemes, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee's actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of 2010 there was a change in the commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group's defined benefit obligation of £1,081 million and a reduction in the Group's unrecognised actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement in 2010 and an equivalent reduction in the balance sheet liability.

Defined contribution schemes

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow and the defined contribution sections of the Lloyds TSB Group Pension Scheme No. 1.

During the year ended 31 December 2012 the charge to the income statement in respect of defined contribution schemes was £229 million (2011: £202 million; 2010: £173 million), representing the contributions payable by the employer in accordance with each scheme's rules.

Other post-retirement benefit schemes

The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants. The principal scheme relates to former Lloyds Bank staff and under this scheme the Group has undertaken to meet the cost of post-retirement healthcare for all eligible former employees (and their dependants) who retired prior to 1 January 1996. The Group has entered into an insurance contract to provide these benefits and a provision has been made for the estimated cost of future insurance premiums payable.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 30 June 2008; this valuation has been updated to 31 December 2012 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 6.50 per cent (2011: 6.61 per cent).

Amount included in the balance sheet:

	2012 £m	2011 £m
Present value of unfunded obligations	(207)	(188)
Unrecognised actuarial losses	26	14
Retirement benefit obligation recognised in the balance sheet	(181)	(174)

Movements in the other post-retirement benefits obligation:

	2012 £m	2011 £m
At 1 January	(188)	(175)
Exchange and other adjustments	(16)	(5)
Insurance premiums paid	8	5
Charge for the year	(11)	(13)
At 31 December	(207)	(188)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 43: Deferred tax

The movement in the net deferred tax balance is as follows:

	2012 £m	2011 £m
Asset at 1 January	4,182	3,917
Exchange and other adjustments	(14)	3
Disposals	–	10
Income statement (charge) credit (note 15):		
Due to change in UK corporation tax rate	(308)	(404)
Other	(254)	1,525
	(562)	1,121
Amount credited (charged) to equity:		
Available-for-sale financial assets (note 48)	344	(574)
Cash flow hedges (note 48)	1	(270)
Share-based compensation	7	(25)
	352	(869)
Asset at 31 December	**3,958**	**4,182**

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

Statutory position	2012 £m	2011 £m	Tax disclosure	2012 £m	2011 £m
Deferred tax assets	4,285	4,496	Deferred tax assets	8,726	7,995
Deferred tax liabilities	(327)	(314)	Deferred tax liabilities	(4,768)	(3,813)
Asset at 31 December	**3,958**	**4,182**	**Asset at 31 December**	**3,958**	**4,182**

The deferred tax (charge) credit in the income statement comprises the following temporary differences:

	2012 £m	2011 £m	2010 £m
Accelerated capital allowances	410	319	(470)
Pensions and other post-retirement benefits	(237)	(153)	(391)
Long-term assurance business	(869)	596	(110)
Allowances for impairment losses	(332)	(56)	73
Tax losses carried forward	974	(55)	873
Tax on fair value of acquired assets	28	(107)	(715)
Other temporary differences	(536)	577	69
Deferred tax (charge) credit in the income statement	**(562)**	**1,121**	**(671)**

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Note 43: Deferred tax (continued)

Deferred tax assets and liabilities are comprised as follows:

	2012 £m	2011 £m
Deferred tax assets:		
Accelerated capital allowances	**167**	–
Allowances for impairment losses	**227**	559
Other provisions	**109**	218
Available-for-sale asset revaluation	**286**	288
Tax losses carried forward	**7,034**	5,862
Other temporary differences	**903**	1,068
Total deferred tax assets	**8,726**	7,995

	2012 £m	2011 £m
Deferred tax liabilities:		
Accelerated capital allowances	**–**	(243)
Long-term assurance business	**(1,849)**	(980)
Pensions and other post-retirement benefits	**(357)**	(120)
Tax on fair value of acquired assets	**(1,741)**	(1,890)
Effective interest rates	**(34)**	(45)
Derivatives	**(333)**	(161)
Other temporary differences	**(454)**	(374)
Total deferred tax liabilities	**(4,768)**	(3,813)

On 21 March 2012, the Government announced that the corporation tax rate applicable from 1 April 2012 would be 24 per cent. This change passed into legislation on 26 March 2012. In addition, the Finance Act 2012, which was substantively enacted on 3 July 2012, included legislation to reduce the main rate of corporation tax from 24 per cent to 23 per cent with effect from 1 April 2013. The change in the main rate of corporation tax from 25 per cent to 23 per cent has resulted in a reduction in the Group's net deferred tax asset at 31 December 2012 of £286 million, comprising the £308 million charge included in the income statement and a £22 million credit included in equity.

The proposed further reduction in the rate of corporation tax by 2 per cent to 21 per cent by 1 April 2014 is expected to be enacted during 2013. The effect of this further change upon the Group's deferred tax balances and leasing business cannot be reliably estimated at this stage.

Deferred tax assets

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised deferred tax assets of £7,034 million (2011: £5,862 million) in relation to trading tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset (see note 3).

Deferred tax assets of £330 million (2011: £384 million) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

Deferred tax assets of £939 million (2011: £733 million) have not been recognised in respect of trading losses carried forward, mainly in certain overseas companies and in respect of other temporary differences in the insurance businesses. Trading losses can be carried forward indefinitely, except for losses in Spain which expire after 18 years and in the USA which expire after 20 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward at 31 December 2012 of £42 million (2011: £171 million), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

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Note 44: Other provisions

	Provisions for commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property £m	Other £m	Total £m
At 1 January 2012	81	2,155	344	140	446	3,166
Exchange and other adjustments	(2)	–	12	2	(15)	(3)
Provisions applied	(4)	(3,299)	(71)	(71)	(33)	(3,478)
(Release) charge for the year	(9)	3,575	650	2	58	4,276
At 31 December 2012	**66**	**2,431**	**935**	**73**	**456**	**3,961**

Provisions for commitments

Provisions are held in cases where the Group is irrevocably committed to advance additional funds, but where there is doubt as to the customer's ability to meet its repayment obligations.

Payment protection insurance

Following the unsuccessful legal challenge by the British Bankers' Association against the FSA and the Financial Ombudsman Service, the Group held discussions with the FSA with a view to seeking clarity around the detailed implementation of the FSA Policy Statement which set out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress in respect of payment protection insurance (PPI) sales standards. As a result, the Group concluded that there are certain circumstances where customer redress will be appropriate. Accordingly the Group made a provision in its income statement for the year ended 31 December 2011 of £3,200 million in respect of the anticipated costs of such redress, including administration expenses.

During the first half of 2012 there was an increase in the volume of complaints being received and, although the level of complaints has declined during the second half of 2012, they are higher than had been anticipated at 31 December 2011. As a consequence, the Group believes that it is appropriate to increase its provision by a further £3,575 million at 31 December 2012. This increases the total estimated cost of redress, including administration expenses, to £6,775 million; redress payments made and expenses incurred on the 1.15 million claims paid to the end of December 2012 amounted to £4,344 million. However, there are still a number of uncertainties as to the eventual redress costs, in particular the total number of complaints and the activities of claims management companies and regulatory bodies.

The Group has calculated the provision by making a number of assumptions based upon current and expected experience. The principal sensitivities are as follows:

- the number of claims received: an increase of 100,000 from the level assumed would increase the provision for redress costs by £140 million;
- uphold rate of claims reviewed: an increase of one percentage point in this assumption would increase the provision by £20 million;
- average future redress payment: an increase of £100 in this assumption would increase the provision by £70 million.

The Group will reassess the continued appropriateness of the assumptions underlying its analysis at each reporting date in the light of current experience and other relevant evidence.

Other regulatory provisions

Litigation in relation to insurance branch business in Germany

As previously disclosed, Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In its accounts for the year ended 31 December 2011 the Group recognised a provision of £175 million with respect to this litigation and following decisions in July 2012 from the Federal Court of Justice (FCJ) in Germany the Group has recognised a further provision of £150 million with respect to this litigation, increasing the total provision to £325 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the implications with respect to the claims facing CMIG. As a result the ultimate financial effect, which could be significantly different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

Interest rate hedging products

In June 2012, a number of banks, including the Group, reached agreement with the FSA to carry out a thorough assessment of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. The Group agreed that on conclusion of this review it would provide redress to any of these customers where appropriate.

Following the completion of a pilot review of IRHP sales to small and medium-sized businesses and agreement reached with the FSA on 30 January 2013 on the principles to be adopted during the course of the wider review, the Group has provided £400 million for the estimated cost of redress and related administration costs. At 31 December 2012, £20 million of the provision had been utilised. A number of uncertainties remain as to the eventual costs given the inherent difficulties in determining the number of customers within the scope of the review and the average compensation to customers.

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Note 44: Other provisions (continued)

Other regulatory matters

In the course of its business, the Group is engaged in discussions with the FSA or other regulators in relation to a range of matters. In 2012 a provision of £100 million was made in respect of certain UK retail and other matters; however, the ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

Vacant leasehold property

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biannual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging three years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

Other

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure.

Other provisions include those arising out of the insolvency of a third party insurer, which remains exposed to asbestos and pollution claims in the US. The ultimate cost and timing of payments are uncertain. The provision held of £37 million at 31 December 2012 represents management's current best estimate of the cost after having regard to actuarial estimates of future losses.

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Note 45: Subordinated liabilities

	2012 £m	2011 £m
Preference shares	**1,385**	1,216
Preferred securities	**4,394**	4,893
Undated subordinated liabilities	**1,927**	1,949
Enhanced Capital Notes	**8,947**	9,085
Dated subordinated liabilities	**17,439**	17,946
Total subordinated liabilities	**34,092**	35,089

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of holders of the dated subordinated liabilities. The subordination of the dated Enhanced Capital Notes ranks equally with that of the dated subordinated liabilities. The Group has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2011: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the Financial Services Authority.

The movement in subordinated liabilities during the year was as follows:

	2012 £m	2011 £m
At 1 January	**35,089**	36,232
Issued during the year	**128**	2,302
Repurchases and redemptions during the year	**(857)**	(4,021)
Foreign exchange and other movements	**(268)**	576
At 31 December	**34,092**	35,089

During February 2012, the Group completed the exchange of part of a series of preferred debt securities issued by the HBOS group for a new series of dated subordinated securities issued by Lloyds TSB Bank plc. This exchange resulted in a gain on the extinguishment of the existing securities of £59 million being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs.

	Note	2012 £m	2011 £m
Preference shares			
6% Non-cumulative Redeemable Preference Shares	a	**–**	–
7.875% Non-cumulative Preference Shares callable 2013 (US$1,250 million)	b	**259**	249
7.875% Non-cumulative Preference Shares callable 2013 (€500 million)	b	**149**	150
6.0884% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (£745 million)	b	**10**	10
5.92% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (US$750 million)	b	**125**	11
6.267% Non-cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million)	b	**280**	301
6.3673% Non-cumulative Fixed to Floating Rate Preference Shares callable 2019 (£335 million)	b	**2**	2
6.475% Non-cumulative Preference Shares callable 2024 (£186 million)	b	**39**	38
6.413% Non-cumulative Fixed to Floating Rate Preference Shares callable 2035 (US$750 million)	b	**104**	131
6.657% Non-cumulative Fixed to Floating Rate Preference Shares callable 2037 (US$750 million)	b	**14**	26
9.25% Non-cumulative Irredeemable Preference Shares (£300 million)	b	**350**	262
9.75% Non-cumulative Irredeemable Preference Shares (£100 million)	b	**53**	36
Total preference shares		**1,385**	1,216

[a] Since 2004, the Company has had in issue 400 6 per cent non-cumulative preference shares of 25p each. The shares, which are redeemable at the option of the Company at any time, carry the rights to a fixed rate non-cumulative preferential dividend of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Company. The holder of the shares waived its right to payment for the period from 1 March 2010 to 1 March 2012.

[b] In November 2009, as part of the state aid restructuring plan, the Group agreed to suspend the payment of coupons on these instruments for the two year period from 31 January 2010 to 31 January 2012.

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Note 45: Subordinated liabilities (continued)

	Note	2012 £m	2011 £m
Preferred securities			
6.90% Perpetual Capital Securities (US$1,000 million)	b	214	247
6.85% Non-cumulative Perpetual Preferred Securities (US$1,000 million)	b	238	316
8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million)	b, c	262	260
7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million)	b, d, e	50	340
7.375% Euro Step-up Non-voting Non-cumulative Preferred Securities callable 2012 (€430 million)	a	–	16
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)		226	239
6.071% Non-cumulative Perpetual Preferred Securities (US$750 million)		382	389
7.834% Sterling Step-up Non-voting Non-cumulative Preferred Securities callable 2015 (£250 million)	a	5	5
4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million)	a	23	20
7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million)		128	112
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	a	83	88
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities (£600 million)		439	444
13% Step-up Perpetual Capital Securities callable 2019 (£785 million)	a	8	12
13% Step-up Perpetual Capital Securities callable 2019 (€532 million)	a	48	47
7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million)		98	104
12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US$2,000 million)		1,239	1,301
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)		95	113
13% Step-up Perpetual Capital Securities callable 2029 (£700 million)	a	629	612
7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million)		227	228
Total preferred securities		**4,394**	4,893

a In November 2009, as part of the state aid restructuring plan, the Group agreed to suspend the payment of coupons on these instruments for the two year period from 31 January 2010 to 31 January 2012.

b These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012.

c The fixed rate on this security was reset from 8.117 per cent to 6.059 per cent with effect from 31 May 2010.

d The fixed rate on this security was reset from 7.627 per cent to 3 months Euribor plus 2.875 per cent with effect from 9 December 2011.

e Following an exchange in February 2012, certain holders elected to exchange some notes into a new series of dated subordinated securities issued by Lloyds TSB Bank plc.

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Note 45: Subordinated liabilities (continued)

	Note	2012 £m	2011 £m
Undated subordinated liabilities			
6.625% Undated Subordinated Step-up Notes (£410 million)	a, b, c	6	1
Floating Rate Undated Subordinated Step-up Notes (€300 million)	b	13	10
6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	b, d	5	4
5.375% Undated Fixed to Floating Rate Subordinated Notes (US$1,000 million)	a	9	12
8.625% Perpetual Subordinated Notes (£200 million)	a	22	24
4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	a	70	75
Floating Rate Undated Subordinated Notes (€500 million)	a	44	45
4.25% Perpetual Fixed to Floating Rate Reset Subordinated Guaranteed Notes (€750 million) (Clerical Medical Finance plc)		261	231
10.25% Subordinated Undated Instruments (£100 million)	a	1	1
5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million) (Scottish Widows plc)		556	554
5.125% Undated Subordinated Fixed to Floating Notes (€750 million)	a	45	52
7.5% Undated Subordinated Step-up Notes (£300 million)		4	5
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	a	2	2
6.5% Undated Subordinated Step-up Notes callable 2019 (£270 million)	a	1	–
7.375% Undated Subordinated Guaranteed Bonds (£200 million) (Clerical Medical Finance plc)		37	36
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019 (£500 million)	a	1	–
12% Perpetual Subordinated Bonds (£100 million)	a	21	30
5.75% Undated Subordinated Step-up Notes (£600 million)		3	3
7.375% Subordinated Undated Instruments (£150 million)	a	–	–
8.75% Perpetual Subordinated Bonds (£100 million)	a	5	4
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	a	–	–
9.375% Perpetual Subordinated Bonds (£50 million)	a	14	17
5.75% Undated Subordinated Step-up Notes (£500 million)		4	3
6.5% Undated Subordinated Step-up Notes callable 2029 (£450 million)	a	–	–
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	a	10	11
Floating Rate Primary Capital Notes (US$250 million)	a, b	111	118
Primary Capital Undated Floating Rate Notes:			
Series 1 (US$750 million)	a, b	165	175
Series 2 (US$500 million)	a, b	173	183
Series 3 (US$600 million)	a, b	223	235
13.625% Perpetual Subordinated Bonds (£75 million)	a	19	16
11.75% Perpetual Subordinated Bonds (£100 million)		102	102
Total undated subordinated liabilities		1,927	1,949

a In November 2009, as part of the state aid restructuring plan, the Group agreed to suspend the payment of coupons on these instruments for the two year period from 31 January 2010 to 31 January 2012.

b These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012.

c The fixed rate on this security was reset from 6.625 per cent to 4.64821 per cent with effect from 15 July 2010.

d The fixed rate on this security was reset from 6.05 per cent to 3 month Euribor plus 2.25 per cent with effect from 23 November 2011.

Note 45: Subordinated liabilities (continued)

With the exception of the two series identified in footnote b below, the ECNs were issued in lower tier 2 format and are convertible into ordinary shares on the breach of a defined trigger. The trigger is if the published core tier 1 ratio of the Group (as defined by the Financial Services Authority in May 2009) falls below 5 per cent.

	Note	2012 £m	2011 £m
Enhanced Capital Notes			
7.625% Enhanced Capital Notes due 2019 (£151 million)		144	142
8.125% Enhanced Capital Notes due 2019 (£4 million)		4	4
9% Enhanced Capital Notes due 2019 (£97 million)		98	98
7.8673% Enhanced Capital Notes due 2019 (£331 million)		332	330
15% Enhanced Capital Notes due 2019 (£775 million)		1,093	1,120
15% Enhanced Capital Notes due 2019 (€487 million)		571	601
8.875% Enhanced Capital Notes due 2020 (€125 million)		113	107
9.334% Enhanced Capital Notes due 2020 (£208 million)		230	232
7.375% Enhanced Capital Notes due 2020 (€95 million)		78	79
Floating Rate Enhanced Capital Notes due 2020 (€53 million)	a	37	38
7.875% Enhanced Capital Notes due 2020 (US$408 million)		267	313
11.04% Enhanced Capital Notes due 2020 (£736 million)		847	861
7.5884% Enhanced Capital Notes due 2020 (£732 million)		703	681
6.385% Enhanced Capital Notes due 2020 (€662 million)		493	503
6.439% Enhanced Capital Notes due 2020 (€711 million)		542	548
8% Fixed to Floating Rate Undated Enhanced Capital Notes callable 2020 (US$1,259 million)	b	662	687
9.125% Enhanced Capital Notes due 2020 (£148 million)		157	157
12.75% Enhanced Capital Notes due 2020 (£57 million)		73	73
7.869% Enhanced Capital Notes due 2020 (£597 million)		591	588
7.625% Enhanced Capital Notes due 2020 (€226 million)		181	184
7.875% Enhanced Capital Notes due 2020 (US$986 million)		608	629
11.125% Enhanced Capital Notes due 2020 (£39 million)		44	44
8.5% Undated Enhanced Capital Notes callable 2021 (US$277 million)	b	147	153
14.5% Enhanced Capital Notes due 2022 (£79 million)		113	114
9.875% Enhanced Capital Notes due 2023 (£57 million)		66	63
11.25% Enhanced Capital Notes due 2023 (£95 million)		113	106
10.5% Enhanced Capital Notes due 2023 (£69 million)		76	67
11.875% Enhanced Capital Notes due 2024 (£35 million)		45	45
7.975% Enhanced Capital Notes due 2024 (£102 million)		99	96
16.125% Enhanced Capital Notes due 2024 (£61 million)		95	97
15% Enhanced Capital Notes due 2029 (£68 million)		108	108
9% Enhanced Capital Notes due 2029 (£107 million)		112	112
8.5% Enhanced Capital Notes due 2032 (£104 million)		105	105
Total Enhanced Capital Notes		8,947	9,085

a Interest is payable quarterly in arrears at a rate of 3 month Euribor plus 3.1 per cent per annum.

b Issued in upper tier 2 format.

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Note 45: Subordinated liabilities (continued)

	Note	2012 £m	2011 £m
Dated subordinated liabilities			
Subordinated Step-up Floating Rate Notes 2016 (€500 million)	a	172	179
Subordinated Step-up Floating Rate Notes 2016 (£300 million)	a	184	184
Callable Floating Rate Subordinated Notes 2016 (€500 million)	a	96	88
Callable Floating Rate Subordinated Notes 2016 (€500 million)	a	137	124
Subordinated Callable Notes 2016 (US$750 million)	a	198	191
Subordinated Callable Notes 2017 (€1,000 million)	b	243	219
6.75% Subordinated Callable Fixed to Floating Rate Instruments 2017 (Aus$200 million)	d	6	5
Subordinated Callable Floating Rate Instruments 2017 (Aus$400 million)	b	38	38
5.109% Callable Fixed to Floating Rate Notes 2017 (Can$500 million)	e	8	8
6.25% Instruments 2012 (€12.8 million)		–	8
Subordinated Callable Notes 2017 (US$1,000 million)	b	198	192
6.305% Subordinated Callable Fixed to Floating Rate Notes 2017 (£500 million)	f	21	22
5.50% Subordinated Fixed Rate Notes 2012 (€750 million)		–	640
6.125% Notes 2013 (€325 million)		280	283
5.625% Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)		858	902
4.25% Subordinated Guaranteed Notes 2013 (US$1,000 million)		619	636
6.45% Fixed to Floating Subordinated Guaranteed Bonds 2023 (€400 million) (Clerical Medical Finance plc)		181	176
11% Subordinated Bonds 2014 (£250 million)		284	290
5.875% Subordinated Notes 2014 (£150 million)		157	154
5.875% Subordinated Guaranteed Bonds 2014 (€750 million)		669	713
4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)		604	621
4.875% Subordinated Notes 2015 (€1,000 million)		844	854
6.625% Subordinated Notes 2015 (£350 million)		375	357
6.9625% Callable Subordinated Fixed to Floating Rate Notes 2020 callable 2015 (£750 million)		716	725
11.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (€1,147 million)		977	977
10.75% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (£466 million)		477	467
9.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (US$568 million)		360	368
10.125% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Can$387 million)		240	246
13% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Aus$417 million)		280	276
10.5% Subordinated Bonds 2018 (£150 million)		177	177
6.75% Subordinated Fixed Rate Notes 2018 (US$2,000 million)		1,146	1,205
10.375% Subordinated Fixed to Fixed Rate Notes 2024 callable 2019 (€154 million)	c	143	–
6.375% Subordinated Instruments 2019 (£250 million)		281	274
6.5% Dated Subordinated Notes 2020 (€1,500 million)		1,458	1,407
7.375% Dated Subordinated Notes 2020		4	3
5.75% Subordinated Fixed to Floating Rate Notes 2025 callable 2020 (£350 million)		371	367
6.5% Subordinated Fixed Rate Notes 2020 (US$2,000 million)		1,345	1,360
Subordinated Floating Rate Notes 2020 (€100 million)		83	87
9.375% Subordinated Bonds 2021 (£500 million)		727	709
5.374% Subordinated Fixed Rate Notes 2021 (€160 million)		152	150
9.625% Subordinated Bonds 2023 (£300 million)		376	319
7.07% Subordinated Fixed Rate Notes 2023 (€175 million)		183	174
4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)		457	463
7.625% Dated Subordinated Notes 2025 (£750 million)		915	876
6% Subordinated Notes 2033 (US$750 million)		399	432
Total dated subordinated liabilities		17,439	17,946

a These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval of the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012.

b The floating interest rate payable on these securities reset during 2012.

c This security was issued in February 2012 as a result of an exchange offer.

d The interest rate payable on this security was reset from 6.75 per cent fixed to Bank Bill Swap Rate plus 0.76 per cent with effect from 1 May 2012.

e The interest rate payable on this security was reset from 5.109 per cent fixed to Canadian Dealer Offered Rate plus 0.65 per cent with effect from 21 June 2012.

f The interest rate payable on this security was reset from 6.305 per cent fixed to 3-month Libor plus 1.2 per cent with effect from 18 October 2012.

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Note 46: Share capital

(1) Authorised share capital

As permitted by the Companies Act 2006, the Company removed references to authorised share capital from its articles of association at the annual general meeting on 5 June 2009. This change took effect from 1 October 2009.

(2) Issued and fully paid share capital

	2012 Number of shares	2011 Number of shares	2010 Number of shares	2012 £m	2011 £m	2010 £m
Ordinary shares of 10p (formerly 25p) each						
At 1 January	**68,726,627,112**	68,074,129,454	63,774,511,536	**6,873**	6,807	6,378
Issued on redemption of preference shares and other subordinated liabilities in 2010	**–**	–	4,299,422,579	**–**	–	429
Issued in relation to the payment of coupons on certain hybrid capital securities	**479,297,215**	–	–	**47**	–	–
Issued under employee share schemes	**1,136,919,962**	652,497,658	195,339	**114**	66	–
At 31 December	**70,342,844,289**	68,726,627,112	68,074,129,454	**7,034**	6,873	6,807
Limited voting ordinary shares of 10p (formerly 25p) each						
At 1 January and 31 December	**80,921,051**	80,921,051	80,921,051	**8**	8	8
Deferred shares of 15p each						
At 1 January	**–**	–	27,242,603,417	**–**	–	4,086
Cancellation of deferred shares	**–**	–	(27,242,603,417)	**–**	–	(4,086)
At 31 December	**–**	–	–	**–**	–	–
Total issued share capital				**7,042**	6,881	6,815

On 5 November 2010 the Company cancelled all of its deferred shares and an amount of £4,086 million was credited to the capital redemption reserve.

