HBOS plc

Report and Accounts
2010

Member of Lloyds Banking Group

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Results

The consolidated income statement on page 13 shows a loss attributable to equity shareholders for the year ended 31 December 2010 of £2,351 million.

Principal activities

HBOS plc (the Company) and its subsidiaries (the Group) provide a wide range of banking and financial services through branches and offices in the UK and overseas.

The Group's revenue is earned through interest and fees on a broad range of financial services products including current and savings accounts, personal loans, credit cards and mortgages within the retail market; loans and capital market products to commercial, corporate and asset finance customers; life, pensions and investment products; general insurance; and private banking and asset management.

Business review

The loss before tax decreased by £11,037 million, or 84 per cent, from £13,088 million to £2,051 million. This was primarily due to an improved credit performance, with impairments reducing by £10,199 million, from £21,077 million to £10,878 million.

The trading surplus increased by £211 million, or 2 per cent, from £8,714 million to £8,925 million comprising a £2,681 million increase in net interest income, a £3,659 million decrease in other income, net of insurance claims, and a £1,189 million reduction in operating expenses.

Net interest income increased by £2,681 million, or 47 per cent, from £5,689 million to £8,370 million, as margins improved as a result of more mortgage customers moving on to, and remaining on, standard variable-rate terms and from the decrease in interest expense as the HBOS funding held outside of the Lloyds Banking Group continues to mature.

Other income, net of insurance claims, excluding the £3,000 million subvention income received in 2009, declined by £659 million, with reduced gains from liability management transactions, which reduced from £2,514 million in 2009 to £359 million in 2010. Insurance premium income also decreased by £1,264 million due to lower gross premium income received as a result of the withdrawal of certain lower-return products in the second half of 2009, more than offset by insurance claims which were £2,170 million lower. Net fee and commission income increased by £31 million, or 6 per cent.

Operating expenses reduced by £1,189 million, or 17 per cent, from £6,870 million to £5,681 million, reflecting integration savings, the non-recurrence of the goodwill impairment charges incurred in 2009, reduced staff costs, a £316 million pension curtailment gain, and lower operating lease asset depreciation charges arising from lower amounts of operating lease assets, offset by a £500 million customer goodwill payments provision.

Impairment losses decreased by £10,199 million, or 48 per cent, from £21,077 million to £10,878 million. This largely reflects the continuing slow recovery of the economy, improved quality of new business and effective portfolio management and the benefit of action taken in 2009, offset by significant impairments incurred in the Group's business in Ireland. On 31 December 2010, Bank of Scotland (Ireland) Limited (BOSI) was merged into Bank of Scotland plc (BOS), a subsidiary of HBOS plc, by virtue of a merger by absorption of a wholly-owned subsidiary pursuant to the Companies (Cross-Border Mergers) Regulations 2007. As a consequence of the merger, all of the assets and liabilities of BOSI were transferred to BOS and BOSI was dissolved without going into liquidation.

Loans and advances to customers decreased by £22,710 million, or 6 per cent, from £404,075 million to £381,365 million reflecting the Group's strategy to reduce assets associated with non-relationship lending. Excluding loans to fellow group undertakings, loans and advances reduced by £32,654 million, or 8 per cent. Customer deposits decreased by £15,619 million, or 7 per cent, from £232,023 million to £216,404 million resulting in a slight increase in the ratio of customer loans to customer deposits from 174 per cent at 31 December 2009 to 176 per cent at 31 December 2010.

Debt securities in issue decreased by 18,397 million, or 15 per cent, from £119,157 million to £100,760 million as funding requirements decreased in line with reductions in asset balances.

Shareholders' equity increased by £975 million from £24,885 million to £25,860 million as capital injections and gains on available-for-sale assets and other reserves offset the Group's loss attributable to equity shareholders of £2,351 million.

Directors' report

At the end of December 2010, the Group's capital ratios increased with a total capital ratio on a Basel II basis of 14.1 per cent (compared to 11.3 per cent at 31 December 2009) and a tier 1 ratio of 11.4 per cent (compared to 9.1 per cent at 31 December 2009). During 2010, risk-weighted assets decreased by £72,032 million to £252,613 million. This reflects lower lending volumes across all banking divisions, a revised assessment of Retail secured lending risk-weighted assets following improvements in the economic outlook and changes introduced as a result of continuing the process of integrating regulatory capital approaches which have impacted particularly on Wholesale.

Financial risk management objectives and policies
Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in note 53. A discussion of the principal risks and uncertainties faced by the Group is set out on pages 7 to 10.

Group structure
Following a reorganisation of the Lloyds Banking Group on 1 January 2010, Lloyds Banking Group plc's holding of 100 per cent of the issued ordinary share capital of the Company was transferred to Lloyds TSB Bank plc.

Directors
The names of the directors of the Company are shown on page 6. Changes to the composition of the board since 1 January 2010 are shown below:

Dr W C G Berndt retired from the board on 6 May 2010.

Three directors joined the board during the year as follows: Mr G R Moreno (1 March 2010), Mr D L Roberts (1 March 2010) and Ms A M Frew (1 December 2010).

Mr A Horta-Osório joined the board on 17 January 2011. Mr J E Daniels will retire from the board on 28 February 2011 and will be succeeded as group chief executive by Mr A Horta-Osório on 1 March 2011.

Directors' interests
The directors are also directors of Lloyds Banking Group plc and their interests in shares in Lloyds Banking Group plc are shown in the report and accounts of that company.

Directors' conflicts of interest
The board, as permitted by the Company's articles of association, has authorised all potential conflicts of interest declared by individual directors. Decisions regarding these conflicts of interest could only be 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 had the ability to impose conditions, if thought appropriate, when granting authorisation. Any authorities given will be reviewed 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 it did not authorise any material conflicts during the year.

Directors' indemnities
The directors, including the former director who retired during the year, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. These 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 board in 2010 and 2011. The indemnities remain in force for the duration of a director's period of office. Deeds for existing directors are available for inspection at the Company's registered office.

Share capital
Information about share capital is shown in note 44 on page 69.

Statement of directors' responsibilities
The directors are responsible for preparing the annual 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 Group and Company 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 comply with the Companies Act 2006. 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 the website www.lloydsbankinggroup.com. The directors are responsible for the maintenance and integrity in relation to the Company on that website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current directors, whose names are shown on page 6 of this annual report, confirms that, to the best of his or her knowledge:

– the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position of the Company and Group and the profit or loss of the Group;
– the business review includes a fair review of the development and performance of the business and the position of the Company and Group; and
– the principal risks and uncertainties faced by the Company and the Group are set out on pages 7 to 10.

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 as discussed in note 1 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.

Employees
The Company, as part of Lloyds Banking Group, is committed to providing employment practices and policies which recognise the diversity of our workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief.

In the UK, Lloyds Banking Group belongs to the major employer groups campaigning for equality for the above groups of staff, including Employers' Forum on Disability, Employers' Forum on Age, Stonewall and the Race for Opportunity. Our involvement with these organisations enables us to identify and implement best practice for our staff.

Employees are kept closely involved in major changes affecting them through measures such 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 plc.

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.

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 ('BIS'), 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 14. 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 2010 bears to the aggregate of the amounts invoiced by suppliers during the year.

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.

A resolution will be proposed at the 2011 annual general meeting to reappoint PricewaterhouseCoopers LLP as auditors. The Company's audit committee is satisfied that the external auditors remain independent and effective.

On behalf of the board

Harry F Baines
Company Secretary
24 February 2011

Company Number 218813

Directors

Sir Winfried Bischoff *Chairman*

J E Daniels *Group Chief Executive* (to 28 February 2011)

A Horta-Osório *Group Chief Executive* (from 1 March 2011)

T J W Tookey *Group Finance Director*

A M Frew

Sir Julian Horn-Smith

A G Kane

Lord Leitch

G R Moreno

D L Roberts

T T Ryan, Jr

M A Scicluna

G T Tate

A Watson CBE

H A Weir CBE

Principal risks and uncertainties

At present the most significant risks faced by the Group are:

Credit
Definition: 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).