Share issuances

In 2012 the Group issued 479 million new ordinary shares in relation to payment of coupons in the year on certain hybrid capital securities that are non-cumulative; the remaining 1,137 million shares issued in 2012 were in respect of employee share schemes.

The shares issued in 2011 were in respect of employee share schemes.

On 18 February 2010, the Company issued 3,141 million ordinary shares as consideration for the redemption of certain preference shares and preferred securities. During May and June 2010, the Company issued a further 1,158 million ordinary shares in relation to three separate exchanges for preference shares and other subordinated liabilities issued by the Group.

Note 46: Share capital (continued)

(3) Share capital and control

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association and:

– certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws);

– pursuant to the UK Listing Authority's listing rules where directors and certain employees of the Company require the approval of the Company to deal in the Company's shares; and

– pursuant to the rules of some of the Company's employee share plans where certain restrictions may apply while the shares are subject to the plans.

Where, under an employee share plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised by the registered owner at the direction of the participant. Outstanding awards and options would normally vest and become exercisable on a change of control, subject to the satisfaction of any performance conditions at that time.

In addition, the Company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights.

Information regarding significant direct or indirect holdings of shares in the Company can be found on page 83.

The directors have authority to allot and issue ordinary and preference shares and to make market purchases of ordinary and preference shares as granted at the annual general meeting on 17 May 2012. The authority to issue shares and the authority to make market purchases of shares will expire at the annual general meeting. Shareholders will be asked, at the annual general meeting, to give similar authorities.

Subject to any rights or restrictions attached to any shares, on a show of hands at a general meeting of the Company every holder of shares present in person or by proxy and entitled to vote has one vote and on a poll every member present and entitled to vote has one vote for every share held.

Further details regarding voting at the annual general meeting can be found in the notes to the notice of the annual general meeting.

Ordinary shares

The holders of ordinary shares (excluding the limited voting ordinary shares), who held 99.9 per cent of the total ordinary share capital at 31 December 2012, are entitled to receive the Company's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares (excluding the limited voting ordinary shares) may also receive a dividend (subject to the provisions of the Company's articles of association and the restrictions noted below) and on a winding up may share in the assets of the Company.

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities for the two-year period from 31 January 2010 to 31 January 2012. Consequently, the terms of these instruments prevented the Company from making dividend payments on ordinary shares during that period.

Limited voting ordinary shares

The limited voting ordinary shares are held by the Lloyds TSB Foundations (the Foundations). The holders of the limited voting ordinary shares, who held 0.1 per cent of the total ordinary share capital at 31 December 2012, are entitled to receive copies of every circular or other document sent out by the Company to the holders of other ordinary shares. These shares carry no rights to dividends but rank pari passu with the ordinary shares in respect of other distributions and in the event of winding up. These shares do not have any right to vote at general meetings other than on resolutions concerning acquisitions or disposals of such importance that they require shareholder consent, or for the winding up of the Company, or for a variation in the class rights of the limited voting ordinary shares. In the event of an offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting ordinary share will convert into an ordinary share and shall rank equally with the ordinary shares in all respects from the date of conversion.

Preference shares

The Company has in issue various classes of preference shares which are all classified as liabilities under IFRS and details of which are shown in note 45.

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Note 47: Share premium account

	2012 **£m**	2011 £m	2010 £m
At 1 January	**16,541**	16,291	14,472
Issued in relation to the settlement of coupons on certain hybrid capital securities[1]	**123**	–	–
Issued under employee share schemes	**208**	250	–
Shares issued on redemption and exchange of preference shares and other subordinated liabilities[2]	**–**	–	1,808
Redemption of preference shares[3]	**–**	–	11
At 31 December	**16,872**	16,541	16,291

[1] During the year the Group issued new ordinary shares for a consideration of £170 million in relation to payment of coupons in 2012 on certain hybrid capital securities that are non-cumulative.

[2] On 18 February 2010, the Company issued 3,141 million ordinary shares as consideration for the redemption of certain preference shares and preferred securities; and during May and June 2010, the Company issued a further 1,158 million ordinary shares in relation to three separate exchanges for preference shares and other subordinated liabilities issued by the Group. A total share premium of £1,808 million was recorded in respect of these transactions.

[3] In January 2010, the Company repurchased and cancelled certain preference shares amounting to £14 million. This resulted in a transfer of £3 million from the merger reserve to the capital redemption reserve and a transfer of £11 million from the merger reserve to the share premium account.

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Note 48: Other reserves

	2012 £m	2011 £m	2010 £m
Other reserves comprise:			
Merger reserve	8,107	8,107	8,107
Capital redemption reserve	4,115	4,115	4,115
Revaluation reserve in respect of available-for-sale financial assets	399	1,326	(285)
Cash flow hedging reserve	350	325	(391)
Foreign currency translation reserve	(69)	(55)	29
At 31 December	**12,902**	13,818	11,575

The merger reserve primarily comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

The revaluation reserve in respect of available-for-sale financial assets represents the cumulative after tax unrealised change in the fair value of financial assets classified as available-for-sale since initial recognition; in the case of available-for-sale financial assets obtained on acquisitions of businesses, since the date of acquisition; and in the case of transferred assets that were previously held at amortised cost, by reference to that amortised cost.

The cash flow hedging reserve represents the cumulative after tax gains and losses on effective cash flow hedging instruments that will be reclassified to the income statement in the periods in which the hedged item affects profit or loss.

The foreign currency translation reserve represents the cumulative after-tax gains and losses on the translation of foreign operations and exchange differences arising on financial instruments designated as hedges of the Group's net investment in foreign operations.

Movements in other reserves were as follows:

	2012 £m	2011 £m	2010 £m
Merger reserve			
At 1 January	8,107	8,107	8,121
Redemption of preference shares[1]	–	–	(14)
At 31 December	**8,107**	8,107	8,107

	2012 £m	2011 £m	2010 £m
Capital redemption reserve			
At 1 January	4,115	4,115	26
Cancellation of deferred shares (note 46)	–	–	4,086
Redemption of preference shares[1]	–	–	3
At 31 December	**4,115**	4,115	4,115

[1] In January 2010, the Company repurchased and cancelled certain preference shares amounting to £14 million. This resulted in a transfer of £3 million from the merger reserve to the capital redemption reserve and a transfer of £11 million from the merger reserve to the share premium account.

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Note 48: Other reserves (continued)

	2012 £m	2011 £m	2010 £m
Revaluation reserve in respect of available-for-sale financial assets			
At 1 January	**1,326**	(285)	(783)
Adjustment on transfer from held-to-maturity portfolio	**1,168**	–	–
Change in fair value of available-for-sale financial assets	**779**	2,603	1,231
Deferred tax	**(445)**	(673)	(460)
Current tax	**(3)**	–	(8)
	1,499	1,930	763
Income statement transfers:			
Disposals (note 9)	**(3,547)**	(343)	(399)
Deferred tax	**848**	30	106
	(2,699)	(313)	(293)
Impairment	**42**	80	114
Deferred tax	**12**	29	(5)
	54	109	109
Other transfers	**290**	(155)	(110)
Deferred tax	**(71)**	40	29
	219	(115)	(81)
At 31 December	**399**	1,326	(285)

	2012 £m	2011 £m	2010 £m
Cash flow hedging reserve			
At 1 January	**325**	(391)	(305)
Change in fair value of hedging derivatives	**116**	916	(1,048)
Deferred tax	**(17)**	(257)	272
Current tax	**–**	–	(3)
	99	659	(779)
Income statement transfers (note 5)	**(92)**	70	932
Deferred tax	**18**	(13)	(239)
	(74)	57	693
At 31 December	**350**	325	(391)

	2012 £m	2011 £m	2010 £m
Foreign currency translation reserve			
At 1 January	**(55)**	29	158
Currency translation differences arising in the year	**(69)**	(58)	33
Foreign currency gains (losses) on net investment hedges (tax: £nil)	**55**	(26)	(162)
At 31 December	**(69)**	(55)	29

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Note 49: Retained profits

	2012 £m	2011 £m	2010 £m
At 1 January	8,680	11,380	11,117
Loss for the year	(1,427)	(2,787)	(320)
Movement in treasury shares	(407)	(276)	20
Value of employee services:			
Share option schemes	81	125	154
Other employee award schemes	256	238	409
At 31 December	7,183	8,680	11,380

Retained profits are stated after deducting £158 million (2011: £33 million; 2010: £47 million) representing 301 million (2011: 58 million; 2010: 49 million) treasury shares held.

Note 50: Ordinary dividends

No dividends were paid on ordinary shares during 2010, 2011 or 2012 and the directors do not propose to pay a final dividend in respect of 2012; in November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities, for the two year period from 31 January 2010 to 31 January 2012. Consequently, the terms of these instruments prevented the Company from making dividend payments on ordinary shares up to that date.

In addition, the trustees of the following holdings of Lloyds Banking Group plc shares in relation to employee share schemes retain the right to receive dividends but chose to waive their entitlement to the dividends on those shares as indicated: the Lloyds Banking Group Share Incentive Plan (holding at 31 December 2012: 12,040,715 shares, 31 December 2011: 8,091,460 shares, waived rights to all dividends), the Lloyds TSB Group Employee Share Ownership Trust (holding at 31 December 2012: 73,007,743 shares, 31 December 2011: 120,085,543 shares, on which it waived rights to all dividends and holding at 31 December 2012: nil shares, 31 December 2011: 253,052 shares, on which it waived rights to all but a nominal amount of one penny in total), Lloyds TSB Group Holdings (Jersey) Limited (holding at 31 December 2012: 42,846 shares, 31 December 2011: 42,846 shares, waived rights to all but a nominal amount of one penny in total) and the Lloyds TSB Qualifying Employee Share Ownership Trust (holding at 31 December 2012: 1,398 shares, 31 December 2011: 1,398 shares, waived rights to all but a nominal amount of one penny in total).

Note 51: Share-based payments

Charge to the income statement

The charge to the income statement is set out below:

	2012 £m	2011 £m	2010 £m
Deferred bonus plan	248	221	355
Executive and SAYE plans:			
Options granted in the year	12	13	59
Options granted in prior years	65	130	75
	77	143	134
Share plans:			
Shares granted in the year	3	3	3
Shares granted in prior years	5	9	49
	8	12	52
Total charge to the income statement	333	376	541

During the year ended 31 December 2012 the Group operated the following share-based payment schemes, all of which are equity settled.

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Note 51: Share-based payments (continued)

Deferred bonus plans

Bonuses in respect of the performance in 2012 of employees within certain of the Group's bonus plans have been recognised in these financial statements in full. The amounts to be settled in shares are included within the total charge to the income statement detailed above.

Lloyds Banking Group executive share option schemes

The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between March 2004 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5.

Performance conditions for executive options

For options granted in 2004

The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds Banking Group plc.

The performance condition was measured over a three year period which commenced at the end of the financial year preceding the grant of the option and continued until the end of the third subsequent year. If the performance condition was not then met, it was measured at the end of the fourth financial year. If the condition was not then met, the options would lapse.

To meet the performance conditions, the Group's ranking against the comparator group was required to be at least ninth. The full grant of options only became exercisable if the Group was ranked first. A performance multiplier (of between nil and 100 per cent) was applied below this level to calculate the number of shares in respect of which options granted to Executive Directors would become exercisable, and were calculated on a sliding scale. If Lloyds Banking Group plc was ranked below median the options would not be exercisable.

Options granted to senior executives other than Executive Directors were not so highly leveraged and, as a result, different performance multipliers were applied to their options. For the majority of executives, options were granted with the performance condition but with no performance multiplier.

Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 14 per cent for Executive Directors, 24 per cent for Managing Directors, and 100 per cent for all other executives.

For options granted in 2005

The same conditions applied as for grants made in 2004, except that:

- the performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds Banking Group plc;
- if the performance condition was not met at the end of the third subsequent year, the options would lapse; and
- the full grant of options became exercisable only if the Group was ranked in the top four places of the comparator group. A sliding scale applied between fourth and eighth positions. If Lloyds Banking Group was ranked below the median (ninth or below) the options would lapse.

Options granted in 2005 became exercisable as the performance condition was met when tested. The performance condition vested at 82.5 per cent for all options granted.

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Note 51: Share-based payments (continued)

Movements in the number of share options outstanding under the executive share option schemes during 2011 and 2012 are set out below:

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**10,174,869**	**225.15**	13,363,301	233.09
Forfeited	**(2,129,973)**	**225.92**	(2,140,790)	225.91
Lapsed	**–**	**–**	(1,047,642)	324.92
Outstanding at 31 December	**8,044,896**	**224.95**	10,174,869	225.15
Exercisable at 31 December	**8,044,896**	**224.95**	10,174,869	225.15

No options were exercised during 2012 or 2011. The weighted average remaining contractual life of options outstanding at the end of the year was 1.9 years (2011: 2.9 years). The fair values of the executive share options have been determined using a standard Black-Scholes model.

Save-As-You-Earn schemes

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £250 per month and, at the expiry of a fixed term of three, five or seven years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

Movements in the number of share options outstanding under the SAYE schemes are set out below:

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**453,019,032**	**49.74**	668,044,034	49.59
Exercised	**–**	**–**	(2,497,658)	47.34
Forfeited	**(8,427,262)**	**49.15**	(18,408,624)	50.52
Cancelled	**(88,340,810)**	**49.83**	(181,350,614)	47.78
Expired	**(41,678,937)**	**62.67**	(12,768,106)	69.08
Outstanding at 31 December	**314,572,023**	**48.01**	453,019,032	49.74
Exercisable at 31 December	**119,141**	**86.50**	25,490,233	77.82

No options were exercised in 2012. The weighted average share price at the time that the options were exercised during 2011 was £0.54. The weighted average remaining contractual life of options outstanding at the end of the year was 0.8 years (2011: 1.7 years).

No SAYE options were granted in 2012 or 2011. The fair values of the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2012 or 2011. The options outstanding at 31 December 2012 had an exercise price of £1.8066 (2011: £1.8066) and a weighted average remaining contractual life of 2.1 years (2011: 2.0 years).

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Note 51: Share-based payments (continued)

Other share option plans

Lloyds Banking Group Executive Share Plan 2003

The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The Plan's usage has now been extended to not only compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

Participants are not entitled to any dividends paid during the vesting period.

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	53,000,069	Nil	47,694,757	Nil
Granted	34,345,366	Nil	16,395,016	Nil
Exercised	(41,290,412)	Nil	(7,591,526)	Nil
Forfeited	(440,873)	Nil	(3,498,178)	Nil
Outstanding at 31 December	45,614,150	Nil	53,000,069	Nil
Exercisable at 31 December	3,065,531	Nil	2,310,418	Nil

The weighted average fair value of options granted in the year was £0.30 (2011: £0.46). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2012 was £0.33 (2011: £0.51). The weighted average remaining contractual life of options outstanding at the end of the year was 3.7 years (2011: 2.1 years).

Lloyds Banking Group Share Buy Out Awards

As part of arrangements to facilitate the recruitment of certain Executives, options have been granted by individual deed and, where appropriate, in accordance with the Listing Rules of the UK Listing Authority.

The awards were granted in recognition that the Executives' outstanding awards over shares in their previous employing company lapsed on accepting employment with the Group.

Movements in the number of options outstanding are set out below:

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	21,321,237	Nil	–	–
Granted	–	–	21,728,172	Nil
Exercised	–	–	(406,935)	Nil
Outstanding at 31 December	21,321,237	Nil	21,321,237	Nil
Exercisable at 31 December	16,509,862	Nil	2,398,593	Nil

No options were granted or exercised in 2012. The weighted average fair value of options granted during 2011 was £0.38. The weighted average share price at the time that the options were exercised during 2011 was £0.54. The weighted average remaining contractual life of options outstanding at the end of the year was 8.6 years (2011: 9.6 years).

Participants are entitled to any dividends paid during the vesting period. This amount will be paid in cash unless the Remuneration Committee decides it will be paid in shares.

The fair values of the majority of options granted have been determined using a standard Black-Scholes model. The fair values of the remaining options have been determined by Monte Carlo simulation.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 51: Share-based payments (continued)

HBOS share option plans

The table below details the outstanding options for the HBOS Share Option Plan and the St James's Place Share Option Plan. The final award under the HBOS Share Option Plan was made in 2004. Under this plan, options over shares, at market value with a face value equal to 20 per cent of salary, were granted to employees with the exception of certain senior executives. A separate option plan exists for some partners of St James's Place, which granted options in respect of Lloyds Banking Group plc shares. The final award under the St James's Place Share Option Plan was made in 2009. Movements in the number of share options outstanding under these schemes are set out below:

Participants are not entitled to any dividends paid during the vesting period.

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**22,058,552**	**394.30**	24,695,494	415.70
Forfeited	**(319,134)**	**572.22**	(213,498)	253.88
Lapsed	**(1,881,726)**	**686.47**	(2,423,444)	624.75
Outstanding at 31 December	**19,857,692**	**363.76**	22,058,552	394.30
Exercisable at 31 December	**19,857,692**	**363.76**	14,227,020	582.82

No options were exercised during 2012 or 2011. The options outstanding under the HBOS Share Option Plan and St James's Place Share Option Plan at 31 December 2012 had exercise prices in the range of £0.5183 to £5.80 (2011: £0.5183 to £8.7189) and a weighted average remaining contractual life of 1.1 years (2011: 2.0 years).

Other share plans

Lloyds Banking Group Long-Term Incentive Plan

The Long-Term Incentive Plan (LTIP) introduced in 2006 is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Group over a three year period. Awards are made within limits set by the rules of the Plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

Participants may be entitled to any dividends paid during the vesting period if the performance conditions are met. An amount equal in value to any dividends paid between the award date and the date the Remuneration Committee determine that the performance conditions were met may be paid, based on the number of shares that vest. The Remuneration Committee will determine if any dividends are to be paid in cash or in shares.

The performance conditions for awards made in April, May and September 2009 were as follows:

(i) **Earnings per share (EPS):** relevant to 50 per cent of the award. Performance was measured based on EPS growth over a three-year period from the baseline EPS of 2008.

If the growth in EPS reached 26 per cent, 25 per cent of this element of the award, being the threshold, would vest. If growth in EPS reached 36 per cent, 100 per cent of this element would vest.

(ii) **Economic Profit (EP):** relevant to 50 per cent of the award. Performance was measured based on the extent to which cumulative EP targets were achieved over the three-year period.

If the absolute improvement in adjusted EP reached 100 per cent, 25 per cent of this element of the award, being the threshold, would vest. If the absolute improvement in adjusted EP reached 202 per cent, 100 per cent of this element would vest.

The EPS and EP performance measures applying to this 2009 LTIP award were set on the basis that the Group would enter into the Government Asset Protection Scheme. As the Group did not participate in the Government Asset Protection Scheme, in June 2010 the Remuneration Committee approved restated performance measures on a basis consistent with the EPS and EP measures used for the 2010 LTIP awards. At the end of the relevant period, neither of the performance conditions had been met and the awards lapsed.

An additional discretionary award was made in April, May and September 2009. The performance conditions for those awards were as follows:

(i) **Synergy Savings:** The release of 50 per cent of the shares was dependent on the achievement of target run-rate synergy savings in 2009 and 2010 as well as the achievement of sustainable synergy savings of at least £1.5 billion by the end of 2011. The award was broken down into three equally weighted annual tranches. Performance was assessed at the end of each year against annual performance targets based on a trajectory to meet the 2011 target. The extent to which targets were achieved determined the proportion of shares to be banked each year. Any release of shares was subject to the Remuneration Committee judging the overall success of the delivery of the integration programme.

(ii) **Integration Balanced Scorecard:** The release of the remaining 50 per cent of the shares was dependent on the outcome of a Balanced Scorecard of non-financial measures of the success of the integration in each of 2009, 2010 and 2011. The Balanced Scorecard element was broken down into three equally weighted tranches. The tranches were crystallised and banked for each year of the performance cycle subject to separate annual performance targets across the four measurement categories of Building the Business, Customer, Risk and People and Organisation Development.

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Note 51: Share-based payments (continued)

The performance conditions were met and, as a consequence, the share awards vested in full in March 2012 for all participants, with the exception of current and former Executive Directors.

The performance conditions for awards made in March and August 2010 were as follows:

(i) **EPS:** relevant to 50 per cent of the award. Performance was measured based on EPS growth over a three-year period from the baseline EPS of 2009.

If the absolute improvement in adjusted EPS reached 158 per cent, 25 per cent of this element of the award, being the threshold, would vest. If absolute improvement in adjusted EPS reached 180 per cent, 100 per cent of this element would vest.

Vesting between threshold and maximum would be on a straight line basis.

(ii) **EP:** relevant to 50 per cent of the award. Performance was measured based on the compound annual growth rate of adjusted EP over the three financial years starting on 1 January 2010 relative to an adjusted 2009 EP base.

If the compounded annual growth rate of adjusted EP reached 57 per cent per annum, 25 per cent of this element of the award, being the threshold, would vest. If the compounded annual growth rate of adjusted EP reached 77 per cent per annum, 100 per cent of this element would vest.

Vesting between threshold and maximum would be on a straight line basis.

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Share Price, relevant to 28 per cent of the award. Performance will be measured based on the Absolute Share Price on 26 March 2013, being the third anniversary of the award date. If the share price at the end of the performance period is 75 pence or less, none of this element of the award will vest. If the share price is 114 pence or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis, provided that shares comprised in the Absolute Share Price element may only be released if both the EPS and EP performance measures have been satisfied at the threshold level or above. The EPS and EP performance conditions each relate to 36 per cent of the total award.

At the end of the performance period for the EPS and EP measures, it has been assessed that neither of the performance conditions has been met and, therefore, the awards will not vest.

The performance conditions for awards made in March and September 2011 are as follows:

(i) **EPS:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EPS outcome.

If the adjusted EPS reaches 6.4p, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted EPS reaches 7.4p, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **EP:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EP outcome.

If the adjusted EP reaches £567 million, 25 per cent of this element of the award, being the threshold, will vest. If the adjusted EP reaches £1,234 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Total Shareholder Return, relevant to one third of the award. Performance will be measured based on the annualised Absolute Total Shareholder Return over the three year performance period. If the annualised Absolute Total Shareholder Return at the end of the performance period is less than 8 per cent, none of this element of the award will vest. If the Absolute Total Shareholder Return is 8 per cent, 25 per cent of this element of the award, being the threshold, will vest. If the Absolute Total Shareholder Return is 14 per cent or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis. The EPS and EP performance conditions will each relate to 33.3 per cent of the total award.

The performance conditions for awards made in March and September 2012 are as follows:

(i) **EP:** relevant to 30 per cent of the award. The performance target is based on 2014 adjusted EP outcome.

If the adjusted EP reaches £160 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £1,653 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2014.

If the ATSR reaches 12 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 30 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

Note 51: Share-based payments (continued)

(iii) **Short-term funding as a percentage of total funding:** relevant to 10 per cent of the award. Performance will be measured relative to 2014 targets.

If the average percentage reaches 20 per cent, 25 per cent of this element of the award, being the threshold, will vest.

If the average percentage reaches 15 per cent, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iv) **Non-core assets at the end of 2014:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet non-core assets at 31 December 2014.

If non-core assets amount to £95 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If non-core assets amount to £80 billion or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(v) **Net Simplification benefits:** relevant to 10 per cent of the award. Performance will be measured by reference to the run rate achieved by the end of 2014.

If a run rate of net Simplification benefits of £1.5 billion is achieved, 25 per cent of this element of the award, being the threshold, will vest.

If a run rate of net Simplification benefits of £1.8 billion is achieved, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(vi) **Customer satisfaction:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FSA reportable complaints per 1,000 customers over the three year period to 31 December 2014.

If complaints per 1,000 customers average 1.5 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 1.3 per annum or less over three years, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

	2012 Number of shares	2011 Number of shares
Outstanding at 1 January	**543,738,186**	447,142,491
Granted	**265,011,679**	147,280,077
Vested	**(71,591,014)**	(3,918,013)
Forfeited	**(221,207,334)**	(46,766,369)
Outstanding at 31 December	**515,951,517**	543,738,186

The weighted average fair value of the share awards granted in 2012 was £0.24 (2011: £0.54). The fair values of the majority of share awards granted have been determined using a standard Black-Scholes model. The fair values of the remaining share awards have been determined by Monte Carlo simulation.

Scottish Widows Investment Partnership Long-Term Incentive Plan

The Scottish Widows Investment Partnership (SWIP) Long-Term Incentive Plan applicable to senior executives and employees of SWIP, which had previously been a cash-only scheme, was amended in May 2012 for awards granted on or after that date. The amendment introduced the receipt of shares in Lloyds Banking Group plc as an element of the total award. The other element will continue to be cash based, with the split between cash based and share based determined by the Remuneration Committee. The amendment is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of SWIP over a three year period. Awards are made within limits set by the rules of the Plan, with the maximum limits for combined cash and shares awarded equating to 3.5 times annual salary. In exceptional circumstances this may increase to 4 times annual salary.

The performance conditions for share-based awards made in June 2012 are as follows:

(i) **Profitability:** relevant to 40 per cent of the award. The performance target is based on a cumulative 3 year profit before tax. If cumulative profit before tax reaches a specified target level, 100 per cent of this element will vest. If cumulative profit before tax reaches 90 per cent of the target level, 25 per cent of this element of the award, being the threshold, will vest. If cumulative profit before tax reaches 110 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

(ii) **Investment performance:** relevant to 40 per cent of the award. The performance target is based on the percentage of SWIP funds achieving at or above benchmark performance (on a competitor median or index basis) over the 3 year period. If 50 per cent of funds exceed benchmark performance, 25 per cent of this element of the award, being the threshold, will vest. If 55 per cent of funds exceed benchmark performance, 100 per cent of this element, being the target, will vest. If 70 per cent of funds exceed benchmark performance, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

(iii) **Funds under management (FUM) growth:** relevant to 20 per cent of the award. The performance target is based on growth in the value of third party assets managed by SWIP by the end of the 3 year period. If third party FUM reaches a specified target level, 100 per cent of this

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Note 51: Share-based payments (continued)

element of the award will vest. If third party FUM reaches 80 per cent of the target level, 25 per cent of this element, being the threshold, will vest. If third party FUM reaches 120 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

For awards made to SWIP's Code Staff (as defined by FSA), a fourth performance condition was set, relating to an internal measure of operational risk. This additional measure is relevant to 15 per cent of the award for these individuals, with a corresponding 5 per cent reduction in each of the weightings for the other three measures described above. As with the other measures, this performance condition has a target value at which 100 per cent of the award will vest, a maximum value at which 200 per cent of the award will vest, and a threshold value at which 25 per cent of the award will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

The relevant period commenced on 1 January 2012 and ends on 31 December 2014.

	2012 Number of shares	2011 Number of shares
Outstanding at 1 January	**–**	–
Granted	**5,452,877**	–
Outstanding at 31 December	**5,452,877**	–

The fair value of the share awards granted in 2012 was £0.27. The fair values of share awards granted have been determined using a standard Black-Scholes model.

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

	Executive schemes			**SAYE schemes**			**Other share option plans**		
	Weighted average exercise price (pence)	**Weighted average remaining life (years)**	**Number of options**	**Weighted average exercise price (pence)**	**Weighted average remaining life (years)**	**Number of options**	**Weighted average exercise price (pence)**	**Weighted average remaining life (years)**	**Number of options**
At 31 December 2012									
Exercise price range									
£0 to £1	**–**	**–**	**–**	**46.79**	**0.8**	**311,648,405**	**5.43**	**4.9**	**74,766,919**
£1 to £2	**199.91**	**1.6**	**233,714**	**178.14**	**1.8**	**2,923,618**	**–**	**–**	**–**
£2 to £3	**225.69**	**1.9**	**7,811,182**	**–**	**–**	**–**	**–**	**–**	**–**
£3 to £4	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
£5 to £6	**–**	**–**	**–**	**–**	**–**	**–**	**566.89**	**0.9**	**12,026,160**

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
At 31 December 2011									
Exercise price range									
£0 to £1	–	–	–	47.94	1.7	446,965,447	4.94	4.1	82,152,838
£1 to £2	199.91	2.6	233,714	179.16	2.0	5,563,072	–	–	–
£2 to £3	225.74	2.9	9,941,155	214.16	0.9	490,513	–	–	–
£3 to £4	–	–	–	–	–	–	–	–	–
£5 to £6	–	–	–	–	–	–	582.82	1.8	14,227,020

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 51: Shared-based payments (continued)

The fair value calculations at 31 December 2012 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	Executive Share Plan 2003	LTIP	Share Buy Out Awards	SWIP LTIP
Weighted average risk-free interest rate	0.45%	0.52%	0.86%	0.38%
Weighted average expected life	2.5 years	3.0 years	1.3 years	2.8 years
Weighted average expected volatility	63%	78%	51%	81%
Weighted average expected dividend yield	4.1%	4.3%	1.6%	4.5%
Weighted average share price	£0.33	£0.35	£0.41	£0.31
Weighted average exercise price	Nil	Nil	Nil	Nil

Expected volatility is a measure of the amount by which the Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

Share incentive plan

Free shares

An award of shares may be made annually to employees based on a percentage of each employee's salary in the preceding year up to a maximum of £3,000. The percentage is normally announced concurrently with the Group's annual results and the price of the shares awarded is announced at the time of award. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves the Group within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited.

The last award of free shares was made in 2008.

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £30 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100 per cent of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2012 was 36,158,343 (2011: 30,999,387), with an average fair value of £0.34 (2011: £0.42), based on market prices at the date of award.

Note 52: Related party transactions

Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

The table below details, on an aggregated basis, key management personnel compensation:

	2012 £m	2011 £m	2010 £m
Compensation			
Salaries and other short-term benefits	12	12	7
Post-employment benefits	–	–	2
Share-based payments	13	11	8
Total compensation	25	23	17

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Note 52: Related party transactions (continued)

Aggregate contributions in respect of key management personnel to defined contribution pension schemes were £0.1 million (2011: £0.2 million; 2010: £0.4 million).

	2012 million	2011 million	2010 million
Share option plans			
At 1 January	**22**	6	2
Granted, including certain adjustments[1] (includes entitlements of appointed key management personnel)	**8**	20	4
Exercised/lapsed (includes entitlements of former key management personnel)	**(5)**	(4)	–
At 31 December	**25**	22	6

[1] 2010 includes adjustments, using a standard HMRC formula, to negate the dilutionary impact of the Group's 2009 capital raising activities.

	2012 million	2011 million	2010 million
Share plans			
At 1 January	**58**	56	19
Granted, including certain adjustments[1] (includes entitlements of appointed key management personnel)	**45**	35	39
Exercised/lapsed (includes entitlements of former key management personnel)	**(33)**	(33)	(2)
At 31 December	**70**	58	56

[1] 2010 includes adjustments, using a standard HMRC formula, to negate the dilutionary impact of the Group's 2009 capital raising activities.

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between the Group and its key management personnel:

	2012 £m	2011 £m	2010 £m
Loans			
At 1 January	**3**	3	2
Advanced (includes loans of appointed key management personnel)	**3**	1	2
Repayments (includes loans of former key management personnel)	**(4)**	(1)	(1)
At 31 December	**2**	3	3

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 2.5 per cent and 29.95 per cent in 2012 (2011: 1.09 per cent and 27.5 per cent; 2010: 0.5 per cent and 17.90 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2011 and 2010: £nil).

	2012 £m	2011 £m	2010 £m
Deposits			
At 1 January	**6**	4	4
Placed (includes deposits of appointed key management personnel)	**39**	17	12
Withdrawn (includes deposits of former key management personnel)	**(35)**	(15)	(12)
At 31 December	**10**	6	4

Deposits placed by key management personnel attracted interest rates of up to 3.8 per cent (2011: 5 per cent; 2010: 4.25 per cent).

At 31 December 2012, the Group did not provide any guarantees in respect of key management personnel (2011 and 2010: none).

At 31 December 2012, transactions, arrangements and agreements entered into by the Group's banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £1 million with five directors and three connected persons (2011: £3 million with four directors and three connected persons; 2010: £2 million with six directors and four connected persons).

Subsidiaries

Details of the principal subsidiaries are given in note 9 to the parent company financial statements. In accordance with IAS 27 *Consolidated and separate financial statements*, transactions and balances with subsidiaries have been eliminated on consolidation.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: Related party transactions (continued)

UK Government

In January 2009, the UK Government through HM Treasury became a related party of the Company following its subscription for ordinary shares issued under a placing and open offer. At 31 December 2012, HM Treasury held a 39.2 per cent (2011: 40.2 per cent) interest in the Company's ordinary share capital and consequently HM Treasury remained a related party of the Company during the year ended 31 December 2012.

From 1 January 2011, in accordance with IAS 24, UK Government-controlled entities became related parties of the Group. The Group regards the Bank of England and entities controlled by the UK Government, including The Royal Bank of Scotland Group plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc, as related parties.

Since 31 December 2011, the Group has had the following significant transactions with the UK Government or UK Government-related entities:

Government and central bank facilities

During the year ended 31 December 2012, the Group participated in a number of schemes operated by the UK Government and central banks and made available to eligible banks and building societies.

Credit guarantee scheme

HM Treasury launched the Credit Guarantee Scheme in October 2008. The drawdown window for the Credit Guarantee Scheme closed for new issuance at the end of February 2010. At 31 December 2011, the Group had £23.5 billion of debt in issue under the Credit Guarantee Scheme but this was all repaid during 2012. During the year ended 31 December 2012, fees of £59 million paid to HM Treasury in respect of guaranteed funding were included in the Group's income statement (2011: £291 million).

National Loan Guarantee Scheme

The Group is participating in the UK Government's National Loan Guarantee Scheme, which was launched on 20 March 2012. Through the scheme, the Group is providing eligible UK businesses with discounted funding, subject to continuation of the scheme and its financial benefits, and based on the Group's existing lending criteria. Eligible businesses who take up the funding benefit from a 1 per cent discount on their funding rate for a certain period of time.

Business Growth Fund

In May 2011 the Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to commit up to £300 million of equity investment by subscribing for shares in the Business Growth Fund plc which is the company created to fulfil the role of the Business Growth Fund as set out in the British Bankers' Association's Business Taskforce Report of October 2010. At 31 December 2012, the Group had invested £50 million (2011: £20 million) in the Business Growth Fund and carried the investment at a fair value of £44 million (2011: £16 million).

Big Society Capital

In January 2012 the Group agreed, together with The Royal Bank of Scotland plc (and two other non-related parties), to commit up to £50 million each of equity investment into the Big Society Capital Fund. The Fund, which was created as part of the Project Merlin arrangements, is a UK social investment fund. The Fund was officially launched on 3 April 2012 and the Group invested £12 million in the Fund during 2012.

Funding for Lending

In August 2012 the Group announced its support for the UK Government's Funding for Lending Scheme and confirmed its intention to participate in the scheme. The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Group. The initiative supports a broad range of UK based customers, providing householders with more affordable housing finance and businesses with cheaper finance to invest and grow. The Group drew down £3.0 billion during 2012.

Central bank facilities

In the ordinary course of business, the Group may from time to time access market-wide facilities provided by central banks.

Other government-related entities

Other than the transactions referred to above, there were no other significant transactions with the UK Government and UK Government-controlled entities (including UK Government-controlled banks) during the period that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Other related party transactions

Pension funds

The Group provides banking and some investment management services to certain of its pension funds. At 31 December 2012, customer deposits of £129 million (2011: £63 million) and investment and insurance contract liabilities of £1,213 million (2011: £928 million) related to the Group's pension funds.

Open Ended Investment Companies (OEICs)

The Group manages 244 (2011: 249) OEICs, and of these 136 (2011: 142) are consolidated. The Group invested £1,563 million (2011: £1,283 million) and redeemed £1,690 million (2011: £884 million) in the unconsolidated OEICs during the year and had investments, at fair value, of

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Note 52: Related party transactions (continued)

£6,479 million (2011: £4,431 million) at 31 December. The Group earned fees of £325 million from the unconsolidated OEICs during 2012 (2011: £318 million).

Joint ventures and associates

The Group provides both administration and processing services to its principal joint venture, Sainsbury's Bank plc. The amounts receivable by the Group during the year were £32 million (2011: £21 million), of which £16 million was outstanding at 31 December 2012 (2011: £10 million). At 31 December 2012, Sainsbury's Bank plc also had balances with the Group that were included in loans and advances to banks of £1,229 million (2011: £1,173 million), deposits by banks of £1,268 million (2011: £780 million) and trading liabilities of £nil (2011: £340 million).

At 31 December 2012 there were loans and advances to customers of £3,424 million (2011: £5,185 million) outstanding and balances within customer deposits of £45 million (2011: £88 million) relating to other joint ventures and associates.

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2012, these companies had total assets of approximately £10,759 million (2011: £11,500 million), total liabilities of approximately £10,956 million (2011: £10,807 million) and for the year ended 31 December 2012 had turnover of approximately £8,169 million (2011: £7,376 million) and made a net loss of approximately £488 million (2011: net loss of £83 million). In addition, the Group has provided £5,146 million (2011: £5,767 million) of financing to these companies on which it received £208 million (2011: £106 million) of interest income in the year.

Note 53: Contingent liabilities and commitments

Interchange fees

On 24 May 2012, the General Court of the European Union upheld the European Commission's 2007 decision that an infringement of EU competition law had arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee (MIFs) in respect of cross border transactions in relation to the use of a MasterCard or Maestro branded payment card.

MasterCard has appealed the General Court's judgment to the Court of Justice of the European Union. MasterCard is supported by several card issuers, including Lloyds Banking Group. Judgment is not expected until late 2013 or later.

In parallel:

- the European Commission is also considering further action, including introducing legislation to regulate interchange fees, following its 2012 Green Paper (Towards an integrated European market for cards, internet and mobile payments) consultation;
- the European Commission is pursuing an investigation with a view to deciding whether arrangements adopted by VISA for the levying of the MIF in respect of cross-border credit card payment transactions also infringe European Union competition laws. In this regard VISA reached an agreement (which expires in 2014) with the European Commission to reduce the level of interchange fee for cross-border debit card transactions to the interim levels agreed by MasterCard; and
- the Office of Fair Trading (OFT) may decide to renew its ongoing examination of whether the levels of interchange fees paid by retailers in respect of MasterCard and VISA credit cards, debit cards and charge cards in the UK infringe competition law. The OFT had placed the investigation on hold pending the outcome of the MasterCard appeal to the General Court.

The ultimate impact of the investigations and any regulatory developments on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings and once regulatory proposals are more certain.

Interbank offered rate setting investigations

A number of government agencies in the UK, US and elsewhere, including the UK Financial Services Authority, the US Commodity Futures Trading Commission, the US Securities and Exchange Commission, the US Department of Justice and a number of State Attorneys General, as well as the European Commission, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates including the BBA London Interbank Offered Rates (LIBOR) and the European Banking Federation's Euribor. Certain Group companies were (at the relevant times) and remain members of various panels whose members make submissions to these bodies including the BBA LIBOR panels. No Group company is or was a member of the Euribor panel. Certain Group companies have received subpoenas and requests for information from certain government agencies and the Group is co-operating with their investigations. In addition certain Group companies, together with other panel banks, have been named as defendants in private lawsuits, including purported class action suits in the US with regard to the setting of LIBOR. It is currently not possible to predict the scope and ultimate outcome of the various regulatory investigations or private lawsuits, including the timing and scale of the potential impact of any investigations and private lawsuits on the Group.

Note 53: Contingent liabilities and commitments (continued)

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS is funded by levies on the industry (and recoveries and borrowings where appropriate). The levies raised comprise both management expenses levies and, where necessary, compensation levies on authorised firms.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. The interest rate on the borrowings with HM Treasury, which total circa £20 billion, increased from 12 month LIBOR plus 30 basis points to 12 month LIBOR plus 100 basis points on 1 April 2012. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

In determining an appropriate accrual in respect of the management expenses levy, certain assumptions have been made including the proportion of total protected deposits held by the Group, the level and timing of repayments to be made by the FSCS to HM Treasury and the interest rate to be charged by HM Treasury. For the year ended 31 December 2012, the Group has charged £87 million (2011: £179 million; 2010: £46 million) to the income statement in respect of the management expenses levy.

The substantial majority of the principal balance of the £20 billion loan between the FSCS and HM Treasury will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted. In March 2012, the FSCS confirmed that it expects a shortfall of approximately £802 million and that it expects to recover that amount by raising compensation levies on all deposit-taking participants over a three year period. In addition to the management expenses levy detailed above, the Group has also charged £88 million (2011: £nil; 2010: £nil) to the income statement in respect of compensation levies. The amount of future compensation levies payable by the Group depends on a number of factors including participation in the market at 31 December, the level of protected deposits and the population of deposit-taking participants.

FSA investigation into Bank of Scotland and report on HBOS

In 2009, the FSA commenced a supervisory review into HBOS. The supervisory review was superseded when the FSA commenced an enforcement investigation into Bank of Scotland plc in relation to its Corporate division between 2006 and 2008. These proceedings have now concluded. The FSA published its Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. The FSA has committed to producing a public interest report on HBOS. The FSA has indicated that the report is expected to be published in the summer.

Shareholder complaints

In November 2011 the Group and two former members of the Group's Board of Directors were named as defendants in a purported securities class action filed in the United States District Court for the Southern District of New York. The complaint asserted claims under the Securities Exchange Act of 1934 in connection with alleged material omissions from statements made in 2008 in connection with the acquisition of HBOS. No quantum is specified. In October 2012 the court dismissed the complaint. An appeal against this decision has been filed. The Group continues to consider that the allegations are without merit.

Other legal actions and regulatory matters

In addition, during the ordinary course of business the Group is subject to other threatened and actual legal proceedings (which may include class action lawsuits brought on behalf of customers, shareholders or other third parties), regulatory investigations, regulatory challenges and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed properly to assess the merits of the case and no provisions are held against such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

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Note 53: Contingent liabilities and commitments (continued)

	2012 £m	2011 £m
Contingent liabilities		
Acceptances and endorsements	107	81
Other:		
Other items serving as direct credit substitutes	523	1,060
Performance bonds and other transaction-related contingencies	2,266	2,729
	2,789	3,789
Total contingent liabilities	2,896	3,870

The contingent liabilities of the Group arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

	2012 £m	2011 £m
Commitments		
Documentary credits and other short-term trade-related transactions	11	105
Forward asset purchases and forward deposits placed	546	596
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	7,404	7,383
Other commitments	53,196	56,527
	60,600	63,910
1 year or over original maturity	40,794	40,972
Total commitments	101,951	105,583

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £52,733 million (2011: £53,459 million) was irrevocable.

Operating lease commitments

Where a Group company is the lessee the future minimum lease payments under non-cancellable premises operating leases are as follows:

	2012 £m	2011 £m
Not later than 1 year	310	348
Later than 1 year and not later than 5 years	987	1,187
Later than 5 years	1,332	1,489
Total operating lease commitments	2,629	3,024

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

Capital commitments

Excluding commitments in respect of investment property (note 27), capital expenditure contracted but not provided for at 31 December 2012 amounted to £279 million (2011: £296 million). Of this amount, £276 million (2011: £292 million) related to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 54: Financial instruments

(1) Measurement basis of financial assets and liabilities

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

		At fair value through profit or loss						
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2012								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	80,298	–	80,298
Items in the course of collection from banks	–	–	–	–	–	1,256	–	1,256
Trading and other financial assets at fair value through profit or loss	–	23,345	130,645	–	–	–	–	153,990
Derivative financial instruments	11,571	44,979	–	–	–	–	–	56,550
Loans and receivables:								
Loans and advances to banks	–	–	–	–	29,417	–	–	29,417
Loans and advances to customers	–	–	–	–	517,225	–	–	517,225
Debt securities	–	–	–	–	5,273	–	–	5,273
	–	–	–	–	551,915	–	–	551,915
Available-for-sale financial assets	–	–	–	31,374	–	–	–	31,374
Total financial assets	11,571	68,324	130,645	31,374	551,915	81,554	–	875,383
Financial liabilities								
Deposits from banks	–	–	–	–	–	38,405	–	38,405
Customer deposits	–	–	–	–	–	426,912	–	426,912
Items in course of transmission to banks	–	–	–	–	–	996	–	996
Trading and other financial liabilities at fair value through profit or loss	–	30,272	5,700	–	–	–	–	35,972
Derivative financial instruments	6,598	42,067	–	–	–	–	–	48,665
Notes in circulation	–	–	–	–	–	1,198	–	1,198
Debt securities in issue	–	–	–	–	–	117,369	–	117,369
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	82,953	82,953
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	54,372	54,372
Unallocated surplus within insurance businesses	–	–	–	–	–	–	267	267
Financial guarantees	–	–	48	–	–	–	–	48
Subordinated liabilities	–	–	–	–	–	34,092	–	34,092
Total financial liabilities	6,598	72,339	5,748	–	–	618,972	137,592	841,249

Note 54: Financial instruments (continued)

	Derivatives designated as hedging instruments £m	At fair value through profit or loss Held for trading £m	 Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2011								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	60,722	–	60,722
Items in the course of collection from banks	–	–	–	–	–	1,408	–	1,408
Trading and other financial assets at fair value through profit or loss	–	18,056	121,454	–	–	–	–	139,510
Derivative financial instruments	12,850	53,163	–	–	–	–	–	66,013
Loans and receivables:								
Loans and advances to banks	–	–	–	–	32,606	–	–	32,606
Loans and advances to customers	–	–	–	–	565,638	–	–	565,638
Debt securities	–	–	–	–	12,470	–	–	12,470
	–	–	–	–	610,714	–	–	610,714
Available-for-sale financial assets	–	–	–	37,406	–	–	–	37,406
Held-to-maturity investments	–	–	–	–	–	8,098	–	8,098
Total financial assets	12,850	71,219	121,454	37,406	610,714	70,228	–	923,871
Financial liabilities								
Deposits from banks	–	–	–	–	–	39,810	–	39,810
Customer deposits	–	–	–	–	–	413,906	–	413,906
Items in course of transmission to banks	–	–	–	–	–	844	–	844
Trading and other financial liabilities at fair value through profit or loss	–	19,616	5,339	–	–	–	–	24,955
Derivative financial instruments	7,246	50,966	–	–	–	–	–	58,212
Notes in circulation	–	–	–	–	–	1,145	–	1,145
Debt securities in issue	–	–	–	–	–	185,059	–	185,059
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	78,991	78,991
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	49,636	49,636
Unallocated surplus within insurance businesses	–	–	–	–	–	–	300	300
Financial guarantees	–	–	49	–	–	–	–	49
Subordinated liabilities	–	–	–	–	–	35,089	–	35,089
Total financial liabilities	7,246	70,582	5,388	–	–	675,853	128,927	887,996

(2) Reclassification of financial assets

During 2012 the Group has reviewed its holding of government securities classified as held-to-maturity. Since it is no longer the Group's intention to hold these to maturity, securities with a carrying amount of £10,811 million and a fair value of £11,979 million were reclassified as available-for-sale financial assets in December 2012. The difference between the carrying amount and the fair value has been recognised in equity.

No financial assets were reclassified in 2011.

In 2010, government securities with a fair value of £3,601 million were reclassified from available-for-sale financial assets to held-to-maturity investments reflecting the Group's then positive intent and ability to hold them until maturity.

In 2009, no financial assets were reclassified.

In 2008, in accordance with the amendment to IAS 39 that became applicable during that year, the Group reviewed the categorisation of its financial assets classified as held for trading and available-for-sale. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, with effect from 1 July 2008, the Group transferred £2,993 million of assets previously classified as held for trading into loans and receivables. With effect from 1 November 2008, the Group transferred £437 million of assets previously classified as available-for-sale financial assets into loans and receivables. At the time of these transfers, the Group had the

Note 54: Financial instruments (continued)

intention and ability to hold them for the foreseeable future or until maturity. As at the date of reclassification, the weighted average effective interest rate of the assets transferred was 6.3 per cent with the estimated recoverable cash flows of £3,524 million.

Carrying value and fair value of reclassified assets

The table below sets out the carrying value and fair value of reclassified financial assets.

	2012		2011		2010		2009		2008	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
From held for trading to loans and receivables	**11**	**9**	67	56	750	727	1,833	1,822	2,883	2,926
From available-for-sale financial assets to loans and receivables	**162**	**203**	217	219	313	340	394	422	454	402
From available-for-sale financial assets to held-to-maturity investments	**–**	**–**	3,624	3,846	3,455	3,539	–	–	–	–
From held-to-maturity investments to available-for-sale financial assets	**4,998**	**4,998**	–	–	–	–	–	–	–	–
Total carrying value and fair value	**5,171**	**5,210**	3,908	4,121	4,518	4,606	2,227	2,244	3,337	3,328

During the year ended 31 December 2012, the carrying value of assets reclassified to loans and receivables decreased by £111 million due to sales and maturities of £137 million and foreign exchange and other movements of £4 million less accretion of discount of £30 million.