Features: Arising in the retail, wholesale and wealth and international operations, reflecting the risks inherent in the Group's lending activities and to a much lesser extent in the insurance operations in respect of investment of own funds. 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 write-downs and allowances for impairment losses. Credit risk can be affected by a range of factors, including, inter alia, increased unemployment, reduced asset values, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates or higher tenant defaults. Over the last three years, the global banking crisis and economic downturn has driven cyclically high bad debt charges. These have arisen from the Group's lending to:

– Wholesale customers (including those in wealth and international operations): where companies continue to face difficult business conditions, resulting in elevated corporate default levels, illiquid commercial property markets and heightened impairment charges. The Group has high levels of exposure in both the UK and internationally, including Ireland, USA, and Australia. There are particular concentrations to financial institutions and commercial real estate, including secondary and tertiary locations.
– Retail customers: this portfolio will remain strongly linked to the economic environment, with inter alia house prices falls, unemployment increases, consumer over-indebtedness and rising interest rates all likely to impact both secured and unsecured retail exposures.

The Group follows a through the economic cycle, relationship based, business model with risk management processes, appetites and experienced staff in place.

Legal and regulatory
Definition: Legal and regulatory risk is the risk of reductions in earnings and/ or value, through financial or reputational loss, from failing to comply with the laws, regulations or codes applicable.

Features: Legal and 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 reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector.

At the time of the acquisition of the Company by Lloyds Banking Group the Office of Fair Trading (OFT) identified some competition concerns in the UK personal current accounts and mortgages markets and for SME banking in Scotland. The OFT reiterated that it would keep these under review and consider whether to refer any banking markets to the Competition Commission if it identifies any prevention, restriction or distortion of competition.

The UK Government appointed an Independent Commission on Banking to review possible structural measures to reform the banking system and promote stability and competition. That commission will publish its final report by the end of September 2011. The Treasury Select Committee is conducting an examination of competition in retail banking. It is too early to quantify the potential impact of these developments on the Group.

From April 2011, lead regulation and supervision of the Group's activities will begin transitioning from the FSA to the new Financial Conduct Authority for conduct of business supervision and the Prudential Regulatory Authority for capital and liquidity supervision. In addition, from 2011, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory approaches across the EU. These could lead to changes in how the Group is regulated and supervised on a day-to-day basis.

Evolving capital and liquidity requirements continue to be a priority for the Group. In September 2010 and further clarified in December 2010, the Basel Committee on Banking Supervision put forward proposals for a reform package which changes the regulatory capital and liquidity standards, the definition of 'capital', introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2012 and 2018.

Lloyds Banking Group is currently assessing the impacts of these regulatory developments and will participate in the consultation and calibration processes to be undertaken by the various regulatory bodies during 2011. The insurance operations are progressing its plans to achieve Solvency II compliance. Lloyds Banking Group continues to work closely with the regulatory authorities and industry associations to ensure that it is able to identify and respond to proposed regulatory changes and mitigate against risks to the Group and its stakeholders.

There is a risk that certain aspects of the Group's business may be determined by the authorities or the courts as not being conducted in accordance with applicable laws or regulations, or with what is fair and reasonable in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

Liquidity and funding
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.

Features: Arising in the banking business of the Group through its retail, wholesale and wealth and international operations reflecting the risk that the Group is unable to attract and retain either retail, wholesale or corporate deposits or issue debt securities. Like all major banks, the Group is dependent on confidence in the short and longer term wholesale funding markets; should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding and provide liquidity when necessary, the Group's ability to fund its financial obligations could be impacted.

The key dependencies for successfully funding the Group's balance sheet include the continued functioning of the money and capital markets; successful right sizing of the Lloyds Banking Group balance sheet; the continuation of HM Treasury and Bank of England facilities to Lloyds Banking Group in accordance with the terms agreed; limited further deterioration in the UK's, Lloyds Banking Group's and the Group's credit ratings and no significant or sudden withdrawal of deposits resulting in increased reliance on wholesale funding markets. A return to the extreme market conditions of 2008 would place a strain on the Group's ability to meet its financial commitments.

Additionally, the Lloyds Banking 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. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

Liquidity and funding risks are 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.

Market Risk
Definition: The risk of reductions in earnings and/or value, through financial or reputational loss, from unfavourable market moves; including changes in, and increased volatility of, interest rates, market-implied inflation rates, credit spreads, foreign exchange rates, equity, property and commodity prices.

Features: 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.

The principal market risks are as follows:

There is a risk to the Group's banking income arising from the level of interest rates and 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 restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

The main equity market risks arise in the life assurance companies and staff pension schemes. Credit spread risk arises in the life assurance companies, pension schemes and banking businesses. Equity market movements and changes in credit spreads impact the Group's results.

Continuing concerns about the scale of deficits in Ireland and southern European countries resulted in increased credit spreads in the areas affected, and fears of contagion affected the Euro and widened spreads between central bank and interbank rates.

The Group's trading activity is small relative to its peers and is not considered to be a principal risk.

Insurance Risk
Definition: The risk of reductions in earnings 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 claims settlements.

Features: The major sources of insurance risk are within the insurance businesses and the staff 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 prime insurance risk carried by the Group's defined benefit pension schemes is related to longevity.

Insurance risks typically, and longevity in particular, may crystallise gradually over time. Actuarial assumption setting for financial reporting and liability management requires expert judgement as to when evidence of an emerging trend is sufficient to require an alteration to long-run assumptions.

Customer treatment
Definition: The risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment.

Features: Customer treatment and how the Group manages its customer relationships affects all aspects of the Group's operations and is closely aligned with achievement of the Group's strategic aim – to create deep long lasting relationships with its customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies.

The FSA continues to drive focus on conduct of business activities and has established a new approach to supervision of Conduct Risk, replacing the previous 'Treating Customers Fairly' initiative for retail customers. Under this new regime the FSA has indicated that it will seek to place greater emphasis on product governance and contract terms in general, and will seek to intervene much earlier in the product lifecycle to prevent customer detriment. The FSA also continues to carry out thematic reviews on a variety of issues across the industry as a whole, for example complaints handling. Lloyds Banking Group actively engages with the regulatory authorities and other stakeholders on these key customer treatment challenges, which includes for example, PPI (see note 51 of the financial statements).

The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers. Since the acquisition of HBOS, the Group has made significant progress in aligning its approach to Treating Customers Fairly across both heritages. In addition the Group has aligned its Treating Customers Fairly governance and management information arrangements, with customer impact being a key factor in assessing every integration proposition. The Group regularly reviews its product range to ensure that it meets regulatory requirements and is competitive in the market place.

People

Definition: The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate colleague actions and behaviour, industrial action, legal action in relation to people, or health and safety issues. Loss can also be incurred through failure to recruit, retain, train, reward and incentivise appropriately skilled staff to achieve business objectives and through failure to take appropriate action as a result of staff underperformance.

Features: The Group aims to attract, retain, and develop high calibre talent. Failure to do so presents a significant risk to delivering the Group's overall strategy and is affected by a range of factors including:

– Ongoing regulatory and public interest in remuneration practices;
– Delivery of Lloyds Banking Group's integration commitments; and
– Uncertainty about EU state aid requirements and the Independent Commission on Banking's proposals for banking reform.

The Group's remuneration arrangements encourage compliant and appropriate behaviour from colleagues, in line with group policies, values and short and long term people risk priorities. The Group has continued to work closely with regulators to seek to ensure compliance with our obligations. However, there is recognition that international consensus must be achieved to avoid UK institutions being significantly disadvantaged in attracting and retaining the highest calibre talent.

The Group continues to manage union relationships actively and the majority of colleagues are now on harmonised Terms and Conditions. There is strong ongoing commitment to support and retain colleagues throughout a period of significant integration and organisational change. Active monitoring of the Colleague Engagement Survey, allows the Group to understand engagement levels. These continue to increase and are now exceeding industry benchmarking for high performing organisations.

The Lloyds Banking Group is closely engaged with the UK Government and regulators on reform proposals, and with the EU on disposal arrangements, to influence and manage colleague uncertainty.

Integration

Definition: The risk that the Group fails to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or incurs unanticipated costs and losses associated with, the acquisition of HBOS plc by Lloyds Banking Group plc.