No financial assets have been reclassified in accordance with paragraphs 50B, 50D or 50E of IAS 39 since 2008; the following disclosures relate to those assets which were so reclassified in 2008.

a) Additional fair value gains (losses) that would have been recognised had the reclassifications not occurred

The table below shows the additional gains (losses) that would have been recognised in the Group's income statement if the reclassifications had not occurred.

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From held for trading to loans and receivables	**1**	(3)	(34)	208	(347)

The table below shows the additional gains (losses) that would have been recognised in other comprehensive income if the reclassifications had not occurred.

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From available-for-sale financial assets to loans and receivables	**24**	(68)	69	161	(108)

Note 54: Financial instruments (continued)

b) Actual amounts recognised in respect of reclassified assets

After reclassification the reclassified financial assets contributed the following amounts to the Group income statement.

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From held for trading to loans and receivables:					
Net interest income	–	1	24	55	31
Impairment losses	–	–	(6)	(49)	(158)
Total amounts recognised	–	1	18	6	(127)

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From available-for-sale financial assets to loans and receivables:					
Net interest income	1	2	1	34	3
Impairment credit (losses)	5	(8)	(2)	(56)	(23)
Total amounts recognised	6	(6)	(1)	(22)	(20)

(3) Fair values of financial assets and liabilities

The following table summarises the carrying values of financial assets and liabilities presented on the Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

	2012		2011	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets				
Cash and balances at central banks	80,298	80,298	60,722	60,722
Items in the course of collection from banks	1,256	1,256	1,408	1,408
Trading and other financial assets at fair value through profit or loss	153,990	153,990	139,510	139,510
Derivative financial instruments	56,550	56,550	66,013	66,013
Loans and receivables:				
Loans and advances to banks	29,417	29,406	32,606	32,554
Loans and advances to customers	517,225	506,418	565,638	549,829
Debt securities	5,273	5,402	12,470	10,953
Available-for-sale financial assets	31,374	31,374	37,406	37,406
Held-to-maturity investments	–	–	8,098	8,144
Financial liabilities				
Deposits from banks	38,405	38,738	39,810	40,012
Customer deposits	426,912	428,749	413,906	414,654
Items in course of transmission to banks	996	996	844	844
Trading and other financial liabilities at fair value through profit or loss	35,972	35,972	24,955	24,955
Derivative financial instruments	48,665	48,665	58,212	58,212
Notes in circulation	1,198	1,198	1,145	1,145
Debt securities in issue	117,369	122,963	185,059	183,113
Liabilities arising from non-participating investment contracts	54,372	54,372	49,636	49,636
Financial guarantees	48	48	49	49
Subordinated liabilities	34,092	36,382	35,089	27,838

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Note 54: Financial instruments (continued)

Valuation methodology

Financial instruments include financial assets, financial liabilities and derivatives. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

Fair value information is not provided for items that do not meet the definition of a financial instrument. These items include intangible assets, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

Fair value of financial instruments carried at amortised cost

Cash and balances at central banks and items in the course of collection from banks

The fair value approximates carrying value due to their short-term nature.

Loans and receivables

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of certain variable rate loans, loans relating to lease financing and impaired lending is assumed to be fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. These techniques take account of expected credit losses and changes in interest rates and expected future cash flows in establishing fair value. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in the counterparty's credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair values of asset-backed securities and secondary loans, which were previously within assets held for trading and were reclassified to loans and receivables, are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

Held-to-maturity investments

The fair values of government securities are based on market prices whereas the carrying value is based on cost, the difference being interest rate driven. In 2012, these assets were transferred to the available-for-sale portfolio and carried at fair value at 31 December 2012.

Deposits from banks and customer deposits

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities. The difference between fair value and carrying value is principally interest rate driven on fixed deposits.

Items in course of transmission to banks

The fair value approximates carrying value due to their short-term nature.

Notes in circulation

The fair value of notes in circulation which are payable on demand is considered to be equal to their carrying value.

Debt securities in issue and subordinated liabilities

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices. The difference between fair value and amortised cost is driven both by interest rates and the Group's credit rating.

Valuation of financial instruments carried at fair value

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1 portfolios

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise equity shares, treasury bills and other government securities.

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Note 54: Financial instruments (continued)

Level 2 portfolios

Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

Level 3 portfolios

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include the Group's venture capital and unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

Valuation control framework

The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

Note 54: Financial instruments (continued)

The table below provides an analysis of the financial assets and liabilities of the Group that are carried at fair value in the Group's consolidated balance sheet, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

Valuation hierarchy

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2012				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	13,632	–	13,632
Loans and advances to banks	–	919	–	919
Debt securities:				
Government securities	18,524	2,207	–	20,731
Other public sector securities	–	1,056	–	1,056
Bank and building society certificates of deposit	68	3,326	–	3,394
Asset-backed securities:				
Mortgage-backed securities	151	687	–	838
Other asset-backed securities	258	1,565	–	1,823
Corporate and other debt securities	5,692	17,647	1,519	24,858
	24,693	26,488	1,519	52,700
Equity shares	84,450	72	1,787	86,309
Treasury and other bills	430	–	–	430
Total trading and other financial assets at fair value through profit or loss	109,573	41,111	3,306	153,990
Available-for-sale financial assets				
Debt securities:				
Government securities	25,555	–	–	25,555
Bank and building society certificates of deposit	42	146	–	188
Asset-backed securities:				
Mortgage-backed securities	–	1,524	–	1,524
Other asset-backed securities	–	687	73	760
Corporate and other debt securities	22	1,826	–	1,848
	25,619	4,183	73	29,875
Equity shares	21	99	408	528
Treasury and other bills	869	16	86	971
Total available-for-sale financial assets	26,509	4,298	567	31,374
Derivative financial instruments	76	54,116	2,358	56,550
Total financial assets carried at fair value	136,158	99,525	6,231	241,914
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	5,700	–	5,700
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	24,553	–	24,553
Short positions in securities	1,850	350	–	2,200
Other	15	3,504	–	3,519
	1,865	28,407	–	30,272
Total trading and other financial liabilities at fair value through profit or loss	1,865	34,107	–	35,972
Derivative financial instruments	36	48,086	543	48,665
Financial guarantees	–	–	48	48
Total financial liabilities carried at fair value	1,901	82,193	591	84,685

There were no significant transfers between level 1 and level 2 during the year.

Note 54: Financial instruments (continued)

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2011				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	9,766	–	9,766
Loans and advances to banks	–	1,355	–	1,355
Debt securities:				
Government securities	21,326	2,041	–	23,367
Other public sector securities	375	808	–	1,183
Bank and building society certificates of deposit	–	3,248	–	3,248
Asset-backed securities:				
Mortgage-backed securities	187	524	–	711
Other asset-backed securities	178	1,605	203	1,986
Corporate and other debt securities	5,098	15,337	1,423	21,858
	27,164	23,563	1,626	52,353
Equity shares	74,381	41	1,315	75,737
Treasury and other bills	299	–	–	299
Total trading and other financial assets at fair value through profit or loss	101,844	34,725	2,941	139,510
Available-for-sale financial assets				
Debt securities:				
Government securities	25,143	93	–	25,236
Other public sector securities	27	–	–	27
Bank and building society certificates of deposit	323	43	–	366
Asset-backed securities:				
Mortgage-backed securities	–	1,803	–	1,803
Other asset-backed securities	–	807	257	1,064
Corporate and other debt securities	41	5,192	12	5,245
	25,534	7,938	269	33,741
Equity shares	55	96	1,787	1,938
Treasury and other bills	972	755	–	1,727
Total available-for-sale financial assets	26,561	8,789	2,056	37,406
Derivative financial instruments	204	63,160	2,649	66,013
Total financial assets carried at fair value	128,609	106,674	7,646	242,929
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	5,339	–	5,339
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	12,378	–	12,378
Short positions in securities	3,168	533	–	3,701
Other	–	3,537	–	3,537
	3,168	16,448	–	19,616
Total trading and other financial liabilities at fair value through profit or loss	3,168	21,787	–	24,955
Derivative financial instruments	35	57,436	741	58,212
Financial guarantees	–	–	49	49
Total financial liabilities carried at fair value	3,203	79,223	790	83,216

Valuation methodology

Asset-backed securities

Where there is no trading activity in asset-backed securities, valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes are used to determine an appropriate valuation. Asset-backed securities are then classified as either level 2 or level 3 depending on whether there is more than one consistent independent source of data. If there is a single, uncorroborated market source for a significant valuation input or where there are materially inconsistent levels then the security is reported as level 3. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

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Note 54: Financial instruments (continued)

Equity investments (including venture capital)
Unlisted equities and fund investments are accounted for as trading and other financial assets at fair value through profit or loss or as available-for-sale financial assets. These investments are valued using different techniques as a result of the variety of investments across the portfolio in accordance with the Group's valuation policy and are calculated using International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

- A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

Unquoted equities and property partnerships in the life funds
Third party valuations are used to obtain the fair value of unquoted investments. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

Derivatives
Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives which are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.
- Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

The Group's level 3 derivative assets include £1,421 million (2011: £1,172 million) in respect of the value of the embedded equity conversion feature of the Enhanced Capital Notes issued in December 2009. The embedded equity conversion feature is valued by comparing the market price of the Enhanced Capital Notes with the market price of similar bonds without the conversion feature. The latter is calculated by discounting the expected Enhanced Capital Note cash flows in the absence of a conversion using prevailing market yields for similar capital securities without the conversion feature. The market price of the Enhanced Capital Notes was calculated with reference to multiple broker quotes. Movements in the fair value of the derivative are recorded in net trading income.

Level 3 derivative assets also include £nil (2011: £14 million) in respect of credit default swaps written on level 3 negative basis asset-backed securities.

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Note 54: Financial instruments (continued)

Movements in Level 3 portfolio

The table below analyses movements in the level 3 financial assets portfolio.

	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Derivative assets £m	Total financial assets £m
At 1 January 2011	2,836	2,646	1,986	7,468
Exchange and other adjustments	(8)	(45)	(8)	(61)
Gains recognised in the income statement	139	78	672	889
Losses recognised in other comprehensive income	–	(148)	–	(148)
Purchases	518	343	–	861
Sales	(747)	(580)	–	(1,327)
Transfers into the level 3 portfolio	331	146	47	524
Transfers out of the level 3 portfolio	(128)	(384)	(48)	(560)
At 31 December 2011	2,941	2,056	2,649	7,646
Exchange and other adjustments	**10**	**(60)**	**12**	**(38)**
Gains (losses) recognised in the income statement	**166**	**(356)**	**(335)**	**(525)**
Losses recognised in other comprehensive income	**–**	**(58)**	**–**	**(58)**
Purchases	**513**	**218**	**45**	**776**
Sales	**(570)**	**(1,358)**	**(13)**	**(1,941)**
Transfers into the level 3 portfolio	**337**	**138**	**–**	**475**
Transfers out of the level 3 portfolio	**(91)**	**(13)**	**–**	**(104)**
At 31 December 2012	**3,306**	**567**	**2,358**	**6,231**
Gains (losses) recognised in the income statement relating to those assets held at 31 December 2012	**85**	**(33)**	**(335)**	**(283)**
Losses recognised in other comprehensive income relating to those assets held at 31 December 2012	**–**	**(24)**	**–**	**(24)**
Gains recognised in the income statement relating to those assets held at 31 December 2011	203	31	178	412
Losses recognised in other comprehensive income relating to those assets held at 31 December 2011	–	(132)	–	(132)

The table below analyses movements in the Level 3 financial liabilities portfolio.

	Derivative liabilities £m	Financial guarantees £m	Total financial liabilities £m
At 1 January 2011	203	54	257
Losses recognised in the income statement	585	5	590
Redemptions	–	(10)	(10)
Transfers into the level 3 portfolio	18	–	18
Transfers out of the level 3 portfolio	(65)	–	(65)
At 31 December 2011	741	49	790
Exchange and other adjustments	**10**	**–**	**10**
Gains recognised in the income statement	**(227)**	**(3)**	**(230)**
Additions	**28**	**2**	**30**
Redemptions	**(25)**	**–**	**(25)**
Transfers into the level 3 portfolio	**16**	**–**	**16**
At 31 December 2012	**543**	**48**	**591**
Gains recognised in the income statement relating to those liabilities held at 31 December 2012	**223**	**3**	**226**
Losses recognised in the income statement relating to those liabilities held at 31 December 2011	(93)	(5)	(98)

Note 54: Financial instruments (continued)

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

Included within the gains (losses) recognised in the income statement are losses of £57 million (2011: gains of £314 million) related to financial instruments that are held in the level 3 portfolio at the year end. These amounts are included in other operating income.

Included within the gains (losses) recognised in other comprehensive income are losses of £24 million (2011: losses of £132 million) related to financial instruments that are held in the level 3 portfolio at the year end.

Sensitivity of level 3 valuations

			At 31 December 2012			At 31 December 2011		
				Effect of reasonably possible alternative assumptions			Effect of reasonably possible alternative assumptions	
	Valuation basis/technique	Main assumptions	Carrying value £m	Favourable changes £m	Unfavourable changes £m	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss								
Asset-backed securities	Lead manager or broker quote/ consensus pricing from market data provider	Use of single pricing source	–	–	–	203	1	(1)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value and earnings multiples, forecast cash flows	**2,081**	**80**	**(59)**	1,823	56	(59)
Unlisted equities and property partnerships in the life funds			**1,225**	–	–	915	–	–
			3,306			2,941		
Available-for-sale financial assets								
Asset-backed securities	Lead manager or broker quote/ consensus pricing from market data provider	Use of single pricing source	**73**	–	–	257	1	(1)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	**494**	**36**	**(11)**	1,799	183	(88)
			567			2,056		
Derivative financial assets								
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves. Equity conversion feature spread	**2,358**	**134**	**(69)**	2,649	134	(20)
Financial assets			**6,231**			7,646		
Derivative financial liabilities								
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**543**	–	–	741	–	–
Financial guarantees			**48**	–	–	49	–	–
Financial liabilities			**591**			790		

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Note 54: Financial instruments (continued)

Asset-backed securities

Reasonably possible alternative valuations have been calculated for asset-backed securities by using alternative pricing sources and calculating an absolute difference. The pricing difference is defined as the absolute difference between the actual price used and the closest, alternative price available.

Derivative financial instruments

(i) In respect of the embedded equity conversion feature of the Enhanced Capital Notes, the sensitivity was based on the absolute difference between the actual price of the Enhanced Capital Note and the closest, alternative broker quote available plus the impact of applying a 10 bps increase/decrease in the market yield used to derive a market price for similar bonds without the conversion feature. The effect of interdependency of the assumptions is not material to the effect of applying reasonably possible alternative assumptions to the valuations of derivative financial instruments.

(ii) In respect of credit default swaps written on level 3 negative basis asset-backed securities, reasonably possible alternative valuations have been calculated by flexing the spread between the underlying asset and the credit default swap, or adjusting market yields, by a reasonable amount. The sensitivity is determined by applying a 60 bps increase/decrease in the spread between the asset and the credit default swap.

Venture capital and equity investments

Third party valuers have been used to determine the value of unlisted equities and property partnerships included in the Group's life insurance funds.

The valuation techniques used for unlisted equities and venture capital investments vary depending on the nature of the investment, as described in the valuation methodology section above. Reasonably possible alternative valuations for these investments have been calculated by reference to the relevant approach taken as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

- for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;
- the discount rates used in discounted cash flow valuations; and
- in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

Derivative valuation adjustments

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

(i) Uncollateralised derivative valuation adjustments, excluding monoline counterparties

The following table summarises the movement on this valuation adjustment account during 2012 and 2011:

	2012 **£m**	2011 £m
At 1 January	**1,226**	570
Income statement (credit) charge	**(209)**	718
Transfers	**(120)**	(62)
At 31 December	**897**	1,226

Represented by:

	2012 **£m**	2011 £m
Credit Valuation Adjustment	**928**	1,425
Debit Valuation Adjustment	**(174)**	(493)
Funding Valuation Adjustment	**143**	294
	897	1,226

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking division.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

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Note 54: Financial instruments (continued)

The CVA is sensitive to:

- the current size of the mark-to-market position on the uncollateralised asset;
- expectations of future market volatility of the underlying asset; and
- expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £154 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. For these, the CVA is calculated on an add-on basis (in total contributing £69 million of the overall CVA balance at 31 December 2012).

The DVA is sensitive to:

- the current size of the mark-to-market position on the uncollateralised liability;
- expectations of future market volatility of the underlying liability; and
- the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £113 million to £287 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £345 million fall in the overall valuation adjustment to £409 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding certain uncollateralised derivative positions where the Group considers that this cost is included in market pricing. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £14 million.

(ii) Uncollateralised derivative valuation adjustments – monoline counterparties

The Group has no significant derivative exposures remaining against monoline counterparties.

(iii) Market liquidity

The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2012, the Group's derivative trading business held mid to bid-offer valuation adjustments of £103 million (2011: £85 million).

(iv) Libor/Overnight Index Swap basis

The Group's derivative trading business applies £74 million (31 December 2011: £74 million) of valuation adjustments against the changing market approach to valuing derivatives that are subject to daily collateral margin, where standard market practice is to pay interest on an Overnight Index Swap basis rather than a Libor rate.

No credit valuation adjustment is taken on collateralised swaps.

Own credit adjustments

The carrying amount of issued notes that are designated under the IAS 39 fair value option is adjusted to reflect the effect of changes in own credit spreads. The resulting gain or loss is recognised in the income statement.

At 31 December 2012, the own credit adjustment arising from the fair valuation of £5,700 million (2011: £5,339 million) of the Group's debt securities in issue designated at fair value through profit or loss resulted in a loss of £437 million (2011: gain of £194 million).

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Note 54: Financial instruments (continued)

(4) Transfers of financial assets

A. Transferred financial assets that continue to be recognised in full

The Group enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets concerned. In all cases, the transferee has the right to sell or repledge the assets concerned .

As set out in note 21, included within loans and receivables are loans securitised under the Group's securitisation programmes. The Group retains all or a majority of the risks and rewards associated with these loans and they are retained on the Group's balance sheet. Assets transferred into the Group's securitisation programmes are not available to be used by the Group during the term of those arrangements.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities lending transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 36). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

At 31 December 2012	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
Repurchase and securities lending transactions		
Trading and other financial assets at fair value through profit or loss	10,612	620
Available-for-sale financial assets	8,967	4,693
Loans and receivables:		
Loans and advances to customers	19,015	6,662
Debt securities classified as loans and receivables	498	346
Securitisation programmes		
Loans and receivables:		
Loans and advances to customers[1]	118,183	28,059[2]

[1] Includes US residential mortgage-backed securities and associated liabilities whose carrying values were £185 million and £221 million respectively; the associated liabilities have recourse only to the securities transferred and, at 31 December 2012, the fair values of the securities and the associated liabilities were £244 million and £311 million respectively, a difference of £67 million.

[2] Excludes securitisation notes held by the Group (£58,732 million).

B. Transferred financial assets derecognised in their entirety with ongoing exposure

The following information by type of ongoing exposure relates to assets and liabilities arising from contractual rights or obligations retained or obtained in connection with financial assets that have been derecognised in their entirety.

	Carrying amount of ongoing exposure in balance sheet			
		At fair value through profit or loss		
At 31 December 2012	Loans and receivables £m	Designated upon initial recognition £m	Fair value of ongoing exposure £m	Maximum exposure to loss £m
Debt securities	119	–	102	119[1]
Fund investments	–	70	70	100[2]
Total	119	70	172	219

[1] Amount represents the carrying amount of the asset.

[2] Amount represents the carrying amount of the asset plus undrawn commitments of £30 million.

Debt securities shown in the table above are notes held in non-controlled securitisation vehicles representing the Group's ongoing involvement in financial assets transferred into those securitisation vehicles in prior years. The debt securities, which benefit from significant credit enhancement, are classified as available-for-sale financial assets and are managed on a similar basis to the Group's other non-traded asset-backed securities.

Fund investments shown in the table above are equity and debt interests in an investment fund representing the Group's ongoing involvement in financial assets transferred into the fund in a prior year. The fund investments were designated at fair value through profit or loss and are managed on a similar basis to the Group's trading assets.

The Group has no obligation or option to repurchase any of the assets transferred.

Amounts recognised in the income statement in 2012

In respect of debt securities shown above, an amount of £2 million was recognised during the year (£5 million cumulatively since derecognition) within net interest income.

In respect of fund investments shown above, an amount of £3 million was recognised during the year (£55 million cumulatively since derecognition) within net trading income.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial risk management

As a bancassurer, financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; liquidity risk; capital risk; and insurance risk. Information about the Group's exposure to each of the above risks and capital can be found on pages 115 to 202. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

Market risk

The Group uses various market risk measures for risk reporting and setting risk appetite limits and triggers. These measures include Value at Risk and Stress Scenarios.

Interest rate risk

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There is a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However, a significant proportion of the Group's lending assets, for example many personal loans and mortgages, bear interest rates which are contractually fixed for periods of up to five years or longer.

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate capital issuances.

At 31 December 2012 the aggregate notional principal of interest rate swaps designated as fair value hedges was £135,516 million (2011: £93,215 million) with a net fair value asset of £4,246 million (2011: asset of £5,484 million) (note 18). The gains on the hedging instruments were £572 million (2011: gains of £1,982 million). The losses on the hedged items attributable to the hedged risk were £560 million (2011: losses of £1,999 million).

In addition the Group has cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. Note 18 shows when the hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2012 was £86,190 million (2011: £152,314 million) with a net fair value asset of £215 million (2011: liability of £358 million) (note 18). In 2012, ineffectiveness recognised in the income statement that arises from cash flow hedges was a gain of £6 million (2011: loss of £13 million).

Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the market and liquidity risk function in London. Associated VaR and the closing, average, maximum and minimum are disclosed on page 171.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using currency borrowings. At 31 December 2012 the aggregate principal of these currency borrowings was £2,489 million (2011: £2,245 million). In 2012, an ineffectiveness loss of £1 million before and after tax (2011: ineffectiveness gain of £23 million before tax and £17 million after tax) was recognised in the income statement arising from net investment hedges.

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Note 55: Financial risk management (continued)

The Group's main overseas operations are in the Americas, Asia, Australasia and Europe. Details of the Group's structural foreign currency exposures, after net investment hedges, are as follows:

Functional currency of Group operations

	2012 £m	2011 £m
Euro:		
Gross exposure	**919**	585
Net investment hedge	**(842)**	(848)
	77	(263)
US dollar:		
Gross exposure	**316**	341
Net investment hedge	**(542)**	(122)
	(226)	219
Swiss franc:		
Gross exposure	**6**	15
Net investment hedge	**(9)**	–
	(3)	15
Australian dollar:		
Gross exposure	**1,104**	1,232
Net investment hedge	**(1,077)**	(1,226)
	27	6
Japanese yen:		
Gross exposure	**19**	20
Net investment hedge	**(19)**	–
	–	20
Other non-sterling	**106**	170
Total structural foreign currency exposures, after net investment hedges	**(19)**	167

Credit risk

The Group's credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom, the European Union, Australia and the United States. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems as inputs and measure the credit risk of loans and advances to customers and banks at a counterparty level using three components: (i) the probability of default by the counterparty on its contractual obligations; (ii) the current exposures to the counterparty and their likely future development, from which the Group derives the exposure at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default.
The Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivative based transactions.

A. Maximum credit exposure

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss, which includes amounts held to cover unit-linked and With Profits funds liabilities, is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial risk management (continued)

	2012 £m	2011 £m
Loans and receivables:		
Loans and advances to banks, net[1]	29,417	32,606
Loans and advances to customers, net[1]	517,225	565,638
Debt securities, net[1]	5,273	12,470
Deposit amounts available for offset[2]	(5,728)	(4,174)
	546,187	606,540
Available-for-sale financial assets (excluding equity shares)	30,846	35,468
Held-to-maturity investments	–	8,098
Trading and other financial assets at fair value through profit or loss (excluding equity shares)[3]:		
Loans and advances	14,551	11,121
Debt securities, treasury and other bills	53,130	52,652
	67,681	63,773
Derivative assets:		
Derivative assets, before offsetting under master netting arrangements	56,550	66,013
Amounts available for offset under master netting arrangements[2]	(38,158)	(46,618)
	18,392	19,395
Assets arising from reinsurance contracts held	2,320	2,534
Financial guarantees	9,520	10,831
Irrevocable loan commitments and other credit-related contingencies[4]	55,629	57,329
Maximum credit risk exposure	730,575	803,968
Maximum credit risk exposure before offset items	774,461	854,760

[1] Amounts shown net of related impairment allowances.

[2] Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

[3] Includes assets within the Group's unit-linked funds for which credit risk is borne by the policyholders and assets within the Group's With-Profits funds for which credit risk is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back related contract liabilities.

[4] See note 53 – Contingent liabilities and commitments for further information.

B. Credit quality of assets

Loans and receivables

The disclosures in the table below and those on pages 321 and 322 are produced under the management basis used for the Group's segmental reporting. The Group believes that, for reporting periods immediately following a significant acquisition such as the acquisition of HBOS in 2009, this management basis, which includes the allowance for loan losses at the acquisition date on a gross basis, more fairly reflects the underlying provisioning status of the loans. The remaining acquisition-related fair value adjustments in respect of this lending are therefore identified separately in this table.

The analysis of lending between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

Note 55: Financial risk management (continued)

Loans and advances

	Loans and advances to banks £m	Loans and advances to customers Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2012						
Neither past due nor impaired	**29,386**	**319,613**	**41,223**	**117,613**	**478,449**	**14,551**
Past due but not impaired	**31**	**12,880**	**922**	**1,527**	**15,329**	**–**
Impaired – no provision required	**–**	**741**	**1,530**	**1,504**	**3,775**	**–**
– provision held	**3**	**7,391**	**2,124**	**33,003**	**42,518**	**–**
Gross	**29,420**	**340,625**	**45,799**	**153,647**	**540,071**	**14,551**
Allowance for impairment losses	**(3)**	**(2,845)**	**(1,326)**	**(17,601)**	**(21,772)**	**–**
Fair value adjustments	**–**				**(1,074)**	**–**
Net balance sheet carrying value	**29,417**				**517,225**	**14,551**
At 31 December 2011						
Neither past due nor impaired	32,494	330,727	41,448	146,655	518,830	11,121
Past due but not impaired	15	12,742	1,093	2,509	16,344	–
Impaired – no provision required	6	1,364	1,604	3,544	6,512	–
– provision held	105	6,701	2,940	44,116	53,757	–
Gross	32,620	351,534	47,085	196,824	595,443	11,121
Allowance for impairment losses	(14)	(2,731)	(1,848)	(23,139)	(27,718)	–
Fair value adjustments	–				(2,087)	–
Net balance sheet carrying value	32,606				565,638	11,121

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2(H). All impaired loans which exceed certain thresholds, principally within the Group's Commercial Banking division, are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances which are individually determined to be impaired with a gross amount before impairment allowances of £34,533 million (31 December 2011: £48,142 million).

The table below sets out the reconciliation of the allowance for impairment losses of £15,250 million (2011: £18,732 million) shown in note 24 to the allowance for impairment losses on a management basis of £21,772 million (2011: £27,718 million) shown above:

	2012 £m	2011 £m
Allowance for impairment losses on loans and advances to customers	**15,250**	18,732
HBOS allowance at 16 January 2009[1]	**11,147**	11,147
HBOS charge covered by fair value adjustments[2]	**11,306**	10,474
Amounts subsequently written off	**(16,383)**	(13,083)
	6,070	8,538
Foreign exchange and other movements	**452**	448
Allowance for impairment losses on loans and advances to customers on a management basis	**21,772**	27,718

[1] Comprises an allowance held at 31 December 2008 of £10,693 million and a charge for the period from 1 January 2009 to 16 January 2009 of £454 million.

[2] This represents the element of the charge on loans and advances to customers in HBOS's results that was included within the Group's fair value adjustments in respect of the acquisition of HBOS on 16 January 2009.

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Note 55: Financial risk management (continued)

Loans and advances which are neither past due nor impaired

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
At 31 December 2012						
Good quality	**28,833**	**313,372**	**30,924**	**60,510**		**14,514**
Satisfactory quality	**174**	**4,532**	**8,579**	**33,477**		**28**
Lower quality	**10**	**552**	**862**	**18,153**		**6**
Below standard, but not impaired	**369**	**1,157**	**858**	**5,473**		**3**
Total loans and advances which are neither past due nor impaired	**29,386**	**319,613**	**41,223**	**117,613**	**478,449**	**14,551**
At 31 December 2011						
Good quality	32,141	323,060	29,123	71,907		11,065
Satisfactory quality	171	5,432	9,747	42,311		45
Lower quality	9	970	1,127	24,676		11
Below standard, but not impaired	173	1,265	1,451	7,761		–
Total loans and advances which are neither past due nor impaired	32,494	330,727	41,448	146,655	518,830	11,121

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models. Further information about the Group's internal probabilities of default rating models can be found on pages 132 and 133.

Loans and advances which are past due but not impaired

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
At 31 December 2012						
0-30 days	**–**	**5,996**	**744**	**860**	**7,600**	**–**
30-60 days	**3**	**2,667**	**138**	**131**	**2,936**	**–**
60-90 days	**2**	**1,750**	**29**	**328**	**2,107**	**–**
90-180 days	**6**	**2,467**	**5**	**56**	**2,528**	**–**
Over 180 days	**20**	**–**	**6**	**152**	**158**	**–**
Total loans and advances which are past due but not impaired	**31**	**12,880**	**922**	**1,527**	**15,329**	**–**
At 31 December 2011						
0-30 days	1	5,989	868	1,163	8,020	–
30-60 days	9	2,618	195	481	3,294	–
60-90 days	4	1,833	25	260	2,118	–
90-180 days	–	2,302	4	159	2,465	–
Over 180 days	1	–	1	446	447	–
Total loans and advances which are past due but not impaired	15	12,742	1,093	2,509	16,344	–

A financial asset is 'past due' if a counterparty has failed to make a payment when contractually due.

Note 55: Financial risk management (continued)

Debt securities classified as loans and receivables

An analysis by credit rating of the Group's debt securities classified as loans and receivables is provided below:

	AAA	AA	A	BBB	Rated BB or lower	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m
At 31 December 2012							
Asset-backed securities:							
Mortgage-backed securities	**637**	**1,109**	**877**	**745**	**368**	**191**	**3,927**
Other asset-backed securities	**541**	**57**	**199**	**107**	**245**	**1**	**1,150**
	1,178	**1,166**	**1,076**	**852**	**613**	**192**	**5,077**
Corporate and other debt securities	**150**	**–**	**–**	**–**	**–**	**252**	**402**
Gross exposure	**1,328**	**1,166**	**1,076**	**852**	**613**	**444**	**5,479**
Allowance for impairment losses							**(206)**
Total debt securities classified as loans and receivables							**5,273**
At 31 December 2011							
Asset-backed securities:							
Mortgage-backed securities	2,008	2,326	1,423	1,024	369	29	7,179
Other asset-backed securities	3,585	430	374	237	403	1	5,030
	5,593	2,756	1,797	1,261	772	30	12,209
Corporate and other debt securities	150	–	67	–	–	320	537
Gross exposure	5,743	2,756	1,864	1,261	772	350	12,746
Allowance for impairment losses							(276)
Total debt securities classified as loans and receivables							12,470

Available-for-sale financial assets (excluding equity shares)

An analysis of the Group's available-for-sale financial assets is included in note 25. The credit quality of the Group's available-for-sale financial assets (excluding equity shares) is set out below:

	AAA	AA	A	BBB	Rated BB or lower	Not rated	Total
	£m	£m	£m	£m	£m	£m	£m
At 31 December 2012							
Debt securities:							
Government securities	**18,227**	**7,328**	**–**	**–**	**–**	**–**	**25,555**
Other public sector securities	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Bank and building society certificates of deposit	**–**	**75**	**71**	**42**	**–**	**–**	**188**
Asset-backed securities:							
Mortgage-backed securities	**976**	**212**	**50**	**120**	**166**	**–**	**1,524**
Other asset-backed securities	**336**	**241**	**116**	**–**	**67**	**–**	**760**
	1,312	**453**	**166**	**120**	**233**	**–**	**2,284**
Corporate and other debt securities	**293**	**281**	**567**	**600**	**85**	**22**	**1,848**
Total debt securities	**19,832**	**8,137**	**804**	**762**	**318**	**22**	**29,875**
Treasury bills and other bills	**866**	**–**	**16**	**89**	**–**	**–**	**971**
Total held as available-for-sale financial assets	**20,698**	**8,137**	**820**	**851**	**318**	**22**	**30,846**
At 31 December 2011							
Debt securities:							
Government securities	19,051	6,179	–	–	–	6	25,236
Other public sector securities	–	–	–	–	–	27	27
Bank and building society certificates of deposit	81	177	71	37	–	–	366
Asset-backed securities:							
Mortgage-backed securities	626	491	398	185	103	–	1,803
Other asset-backed securities	399	299	224	34	90	18	1,064
	1,025	790	622	219	193	18	2,867
Corporate and other debt securities	1,609	856	2,351	341	–	88	5,245
Total debt securities	21,766	8,002	3,044	597	193	139	33,741
Treasury bills and other bills	1,717	–	10	–	–	–	1,727
Total held as available-for-sale financial assets	23,483	8,002	3,054	597	193	139	35,468

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Note 55: Financial risk management (continued)

Held-to-maturity investments

The Group no longer holds any held-to-maturity investments. An analysis of the credit quality of the Group's held-to-maturity investments at 31 December 2011 is provided below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
Government securities	6,319	1,779	–	–	–	–	8,098

Debt securities, treasury and other bills held at fair value through profit or loss

An analysis of the Group's trading and other financial assets at fair value through profit or loss is included in note 17. The credit quality of the Group's debt securities, treasury and other bills held at fair value through profit or loss is set out below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2012							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets:							
Government securities	3,688	277	–	–	–	–	3,965
Bank and building society certificates of deposit	–	2,182	907	77	–	–	3,166
Asset-backed securities:							
Mortgage-backed securities	42	10	78	–	–	–	130
Other asset-backed securities	2	14	4	1	–	–	21
	44	24	82	1	–	–	151
Corporate and other debt securities	385	148	330	278	30	1	1,172
Total debt securities held as trading assets	4,117	2,631	1,319	356	30	1	8,454
Treasury bills and other bills	370	4	–	–	–	–	374
Total held as trading assets	4,487	2,635	1,319	356	30	1	8,828
Other assets held at fair value through profit or loss:							
Government securities	14,557	1,606	220	372	1	10	16,766
Other public sector securities	694	205	131	6	–	20	1,056
Bank and building society certificates of deposit	–	94	134	–	–	–	228
Asset-backed securities:							
Mortgage-backed securities	219	95	264	122	–	8	708
Other asset-backed securities	263	383	732	359	16	49	1,802
	482	478	996	481	16	57	2,510
Corporate and other debt securities	3,107	2,731	7,305	6,633	2,115	1,795	23,686
Total debt securities held at fair value through profit or loss	18,840	5,114	8,786	7,492	2,132	1,882	44,246
Treasury bills and other bills	56	–	–	–	–	–	56
Total other assets held at fair value through profit or loss	18,896	5,114	8,786	7,492	2,132	1,882	44,302
Total held at fair value through profit or loss	23,383	7,749	10,105	7,848	2,162	1,883	53,130

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Note 55: Financial risk management (continued)

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2011							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets:							
Government securities	1,994	6	–	–	–	–	2,000
Bank and building society certificates of deposit	–	1,147	1,574	142	–	–	2,863
Asset-backed securities:							
Mortgage-backed securities	63	34	1	–	1	–	99
Other asset-backed securities	19	151	52	–	–	–	222
	82	185	53	–	1	–	321
Corporate and other debt securities	304	141	312	489	151	179	1,576
Total debt securities held as trading assets	2,380	1,479	1,939	631	152	179	6,760
Treasury bills and other bills	224	75	–	–	–	–	299
Total held as trading assets	2,604	1,554	1,939	631	152	179	7,059
Other assets held at fair value through profit or loss:							
Government securities	17,667	1,027	950	642	644	437	21,367
Other public sector securities	908	170	35	59	11	–	1,183
Bank and building society certificates of deposit	–	330	55	–	–	–	385
Asset-backed securities:							
Mortgage-backed securities	194	45	255	116	–	2	612
Other asset-backed securities	320	198	794	383	53	16	1,764
	514	243	1,049	499	53	18	2,376
Corporate and other debt securities	3,415	2,111	6,197	5,195	1,199	2,165	20,282
Total other assets held at fair value through profit or loss	22,504	3,881	8,286	6,395	1,907	2,620	45,593
Total held at fair value through profit or loss	25,108	5,435	10,225	7,026	2,059	2,799	52,652

Credit risk in respect of trading and other financial assets at fair value through profit or loss held within the Group's unit-linked funds is borne by the policyholders and credit risk in respect of with-profits funds is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back those contract liabilities.

Derivative assets

An analysis of derivative assets is given in note 18. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's maximum credit risk relating to derivative assets of £18,392 million (2011: £19,395 million), cash collateral of £5,429 million (2011: £5,269 million) was held and a further £1,387 million was due from OECD banks (2011: £7,875 million).

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2012							
Trading and other	**226**	**13,507**	**18,130**	**5,046**	**6,439**	**1,631**	**44,979**
Hedging	**–**	**6,038**	**4,596**	**111**	**824**	**2**	**11,571**
Total derivative financial instruments	**226**	**19,545**	**22,726**	**5,157**	**7,263**	**1,633**	**56,550**
At 31 December 2011							
Trading and other	313	25,268	14,474	6,612	3,588	2,908	53,163
Hedging	35	8,718	3,237	786	9	65	12,850
Total derivative financial instruments	348	33,986	17,711	7,398	3,597	2,973	66,013

Assets arising from reinsurance contracts held

Of the assets arising from reinsurance contracts held at 31 December 2012 of £2,320 million (2011: £2,534 million), £764 million (2011: £842 million) were due from insurers with a credit rating of AA or above.

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Note 55: Financial risk management (continued)

Financial guarantees and irrevocable loan commitments

Financial guarantees represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards.

C. Collateral held as security for financial assets

A general description of collateral held as security in respect of financial instruments is provided on pages 134 and 135. The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

Loans and receivables

The disclosures below are produced under the management basis used for the Group's segmental reporting. The Group believes that, for reporting periods immediately following a significant acquisition, such as the acquisition of HBOS in 2009, this management basis, which includes the allowance for loan losses at the acquisition on a gross basis, more fairly reflects the underlying provisioning status of the loans.

The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as loans and receivables.

Loans and advances to banks

The Group may require collateral before entering into a credit commitment with another bank, depending on the type of financial product and the counterparty involved, and netting arrangements are obtained whenever possible and to the extent that such agreements are legally enforceable. Collateral is held as part of reverse repurchase or securities borrowing transactions.

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £662 million (2011: £508 million), against which the Group held collateral with a fair value of £662 million (2011: £511 million), all of which the Group is able to repledge.

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Loans and advances to customers

The Group holds collateral against loans and advances to customers in the form of mortgages over residential and commercial real estate, charges over business assets such as premises, inventory and accounts receivable, charges over financial instruments such as debt securities and equities, and guarantees received from third parties.

Retail lending

Mortgages

An analysis by loan-to-value ratio of the Group's residential mortgage lending is provided below. The value of collateral used in determining the loan-to-value ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations.

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
At 31 December 2012				
Less than 70 per cent	131,277	3,283	1,470	136,030
70 per cent to 80 per cent	61,677	1,962	846	64,485
80 per cent to 90 per cent	52,651	2,314	1,114	56,079
90 per cent to 100 per cent	36,428	2,092	1,133	39,653
Greater than 100 per cent	37,580	3,229	3,569	44,378
Total	319,613	12,880	8,132	340,625

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Note 55: Financial risk management (continued)

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
At 31 December 2011				
Less than 70 per cent	137,224	3,203	1,420	141,847
70 per cent to 80 per cent	60,236	1,894	843	62,973
80 per cent to 90 per cent	53,113	2,250	1,103	56,466
90 per cent to 100 per cent	40,236	2,182	1,196	43,614
Greater than 100 per cent	39,918	3,213	3,503	46,634
Total	330,727	12,742	8,065	351,534

Other

No collateral is held in respect of retail credit cards or overdrafts, or unsecured personal loans. For non-mortgage retail lending to small businesses, collateral will often include second charges over residential property and the assignment of life cover.

The majority of non-mortgage retail lending is unsecured. At 31 December 2012, impaired non-mortgage lending amounted to £2,328 million, net of an impairment allowance of £1,326 million (2011: £2,696 million, net of an impairment allowance of £1,848 million). The fair value of the collateral held in respect of this lending was £48 million (2011: £43 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £42,145 million (2011: £42,541 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are thereafter monitored in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is reassessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

Wholesale lending

Reverse repurchase transactions

There were reverse repurchase agreements which are accounted for as collateralised loans with a carrying value of £5,087 million (2011: £16,835 million), against which the Group held collateral with a fair value of £4,916 million (2011: £16,936 million), all of which the Group is able to repledge. Included in these amounts are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £2 million (2011: £34 million). These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Impaired secured lending

The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt.

At 31 December 2012, impaired secured wholesale lending amounted to £17,257 million, net of an impairment allowance of £15,193 million (2011: £23,913 million, net of an impairment allowance of £20,675 million). The fair value of the collateral held in respect of impaired secured wholesale lending was £9,414 million (2011: £13,977 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured wholesale lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Impaired secured wholesale lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

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Note 55: Financial risk management (continued)

Unimpaired secured lending

Unimpaired secured wholesale lending amounted to £74,485 million (2011: £96,381 million). Wholesale lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination. The types of collateral taken and the frequency with which collateral is required at origination is dependent upon the size and structure of the borrower. For exposures to corporate customers and other large institutions, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a mortgage debenture over the company's undertaking and one or more of its assets, and keyman insurance. The Group maintains policies setting out acceptable collateral, maximum loan-to-value ratios and other criteria to be considered when reviewing a loan application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the customer. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, the provision of collateral will not determine the outcome of a credit application. The fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay debt.

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor. Although lending decisions are predominantly based on expected cash flows, any collateral provided may impact the pricing and other terms of a loan or facility granted; this will have a financial impact on the amount of net interest income recognised and on internal loss-given-default estimates that contribute to the determination of asset quality.

For unimpaired secured wholesale lending, the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

Unimpaired secured wholesale lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for impaired lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured wholesale lending portfolio is provided to key management personnel.

Trading and other financial assets at fair value through profit or loss (excluding equity shares)

In respect of trading and other financial assets at fair value through profit or loss, the fair value of collateral accepted under reverse repurchase transactions which are accounted for as collateralised loans that the Group is permitted by contract or custom to sell or repledge was £19,629 million (2011: £15,765 million). Of this, £15,640 million was sold or repledged (2011: £3,740 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £38,040 million (2011: £10,438 million). Of this amount, £36,549 million (2011: £5,308 million) had been resold or repledged as collateral for the Group's own transactions.

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Derivative assets, after offsetting of amounts under master netting arrangements

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £18,392 million (2011: £19,395 million), cash collateral of £5,429 million (2011: £5,269 million) was held.

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Note 55: Financial risk management (continued)

Irrevocable loan commitments and other credit-related contingencies

At 31 December 2012, the Group held irrevocable loan commitments and other credit-related contingencies of £55,629 million (2011: £57,329 million). Collateral is held as security, in the event that lending is drawn down, on £17,697 million (2011: £13,279 million) of these balances.

Lending decisions in respect of irrevocable loan commitments are based on the obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. For wholesale commitments, it is the Group's practice to request collateral whose value is commensurate with the nature of the commitment. For retail mortgage commitments, the majority are for mortgages with a loan--to-value ratio of less than 100 per cent. Aggregated collateral information covering the entire balance of irrevocable loan commitments over which security will be taken is not provided to key management personnel.

D. Collateral pledged as security

Repo and stock lending transactions

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £48,077 million (2011: £39,679 million). In addition, the following financial assets on the balance sheet have been pledged as collateral as part of securities lending transactions:

Assets pledged

	2012 £m	2011 £m
Trading and other financial assets at fair value through profit or loss	10,000	3,102
Loans and advances to customers	11,603	37,926
Debt securities classified as loans and receivables	154	398
Available-for-sale financial assets	4,251	1,618
	26,008	43,044

In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 21 and 22.

E. Collateral repossessed

	2012 £m	2011 £m
Residential property	936	968
Other	6	13
	942	981

In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

F. Treatment of customers experiencing financial stress

The Group operates a number of schemes to assist borrowers who are experiencing financial stress. The material elements of these schemes are described in the Risk Management report on pages 135 to 137 and further details relating to those cases where the Group has granted a concession, whether temporarily or permanently, are set out below.

Retail customers

Forbearance activities

The Group classifies the treatments offered to retail customers who have experienced financial difficulty into the following categories:

Reduced contractual monthly payment – Capital payment break

These allow customers who are currently on a capital and interest repayment basis to temporarily transfer their loan onto an interest only basis in order to reduce their contractual monthly payment and help them through their period of financial difficulty. During this period, the Group regularly reviews the customer's situation and works with them to try to restore their position and return them to a full capital and interest repayment basis. Prior to allowing the transfer, the Group undertakes a full financial review to confirm the customer's financial difficulty and ability to maintain the revised level of payment. The transfers are initially for six months and are limited to a maximum of two years during the lifetime of the mortgage.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial risk management (continued)

Commensurate with the aim of this activity (i.e. to manage customers through their temporary financial difficulty) during the capital payment break arrears accrue based on the temporary interest only contractual monthly payment. On expiry of the break, the customer is transferred back onto capital and interest repayment terms, with the outstanding balance recovered across the remaining term of the original loan.

Reduced contractual monthly payment – Payment assistance break

These agreements allow customers to suspend monthly payments for a limited period in order to address short-term financial difficulties. This treatment is only available as a forbearance tool to customers who are less than one monthly payment in arrears and for a maximum period of three months during the term of the mortgage.

Arrears do not accrue during the break. The contractual monthly payment is recalculated at the end of the break to take account of missed interest and, if appropriate, capital payments.

Financial distress – Term extension

These allow customers to permanently extend their mortgage term in order to reduce their contractual monthly payment. Term extensions are rarely granted to customers in financial distress as the focus is on minimising the longer term impact on the customer. The maximum term for the extension is aligned to the overall standard term limits for mortgages and, in general, the mortgage must be up to date.

The contractual monthly payment is reset when the term extension is implemented and any subsequent arrears will accrue based on this revised payment.

Financial distress – Arrangement to pay

Customers who are experiencing short-term financial difficulties may reach agreement with the Group to pay an amount differing from their normal contractual monthly payment for a specified period of time. This is agreed with the customer as being affordable and practical based on their individual circumstances. Arrangements to pay less than the contractual monthly payment can be granted for up to three months after which the customer's circumstances will be reviewed.

During the arrangement period, there is no clearing down of arrears such that, unless the customer is paying more than their contractual monthly payment, arrears balances will remain and the loan will continue to be reported as impaired or past due. When customers come to the end of their arrangement period they will continue to be managed as a mainstream collections case, if still in arrears.

Repair – Capitalisation of arrears

Once customers have evidenced recovery from financial difficulty and re-established a strong payment record, this treatment allows the repair of the customer's financial position through the permanent capitalisation of arrears. Customers must demonstrate that they can meet the contractual terms of their loan by making six consecutive contractual monthly payments and must give their permission for the capitalisation. Arrears may not be capitalised more than twice in a five year period.

The contractual monthly payment is reset when the capitalisation is implemented to enable repayment over the original term. Any subsequent arrears will accrue based on this revised payment.

Customers receiving support from UK Government sponsored programmes

The Group participates in a number of UK Government sponsored programmes designed to support households, which are described on page 136. Where these schemes provide borrowers with a state benefit that is used to service the loan, there is no change in the reported status of the loan which is managed and reported in accordance with its original terms.

The Group assesses whether a loan benefitting from a UK Government sponsored programme is impaired using the same accounting policies and practices as it does for loans not benefitting from such a programme. There is no direct impact on the impairment status of a loan benefitting from the Mortgage Rescue schemes, as these schemes involve the purchase, and eventual sale, of the property. The loans included within the Income Support for Mortgage Interest scheme and the Homeowner Mortgage Support scheme may be impaired, in accordance with the normal definition of impairment.

The Income Support for Mortgage Interest scheme remains the most successful of the Government backed schemes. It is the longest-running, is the most widely known and provides both the customer and the Group with an assurance as to the maintenance of at least two years' worth of interest payments. The Group estimates that around £2.6 billion of its mortgage exposures are receiving this benefit. This includes those who are also receiving other treatments for financial difficulty.

The Group's own UK retail secured schemes have also shown signs of success with 86 per cent of customers who have accepted capital payment breaks having maintained or improved their arrears position over the twelve months after transfer. The Group believes that its mortgage payment arrangements continue to be an effective way to manage short-term affordability issues.

Treatments offered to Irish retail secured customers in financial difficulty

While the treatments offered to mortgage customers in financial difficulty in the UK and in Ireland are broadly similar, the current period of economic distress in Ireland and resultant regulatory Code of Conduct on Mortgage Arrears have resulted in an environment of ongoing assistance to customers, with greater flexibility within policy as to the duration and frequency of treatments. Care is taken to keep customers informed of their position and their circumstances are reviewed at least every six months.