Features: The integration of the two heritage organisations continues to be one of the largest integration challenges that has been seen in the UK financial services industry. While there continue to be delivery risks to the programme, not least the risk of new regulatory requirements which may have an effect on resourcing, the Group is now two years into the integration programme and has a fully developed and functioning governance framework to manage these risks. There is a clear understanding of the phased deliverables to ensure effective delivery through to 2012.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF HBOS PLC

We have audited the Group and Company financial statements (the 'financial statements') of HBOS plc for the year ended 31 December 2010 which comprise the Consolidated and Company balance sheets, the Consolidated income statement, the Consolidated and Company statements of comprehensive income, the Consolidated and Company cash flow statements, the Consolidated and Company statements of changes in equity 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 regards the Company financial statements, 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 pages 3 and 4, the directors are responsible for the preparation of the 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 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 and 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.

Opinion on financial statements

In our opinion:

– the financial statements give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2010 and of the Group's loss and Group's and Company's cash flows for the year then ended;
– the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
– the Company financial statements 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
– the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the 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 Company, or returns adequate for our audit have not been received from branches not visited by us; or
– the Company financial statements 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.

Ian Rankin (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh
24 February 2011

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the Group 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 2010

	Note	**2010 £ million**	2009[1] £ million
Interest and similar income		**18,061**	18,456
Interest and similar expense		**(9,691)**	(12,767)
Net interest income	5	**8,370**	5,689
Fee and commission income		**1,480**	1,492
Fee and commission expense		**(964)**	(1,007)
Net fee and commission income	6	**516**	485
Net trading income	7	**9,095**	8,859
Insurance premium income	8	**3,649**	4,913
Subvention income	9	**–**	3,000
Other operating income	9	**2,127**	3,959
Other income		**15,387**	21,216
Total income		**23,757**	26,905
Insurance claims	10	**(9,151)**	(11,321)
Total income, net of insurance claims		**14,606**	15,584
Operating expenses	11	**(5,681)**	(6,870)
Trading surplus		**8,925**	8,714
Impairment	12	**(10,878)**	(21,077)
Share of results of joint ventures and associates	13	**(98)**	(725)
Loss before tax		**(2,051)**	(13,088)
Taxation	14	**(264)**	2,698
Loss for the year		**(2,315)**	(10,390)
Profit attributable to non-controlling interests		**36**	101
Loss attributable to equity shareholders		**(2,351)**	(10,491)
Loss for the year		**(2,315)**	(10,390)

[1]Restated – see note 1.

The accompanying notes are an integral part of the financial statements.

Consolidated statement of comprehensive income

for the year ended 31 December 2010

	2010 £ million	2009[1] £ million
Loss for the year	**(2,315)**	(10,390)
Other comprehensive income		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	**205**	2,588
Income statement transfers in respect of disposals	**(52)**	3
Income statement transfers in respect of impairment	**641**	1,479
Other income statement transfers	**(62)**	(147)
Taxation	**(231)**	(1,048)
	501	2,875
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value of hedging derivatives	**(781)**	(613)
Net income statement transfers	**1,378**	895
Taxation	**(174)**	(79)
	423	203
Currency translation differences:		
Currency translation differences, before tax	**(204)**	5
Taxation	**–**	(4)
	(204)	1
Other comprehensive income for the year, net of tax	**720**	3,079
Total comprehensive income for the year	**(1,595)**	(7,311)
Total comprehensive income attributable to non-controlling interests	**36**	101
Total comprehensive income attributable to equity shareholders	**(1,631)**	(7,412)
Total comprehensive income for the year	**(1,595)**	(7,311)

[1]Restated – see note 1.

Consolidated balance sheet

as at 31 December 2010

	Note	2010 £ million	2009[1] £ million	1 January 2009[1] £ million
Assets				
Cash and balances at central banks		**2,375**	2,905	2,502
Items in the course of collection from banks		**319**	534	445
Trading and other financial assets at fair value through profit or loss	15	**103,086**	101,908	89,691
Derivative financial instruments	16	**30,000**	30,919	51,810
Loans and receivables:				
Loans and advances to banks	17	**65,170**	98,524	16,796
Loans and advances to customers	18	**381,365**	404,075	450,421
Debt securities	21	**23,632**	31,468	39,053
		470,167	534,067	506,270
Available-for-sale financial assets	23	**13,843**	21,591	28,048
Investment properties	24	**3,356**	2,417	3,045
Investments in joint ventures and associates	13	**428**	393	1,161
Goodwill	26	**850**	850	1,556
Value of in-force business	27	**3,171**	2,986	3,284
Other intangible assets	28	**74**	97	117
Tangible fixed assets	29	**3,482**	5,103	5,810
Current tax recoverable		**64**	495	983
Deferred tax assets	41	**4,062**	4,724	2,832
Retirement benefit assets	40	**152**	67	46
Other assets	30	**6,323**	10,127	7,208
		641,752	719,183	704,808

[1]Restated – see note 1.

The accompanying notes are an integral part of the consolidated financial statements.

The directors approved the consolidated financial statements on 24 February 2011.

Sir Winfried Bischoff
Chairman

J Eric Daniels
Chief Executive

Tim J W Tookey
Finance Director

Consolidated balance sheet

as at 31 December 2010

	Note	2010 £ million	2009[1] £ million	1 January 2009[1] £ million
Equity and liabilities				
Liabilities				
Deposits from banks	31	**143,137**	179,064	97,150
Customer deposits	32	**216,404**	232,023	237,449
Items in course of transmission to banks		**251**	495	521
Trading liabilities	33	**18,786**	27,372	18,851
Derivative financial instruments	16	**25,075**	25,801	38,905
Notes in circulation		**1,074**	981	957
Debt securities in issue	34	**100,760**	119,157	188,448
Liabilities arising from insurance contracts and participating investment contracts	35	**40,076**	39,234	36,873
Liabilities arising from non-participating investment contracts	37	**35,136**	30,614	29,057
Unallocated surplus within insurance businesses	38	**321**	772	551
Other liabilities	39	**16,561**	17,474	12,151
Retirement benefit obligations	40	**100**	467	562
Current tax liabilities		**134**	29	58
Deferred tax liabilities	41	**47**	208	227
Other provisions	42	**806**	258	147
Subordinated liabilities	43	**16,674**	19,078	30,119
Total liabilities		**615,342**	693,027	692,026
Equity				
Share capital	44	**3,763**	3,763	1,550
Share premium account	45	**18,655**	16,056	6,709
Other reserves	46	**8,857**	8,137	(4,551)
Retained profits	47	**(5,415)**	(3,071)	7,774
Shareholders' equity		**25,860**	24,885	11,482
Non-controlling interests		**550**	1,271	1,300
Total equity		**26,410**	26,156	12,782
Total equity and liabilities		**641,752**	719,183	704,808

[1]Restated – see note 1.

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated statement of changes in equity

for the year ended 31 December 2010

	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 2009:						
As previously stated	8,259	(5,616)	8,839	11,482	1,300	12,782
Prior year adjustment[1]	–	1,065	(1,065)	–	–	–
Restated	8,259	(4,551)	7,774	11,482	1,300	12,782
Comprehensive income						
(Loss) profit for the year	–	–	(10,491)	(10,491)	101	(10,390)
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	2,875	–	2,875	–	2,875
Movements in cash flow hedging reserve, net of tax	–	203	–	203	–	203
Currency translation differences, net of tax	–	1	–	1	–	1
Total other comprehensive income	–	3,079	–	3,079	–	3,079
Total comprehensive income	–	3,079	(10,491)	(7,412)	101	(7,311)
Transactions with owners						
Dividends	–	–	(355)	(355)	(95)	(450)
Issue of ordinary and preference shares	15,827	9,468	–	25,295	–	25,295
Redemption of preference shares	(4,267)	–	–	(4,267)	–	(4,267)
Purchase/sale of treasury shares	–	–	36	36	–	36
Capital redemption reserve	–	141	(141)	–	–	–
Employee share option plans:						
Value of employees services	–	–	106	106	–	106
Extinguishment of non-controlling interests	–	–	–	–	(35)	(35)
Total transactions with owners	11,560	9,609	(354)	20,815	(130)	20,685
Balance at 31 December 2009[1]	19,819	8,137	(3,071)	24,885	1,271	26,156
Comprehensive income						
(Loss) profit for the year	**–**	**–**	**(2,351)**	**(2,351)**	**36**	**(2,315)**
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	**–**	**501**	**–**	**501**	**–**	**501**
Movements in cash flow hedging reserve, net of tax	**–**	**423**	**–**	**423**	**–**	**423**
Currency translation differences, net of tax	**–**	**(204)**	**–**	**(204)**	**–**	**(204)**
Total other comprehensive income	**–**	**720**	**–**	**720**	**–**	**720**
Total comprehensive income	**–**	**720**	**(2,351)**	**(1,631)**	**36**	**(1,595)**
Transactions with owners						
Dividends	**–**	**–**	**–**	**–**	**(24)**	**(24)**
Issue of ordinary shares	**2,599**	**–**	**–**	**2,599**	**–**	**2,599**
Employee share option plans:						
Value of employees services	**–**	**–**	**7**	**7**	**–**	**7**
Extinguishment of non-controlling interests	**–**	**–**	**–**	**–**	**(733)**	**(733)**
Total transactions with owners	**2,599**	**–**	**7**	**2,606**	**(757)**	**1,849**
Balance at 31 December 2010	**22,418**	**8,857**	**(5,415)**	**25,860**	**550**	**26,410**

[1]Restated – see note 1.

Consolidated cash flow statement

for the year ended 31 December 2010

	Note	2010 £ million	2009[1] £ million
Loss before tax		**(2,051)**	(13,088)
Adjustments for:			
Change in operating assets	55a	**57,056**	(48,706)
Change in operating liabilities	55b	**(70,686)**	21,845
Non-cash and other items	55c	**5,624**	20,508
Tax received		**486**	289
Net cash used in operating activities		**(9,571)**	(19,152)
Cash flows from investing activities			
Purchase of available-for-sale financial assets		**(1,561)**	(10,944)
Proceeds from sale and maturity of available-for-sale financial assets		**10,293**	16,442
Purchase of fixed assets		**(1,277)**	(275)
Proceeds from sale of fixed assets		**1,021**	687
Acquisition of businesses, net of cash acquired		**(65)**	(314)
Disposal of businesses, net of cash disposed	55f	**2,783**	259
Net cash provided by investing activities		**11,194**	5,855
Cash flows from financing activities			
Dividends paid to preference shareholders		**–**	(355)
Dividends paid to non-controlling interests	55e	**(24)**	(95)
Interest paid on subordinated liabilities		**(809)**	(1,302)
Redemption of preference shares	55e	**–**	(4,267)
Proceeds from issue of ordinary shares	55e	**–**	25,295
Proceeds from disposal of own shares		**–**	36
Repayment of subordinated liabilities	55e	**(331)**	(8,178)
Repayment of capital to non-controlling interests	55e	**–**	(35)
Net cash (used in) provided by financing activities		**(1,164)**	11,099
Effects of exchange rate changes on cash and cash equivalents		**–**	46
Change in cash and cash equivalents		**459**	(2,152)
Cash and cash equivalents at beginning of year		**9,084**	11,236
Cash and cash equivalents at end of year	55d	**9,543**	9,084

[1]Restated

The accompanying notes are an integral part of the consolidated financial statements.

Company statement of comprehensive income

for the year ended 31 December 2010

	2010 £ million	2009 £ million
Profit (loss) for the year	**1,944**	(7,322)
Other comprehensive income		
Currency translation differences before and after tax	**–**	16
Other comprehensive income for the year, net of tax	**–**	16
Total comprehensive income for the year	**1,944**	(7,306)

Company balance sheet

for the year ended 31 December 2010

	Note	**2010 £ million**	2009 £ million
Assets			
Amounts owed by Group entities		**49,687**	46,186
Derivative financial instruments	16	**2,061**	1,711
Loans and receivables: debt securities		**–**	1
Intangible assets	28	**–**	2
Deferred tax assets	41	**–**	113
Retirement benefit assets	40	**150**	67
Other assets	30	**5**	1,780
Investments in subsidiary undertakings	25	**26,923**	26,128
Total assets		**78,826**	75,988
Liabilities			
Amounts owed to Group entities		**39,226**	37,450
Derivative financial instruments	16	**–**	43
Other liabilities	39	**363**	432
Current tax liabilities		**66**	144
Retirement benefit obligations	40	**98**	479
Deferred tax liabilities	41	**27**	–
Subordinated liabilities	43	**11,617**	14,554
Total liabilities		**51,397**	53,102
Equity			
Issued share capital	44	**3,763**	3,763
Share premium account	45	**18,655**	16,056
Other reserves	46	**9,692**	9,692
Retained profits	47	**(4,681)**	(6,625)
Shareholders' equity		**27,429**	22,886
Total equity and liabilities		**78,826**	75,988

The accompanying notes are an integral part of the financial statements.

Approved by the Board on 24 February 2011 and signed on its behalf by:

Sir Winfried Bischoff	**J Eric Daniels**	**Tim J W Tookey**
Chairman	Chief Executive	Finance Director

Company statement of changes in equity

for the year ended 31 December 2010

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
Balance at 1 January 2009	8,259	67	1,082	9,408
Comprehensive income				
Loss for the year	–	–	(7,322)	(7,322)
Other comprehensive income				
Currency translation differences, net of tax	–	16	–	16
Total comprehensive income	–	16	(7,322)	(7,306)
Transactions with owners				
Dividends	–	–	(355)	(355)
Issue of ordinary and preference shares	15,827	9,468	–	25,295
Redemption of preference shares	(4,267)	–	–	(4,267)
Capital redemption reserve	–	141	(141)	–
Purchase/sale of treasury shares	–	–	12	12
Employee share option plans:				
Value of employee services	–	–	99	99
Total transactions with owners	11,560	9,609	(385)	20,784
Balance at 31 December 2009	19,819	9,692	(6,625)	22,886
Comprehensive income				
Profit for the year	**–**	**–**	**1,944**	**1,944**
Total comprehensive income	**–**	**–**	**1,944**	**1,944**
Transactions with owners				
Issue of ordinary and preference shares	**2,599**	**–**	**–**	**2,599**
Total transactions with owners	**2,599**	**–**	**–**	**2,599**
Balance at 31 December 2010	**22,418**	**9,692**	**(4,681)**	**27,429**

Company cash flow statement

for the year ended 31 December 2010

	2010 **£ million**	2009 £ million
Profit (loss) before tax	**2,005**	(6,997)
Adjustments for:		
Dividend income	**(986)**	–
Fair value and exchange adjustments	**(366)**	–
Change in operating assets	**(10,319)**	1,980
Change in operating liabilities	**1,326**	1,095
Non-cash and other items	**–**	9,050
Tax paid	**–**	(3)
Net cash (used in) provided by operating activities	**(8,340)**	5,125
Cash flows from investing activities		
Capital lending to subsidiaries	**–**	(20,189)
Cash flows from financing activities		
Dividends received from subsidiaries	**986**	–
Dividends paid to preference shareholders	**–**	(355)
Proceeds from issue of ordinary shares	**–**	25,295
Redemption of preference shares	**–**	(4,267)
Repayment of subordinated liabilities	**–**	(6,126)
Interest paid on subordinated liabilities	**(364)**	(973)
Purchase of own shares	**–**	12
Net cash provided by financing activities	**622**	13,586
Change in cash and cash equivalents	**(7,718)**	(1,478)
Cash and cash equivalents at beginning of year	**38,113**	39,591
Cash and cash equivalents at end of year	**30,395**	38,113

The accompanying notes are an integral part of the Company financial statements.

1 Basis of preparation

The financial statements of HBOS plc have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union (EU) as applied in accordance with the provisions of the Companies Act 2006. 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.