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Note 55: Financial risk management (continued)

Forbearance granted

The tables below set out the Group's retail forborne loans at 31 December 2012.

Secured retail

At 31 December 2012, UK and Irish retail secured loans and advances subject to forbearance were 1.8 per cent (2011: 1.9 per cent) of total UK and Irish retail secured loans of £330,485 million (2011: £339,121 million). Further analysis of the forborne loan balances are set out below:

At 31 December	Total loans and advances which are forborne 2012 £m	2011 £m	Total forborne loans and advances which are impaired 2012 £m	2011 £m	Impairment allowance as % of loans and advances which are forborne 2012 %	2011 %
Reduced contractual monthly payment	**2,717**	4,028	**365**	455	**3.8**	2.7
Financial distress[1,2]	**1,340**	729	**403**	192	**11.3**	9.8
Repair[1]	**1,930**	1,772	**63**	65	**8.6**	6.7
Total	**5,987**	6,529	**831**	712	**7.0**	4.6

[1] Where the treatment involves a permanent change to the contractual basis of the customer's account (i.e. capitalisation of arrears and term extensions), those commenced during the year and remaining as customers at the year-end are shown.

[2] The financial distress balance include arrangements to pay where the customer is paying less than the contractual payment and had such arrangements at the year end.

Collective impairment assessment of retail secured loans subject to forbearance

Loans which are forborne are grouped with other assets with similar risk characteristics and assessed collectively for impairment as described below. The loans are not considered as impaired loans unless they meet the Group's definition of an impaired asset.

The Group's approach is to ensure that provisioning models, supported by management judgement, appropriately reflect the underlying loss risk of exposures. The Group uses sophisticated behavioural scoring to assess customers' credit risk. The underlying behavioural scorecards consider many different characteristics of customer behaviour, both static and dynamic, from internal sources and also from credit bureaux data, including characteristics that may identify when a customer has been in arrears on products held with other firms. Hence, these models take a range of potential indicators of customer financial distress into account.

The performance of such models is monitored and challenged on an ongoing basis, in line with the Group's model governance policies. The models are also regularly recalibrated to reflect up to date customer behaviour and market conditions. Specifically, regular detailed analysis of modelled provision outputs is undertaken to demonstrate that the risk of forbearance or other similar activities is recognised, that the outcome period adequately captures the risk and that the underlying risk is appropriately reflected. Where this is not the case, additional provisions are applied to capture the risk.

Unsecured retail

At 31 December 2012, UK retail unsecured loans and advances subject to reduced contractual monthly payment, financial distress and repair treatment were 2.1 per cent (2011: 3.2 per cent) of total UK retail unsecured loans and advances of £22,698 million (2011: £24,764 million). Further analysis of the forborne loan balances are set out below:

At 31 December	Total loans and advances which are forborne 2012 £m	2011 £m	Total forborne loans and advances which are impaired 2012 £m	2011 £m	Impairment allowance as % of loans and advances which are forborne 2012 %	2011 %
Reduced contractual monthly payment	**257**	450	**239**	431	**50.1**	53.9
Financial distress[1,2]	**90**	183	**84**	108	**57.9**	50.3
Repair[1]	**125**	155	**33**	39	**4.2**	4.8
Total	**472**	788	**356**	578	**39.4**	43.4

[1] Where the treatment involves a permanent change to the contractual basis of the customer's account (i.e. capitalisation of arrears and term extensions), those commenced during the year and remaining as customers at the year-end are shown.

[2] The financial distress balance include arrangements to pay where the customer is paying less than the contractual payment and had such arrangements at the year end.

Collective impairment assessment of UK retail unsecured loans and advances subject to forbearance

Credit risk provisioning for the UK retail unsecured portfolio is undertaken on a purely collective basis. The approach used is based on segmented cash flow models, divided into two primary streams for loans judged to be impaired and those that are not. Accounts subject to repayment plans and collections refinance loans are among those considered to be impaired.

For exposures that are judged to be impaired, provisions are determined through modelling the expected cure rates, write-off propensity and cash flows with segments explicitly relating to repayment plans and refinance loans treatments. Payments of less than the monthly contractual amount are reflected in reduced cash flow forecasts when calculating the impairment allowance for these accounts.

The outputs of the models are monitored and challenged on an ongoing basis. The models are run monthly meaning that current market conditions and customer processes are reflected in the output. Where the risks identified are not captured in the underlying models, appropriate additional provisions are made.

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Note 55: Financial risk management (continued)

Asset Finance UK

Asset Finance operates a number of retail portfolios. At 31 December 2012, Asset Finance retail loans and advances subject to forbearance were 9.6 per cent of total Asset Finance retail loans and advances of £4,644 million. Further analysis of the forborne loan balances is set out below:

	Total loans and advances which are forborne £m	Total forborne loans and advances which are impaired £m	Impairment allowance as a % of loans and advances which are forborne %
At 31 December 2012			
Reduced contractual monthly payment	**328**	**301**	**58.0**
Financial distress	**112**	**102**	**24.8**
Repair	**7**	**2**	**1.6**
Total	**447**	**405**	**48.8**

Commercial customers

Forbearance activities

It is Group policy that where forbearance has been granted for a commercial customer it must be managed either within the Group's good book watchlist classifications or within a Business Support Unit. Whilst the Group treats all impaired assets as having been granted some form of forbearance in the past, granting forbearance does not necessarily mean that it is expected that future cash flows will fall, or that the asset is impaired. Depending on circumstances and within robust parameters and controls, the Group believes forbearance can help support the customer in the medium term.

Multiple types of forbearance concessions may occur and each case is treated depending on its own specific circumstances, as the Group's strategy and offer of forbearance is largely dependent on the individual situation. Early identification, control and monitoring are key in order to support the customer and protect the Group.

Following a forbearance event, should the customer show a sustained period of stabilisation on their new terms and conditions or where the forbearance has reversed or cured, it would be expected that the customer would likely be returned to the mainstream good classification, at which point they may no longer be considered forborne. Such a decision can be made only by the independent Risk Division.

The Group notes that forbearance alone is not necessarily an indicator of impairment but is a trigger point for it to review the customer's credit profile.

The Group's forbearance actions for its commercial customers experiencing financial difficulties fall into the following categories:

Amendments – Covenant resets and breach of covenant waivers

These amend a clause in a loan agreement (or similar document) or waive a breach of an existing clause. The identification of a covenant breach will usually occur through the processing of audited or management accounts; contact from the customer during preparation of their compliance certificate; the receipt of customer information from which covenant compliance is calculated; or the receipt of a compliance certificate from a customer or agent.

A customer is not automatically classed as being in financial distress as a result of a covenant breach, but an actual or projected breach will prompt a review of the customer's circumstances and their facilities.

Extensions – Extension of facilities outside of agreed terms

These allow customers to formally extend their facility term in order to reduce their contractual repayments or to improve their liquidity position.

Extensions – Capital repayment holidays

These allow customers who are currently on a capital and interest repayment basis to temporarily transfer their loan onto an interest-only basis in order to reduce their contractual repayments and help them through their period of financial difficulty. During this period, the Group regularly reviews the customer's situation and works with them to try to restore their position and return them to a full capital and interest repayment basis.

Prior to allowing the capital repayment holiday, the Group undertakes a full financial review to confirm the customer's financial difficulty and ability to maintain the revised level of repayment. The aim of this activity is to manage customers through their temporary financial distress, and accordingly, on expiry of the break, the Group will look to transfer the customer back onto capital and interest repayment terms, with the outstanding balance recovered across the remaining term of the original loan.

Forgiveness – Debt for equity swaps

This type of forbearance involves the Group writing off debt, either partially or in whole, in exchange for equity in the company, usually in the form of ordinary shares, warrants, options or other equity instruments. The primary goals of debt for equity swaps are to reduce the debt service (capital and interest) burden on the borrower, to encourage early repayment of outstanding loans to the Group, to protect the value of the residual debt provided, and to benefit from any future growth in value of the borrower. Debt for equity swaps are typically used as a last resort. This type of forbearance will always give rise to an impairment.

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Note 55: Financial risk management (continued)

Forgiveness – Partial debt write off

An agreement to write off part of a contractual financial obligation in order to facilitate survival of a corporate entity on a going concern basis. Partial debt write-offs are typically used as a last resort. This type of forbearance will always give rise to an impairment.

Forbearance granted

The tables below set out the Group's forborne loans and advances to commercial customers at 31 December 2012.

Commercial Banking

At 31 December 2012, Commercial Banking loans and advances to customers subject to forbearance were 22.8 per cent of total Commercial Banking loans of £144,770 million. Forborne loans managed in the Good Book were 1.6 per cent of total loans and advances. Further analysis of the forborne loan balances is set out below:

	Total loans and advances which are forborne £m	Total forborne loans and advances which are impaired £m	Impairment allowance as a % of loans and advances which are forborne %
At 31 December 2012			
Impaired	23,965	23,965	41.7
Unimpaired – Business Support Unit	6,734	–	–
Unimpaired – Good Book	2,293	–	–
Total forborne	32,992	23,965	30.3

Whilst the material portfolios have been reviewed for forbearance, some portfolios within Commercial Banking have not been reviewed on the basis that the level is relatively immaterial or because the concept of forbearance is not relevant.

All impaired assets are considered forborne. In Business Support, £6,734 million of its unimpaired assets are also considered forborne as a result of proactive management of cases to help customers in financial difficulties. Risk is re-assessed on a regular basis and impairments marked as necessary.

Ireland wholesale

At 31 December 2012, all loans and advances in Ireland wholesale (whether impaired or unimpaired) are treated as forborne and all assets are managed in a Business Support Unit. Further analysis of these forborne loans are set out below:

	Total loans and advances which are forborne £m	Total forborne loans and advances which are impaired £m	Impairment allowance as a % of loans and advances which are forborne %
At 31 December 2012			
Impaired	10,967	10,967	68.0
Unimpaired – Business Support Unit	1,908	–	–
Unimpaired – Good Book	–	–	–
Total	12,875	10,967	58.0

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Note 55: Financial risk management (continued)

G. Credit market exposures

The Group's credit market exposures primarily relate to asset-backed securities exposures held in the Commercial Banking division and at the Group's centre. An analysis of the carrying value of these exposures, which are classified as loans and receivables (note 23), available-for-sale financial assets (note 25) or trading and other financial assets at fair value through profit or loss (note 17) depending on the nature of the investment, is set out below.

	Loans and receivables £m	Available-for-sale £m	Trading £m	Net exposure at 31 December 2012 £m	Net exposure at 31 December 2011 £m
Mortgage-backed securities:					
US residential	3,312	–	–	3,312	4,063
Non-US residential	286	1,411	130	1,827	3,125
Commercial	253	113	–	366	1,788
	3,851	1,524	130	5,505	8,976
Collateralised debt obligations:					
Collateralised loan obligations	272	23	–	295	1,162
Other	–	–	–	–	264
	272	23	–	295	1,426
Federal family education loan programme student loans	119	135	–	254	3,526
Personal sector	368	11	–	379	511
Other asset-backed securities	392	591	21	1,004	656
Total uncovered asset-backed securities	5,002	2,284	151	7,437	15,095
Negative basis[1]	–	–	–	–	186
Total	5,002	2,284	151	7,437	15,281
Direct	3,674	1,745	151	5,570	10,705
Conduits (note 22)	1,328	539	–	1,867	4,576
Total	5,002	2,284	151	7,437	15,281

[1] Negative basis means bonds held with separate matching credit default swap protection.

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Note 55: Financial risk management (continued)

An analysis of these asset-backed securities by credit rating is provided below.

	Net Exposure £m	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Below B £m
Mortgage-backed securities:								
US residential mortgage-backed securities:								
Prime	645	124	207	129	123	39	16	7
Alt-A	2,667	513	856	533	508	162	65	30
Sub-prime	–	–	–	–	–	–	–	–
	3,312	637	1,063	662	631	201	81	37
Non-US residential mortgage-backed securities	1,827	981	286	102	196	262	–	–
Commercial mortgage-backed securities	366	23	–	241	87	15	–	–
	5,505	1,641	1,349	1,005	914	478	81	37
Collateralised loan obligations	295	56	80	114	–	16	29	–
Federal family education loan programme student loans	254	151	84	19	–	–	–	–
Personal sector	379	369	8	–	–	1	1	–
Other asset-backed securities	1,004	375	70	191	107	148	113	–
Total at 31 December 2012	7,437	2,592	1,591	1,329	1,021	643	224	37
Total at 31 December 2011	15,281	6,974	3,643	2,320	1,529	770	16	29

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial risk management (continued)

Liquidity risk

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses assets and liabilities of the Group into relevant maturity groupings based on the remaining contractual period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

Maturities of assets and liabilities

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2012						
Assets						
Cash and balances at central banks	80,035	259	4	–	–	80,298
Trading and other financial assets at fair value through profit or loss	7,949	9,813	5,479	7,116	123,633	153,990
Derivative financial instruments	2,450	938	2,744	17,743	32,675	56,550
Loans and advances to banks	14,827	6,513	3,674	3,728	675	29,417
Loans and advances to customers	44,781	8,718	31,052	91,821	340,853	517,225
Debt securities held as loans and receivables	153	–	22	439	4,659	5,273
Available-for-sale financial assets	565	130	764	4,409	25,506	31,374
Other assets	5,394	463	2,057	519	41,992	50,425
Total assets	156,154	26,834	45,796	125,775	569,993	924,552
Liabilities						
Deposits from banks	14,131	3,212	11,296	8,435	1,331	38,405
Customer deposits	322,788	14,159	37,857	50,589	1,519	426,912
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	12,818	5,556	12,843	20,164	33,256	84,637
Debt securities in issue	13,912	10,505	12,167	46,374	34,411	117,369
Liabilities arising from insurance and investment contracts	27,230	1,469	5,270	20,676	82,947	137,592
Other liabilities	10,171	298	1,571	1,363	27,458	40,861
Subordinated liabilities	402	1,541	294	8,298	23,557	34,092
Total liabilities	401,452	36,740	81,298	155,899	204,479	879,868
At 31 December 2011						
Assets						
Cash and balances at central banks	60,420	296	6	–	–	60,722
Trading and other financial assets at fair value through profit or loss	10,508	6,791	2,919	7,968	111,324	139,510
Derivative financial instruments	2,327	1,719	3,699	20,498	37,770	66,013
Loans and advances to banks	22,976	3,261	2,241	3,671	457	32,606
Loans and advances to customers	68,983	10,146	31,056	105,808	349,645	565,638
Debt securities held as loans and receivables	98	–	8	689	11,675	12,470
Available-for-sale financial assets	1,389	1,247	712	6,348	27,710	37,406
Held-to-maturity investments	–	–	–	340	7,758	8,098
Other assets	5,273	532	841	448	40,989	48,083
Total assets	171,974	23,992	41,482	145,770	587,328	970,546
Liabilities						
Deposits from banks	19,284	3,680	4,459	11,315	1,072	39,810
Customer deposits	324,702	15,995	33,518	38,067	1,624	413,906
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	10,612	4,838	6,729	21,407	39,581	83,167
Debt securities in issue	31,285	22,158	29,137	55,350	47,129	185,059
Liabilities arising from insurance and investment contracts	11,723	1,786	5,568	19,971	89,879	128,927
Other liabilities	14,951	407	963	3,406	18,267	37,994
Subordinated liabilities	157	149	1,006	7,581	26,196	35,089
Total liabilities	412,714	49,013	81,380	157,097	223,748	923,952

Note 55: Financial risk management (continued)

The above tables are provided on a contractual basis. The Group's assets and liabilities may be repaid or otherwise mature earlier or later than implied by their contractual terms and readers are, therefore, advised to use caution when using this data to evaluate the Group's liquidity position. In particular, amounts in respect of customer deposits are often contractually payable on demand or at short notice. However, in practice, these deposits are not usually withdrawn on their contractual maturity.

The table below analyses financial instrument liabilities of the Group, excluding those arising from insurance and participating investment contracts, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2012						
Deposits from banks	**13,858**	**3,556**	**11,187**	**8,566**	**1,382**	**38,549**
Customer deposits	**323,925**	**14,928**	**39,298**	**51,043**	**1,579**	**430,773**
Trading and other financial liabilities at fair value through profit or loss	**11,622**	**4,720**	**10,454**	**6,931**	**3,764**	**37,491**
Debt securities in issue	**14,186**	**10,890**	**16,223**	**63,851**	**27,451**	**132,601**
Liabilities arising from non-participating investment contracts	**27,205**	**–**	**–**	**–**	**27,167**	**54,372**
Subordinated liabilities	**61**	**1,768**	**1,705**	**15,903**	**30,032**	**49,469**
Total non-derivative financial liabilities	**390,857**	**35,862**	**78,867**	**146,294**	**91,375**	**743,255**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**2,331**	**3,243**	**7,097**	**51,424**	**33,678**	**97,773**
Gross settled derivatives – inflows	**(2,026)**	**(2,790)**	**(6,853)**	**(50,384)**	**(32,145)**	**(94,198)**
Gross settled derivatives – net flows	**305**	**453**	**244**	**1,040**	**1,533**	**3,575**
Net settled derivatives liabilities	**39,146**	**212**	**1,052**	**3,132**	**1,233**	**44,775**
Total derivative financial liabilities	**39,451**	**665**	**1,296**	**4,172**	**2,766**	**48,350**
At 31 December 2011						
Deposits from banks	19,504	4,368	5,517	10,469	1,292	41,150
Customer deposits	322,752	16,253	33,558	41,398	1,816	415,777
Trading and other financial liabilities at fair value through profit or loss	10,284	2,336	3,516	6,491	3,602	26,229
Debt securities in issue	34,801	27,173	26,040	74,735	32,855	195,604
Liabilities arising from non-participating investment contracts	27,429	–	–	–	22,207	49,636
Subordinated liabilities	284	392	3,538	17,296	33,604	55,114
Total non-derivative financial liabilities	415,054	50,522	72,169	150,389	95,376	783,510
Derivative financial liabilities:						
Gross settled derivatives – outflows	3,723	5,842	9,153	38,360	25,495	82,573
Gross settled derivatives – inflows	(2,435)	(3,840)	(8,281)	(37,414)	(22,574)	(74,544)
Gross settled derivatives – net flows	1,288	2,002	872	946	2,921	8,029
Net settled derivatives liabilities	50,577	539	1,071	2,684	863	55,734
Total derivative financial liabilities	51,865	2,541	1,943	3,630	3,784	63,763

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £9,520 million at 31 December 2012 (2011: £10,831 million) with £4,865 million expiring within one year; £1,302 million between one and three years; £1,729 million between three and five years; and £1,624 million over five years (2011: £4,989 million expiring within one year; £2,008 million between one and three years; £2,198 million between three and five years; and £1,636 million over five years).

The majority of the Group's non-participating investment contract liabilities are unit-linked. These unit-linked products are invested in accordance with unit fund mandates. Clauses are included in policyholder contracts to permit the deferral of sales, where necessary, so that linked assets can be realised without being a forced seller.

The principal amount for undated subordinated liabilities with no redemption option is included within the over five years column; interest of approximately £79 million (2011: £187 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

Further information on the Group's liquidity exposures is provided on pages 177 to 184.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial risk management (continued)

Liabilities arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2012	**989**	**1,451**	**5,198**	**20,426**	**54,889**	**82,953**
At 31 December 2011	748	1,724	5,257	18,132	53,130	78,991

For insurance and participating investment contracts which are neither unit-linked nor in the Group's with-profit funds, in particular annuity liabilities, the aim is to invest in assets such that the cash flows on investments match those on the projected future liabilities.

The following tables set out the amounts and residual maturities of the Group's off balance sheet contingent liabilities and commitments.

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2012					
Acceptances and endorsements	**73**	**–**	**33**	**1**	**107**
Other contingent liabilities	**1,236**	**662**	**144**	**747**	**2,789**
Total contingent liabilities	**1,309**	**662**	**177**	**748**	**2,896**
Lending commitments	**65,739**	**14,493**	**17,486**	**3,676**	**101,394**
Other commitments	**557**	**–**	**–**	**–**	**557**
Total commitments	**66,296**	**14,493**	**17,486**	**3,676**	**101,951**
Total contingents and commitments	**67,605**	**15,155**	**17,663**	**4,424**	**104,847**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2011					
Acceptances and endorsements	81	–	–	–	81
Other contingent liabilities	1,514	1,092	426	757	3,789
Total contingent liabilities	1,595	1,092	426	757	3,870
Lending commitments	71,216	13,999	17,380	2,287	104,882
Other commitments	701	–	–	–	701
Total commitments	71,917	13,999	17,380	2,287	105,583
Total contingents and commitments	73,512	15,091	17,806	3,044	109,453

Capital risk

Capital risk is defined as the risk of the Group having a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Capital risk appetite is set by the Board and reported through various metrics that enable the Group to manage capital constraints and market expectations. The Group Chief Executive, assisted by the Group Asset and Liability Committee, regularly reviews performance against risk appetite. A key metric is the Group's core tier 1 capital ratio which the Group currently aims to maintain prudently in excess of 10 per cent.

The Group maintains its own buffer to ensure that the regulatory minimum requirements and regulatory targets and buffers are met at all times.

Additionally an extensive series of stress analyses is undertaken during the year to determine the adequacy of the Group's capital resources against the FSA minimum requirements in severe economic conditions.

Insurance risk

Insurance risk is the risk of reductions in earnings, capital and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/underwritten events and to fluctuations in the timing and amount of claim settlements. This includes fluctuations in profits due to customer behaviour.

The Group's appetite for solvency and earnings in insurance entities is reviewed and approved annually by the Board. Insurance risks are measured using a variety of techniques including stress and scenario testing, and, where appropriate, stochastic modelling. Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations, as well as evaluating the effectiveness of controls put in place to manage insurance risk.

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Note 56: Consolidated cash flow statement

(A) Change in operating assets

	2012 £m	2011 £m	2010 £m
Change in loans and receivables	**53,842**	39,361	40,101
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**(2,003)**	5,867	(7,378)
Change in other operating assets	**(3,506)**	(1,131)	(863)
Change in operating assets	**48,333**	44,097	31,860

(B) Change in operating liabilities

	2012 £m	2011 £m	2010 £m
Change in deposits from banks	**(1,325)**	(10,480)	(32,162)
Change in customer deposits	**13,392**	20,283	(13,249)
Change in debt securities in issue	**(66,947)**	(43,893)	(5,655)
Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss	**1,521**	14,249	160
Change in investment contract liabilities	**7,421**	793	8,161
Change in other operating liabilities	**(743)**	(139)	(2,938)
Change in operating liabilities	**(46,681)**	(19,187)	(45,683)

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Note 56: Consolidated cash flow statement (continued)

(C) Non-cash and other items

	2012 £m	2011 £m	2010 £m
Depreciation and amortisation	**2,126**	2,175	2,432
Impairment of tangible fixed assets	**–**	65	202
Revaluation of investment properties	**264**	107	(434)
Allowance for loan losses	**5,121**	8,069	10,771
Write-off of allowance for loan losses	**(7,922)**	(7,405)	(6,909)
Impairment of available-for-sale financial assets	**37**	80	106
Change in insurance contract liabilities	**3,929**	(2,081)	4,021
Customer goodwill payments provision	**–**	–	500
Payment protection insurance provision	**3,575**	3,200	–
German insurance business litigation provision	**150**	175	–
Other provision movements	**379**	(294)	49
Net charge (credit) in respect of defined benefit schemes	**68**	199	(455)
Impact of consolidation and deconsolidation of OEICs[1]	**(829)**	(6,094)	(878)
Unwind of discount on impairment allowances	**(374)**	(226)	(403)
Foreign exchange impact on balance sheet[2]	**(219)**	302	(1,159)
Liability management gains within other income[3]	**(59)**	(599)	(423)
Interest expense on subordinated liabilities	**2,783**	2,155	3,619
Loss on disposal of businesses	**7**	21	314
Other non-cash items	**(3,032)**	1,186	472
Total non-cash items	**6,004**	1,035	11,825
Contributions to defined benefit schemes	**(675)**	(838)	(653)
Payments in respect of customer goodwill payments provision	**–**	(497)	–
Payments in respect of payment protection insurance provision	**(3,299)**	(1,045)	–
Other	**15**	6	1
Total other items	**(3,959)**	(2,374)	(652)
Non-cash and other items	**2,045**	(1,339)	11,173

[1] These OEICs (Open-ended investment companies) are mutual funds which are consolidated if the Group manages the funds and also has a majority beneficial interest. The population of OEICs to be consolidated varies at each reporting date as external investors acquire and divest holdings in the various funds. The consolidation of these funds is effected by the inclusion of the fund investments and a matching liability to the unitholders; and changes in funds consolidated represent a non-cash movement on the balance sheet.

[2] When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

[3] A number of capital transactions entered into by the Group in 2010, 2011 and 2012 involved the exchange of existing securities for new issues and as a result there was no related cash flow.

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Note 56: Consolidated cash flow statement (continued)

(D) Analysis of cash and cash equivalents as shown in the balance sheet

	2012 £m	2011 £m	2010 £m
Cash and balances at central banks	**80,298**	60,722	38,115
Less: mandatory reserve deposits[1]	**(580)**	(1,070)	(1,089)
	79,718	59,652	37,026
Loans and advances to banks	**29,417**	32,606	30,272
Less: amounts with a maturity of three months or more	**(8,077)**	(6,369)	(4,998)
	21,340	26,237	25,274
Total cash and cash equivalents	**101,058**	85,889	62,300

[1] Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

Included within cash and cash equivalents at 31 December 2012 is £17,889 million (2011: £21,601 million; 2010: £14,694 million) held within the Group's life funds, which is not immediately available for use in the business.

(E) Acquisition of group undertakings and businesses

	2012 £m	2011 £m	2010 £m
Net cash outflow arising from acquisitions of and additional investment in joint ventures in the year	**(11)**	(10)	(65)
Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000	**–**	(3)	(8)
Net cash outflow	**(11)**	(13)	(73)

(F) Disposal and closure of group undertakings and businesses

	2012 £m	2011 £m	2010 £m
Loans and advances to customers	**15**	–	–
Other net assets and liabilities	**29**	319	742
	44	319	742
Loss on sale of businesses	**(7)**	(21)	(314)
Net cash inflow from disposals	**37**	298	428

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Note 57: Future accounting developments

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2012 and have not been applied in preparing these financial statements. Save as disclosed, the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
Amendments to IAS 1 *Presentation of Financial Statements – 'Presentation of Items of Other Comprehensive Income'*	Requires entities to group items presented in other comprehensive income on the basis of whether they are potentially reclassified to profit or loss subsequently.	Annual periods beginning on or after 1 July 2012.
Amendments to IFRS 7 *Financial Instruments: Disclosures – 'Disclosures-Offsetting Financial Assets and Financial Liabilities'*	Requires an entity to disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's balance sheet.	Annual and interim periods beginning on or after 1 January 2013.
IFRS 10 *Consolidated Financial Statements*	Supersedes IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities* and establishes the principles for when the Group controls another entity and therefore is required to consolidate the other entity in the Group's financial statements. The implementation of IFRS 10 will result in the Group consolidating certain entities that were previously not consolidated, and deconsolidating certain entities which were previously consolidated. The effect of applying IFRS 10 in 2012 would have been to recognise an increase in total assets and total liabilities at 31 December 2012 of approximately £8.3 billion resulting in no change to shareholders' equity. There would have been no impact on the result for the year to 31 December 2012.	Annual periods beginning on or after 1 January 2013.
IFRS 12 *Disclosure of Interests in Other Entities*	Requires an entity to disclose information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.	Annual periods beginning on or after 1 January 2013.
IFRS 13 *Fair Value Measurement*	Defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements. It applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements.	Annual and interim periods beginning on or after 1 January 2013.
Amendments to IAS 19 *Employee Benefits*	Prescribes the accounting and disclosure by employers for employee benefits. The main change is that actuarial gains and losses (remeasurements) in respect of defined benefit pension schemes are no longer permitted to be deferred using the corridor approach and must be recognised immediately in other comprehensive income. In addition, revised IAS 19 also replaces interest cost and expected return on plan assets with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset). Had the Group adopted these changes in 2012, the loss for the year to 31 December 2012 would have been approximately £40 million higher and other comprehensive income net of tax some £1.6 billion lower. As at 31 December 2012, unrecognised actuarial losses of some £2.7 billion and deferred tax assets of £0.6 billion would have been recognised and shareholders' equity would have been £2.1 billion lower.	Annual periods beginning on or after 1 January 2013.
Amendments to IAS 32 *Financial Instruments: Presentation – 'Offsetting Financial Assets and Financial Liabilities'*	Inserts application guidance to address inconsistencies identified in applying the offsetting criteria used in the standard. Some gross settlement systems may qualify for offsetting where they exhibit certain characteristics akin to net settlement.	Annual periods beginning on or after 1 January 2014.

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Note 57: Future accounting developments (continued)

Pronouncement	Nature of change	IASB effective date
IFRS 9 *Financial Instruments*[1,2]	Replaces those parts of IAS 39 *Financial Instruments: Recognition and Measurement* relating to the classification, measurement and derecognition of financial assets and liabilities. IFRS 9 requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments and eliminates the available-for-sale financial asset and held-to-maturity investment categories in IAS 39. The requirements for derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities except for those designated at fair value through profit or loss whereby that part of the fair value change attributable to an entity's own credit risk is recorded in other comprehensive income.	Annual periods beginning on or after 1 January 2015.

[1] As at 1 March 2013, this pronouncement is awaiting EU endorsement.

[2] IFRS 9 is the initial stage of the project to replace IAS 39. Future stages are expected to result in amendments to IFRS 9 to deal with changes to the impairment of financial assets measured at amortised cost and hedge accounting, as well as a reconsideration of classification and measurement. Until all stages of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39.

Note 58: Approval of financial statements

The consolidated financial statements were approved by the Directors of Lloyds Banking Group plc on 1 March 2013.

REPORT OF THE INDEPENDENT AUDITORS ON THE PARENT COMPANY FINANCIAL STATEMENTS

Independent auditors' report to the members of Lloyds Banking Group plc

We have audited the parent company financial statements of Lloyds Banking Group plc for the year ended 31 December 2012 which comprise the parent company balance sheet, the parent company statement of changes in equity, the parent company cash flow statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of directors' responsibilities on page 84, the directors are responsible for the preparation of the parent company financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the parent company financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the parent company financial statements:

- give a true and fair view of the state of the Company's affairs at 31 December 2012 and of its cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report for the financial year for which the parent company financial statements are prepared is consistent with the parent company financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Other matter

We have reported separately on the group financial statements of Lloyds Banking Group plc for the year ended 31 December 2012.

Philip Rivett
Senior Statutory Auditor
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
1 March 2013

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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PARENT COMPANY BALANCE SHEET

at 31 December

	Note	2012 £ million	2011 £ million
Assets			
Non-current assets:			
Investment in subsidiaries	9	**40,534**	40,534
Loans to subsidiaries	9	**8,123**	8,286
Deferred tax asset	2	**9**	8
		48,666	48,828
Current assets:			
Derivative financial instruments		**1,693**	1,660
Other assets		**974**	880
Amounts due from subsidiaries	3	**147**	212
Cash and cash equivalents		**2,231**	1,105
		5,045	3,857
Total assets		**53,711**	52,685
Equity and liabilities			
Capital and reserves:			
Share capital	4	**7,042**	6,881
Share premium account	4	**16,872**	16,541
Merger reserve	5	**7,764**	7,764
Capital redemption reserve	5	**4,115**	4,115
Retained profits	6	**2,017**	2,198
Total equity		**37,810**	37,499
Non-current liabilities:			
Debt securities in issue	8	**545**	555
Subordinated liabilities	7	**4,349**	4,308
		4,894	4,863
Current liabilities:			
Current tax liabilities		**266**	10
Other liabilities		**10,741**	10,313
		11,007	10,323
Total liabilities		**15,901**	15,186
Total equity and liabilities		**53,711**	52,685

The accompanying notes are an integral part of the parent company financial statements.

The directors approved the parent company financial statements on 1 March 2013.

Sir Winfried Bischoff
Chairman

António Horta-Osório
Group Chief Executive

George Culmer
Group Finance Director

PARENT COMPANY STATEMENT OF CHANGES IN EQUITY

	Share capital and premium £ million	Merger reserve £ million	Capital redemption reserve £ million	Retained profits[1] £ million	Total £ million
Balance at 1 January 2010	24,944	7,778	26	2,547	35,295
Total comprehensive income[1]	–	–	–	(799)	(799)
Issue of ordinary shares	2,237	–	–	–	2,237
Cancellation of deferred shares	(4,086)	–	4,086	–	–
Redemption of preference shares	11	(14)	3	–	–
Movement in treasury shares	–	–	–	(10)	(10)
Value of employee services:					
Share option schemes	–	–	–	129	129
Other employee award schemes	–	–	–	409	409
Balance at 31 December 2010	23,106	7,764	4,115	2,276	37,261
Total comprehensive income[1]	–	–	–	(168)	(168)
Issue of ordinary shares	316	–	–	–	316
Movement in treasury shares	–	–	–	(291)	(291)
Value of employee services:					
Share option schemes	–	–	–	143	143
Other employee award schemes	–	–	–	238	238
Balance at 31 December 2011	23,422	7,764	4,115	2,198	37,499
Total comprehensive income[1]	**–**	**–**	**–**	**(224)**	**(224)**
Issue of ordinary shares	**492**	**–**	**–**	**–**	**492**
Movement in treasury shares	**–**	**–**	**–**	**(282)**	**(282)**
Value of employee services:					
Share option schemes	**–**	**–**	**–**	**69**	**69**
Other employee award schemes	**–**	**–**	**–**	**256**	**256**
Balance at 31 December 2012	**23,914**	**7,764**	**4,115**	**2,017**	**37,810**

[1] Total comprehensive income comprises only the profit (loss) for the year; no statement of comprehensive income has been shown for the parent company, as permitted by section 408 of the Companies Act 2006.

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PARENT COMPANY CASH FLOW STATEMENT

for the year ended 31 December

	2012 £ million	2011 £ million	2010 £ million
Loss before tax	**(259)**	(202)	(961)
Fair value and exchange adjustments	**245**	329	198
Change in other assets	**14**	255	1,021
Change in other liabilities and other items	**750**	2,576	(2,466)
Tax received (paid)	**290**	151	122
Net cash provided by (used in) operating activities	**1,040**	3,109	(2,086)
Cash flows from investing activities			
Capital injection into Lloyds TSB Bank plc	**–**	(2,340)	–
Amounts advanced to subsidiaries	**–**	–	(1,425)
Redemption of loans to subsidiaries	**209**	–	850
Net cash used in investing activities	**209**	(2,340)	(575)
Cash flows from financing activities			
Interest paid on subordinated liabilities	**(293)**	(39)	–
Proceeds from issue of debt securities	**–**	–	549
Repayment of debt securities in issue	**–**	–	(350)
Proceeds from issue of ordinary shares	**170**	–	–
Net cash (used in) provided by financing activities	**(123)**	(39)	199
Change in cash and cash equivalents	**1,126**	730	(2,462)
Cash and cash equivalents at beginning of year	**1,105**	375	2,837
Cash and cash equivalents at end of year	**2,231**	1,105	375

The accompanying notes are an integral part of the parent company financial statements.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 1: Accounting policies

The Company has applied International Financial Reporting Standards as adopted by the European Union in its financial statements for the year ended 31 December 2012. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Company has not taken advantage of this relaxation, and therefore there is no difference in application to the Company between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of all derivative contracts.

The accounting policies of the Company are the same as those of the Group which are set out in note 2 to the consolidated financial statements, except that it has no policy in respect of consolidation and investments in subsidiaries are carried at historical cost, less any provisions for impairment.

Note 2: Deferred tax asset

The movement in the net deferred tax asset is as follows:

	2012 **£m**	2011 £m
At 1 January	**8**	6
Income statement credit	**1**	2
At 31 December	**9**	8

The deferred tax asset relates to temporary differences.

Note 3: Amounts due from subsidiaries

These comprise short-term lending to subsidiaries, repayable on demand. The fair values of amounts owed by subsidiaries are equal to their carrying amounts. No provisions have been recognised in respect of amounts owed by subsidiaries.

Note 4: Share capital and share premium

Details of the Company's share capital and share premium account are as set out in notes 46 and 47 to the consolidated financial statements.

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Note 5: Other reserves

The merger reserve comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

Movements in other reserves were as follows:

	2012 £m	2011 £m	2010 £m
Merger reserve			
At 1 January	7,764	7,764	7,778
Redemption of preference shares[1]	–	–	(14)
At 31 December	**7,764**	7,764	7,764

	2012 £m	2011 £m	2010 £m
Capital redemption reserve			
At 1 January	4,115	4,115	26
Redemption of preference shares[1]	–	–	3
Cancellation of deferred shares	–	–	4,086
At 31 December	**4,115**	4,115	4,115

[1] In January 2010, the Company repurchased and cancelled certain preference shares amounting to £14 million. This resulted in a transfer of £3 million from the merger reserve to the capital redemption reserve and a transfer of £11 million from the merger reserve to the share premium account. Details of the preference shares redeemed are set out in note 46 to the consolidated financial statements.

Note 6: Retained profits

	£m
At 1 January 2010	2,547
Loss for the year	(799)
Movement in treasury shares	(10)
Value of employee services:	
Share option schemes	129
Other employee award schemes	409
At 31 December 2010	2,276
Loss for the year	(168)
Movement in treasury shares	(291)
Value of employee services:	
Share option schemes	143
Other employee award schemes	238
At 31 December 2011	2,198
Loss for the year	(224)
Movement in treasury shares	(282)
Value of employee services:	
Share option schemes	69
Other employee award schemes	256
At 31 December 2012	**2,017**

Details of the Company's dividends are as set out in note 50 to the consolidated financial statements.

Note 7: Subordinated liabilities

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer. Any repayments of subordinated liabilities require the consent of the Financial Services Authority.

	Note	2012 £m	2011 £m
Preference shares			
6% Non-Cumulative Redeemable Preference Shares	a	–	–
7.875% Non-Cumulative Preference Shares callable 2013 (US$1,250 million)	a	204	170
7.875% Non-Cumulative Preference Shares callable 2013 (€500 million)	a	105	83
6.0884% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2015 (£745 million)	a	10	10
5.92% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2015 (US$750 million)	a	119	124
6.267% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million)	a	284	306
6.3673% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2019 (£335 million)	a	2	2
6.475% Non-Cumulative Preference Shares callable 2024 (£186 million)	a	39	38
6.413% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2035 (US$750 million)	a	107	114
6.657% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2037 (US$750 million)	a	125	131
9.25% Non-Cumulative Irredeemable Preference Shares (£300 million)	a	266	266
9.75% Non-Cumulative Irredeemable Preference Shares (£100 million)	a	54	54
Total preference shares		**1,315**	1,298
Undated subordinated liabilities			
6.0884% Undated Subordinated Notes callable 2015 (£732 million)		668	642
6.369% Undated Subordinated Notes callable 2015 (£597 million)		551	533
5.92% Undated Subordinated Notes callable 2015 (US$378 million)		200	188
6.267% Undated Subordinated Notes callable 2016 (US$466 million)		237	227
6.3673% Undated Subordinated Notes callable 2019 (£331 million)		296	291
6.475% Undated Subordinated Notes callable 2024 (£102 million)		88	87
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	b	10	11
6.413% Undated Subordinated Notes callable 2035 (US$375 million)		172	171
6.657% Undated Subordinated Notes callable 2037 (US$316 million)		143	143
Total undated subordinated liabilities		**2,365**	2,293
Dated subordinated liabilities			
5.875% Subordinated Guaranteed Bonds 2014 (€750 million)		669	717
Total dated subordinated liabilities		**669**	717
Total subordinated liabilities		**4,349**	4,308

a Further information regarding these issues can be found in note 45 to the consolidated financial statements.

b In certain circumstances, these bonds would acquire the characteristics of preference share capital. They are accounted for as liabilities as coupon payments are mandatory as a consequence of the terms of the 6 per cent non-cumulative redeemable preference shares. At the callable date the coupon on these bonds will be reset by reference to the applicable five year benchmark gilt rate. Further information regarding this can be found in note 45 to the consolidated financial statements.

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Note 8: Debt securities in issue

These comprise US$862.5 million 7.75% Public Income Notes due 2050 issued by the Company in July 2010.

Note 9: Related party transactions

In January 2009 HM Treasury became a related party of the Company and has remained so during 2011 and 2012. From 1 January 2011, in accordance with IAS 24, UK Government-controlled entities also became related parties of the Group. Further information on the relationship and transactions with HM Treasury and UK Government-controlled entities is given in note 52 to the consolidated financial statements.

Key management personnel

The key management personnel of the Group and the Company are the same. The relevant disclosures are given in note 52 to the consolidated financial statements.

The Company has no employees (2011: nil).

As discussed in note 51 to the consolidated financial statements, the Group provides share-based compensation to employees through a number of schemes; these are all in relation to shares in the Company and the cost of providing those benefits is recharged to the employing companies in the Group on a cash basis.

Investment in subsidiaries

	2012 £m	2011 £m
At 1 January	40,534	38,194
Capital injections into Lloyds TSB Bank plc	–	2,340
At 31 December	**40,534**	40,534

The principal subsidiaries, all of which have prepared accounts to 31 December and whose results are included in the consolidated accounts of Lloyds Banking Group plc, are:

	Share class	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Lloyds TSB Bank plc	Ordinary	England	100%	Banking and financial services
Scottish Widows plc	Ordinary	Scotland	100%[1]	Life assurance
HBOS plc	Ordinary	Scotland	100%[1]	Holding company
Bank of Scotland plc	Ordinary	Scotland	100%[1]	Banking and financial services
St. Andrew's Insurance plc	Ordinary	England	100%[1]	General insurance
Clerical Medical Investment Group Limited	Ordinary	England	100%[1]	Life assurance
Clerical Medical Managed Funds Limited	Ordinary	England	100%[1]	Life assurance

[1] Indirect interest.

The principal area of operation for each of the above subsidiaries is the United Kingdom.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 9: Related party transactions (continued)

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, Lloyds Banking Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. The Group also agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra-group. Consequently, in accordance with the terms of some of these instruments, subsidiaries could have been prevented from making dividend payments on ordinary shares during this period. In addition, certain subsidiary companies currently have insufficient distributable reserves to make dividend payments.

Subject to the foregoing, there were no further significant restrictions on any of the Company's subsidiaries in paying dividends or repaying loans and advances. All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

Loans to subsidiaries

	2012 £m	2011 £m
At 1 January	**8,286**	8,332
Exchange and other adjustments	**46**	(46)
Redemptions	**(209)**	–
At 31 December	**8,123**	8,286

In addition the Company carries out banking activities through its subsidiary, Lloyds TSB Bank plc. At 31 December 2012, the Company held deposits of £2,231 million with Lloyds TSB Bank plc (2011: £1,105 million). Given the volume of transactions flowing through the account, it is not meaningful to provide gross inflow and outflow information. Included within subordinated liabilities is £2,355 million (2011: £2,287 million) and within other liabilities is £10,630 million (2011: £10,261 million) due to subsidiary undertakings. In addition, at 31 December 2012 the Company had interest rate and currency swaps with Lloyds TSB Bank plc with an aggregate notional principal amount of £2,338 million and a net positive fair value of £1,693 million (2011: notional principal amount of £2,338 million and a net positive fair value of £1,660 million), of which contracts with an aggregate notional principal amount of £2,338 million and a net positive fair value of £272 million (2011: notional principal amount of £1,349 million and a net positive fair value of £314 million) were designated as fair value hedges to manage the Company's issuance of subordinated liabilities and debt securities in issue.

Guarantees

The Company guarantees certain of its subsidiaries' liabilities to the Bank of England.

Other related party transactions

Related party information in respect of other related party transactions is given in note 52 to the consolidated financial statements.

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Note 10: Financial instruments

Measurement basis of financial assets and liabilities

The accounting policies in note 2 to the consolidated financial statements describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the Company's financial assets and liabilities by category and by balance sheet heading.

	Derivatives designated as hedging instruments, held at fair value through profit or loss £m	Held for trading at fair value through profit or loss £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2012					
Financial assets:					
Cash and cash equivalents	**–**	**–**	**–**	**2,231**	**2,231**
Derivative financial instruments	**272**	**1,421**	**–**	**–**	**1,693**
Loans to subsidiaries	**–**	**–**	**8,123**	**–**	**8,123**
Amounts due from subsidiaries	**–**	**–**	**147**	**–**	**147**
Total financial assets	**272**	**1,421**	**8,270**	**2,231**	**12,194**
Financial liabilities:					
Debt securities in issue	**–**	**–**	**–**	**545**	**545**
Subordinated liabilities	**–**	**–**	**–**	**4,349**	**4,349**
Total financial liabilities	**–**	**–**	**–**	**4,894**	**4,894**
At 31 December 2011					
Financial assets:					
Cash and cash equivalents	–	–	–	1,105	1,105
Derivative financial instruments	314	1,346	–	–	1,660
Loans to subsidiaries	–	–	8,286	–	8,286
Amounts due from subsidiaries	–	–	212	–	212
Total financial assets	314	1,346	8,498	1,105	11,263
Financial liabilities:					
Debt securities in issue	–	–	–	555	555
Subordinated liabilities	–	–	–	4,308	4,308
Total financial liabilities	–	–	–	4,863	4,863

Note 54 to the consolidated financial statements outlines the valuation hierarchy into which financial instruments measured at fair value are categorised.

The derivative assets designated as hedging instruments represent level 2 portfolios. The derivative assets classified as held for trading (not being designated as hedging instruments) shown above represent level 3 portfolios (2011: £174 million level 2 and £1,172 million level 3). The level 3 derivatives reflect the value of the equity conversion feature of the Enhanced Capital Notes issued in December 2009 as part of Lloyds Banking Group's recapitalisation and exit from the Government Asset Protection Scheme.

The following reconciliation shows the movements in derivative financial instrument assets within level 3 portfolios:

	2012 £m	2011 £m
At 1 January	**1,172**	1,177
Gains (losses) recognised in the income statement	**249**	(5)
At 31 December	**1,421**	1,172

Interest rate risk and currency risk

The Company is exposed to interest rate risk and currency risk on its debt securities in issue and its subordinated debt.

As discussed in note 9, the Company has entered into interest rate and currency swaps with its subsidiary, Lloyds TSB Bank plc, to manage these risks.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 10: Financial instruments (continued)

Credit risk

The majority of the Company's credit risk arises from amounts due from its wholly owned subsidiary, Lloyds TSB Bank plc, and subsidiaries of that company.

Liquidity risk

The table below analyses financial instrument liabilities of the Company, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2012						
Debt securities in issue	**10**	**–**	**31**	**616**	**–**	**657**
Subordinated liabilities	**–**	**24**	**308**	**3,675**	**1,785**	**5,792**
Total financial instrument liabilities	**10**	**24**	**339**	**4,291**	**1,785**	**6,449**
At 31 December 2011						
Debt securities in issue	11	–	32	688	–	731
Subordinated liabilities	–	24	315	4,385	1,828	6,552
Total financial instrument liabilities	11	24	347	5,073	1,828	7,283

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £296 million (2011: £303 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

Fair values of financial assets and liabilities

The valuation techniques for the Company's financial instruments are as discussed in note 54 to the consolidated financial statements.

	2012		2011	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets:				
Cash and cash equivalents	**2,231**	**2,231**	1,105	1,105
Derivative financial instruments	**1,693**	**1,693**	1,660	1,660
Loans to subsidiaries	**8,123**	**8,318**	8,286	8,291
Amounts due from subsidiaries	**147**	**147**	212	212
Financial liabilities:				
Debt securities in issue	**545**	**545**	555	555
Subordinated liabilities	**4,349**	**4,711**	4,308	3,370

Note 11: Approval of the financial statements and other information

The parent company financial statements were approved by the directors of Lloyds Banking Group plc on 1 March 2013.

Lloyds Banking Group plc was incorporated as a public limited company and registered in Scotland under the UK Companies Act 1985 on 21 October 1985 with the registered number 95000. Lloyds Banking Group plc's registered office is The Mound, Edinburgh EH1 1YZ, Scotland, and its principal executive offices in the UK are located at 25 Gresham Street, London EC2V 7HN.

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SHAREHOLDER INFORMATION

Annual general meeting

The annual general meeting will be held at 11.00 am on Thursday 16 May 2013 at the Edinburgh International Conference Centre, The Exchange, Edinburgh, EH3 8EE. Further details about the meeting, including the proposed resolutions, can be found in our notice of annual general meeting which is sent to all shareholders who have requested paper copy documents. It is also available on our website www.lloydsbankinggroup.com

Shareholder enquiries

The Company's share register and the Lloyds Banking Group Shareholder Account are maintained by Equiniti Limited. Contact them using the details below if you have enquiries about your shareholding, including:

- Change of name or address;
- Loss of share certificate; and
- Dividend information, including loss of dividend warrant or tax voucher.

Equiniti Limited
Aspect House
Spencer Road
Lancing
West Sussex BN99 6DA

Telephone 0871 384 2990
Textphone 0871 384 2255
Overseas +44 (0)121 415 7066

Telephone lines are open 8.30 am to 5.30 pm, Monday to Friday.

Calls to 0871 numbers are charged at 8p per minute plus network extras. Calls from outside the United Kingdom are charged at applicable international rates. The call prices we have quoted were correct in February 2013.