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 Principal risks and uncertainties section under Liquidity and funding on page 8 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

During 2010, IFRIC clarified the treatment of amounts previously recognised in equity in respect of assets that were transferred from the available-for-sale category to the loans and receivables category. When an impairment loss is recognised in respect of such transferred financial assets, the unamortised balance of any available-for-sale revaluation reserves that remains in equity should be transferred to the income statement and recorded as part of the impairment loss. The Group has changed its accounting policy to reflect this clarification. Under the Group's previous accounting policy, when such a transferred financial asset became impaired, not all of the unamortised amounts previously transferred to equity were recycled to the income statement and therefore continued to be accreted over the expected remaining life of the financial asset. This change is applied retrospectively and the effect on the Group has been to reduce retained profits and increase available-for-sale revaluation reserves by £1,065 million at 1 January 2009; shareholders' equity is unchanged. The effect on the year ended 31 December 2009 has been to increase the impairment charge by £937 million; increase net interest income by £186 million; increase other income by £39 million; increase the tax credit by £200 million and increase available-for-sale revaluation reserves by £512 million. The financial statements and capital ratios have been restated accordingly.

The Group has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2010. None of these standards or amendments have had a material impact on these financial statements.

(i) IFRS 3 *Business Combinations*. This revised standard applies prospectively to business combinations from 1 January 2010. The revised standard continues to require the use of the acquisition method of accounting for business combinations. All payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the non-controlling interest, and all transaction costs are expensed (other than those in relation to the issuance of debt instruments or share capital).

(ii) IAS 27 *Consolidated and Separate Financial Statements*. Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is remeasured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.

(iii) IFRIC 17 *Distributions of Non-cash Assets to Owners*. Provides accounting guidance for non-reciprocal distributions of non-cash assets to owners (and those in which owners may elect to receive a cash alternative).

(iv) Amendment to IAS 39 *Financial Instruments: Recognition and Measurement – 'Eligible Hedged Items'*. Clarifies how the principles underlying hedge accounting should be applied in particular situations.

(v) *Improvements to IFRSs* (issued April 2009). Sets out minor amendments to IFRS standards as part of the annual improvements process.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2010 and which have not been applied in preparing these financial statements are given in note 56.

2 Accounting policies

The accounting policies are set out below.

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, joint ventures and associates.

(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 25.

Investment vehicles, such as Open Ended Investment Companies (OEICs), where the Group has control, typically through acting as fund manager and the life funds having a beneficial interest greater than 50 per cent, are consolidated. The non-controlling unitholders' interest is 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.

2 Accounting policies (continued)

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Change 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 2e(4)) or share capital (see 2r(1)). 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.

c Other intangible assets
Other intangible assets include brands and 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 5 years
Brands (which have been assessed as having finite lives)	10-15 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, except for those classified at fair value through profit or loss, using the effective interest method. 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).

2 Accounting policies (continued)

e Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets 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.

(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.

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: Valuation of financial instruments) and note 52 (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;
- 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 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

2 Accounting policies (continued)

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. These loans and advances to customers continue to be recognised by the Group, together with a corresponding liability for the funding.

(4) 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.

(5) 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.

(6) Derecognition of financial assets and liabilities
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.

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 52(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 the same. 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:

(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

2 Accounting policies (continued)

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 instruments 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 Wholesale and Wealth 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 and International division 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).

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
In respect of portfolios of smaller balance, homogenous loans, or otherwise where there is no objective evidence of individual impairment, 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, 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 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 noted 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 to reflect the effects of current conditions that did not affect the period on which the historical loss

2 Accounting policies (continued)

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.

The collective provision also includes provision for inherent losses, that is loan losses that have been incurred but have not been identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. An assessment is made, based on statistical techniques, of the likelihood of each account becoming recognised as impaired within an emergence period, with the economic loss that each portfolio is likely to generate were it to become impaired. The emergence period is the time between the loss event and the date the impairment is recognised. The emergence period is determined by local management for each portfolio. In general the periods used across the Group vary between one month and twelve months based on historical experience.

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. There are a number of different types of loan renegotiation, including the capitalisation of arrears, payment holidays, interest rate adjustments and extensions of the due date of payment. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, this results in the asset continuing to be reported as past due and it 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. In other cases, renegotiation may lead to a new agreement, which is treated as a new loan.

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.

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. 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; although 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.

2 Accounting policies (continued)

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 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. 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

Lloyds Banking 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. 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. 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 over the remaining vesting period, 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 in accordance with IFRS 2 (Revised) 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 over any remaining vesting period.

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 equity holders' 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.

2 Accounting policies (continued)

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 substantially 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.

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.

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). Changes in the value of these liabilities are recognised 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.

(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 insurance claims.

2 Accounting policies (continued)

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 losses on one or more contracts issued by the Group and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held.

The benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers as well as longer term receivables that are dependent on the expected claims and benefits arising under the related reinsured 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.

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.

2 Accounting policies (continued)

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.

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.

t Investment in subsidiaries
Investments in subsidiaries are carried at historical cost, less any provisions for impairment.

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.

The estimates and judgements applied to these areas in the preparation of the Group's financial statements are summarised below.

Allowance for impairment losses on loans and receivables
At 31 December 2010 gross loans and receivables totalled £496,774 million (2009: £557,339 million) against which impairment allowances of £26,607 million (2009: £23,272 million) had been made (see note 22). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2h; 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 real estate 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. 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.

3 Critical accounting estimates and judgements (continued)

Given the relative size of the mortgage portfolio, a key variable is UK 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 10 per cent lower than those estimated at 31 December 2010, the related impairment charge would increase by approximately £210 million.

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 Group's wholesale businesses, 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 £278 million.

Fair value of financial instruments
In accordance with IFRS 7, 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 require management judgement and contain significant estimation uncertainty.

In particular, significant judgement is required by management in determining appropriate assumptions to be used for level 3 financial instruments. At 31 December 2010, the Group classified £3,328 million of financial assets and £46 million of financial liabilities as level 3. The effect of applying reasonably possible alternative assumptions in determining the fair value of the Group's level 3 financial assets is set out in note 52.

Recoverability of deferred tax assets
At 31 December 2010 the Group carried deferred tax assets on its balance sheet of £4,062 million (2009: £4,724 million) and deferred tax liabilities of £47 million (2009: £208 million) (note 41). 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 41 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward. At 31 December 2010, the Group recognised a deferred tax asset of £3,899 million (2009 £3,625 million) in respect of tax losses carried forward.

The recognition of a deferred tax asset in respect of tax losses is permitted only to the extent that it is probable that future taxable profits will be available to utilise the tax losses carried forward. The assessment of future taxable profits involves significant estimation uncertainty, principally relating to management's projections of future taxable income which are based on business plans. These projections include assumptions about the future strategy of the Group, the economic and regulatory environment in which the Group operates, future tax legislation, customer behaviour, and the ability of the Group to deliver expected integration benefits, amongst other variables. At 31 December 2010, management has concluded that future taxable profits generated by the Group companies with tax losses carried forward are expected to be sufficient to utilise the tax losses carried forward in full.

Retirement benefit obligations
The net asset recognised in the balance sheet at 31 December 2010 in respect of the Group's retirement benefit obligations was £52 million (2009: net liability £400 million). In 2010, this comprised an asset of £152 million and a liability of £100 million; (2009: an asset of £67 million and a liability of £467 million) of which an asset of £108 million (2009: a liability of £346 million) related to defined benefit pension schemes. As explained in note 2l, 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 £7 million (2009: £488 million). The defined benefit pension schemes' gross surplus totalled £101 million (2009: deficit of £834 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 significant management judgement in determining the appropriate assumptions to be used. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The size of the 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, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience. Assumptions used by management reflect recent longevity experience and extrapolate the improving trend.

The effect on the gross defined benefit pension scheme asset or liability and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in note 40.

Valuation of assets and liabilities arising from life insurance business
At 31 December 2010, the Group recognised a value of in-force business asset of £3,035 million (2009: £2,838 million) and an acquired value of in-force business asset of £136 million (2009: £148 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 2o(1)(iii). 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 2010 are set out in note 27.

At 31 December 2010, the Group carried liabilities arising from insurance contracts and participating investment contracts of £40,076 million (2009: £39,234 million). The methodology used to value these liabilities is described in note 2o(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 35.

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 36.

4 Segmental analysis

IFRS 8 'Operating Segments' requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision maker has been identified as the Group Executive Committee of Lloyds Banking Group. The HBOS Group is managed on an entity basis and not by segment. The Group Executive Committee does not assess the HBOS Group's performance and allocate resources across any segments, accordingly no segmental information is provided. A brief overview of the Group's sources of income is provided in this document. The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Lloyds Banking Group.

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.

	2010			2009[1]		
	UK £m	**Non-UK £m**	**Total £m**	UK £m	Non-UK £m	Total £m
Total income	**19,766**	**3,991**	**23,757**	24,702	2,203	26,905
Total assets	**552,485**	**89,267**	**641,752**	636,677	82,506	719,183

[1]Restated – see note 1.

There was no individual non-UK country contributing more than 5 per cent of total income or total assets.

5 Net interest income

	Weighted average effective interest rate			
	2010 %	2009[1] %	**2010 £m**	2009[1] £m
Interest and similar income:				
Loans and advances to customers, excluding lease and hire purchase receivables	**4.23**	3.66	**16,732**	16,229
Loans and advances to banks	**0.27**	0.86	**211**	468
Debt securities held as loans and receivables	**2.41**	2.32	**713**	876
Lease and hire purchase receivables	**4.41**	4.86	**24**	254
Interest receivable on loans and receivables	**3.51**	3.29	**17,680**	17,827
Available-for-sale financial assets	**2.28**	2.06	**381**	573
Other	**–**	–	**–**	56
Total interest and similar income	**3.47**	3.23	**18,061**	18,456
Interest and similar expense:				
Deposits from banks, excluding liabilities under sale and repurchase agreements	**0.24**	0.76	**(340)**	(1,121)
Customer deposits, excluding liabilities under sale and repurchase agreements	**2.38**	2.12	**(4,484)**	(4,245)
Debt securities in issue	**2.36**	2.31	**(2,694)**	(3,329)
Subordinated liabilities	**5.36**	4.50	**(918)**	(1,212)
Liabilities under sale and repurchase agreements	**1.11**	2.22	**(548)**	(1,261)
Interest payable on liabilities held at amortised cost	**1.76**	1.94	**(8,984)**	(11,168)
Other	**12.18**	–	**(707)**	(1,599)
Total interest and similar expense	**1.88**	2.20	**(9,691)**	(12,767)
Net interest income			**8,370**	5,689

[1]Restated – see note 1.

Included within interest and similar income is £916 million (2009: £969 million) in respect of impaired financial assets. Net interest income also includes a charge of £1,378 million (2009: £890 million) transferred from the cash flow hedging reserve.

6 Net fee and commission income

	2010 £m	2009 £m
Fee and commission income:		
Current accounts	**343**	329
Credit and debit card fees	**203**	212
Other	**934**	951
Total fee and commision income	**1,480**	1,492
Fee and commission expense	**(964)**	(1,007)
Net fee and commission income	**516**	485

As discussed in note 2d, 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.

7 Net trading income

	2010 £m	2009 £m
Foreign exchange translation gains (losses)	**207**	(248)
Gains on foreign exchange trading transactions	**160**	105
Total foreign exchange	**367**	(143)
Investment property gains (losses) (note 24)	**233**	(112)
Securities and other gains (see below)	**8,495**	9,114
Net trading income	**9,095**	8,859

Securities and other gains comprise net gains arising on assets and liabilities held at fair value through profit or loss and for trading as follows:

	2010 £m	2009 £m
Net income arising on assets held at fair value through profit or loss:		
Debt securities, loans and advances	**905**	773
Equity shares	**6,697**	9,510
Total net income arising on assets held at fair value through profit or loss	**7,602**	10,283
Net gains (losses) on financial instruments held for trading	**893**	(1,169)
Securities and other gains	**8,495**	9,114

8 Insurance premium income

	2010 £m	2009 £m
Life insurance		
Gross premiums	**3,116**	4,290
Ceded reinsurance premiums	**(188)**	(206)
Net earned premiums	**2,928**	4,084
Non-life insurance		
Gross written premiums	**739**	794
Ceded reinsurance premiums	**(90)**	(66)
Net written premiums	**649**	728
Change in provision for unearned premiums (note 35(2))	**73**	86
Change in provision for ceded unearned premiums (note 35(2))	**(1)**	15
Net earned premiums	**721**	829
Total net earned premiums	**3,649**	4,913

8 Insurance premium income (continued)

Life insurance gross premiums can be further analysed as follows:

	2010 £m	2009 £m
Life and pensions	**2,961**	4,067
Annuities	**154**	223
Other	**1**	–
Gross premiums	**3,116**	4,290

Non-life insurance gross written premiums can be further analysed as follows:

	2010 £m	2009 £m
Credit protection	**243**	302
Home	**496**	492
Gross written premiums	**739**	794

9 Other operating income

	2010 £m	2009[1] £m
Operating lease rental income	**807**	1,100
Rental income from investment properties (note 24)	**158**	177
Other rents receivable	**9**	19
Gains less losses on disposal of available-for-sale financial assets	**52**	(3)
Gains on capital transactions	**359**	2,514
Movement in value of in-force business (note 27)	**227**	(178)
Other income	**515**	330
Total other operating Income	**2,127**	3,959

[1] Restated – see note 1.

During 2010 and 2009, as part of the Lloyds Banking Group's management of capital, the Group exchanged certain existing subordinated debt securities for new securities. These exchanges resulted in a gain on extinguishment of the existing liabilities of £359 million (2009: £2,514 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.

Subvention income
In addition to the other operating income above, during the year ended 31 December 2009 Bank of Scotland plc, a member of the HBOS Group, received a payment of £3,000 million from Lloyds TSB Bank plc, a member of the Lloyds Banking Group, to support its financial and reputational position and to facilitate the ongoing integration of the group's banking operations.

10 Insurance claims

Insurance claims comprise:

	2010 £m	2009 £m
Life insurance and participating investment contracts		
Claims and surrenders:		
Gross (see below)	**5,285**	3,952
Reinsurers' share	**(102)**	(74)
	5,183	3,878
Change in insurance and participating investment contract liabilities (note 35(1)):		
Change in gross liabilities	**865**	2,570
Change in reinsurers' share of liabilities	**(162)**	(133)
	703	2,437
Change in gross non-participating investment contract liabilities:		
Change in gross liabilities	**3,471**	4,399
Change in reinsurers' share of liabilities	**(65)**	–
	3,406	4,399
Change in unallocated surplus (note 38)	**(451)**	254
Total life insurance and participating investment contracts	**8,841**	10,968
Non-life insurance		
Claims and claims paid:		
Gross	**282**	309
Reinsurers' share	**(9)**	(13)
	273	296
Change in liabilities (note 35(2)):		
Gross	**41**	62
Reinsurers' share	**(4)**	(5)
	37	57
Total non-life insurance	**310**	353
Total insurance claims	**9,151**	11,321

Life insurance and participating investment contract gross claims can also be analysed as follows:

	2010 £m	2009 £m
Deaths	**414**	367
Maturities	**466**	511
Surrenders	**3,968**	2,636
Annuities	**178**	170
Other	**259**	268
Total life insurance gross claims	**5,285**	3,952

A non-life insurance claims development table is included in note 35.

11 Operating expenses

	2010 £m	2009 £m
Staff costs:		
Salaries	**1,797**	2,197
Social security costs	**168**	198
Pensions and other post-retirement benefit schemes (note 40):		
Curtailment gain[1]	**(316)**	–
Other	**257**	279
	(59)	279
Restructuring costs	**56**	225
Other staff costs	**182**	207
	2,144	3,106
Premises and equipment:		
Rent and rates	**274**	234
Hire of equipment	**4**	10
Repairs and maintenance	**39**	53
Other	**204**	144
	521	441
Other expenses:		
Communications and data processing	**287**	111
Advertising and promotion	**162**	158
Professional fees	**159**	198
Customer goodwill payments provision (note 42)	**500**	–
Other	**978**	918
	2,086	1,385
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 29)	**839**	1,087
Amortisation of acquired value of in-force non-participating investment contracts (note 27)	**12**	53
Amortisation of other intangible assets (note 28)	**27**	34
	878	1,174
Impairment of tangible fixed assets (note 29)	**52**	–
Goodwill impairment (note 26)	**–**	764
Total operating expenses	**5,681**	6,870

[1]Following changes by the Group to the terms of its defined benefit pension schemes, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each emplyee's actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of the year of the year there was a change in commutation factors in certain defined benefit schemes. The combined effect of these changes is a reduction in the Group's defined benefit obligation of £380 million and a reduction in the Group's unrecognised actuarial losses of £64 million, resulting in a net curtailment gain of £316 million recognised in the income statement and a reduction in the balance sheet liability.