Online portfolio management and enquiries

Equiniti operates a web based enquiry and portfolio management service. Visit www.shareview.co.uk for details on how to register to access the following facilities:

- register your preferred format for receiving Company communications;
- register your proxy appointment or voting instructions;
- update your address details directly; and
- choose your preferred contact methods – via email, phone or in writing.

You may also visit help.shareview.co.uk where you can register an enquiry via email, find answers to frequently asked questions and access useful fact sheets, guidance notes and downloadable forms.

Share dealing facilities

Lloyds Banking Group offers shareholders a choice of three dealing services:

Bank of Scotland Share Dealing

- Internet dealing. Visit www.bankofscotlandsharedealing.co.uk
- Telephone dealing. Call 0845 606 1188

Halifax Share Dealing

- Internet dealing. Visit www.halifaxsharedealing.co.uk
- Telephone dealing. Call 08457 22 55 25

Shareholders in the Lloyds Banking Group Shareholder Account can only trade by telephone through the Halifax Share Dealing Service.

Bank of Scotland Share Dealing and Halifax Share Dealing internet services are available 24/7 and telephone services are available between 8.00 am and 9.15 pm, Monday to Friday and 9.00 am to 1.00 pm on Saturday. To open a share dealing account with either of these services, you must be 18 years of age or over and be resident in the UK, Jersey, Guernsey or the Isle of Man.

Lloyds TSB Share Dealing

- Internet dealing. Visit www.lloydstsbsharedealing.com
- Telephone dealing. Call 0845 60 60 560

Internet services are available 24/7 and telephone services are available between 8.00 am and 6.00 pm, Monday to Friday. Details of any dealing costs are available when you log on to the share dealing website or when you call the above number. To open a Lloyds TSB Share Dealing Account, you must be 18 years of age or over and be resident in the UK, the Channel Islands or the Isle of Man.

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Share price information

Shareholders can access both the latest and historical share prices via our website, www.lloydsbankinggroup.com, as well as listings in most national newspapers. For a real time buying or selling price, you will need to contact a stockbroker, or you can contact the sharedealing providers detailed above.

Individual Savings Accounts (ISAs)

The Company provides a number of options for investing in Lloyds Banking Group shares through an ISA. For details contact: Bank of Scotland Share Dealing, Halifax Share Dealing or Lloyds TSB Share Dealing.

American Depositary Receipts (ADRs)

Lloyds Banking Group shares are traded in the USA through a New York Stock Exchange-listed sponsored ADR facility, with The Bank of New York Mellon as the depositary. The ADRs are traded on the New York Stock Exchange under the symbol LYG. The CUSIP number is 539439109 and the ratio of ADRs to ordinary shares is 1:4.

For details contact: BNY Mellon Depositary Receipts, PO Box 43006, Providence, RI 02940-3006.
Telephone: 1-866-259-0336 (US toll free), international callers: +1 201-680-6825. Alternatively visit www.adrbnymellon.com or email shrrelations@bnymellon.com

Analysis of shareholders

At 31 December 2012	Shareholders		Number of ordinary shares	
Size of shareholding	Number	%	Millions	%
1 – 999	2,222,336	81.32	680.0	0.97
1,000 – 9,999	449,623	16.45	1182.4	1.68
10,000 – 99,999	57,287	2.10	1,344.2	1.91
100,000 – 999,999	2,439	0.09	568.0	0.81
1,000,000 – 4,999,999	453	0.02	1,062.5	1.51
5,000,000 – 9,999,999	151	0.01	1,069.4	1.52
10,000,000 – 49,999,999	248	0.01	5,760.8	8.19
50,000,000 – 99,999,999	47	0.00	3,170.3	4.51
100,000,000 – 499,999,999	54	0.00	10,762.9	15.30
500,000,000 – 999,999,999	14	0.00	9,630.9	13.69
1,000,000,000 and over	6	0.00	35,111.4	49.91
	2,732,658	100.00	70,342.8	100.00

Share sale fraud

Lloyds Banking Group has been made aware of an increasing number of share sale frauds being reported by listed companies. This involves bogus stockbrokers, usually based overseas, cold calling people to:

- pressure them into buying shares that promise high returns; or
- offer to buy their shares at an inflated price claiming that there is a 'secret' takeover or merger. This is followed by a request for an upfront cash bond to commit to the deal.

In reality, the shares or secret information are either worthless or non-existent and if you receive such a call, we strongly recommend that you seek independent investment advice from an FSA authorised adviser before you take any action.

If you are concerned that you may have been targeted by such a scheme, please contact the FSA Consumer Helpline on 0845 606 1234, www.fsa.gov.uk or Action Fraud on 0300 123 2040, www.actionfraud.org.uk for further advice.

FORWARD LOOKING STATEMENTS

This annual report contains certain forward looking statements within the meaning of the safe harbor provisions of the US Private Securities Litigation Reform Act of 1995 with respect to the business, strategy and plans of Lloyds Banking Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about Lloyds Banking Group or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, expenditures or any other financial items or ratios; statements of plans, objectives or goals of the Group or its management including in respect of certain synergy targets; statements about the future business and economic environments in the United Kingdom (UK) and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; inflation, deflation, interest rates and policies of the Bank of England, the European Central Bank and other G8 central banks; fluctuations in exchange rates, stock markets and currencies; the ability to access sufficient funding to meet the Group's liquidity needs; changes to the Group's credit ratings; the ability to derive cost savings and other benefits including, without limitation, as a result of the integration of HBOS and the Group's Simplification Programme; changing demographic developments including mortality and changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes; natural and other disasters, adverse weather and similar contingencies outside the Group's control; inadequate or failed internal or external processes, people and systems; terrorist acts and other acts of war or hostility and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, taxation, accounting standards or practices; regulatory capital or liquidity requirements and similar contingencies outside the Group's control; the policies and actions of governmental or regulatory authorities in the UK, the European Union (EU), the US or elsewhere; the implementation of the draft EU crisis management framework directive and banking reform, following the recommendations made by the Independent Commission on Banking; the ability to attract and retain senior management and other employees; requirements or limitations imposed on the Group as a result of HM Treasury's investment in the Group; the ability to complete satisfactorily the disposal of certain assets as part of the Group's EU State Aid obligations; the extent of any future impairment charges or write-downs caused by depressed asset valuations, market disruptions and illiquid markets; market related trends and developments; exposure to regulatory scrutiny, legal proceedings, regulatory investigations or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services and lending companies; and the success of the Group in managing the risks of the foregoing. Please refer to the latest Annual Report on Form 20-F filed with the US Securities and Exchange Commission for a discussion of certain factors.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this annual report are made as of the date hereof, and Lloyds Banking Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this annual report to reflect any change in Lloyds Banking Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

GLOSSARY

Alt-A
Alt-A are mortgage loans regarded as lower risk than sub-prime, but they share higher risk characteristics than lending under normal criteria. Further information on the Group's exposure to Alt-A investments is given in note 55.

Arrears
A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency. When a customer is in arrears, the entire outstanding balance is said to be delinquent, meaning that delinquent balances are the total outstanding loans on which payments are overdue.

Asset-Backed commercial paper
See **Commercial Paper**

Asset-Backed Securities (ABS)
Asset-backed securities are securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages but could also include leases, credit card receivables, motor vehicles, student loans. Further information on the Group's investments in ABS is given in note 55.

Asset Quality Ratio
The impairment charge for the year in respect of loans and advances to customers expressed as a percentage of average loans and advances to customers.

Bank levy
The levy that applies to certain UK banks, UK building societies and the UK operations of foreign banks from 1 January 2011. The levy is payable based on a percentage of the chargeable equity and liabilities of the bank as at the balance sheet date.

Basel II
The capital adequacy framework issued by the Basel Committee on Banking Supervision in June 2006 in the form of the 'International Convergence of Capital Measurement and Capital Standards'.

Basel III
The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in from 1 January 2013 onwards.

Basis point
One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates or yields on securities.

Buy-to-let mortgages
Buy-to-let mortgages are those mortgages offered to customers purchasing residential property as a rental investment.

Collateralised Debt Obligation (CDO)
A security issued by a third party which references ABSs or other assets purchased by the issuer. Lloyds Banking Group has invested in instruments issued by other banking groups, including Collateralised Loan Obligations and Commercial Real Estate CDOs. Details of these investments are given in note 55.

Collateralised Loan Obligation (CLO)
A security backed by the repayments from a pool of commercial loans. CLOs are usually structured products with different tranches whereby senior classes of holder receive repayment before other tranches are repaid.

Collectively assessed loan impairment provision
A provision established following an impairment assessment on a collective basis for homogeneous groups of loans, such as credit card receivables and personal loans, that are not considered individually significant and for loan losses that have been incurred but not separately identified at the balance sheet date.

Commercial Mortgage-Backed Securities (CMBS)
Commercial Mortgage-Backed Securities are securities that represent interests in a pool of commercial mortgages. Investors in these securities have the right to cash received from mortgage repayments of interest and principal. Further information on the Group's investment in CMBS is given in note 55.

Commercial Paper
Commercial paper is an unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date. Commercial paper can be issued as an unsecured obligation of the Group or, for example when issued by the Group's conduits, as an asset-backed obligation (in such case it is referred to as **asset-backed commercial paper**). Commercial paper is usually issued for periods from as little as a week up to nine months.

Commercial Real Estate
Commercial real estate includes office buildings, industrial property, medical centres, hotels, malls, retail stores, shopping centres, farm land, multifamily housing buildings, warehouses, garages, and industrial properties.

Conduits
A financial vehicle that holds asset-backed securities which are financed with short-term deposits (generally **commercial paper**) that use the asset-backed securities as collateral. The conduit will often have a liquidity line provided by a bank that it can draw down on in the event that it is unable to issue funding to the market. The Group sponsors three asset-backed conduits, Argento, Cancara and Grampian. Further details are provided in note 22.

Contractual maturities
Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.

Core tier 1 capital
As defined by the FSA mainly comprising shareholders' equity and equity non-controlling interests after deducting goodwill, other intangible assets and other regulatory deductions. Further details are given in the Capital Risk section on page 187.

GLOSSARY

Core tier 1 ratio
Core tier 1 capital as a percentage of **risk weighted assets**.

Cost:Income ratio
Operating expenses compared to total income net of insurance claims. The Group calculates this ratio using the 'reported basis' which is the basis on which financial information is reported internally to management.

Coverage ratio
Impairment provisions as a percentage of impaired loans.

Covered mortgage bonds
A bond backed by a pool of mortgage loans. The mortgages remain on the issuer's balance sheet. The issuing bank can change the make-up of the loan pool or the terms of the loans to preserve credit quality. Covered bonds thus have a higher risk weighting than mortgage-backed securities because the holder is exposed to both the non-payment of the mortgages and the financial health of the issuer. The Group issues covered bonds as part of its funding activities. Further details are provided in note 21.

Credit Default Swap
A credit default swap is also referred to as a credit derivative. It is an arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection. A credit default swap is a contract where the protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.

Credit derivatives
A credit derivative is a financial instrument that derives its value from the credit rating of an underlying instrument carrying the credit risk of the issuing entity. The principal type of credit derivatives are **credit default swaps**, which are used by the Group as part of its trading activity and to manage its own exposure to credit risk.

Credit Risk
The risk of reductions in earnings and/or value, through financial loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

Credit risk spread (or credit spread)
The credit spread is the yield spread between securities with the same currency and maturity structure but with different associated credit risks, with the yield spread rising as the credit rating worsens. It is the premium over the benchmark or risk-free rate required by the market to take on a lower credit quality.

Credit valuation adjustments
These are adjustments to the fair values of derivative assets to reflect the creditworthiness of the counterparty. Further details are given in note 54.

Customer deposits
Money deposited by account holders. Such funds are recorded as liabilities of the Group. The Group includes certain **repos** within customer deposits.

Debt restructuring
This is when the terms and provisions of outstanding debt agreements are changed. This is often done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as reducing the debt or interest charged on the loan.

Debt securities
Debt securities are assets held by the Group representing certificates of indebtedness of credit institutions, public bodies or other undertakings, excluding those issued by Central Banks.

Debt securities in issue
These are unsubordinated debt securities issued by the Group. They include commercial paper, certificates of deposit, bonds and medium-term notes.

Delinquency
See **Arrears**.

Embedded equity conversion feature
An embedded equity conversion feature is a derivative contained within the terms and conditions of a debt instrument that enables or requires the instrument to be converted into equity under a particular set of circumstances. The Group's Enhanced Capital Notes (ECNs) contain such a feature whereby these notes convert to ordinary shares in the event that the consolidated core tier 1 ratio of the Group falls below 5 per cent.

Enhanced Capital Notes (ECNs)
The Group's ECNs are subordinated notes issued by the Group that contain an embedded equity conversion feature. Further details of these are given in note 45.

Enterprise Risk Management
As defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Enterprise Risk Management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

Expected loss
This is the amount of loss that can be expected by the Group calculated in accordance with FSA rules. In broad terms it is calculated by multiplying the Default Frequency by the **Loss Given Default** by the **Exposure at Default**.

Exposure at Default
An estimate of the amount expected to be owed by a customer at the time of the customer's default.

Fair value adjustment
Fair value adjustments arise on acquisition when assets and liabilities are acquired at fair values that are different from the carrying values in the acquired company. In respect of the Group's acquisition of HBOS the principal adjustments were write-downs in respect of loans and advances to customers and debt issued.

Financial Services Compensation Scheme (FSCS)

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS is funded by management expenses levies and, where necessary, compensation levies on authorised firms.

First/Second lien

A first lien gives the holder (usually the bank lending the funds) the first right to collect compensation from the sale of the underlying collateral in the event of a default on the loan. A second lien may be issued against the same collateral but in the case of default, compensation for this debt will only be received after the first lien has been repaid.

Forbearance

A term generally applied to concessions provided to support borrowers experiencing financial stress. Such concessions include reduced or nil payments, term extensions, transfers to interest only and the capitalisation of arrears, and can be granted on a temporary or permanent basis.

Full time equivalent

A full time employee is one that works a standard five day week. The hours or days worked by part time employees are measured against this standard and accumulated along with the number of full time employees and counted as full time equivalents. This is a more consistent measure of the amount of time worked than employee numbers which will fluctuate as the mix of part-time and full-time employees changes.

Funded/unfunded exposures

Exposures where the notional amount of the transaction is either funded or unfunded.

Guaranteed mortgages

Mortgages for which there is a guarantor to provide the lender a certain level of financial security in the event of default of the borrower.

Home loans

A loan to purchase a residential property which is then used as collateral to guarantee repayment of the loan. The borrower gives the lender a **lien** against the property, and the lender can foreclose on the property if the borrower does not repay the loan per the agreed terms.

Impaired loans

Impaired loans are loans where the Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.

Impairment allowances

Impairment allowances are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.

Impairment losses

An impairment loss is the reduction in value that arises following an impairment review of an asset that determines that the asset's value is lower than it's carrying value. For impaired financial assets measured at amortised cost, impairment losses are the difference between the carrying value and the present value of estimated future cash flows, discounted at the asset's original effective interest rate. Impairment losses can be difficult to assess and the critical accounting estimates and judgements in note 3 detail the key assessments made when determining impairment losses.

Individually/Collectively Assessed

Impairment is measured individually for assets that are individually significant, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available.

Individually assessed loan impairment provisions

Impairment loss provisions for individually significant impaired loans are assessed on a case-by-case basis, taking into account the financial condition of the counterparty, any guarantor and the realisable value of any collateral held.

Internal Capital Adequacy Assessment Process (ICAAP)

The Group's own assessment, based on Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events as they apply on a solo level and on a consolidated level.

Investment grade

This refers to the highest range of credit ratings, from 'AAA' to 'BBB' as measured by external credit rating agencies.

ISDA (International Swaps and Derivatives Association) master agreement

A standardised contract developed by the ISDA which is used as an umbrella contract for bilateral derivative contracts.

Level 1 fair value measurements

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 fair value measurements

Level 2 fair value measurements are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active, or where valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data.

Level 3 fair value measurements

Level 3 fair value measurements are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data.

Leverage finance

Funding provided for entities with higher than average indebtedness, which typically arises from sub-investment grade acquisitions or event-driven financing.

GLOSSARY

Liquidity and Credit enhancements

Credit enhancement facilities are used to enhance the creditworthiness of financial obligations and cover losses due to asset default. Two general types of credit enhancement are third-party loan guarantees (such as **guaranteed mortgages**) and self-enhancement through over collateralisation (in the case of **covered mortgage bonds**). Liquidity enhancement makes funds available if required, for other reasons than asset default, eg to ensure timely repayment of maturing commercial paper.

Loan to deposit ratio

The ratio of loans and advances to customers net of allowance for impairment losses and excluding reverse repurchase agreements divided by customer deposits excluding repurchase agreements.

Loan-to-value ratio (LTV)

The loan-to-value ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.

Loans past due

Loans are past due when a counterparty has failed to make a payment when contractually due.

Loss emergence period

The loss emergence period is the estimated period between impairment occurring and the loss being specifically identified and evidenced by the establishment of an appropriate impairment allowance.

Loss Given Default

The estimated loss that will arise if a customer defaults. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.

Market risk

The risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments) lead to reductions in earnings and/ or value.

Medium Term Notes

Medium term notes are a form of corporate borrowing covering maturity periods ranging from nine months to 30 years. Details of the notes issued under the Group's medium term notes programmes are given in note 36.

Monolines

A monoline insurer is defined as an entity which specialises in providing credit protection to the holders of debt instruments in the event of default by the debt security counterparty. This protection is typically provided in the form of derivatives such as **credit default swaps** referencing the underlying exposures held.

Mortgage-backed securities

See Residential and Commercial Mortgage-Backed Securities.

Mortgage related assets

Assets which are referenced to underlying mortgages.

Mortgage vintage

The year the mortgage was issued.

Negative basis bonds

ABS held with a separately purchased matching **credit default swaps** to protect against the risk of default of the security. The Group refers to ABS without the benefit of CDS protection as **Uncovered ABS**.

Negative Equity Mortgages

Negative equity occurs when the value of the property purchased using the mortgage is below the balance outstanding on the loan. Negative equity is the value of the asset less the outstanding balance on the loan.

Net asset value per ordinary share

Shareholders' equity divided by the number of ordinary shares and limited voting ordinary shares in issue, adjusted to exclude shares held under certain employee share ownership plans.

Net Interest Income

The difference between interest received on assets and interest paid on liabilities.

Net interest margin

Net interest margin is net interest income as a percentage of average interest-earning assets. Details of the Group's banking net interest margin are given on page 75.

Operational risk

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people-related or external events.

Over-the-counter derivatives

Over-the-counter derivatives are derivatives for which the terms and conditions can be freely negotiated by the counterparties involved, unlike exchange traded derivatives which have standardised terms.

Prime mortgages

Prime mortgages are those granted to the most creditworthy category of borrower.

Private equity investments

Private equity is equity securities in operating companies not quoted on a public exchange. Investment in private equity often involves the investment of capital in private companies or the acquisition of a public company that results in the delisting of public equity. Capital for private equity investment is raised by retail or institutional investors and used to fund investment strategies such as leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital.

Probability of default

The likelihood that a customer will default on their obligation within the next year.

Renegotiated loans

Loans and advances are generally renegotiated either as part of an ongoing customer relationship or in response to an adverse change in the circumstances of the borrower. In the latter case renegotiation can result in an extension of the due date of payment or repayment plans under which the Group offers a concessionary rate of interest to genuinely distressed borrowers. This will result in the asset continuing to be overdue and will be impaired where the renegotiated payments of interest and principal will not recover the original carrying amount of the asset. In other cases, renegotiation will lead to a new agreement, which is treated as a new loan.

Repurchase agreements or 'repos'
Short-term funding agreements which allow a borrower to sell a financial asset, such as ABS or Government bonds as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.

Residential Mortgaged-Backed Securities (RMBS)
Residential Mortgage-Backed Securities are a category of **ABS**. They are securities that represent interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).

Retail loans
Money loaned to individuals rather than institutions. These include both secured and unsecured loans such as mortgages and credit card balances.

Risk appetite
The amount and type of risk that the Group is prepared to seek, accept or tolerate.

Risk-weighted assets
A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with the Basel Capital Accord as implemented by the FSA.

Securitisation
Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. Securitisation is the process by which ABS are created. A company sells assets to a special purpose entity which then issues securities backed by the assets. This allows the credit quality of the assets to be separated from the credit rating of the original company and transfers risk to external investors. Assets used in securitisations include mortgages to create mortgage-backed securities or **Residential Mortgage-Backed Securities** as well as **Commercial Mortgage-Backed Securities**. The Group has established several securitisation structures as part of its funding and capital management activities. These generally use mortgages, corporate loans and credit cards as asset pools. A listing of these programmes with the amounts secured and associated funding raised is given in note 21.

Sovereign Exposures
Exposures to central governments and central government departments, central banks and entities owned or guaranteed by the aforementioned.

Special Purpose Entities (SPEs)
SPEs are entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses a number of SPEs, including those set-up under **securitisation** programmes, and as **conduits**. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group's results.

Specialist mortgages
Specialist mortgages include those mortgage loans provided to customers who have self-certified their income (normally as a consequence of being self-employed) or who are otherwise regarded as a sub-prime credit risk. New mortgage lending of this type has not been offered by the Group since early 2009.

Standardised Approach
In relation to credit risk, a method for calculating credit risk capital requirements using External Credit Assessment Institutions (ECAI) ratings of obligors (where available) and supervisory risk weights. In relation to operational risk, a method of calculating the operational risk capital requirement by the application of a supervisory defined percentage charge to the gross income of specified business lines.

Student loan related assets
Assets which are referenced to underlying student loans (see note 55).

Sub-investment grade
This refers to credit ratings issued by external credit rating agencies that are below 'BBB' grade or its equivalent.

Subordinated liabilities
Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer. Details of the Group's subordinated liabilities are set out in note 45.

Sub-Prime
Sub-prime is defined as loans to borrowers typically having weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, high debt-to-income ratios, or other criteria indicating heightened risk of default.

Tier 1 capital
A measure of a bank's financial strength defined by the FSA. It captures core tier 1 capital plus other tier 1 securities in issue, but is subject to a deduction in respect of material holdings in financial companies. Further details are given in the Capital Risk section on page 187.

Tier 1 capital ratio
Tier 1 capital as a percentage of risk-weighted assets.

Tier 2 capital
A component of regulatory capital defined by the FSA, mainly comprising qualifying subordinated loan capital, certain non-controlling interests and eligible collective impairment allowances. Further details are given in the Capital Risk section on page 187.

Uncovered ABS
ABS held without the benefit of separately purchased matching credit default swaps to protect against the risk of default of the security. Details of the Group's uncovered ABS are given in note 55.

Value-at-Risk
Value-at-Risk is an estimate of the potential loss in earnings which might arise from market movements under normal market conditions, if the current positions were to be held unchanged for one business day, measured to a confidence level of 95 per cent.

Write Downs
The depreciation or lowering of the value of an asset in the books to reflect a decline in their value, or expected cash flows.

ABBREVIATIONS

ABS	Asset-Backed Securities
ADRs	American Depositary Receipts
BSU	Business Support Unit
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
CLO	Collateralised Loan Obligation
CMIG	Clerical Medical Investment Group Limited
CRA	Credit Reference Agency
CRD IV	Capital Requirements Directive IV
CVA	Credit Valuation Adjustment
DVA	Debit Valuation Adjustment
ECNs	Enhanced Capital Notes
EEI	Employee Engagement Index
EEV	European Embedded Value
EP	Economic Profit
EPS	Earnings Per Share
ERM	Enterprise Risk Management
EU	European Union
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
HMRC	Her Majesty's Revenue & Customs
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICG	Individual Capital Guidance
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
ISA	Individual Savings Account
KPIs	Key Performance Indicators
LCR	Liquidity Coverage Ratio
LDC	Lloyds Development Capital
LIBOR	London Inter-Bank Offered Rate
LP&I	Life, Pensions and Investments
LTIP	Long-Term Incentive Plan
LTV	Loan-to-value
MIF	Multilateral Interchange Fee
NSFR	Net Stable Funding Ratio
OEICs	Open Ended Investment Companies
OFT	Office of Fair Trading
PEI	Performance Excellence Index
PFI	Private Finance Initiative
PPI	Payment Protection Insurance
PPP	Public Private Partnership
PVNBP	Present Value of New Business Premiums
RDR	Retail Distribution Review
SAYE	Save-As-You-Earn
SMEs	Small and Medium sized enterprises
SPE	Special Purpose Entity
SWIP	Scottish Widows Investment Partnership
TSR	Total Shareholder Return
UK	United Kingdom of Great Britain and Northern Ireland
UKFI	UK Financial Investments Limited
US	United States of America
VaR	Value-at-Risk

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