The average number of persons on a headcount basis employed by the Group during the year was as follows:

	2010	2009
UK	**53,646**	61,219
Overseas	**2,876**	4,767
Total	**56,522**	65,986

Fees payable to the Company's auditors

During the year the auditors earned the following fees:

	2010 £m	2009 £m
Fees payable for the audit of the Company's current year annual report	**2.6**	1.7
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	**6.6**	9.1
Other services supplied pursuant to legislation	**0.8**	1.1
Other services – audit related fees	**0.1**	0.1
Services relating to taxation	**0.5**	0.5
Services relating to corporate finance transactions	**–**	0.1
All other services	**0.1**	0.3
Total fees payable to the Company's auditors by the Group	**10.7**	12.9

During the year, the auditors also earned fees payable by entities outside the consolidated Group in respect of the following:

	2010 £m	2009 £m
Audits of Group pension schemes	**0.1**	0.1
Reviews of the financial position of corporate and other borrowers	**13.5**	12.0

12 Impairment

	2010 £m	2009[1] £m
Impairment losses on loans and receivables (note 22):		
Loans and advances to customers	**10,786**	18,231
Debt securities classified as loans and receivables	**(19)**	1,284
Total impairment losses on loans and receivables	**10,767**	19,515
Impairment of available-for-sale financial assets	**100**	1,557
Other credit risk provisions (note 42)	**11**	5
Total impairment charged to the income statement	**10,878**	21,077

[1]Restated – see note 1.

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	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Share of income statement amounts:						
Income	**313**	698	**132**	5	**445**	703
Expenses	**(209)**	(544)	**(91)**	(96)	**(300)**	(640)
Impairment	**(126)**	(272)	**(92)**	(77)	**(218)**	(349)
Insurance claims	**–**	(465)	**–**	–	**–**	(465)
Loss before tax	**(22)**	(583)	**(51)**	(168)	**(73)**	(751)
Tax	**(24)**	24	**(1)**	2	**(25)**	26
Share of post-tax results	**(46)**	(559)	**(52)**	(166)	**(98)**	(725)
Share of balance sheet amounts:						
Current assets	**3,369**	2,744	**376**	606	**3,745**	3,350
Non-current assets	**2,868**	5,392	**1,184**	1,611	**4,052**	7,003
Current liabilities	**(588)**	(2,128)	**(433)**	(493)	**(1,021)**	(2,621)
Non-current liabilities	**(5,323)**	(5,726)	**(1,025)**	(1,613)	**(6,348)**	(7,339)
Share of net assets at 31 December	**326**	282	**102**	111	**428**	393
Movement in investments over the year:						
At 1 January	**282**	938	**111**	223	**393**	1,161
Additional investments	**71**	140	**6**	12	**77**	152
Acquisitions	**–**	3	**–**	60	**–**	63
Disposals	**(12)**	(199)	**(2)**	(39)	**(14)**	(238)
Share of post-tax results	**(46)**	(559)	**(52)**	(166)	**(98)**	(725)
Dividends paid	**–**	(21)	**(1)**	–	**(1)**	(21)
Exchange and other adjustments	**31**	(20)	**40**	21	**71**	1
Share of net assets at 31 December	**326**	282	**102**	111	**428**	393

The Group's unrecognised share of losses of associates for the year is £8 million (2009: £64 million) and of joint ventures is £180 million (2009: £424 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 £104 million (2009: £155 million) and of joint ventures is £339 million (2009: £623 million).

The Group's principal joint venture investment at 31 December 2010 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.

14 Taxation

a Analysis of tax (charge) credit for the year

	2010 £m	2009 £m
UK corporation tax:		
Current tax on loss for the year	**(190)**	(1)
Adjustments in respect of prior years	**104**	(203)
	(86)	(204)
Double taxation relief	**–**	10
	(86)	(194)
Foreign tax:		
Current tax on loss for the year	**(39)**	(110)
Adjustments in respect of prior years	**38**	33
	(1)	(77)
Current tax charge	**(87)**	(271)
Deferred tax (note 41):		
Origination and reversal of temporary differences	**(28)**	2,874
Reduction in UK corporation tax rate	**(119)**	–
Adjustments in respect of prior years	**(30)**	95
	(177)	2,969
Tax (charge) credit	**(264)**	2,698

The tax (charge) credit for 2010 and 2009 is based on a UK corporation tax rate of 28.0 per cent.

	2010 £m	2009 £m
The above income tax (charge) credit is made up as follows:		
Tax charge attributable to policyholders	**(151)**	(196)
Shareholder tax (charge) credit	**(113)**	2,894
Tax (charge) credit	**(264)**	2,698

b Factors affecting the tax (charge) credit for the year

A reconciliation of the credit that would result from applying the standard UK corporation tax rate to the loss before tax to the tax (charge) credit for the year is given below:

	2010 £m	2009 £m
Loss before tax	**(2,051)**	(13,088)
Tax credit thereon at UK corporation tax rate of 28.0 per cent (2009: 28.0 per cent)	**574**	3,665
Factors affecting credit:		
UK corporation tax rate change	**(119)**	–
Goodwill impairment	**–**	(214)
Disallowed and non-taxable items	**48**	604
Overseas tax rate differences	**109**	(437)
Gains exempted or covered by capital losses	**54**	10
Policyholder interests	**(109)**	(141)
Adjustments in respect of previous years	**112**	(79)
Impairment of financial instruments	**36**	13
Effect of results of joint ventures and associates	**(27)**	(200)
Losses surrendered for no payment	**(421)**	–
Tax losses where no deferred tax provided	**(526)**	(488)
Other items	**5**	(35)
Tax (charge) credit on loss on ordinary activities	**(264)**	2,698

15 Trading and other financial assets at fair value through profit or loss of the Group

	2010 £m	2009 £m
Trading assets	**23,751**	27,611
Other financial assets at fair value through profit or loss	**79,335**	74,297
Total	**103,086**	101,908

These assets are comprised as follows:

	2010		2009	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to customers	**11,759**	**–**	13,307	–
Loans and advances to banks	**3,936**	**–**	5,577	635
Debt securities:				
Government securities	**1,403**	**10,301**	2,864	9,159
Other public sector securities	**–**	**797**	–	666
Bank and building society certificates of deposit	**3,692**	**606**	2,034	–
Asset-backed securities:				
Mortgage-backed securities	**–**	**106**	–	126
Other asset-backed securities	**973**	**195**	891	343
Corporate and other debt securities	**1,755**	**6,555**	2,938	7,034
	7,823	**18,560**	8,727	17,328
Equity shares:				
Listed	**–**	**30,501**	–	25,392
Unlisted	**6**	**30,274**	–	30,942
	6	**60,775**	–	56,334
Treasury and other bills	**227**	**–**	–	–
Total	**23,751**	**79,335**	27,611	74,297

At 31 December 2010 £79,947 million (2009: £62,140 million) of trading and other financial assets at fair value through profit or loss had a contractual residual maturity of greater than one year.

Other financial assets at fair value through profit or loss include financial assets backing insurance contracts and investment contracts of £81,013 million (2009: £74,040 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.

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £864 million (2009: £3,799 million) for the Group; the value of the related liability is £873 million (2009: £3,009 million). In all cases the transferee has the right to sell or repledge the assets concerned.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £15,513 million for the Group (2009: £18,867 million). Collateral is held with a fair value of £7,261 million for the Group (2009: £15,776 million), all of which the Group is able to repledge. At 31 December 2010, £10,371 million had been repledged by the Group (2009: £6,559 million).

16 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, cash flow and net investment hedge approaches as described in note 53; and
- Derivatives held in policyholders 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 52.

16 Derivative financial instruments (continued)

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.
- 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.

The fair values and notional amounts of derivative instruments are set out in the following table:

	2010			2009		
Group	**Contract/ notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading						
Exchange rate contracts:						
Spot, forwards and futures	**11,561**	**203**	**235**	23,131	291	288
Currency swaps	**59,990**	**3,126**	**843**	92,342	4,302	545
Options purchased	**103**	**8**	**–**	–	–	–
Options written	**100**	**–**	**4**	–	–	–
	71,754	**3,337**	**1,082**	115,473	4,593	833
Interest rate contracts:						
Interest rate swaps	**951,706**	**18,338**	**18,491**	703,791	14,744	14,957
Forward rate agreements	**729,594**	**238**	**216**	796,099	401	381
Options purchased	**15,682**	**661**	**–**	19,999	763	–
Options written	**21,872**	**–**	**779**	25,832	–	706
Futures	**21,259**	**3**	**–**	12,303	2	7
	1,740,113	**19,240**	**19,486**	1,558,024	15,910	16,051
Credit derivatives	**1,377**	**51**	**16**	4,980	153	11
Equity and other contracts	**6,462**	**1,344**	**810**	14,489	1,329	878
Total derivative assets/liabilities held for trading	**1,819,706**	**23,972**	**21,394**	1,692,966	21,985	17,773
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**39,631**	**3,417**	**470**	55,891	3,040	491
Cross currency swaps	**9,418**	**606**	**35**	26,162	635	108
	49,049	**4,023**	**505**	82,053	3,675	599
Derivatives designated as cash flow hedges:						
Interest rate swaps	**97,812**	**1,770**	**3,055**	229,390	5,246	7,277
Cross currency swaps	**17,911**	**232**	**121**	8,938	8	144
Options	**–**	**–**	**–**	2,754	4	5
Futures	**1,299**	**1**	**–**	5,137	1	3
	117,022	**2,003**	**3,176**	246,219	5,259	7,429
Derivatives designated as net investment hedges:						
Cross currency swaps	**86**	**2**	**–**	–	–	–
Total derivative assets/liabilities held for hedging	**166,157**	**6,028**	**3,681**	328,272	8,934	8,028
Total recognised derivative assets/liabilities	**1,985,863**	**30,000**	**25,075**	2,021,238	30,919	25,801

16 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.

2010	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	**76**	**246**	**427**	**478**	**373**	**329**	**131**	**143**	**2,203**
Forecast payable cash flows	**(85)**	**(34)**	**(137)**	**(82)**	**(58)**	**(175)**	**(286)**	**(57)**	**(914)**
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	**76**	**287**	**387**	**478**	**373**	**345**	**136**	**121**	**2,203**
Forecast payable cash flows	**(85)**	**(79)**	**(92)**	**(82)**	**(58)**	**(244)**	**(248)**	**(26)**	**(914)**

2009	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	39	44	–	49	80	468	374	142	1,196
Forecast payable cash flows	(300)	(569)	(247)	(184)	(82)	(257)	(606)	(84)	(2,329)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	39	44	22	37	123	453	340	138	1,196
Forecast payable cash flows	(300)	(569)	(331)	(130)	(74)	(287)	(563)	(75)	(2,329)

At 31 December 2010 £27,299 million of total recognised derivative assets of the Group and £22,124 million of total recognised derivative liabilities of the Group (2009: £26,486 million of assets and £22,106 million of liabilities) had a contractual residual maturity of greater than one year.

	2010			2009		
Company	**Contract/ notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Hedging						
Derivatives designated as fair value hedges:						
Currency swaps	**5,686**	**1,895**	**–**	9,447	1,567	–
Interest rate swaps	**496**	**166**	**–**	1,416	144	43
Total recognised derivative assets/liabilities, held for hedging	**6,182**	**2,061**	**–**	10,863	1,711	43

At 31 December 2010 £1,889 million of total recognised derivative assets of the Company and £nil of total recognised derivative liabilities of the Company (2009: £1,711 million of assets and £43 million of liabilities) had a contractual residual maturity of greater than one year.

The principal amount of a 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 and the Company 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 53.

17 Loans and advances to banks of the Group

	2010 £m	2009 £m
Lending to banks	**55,053**	88,620
Money market placements with banks	**10,117**	9,904
Total loans and advances to banks	**65,170**	98,524

No allowance for impaired loans was carried against these exposures at 31 December 2010 or 31 December 2009.

At 31 December 2010 £11,808 million (2009: £2,833 million) of loans and advances to banks had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £20,664 million (2009: £34,423 million). Collateral is held with a fair value of £15,318 million (2009: £34,362 million), all of which the Group is able to repledge.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £4 million (2009: £19 million).

18 Loans and advances to customers of the Group

	2010 £m	2009 £m
Agriculture, forestry and fishing	**602**	772
Energy and water supply	**1,145**	1,129
Manufacturing	**3,881**	6,836
Construction	**6,983**	11,169
Transport, distribution and hotels	**23,232**	21,496
Postal and telecommunications	**1,032**	1,449
Property companies	**58,092**	65,144
Financial, business and other services	**32,029**	36,352
Personal:		
Mortgages	**246,690**	252,745
Other	**16,974**	19,518
Lease financing	**4,458**	4,990
Hire purchase	**1,358**	3,486
Due from fellow Group undertakings	**10,205**	261
Total loans and advances to customers before allowance for impairment losses	**406,681**	425,347
Allowance for impairment losses (note 22)	**(25,316)**	(21,272)
Total loans and advances to customers	**381,365**	404,075

At 31 December 2010 £324,975 million (2009: £342,904 million) of loans and advances to customers had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £2,579 million (2009: £nil). Collateral is held with a fair value of £10 million (2009: £nil), all of which the Group is able to repledge.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £42 million (2009: £203 million).

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

	2010 £m	2009 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**614**	726
Later than 1 year and not later than 5 years	**1,395**	2,106
Later than 5 years	**2,581**	2,988
	4,590	5,820
Unearned future finance income on finance leases	**(132)**	(830)
Net investment in finance leases	**4,458**	4,990

The net investment in finance leases represents amounts recoverable as follows:

	2010 £m	2009 £m
Not later than 1 year	**671**	644
Later than 1 year and not later than 5 years	**1,224**	1,511
Later than 5 years	**2,563**	2,835
Net investment in finance leases	**4,458**	4,990

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 2010 and 2009 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 for the Group is £227 million (2009: £103 million).

19 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 two conduit programmes, Grampian and Landale.

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 notes in issue at 31 December, are listed below. The notes in issue are reported in note 34.

	2010		2009	
	Gross assets securitised £m	**Notes in issue £m**	Gross assets securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	**102,801**	**83,367**	104,257	95,228
US residential mortgage-backed securities	**7,197**	**7,221**	7,897	7,897
Irish residential mortgages	**6,061**	**6,191**	6,522	6,585
Credit card receivables	**7,372**	**3,856**	5,155	2,699
Dutch residential mortgages	**4,551**	**4,415**	4,812	4,834
Personal loans	**3,012**	**2,011**	3,730	2,613
Commercial loans	**667**	**633**	928	976
Motor vehicle loans	**926**	**975**	443	470
	132,587	**108,669**	133,744	121,302
Less held by the Group		**(78,686)**		(87,359)
Total securitisation programmes (note 34)		**29,983**		33,943
Covered bond programmes				
Residential mortgage-backed	**55,032**	**44,271**	61,537	49,644
Social housing loan-backed	**3,377**	**2,400**	3,407	2,976
	58,409	**46,671**	64,944	52,620
Less held by the Group		**(17,239)**		(23,060)
Total covered bond programmes (note 34)		**29,432**		29,560
Total securitisation and covered bond programmes		**59,415**		63,503

Cash deposits of £25,139 million (2009: £24,271 million) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs, covered bonds issued by Bank of Scotland plc and other legal obligations.

20 Special purpose entities

In addition to the SPEs discussed in note 19, which are used for securitisation and covered bond programmes, the Group sponsors two asset-backed conduits, Grampian and Landale, which invest in debt securities. All the external assets in these conduits are consolidated in the Groups' financial statements. The total consolidated exposures in these conduits are set out in the table below:

At 31 December 2010	**Grampian £m**	**Landale £m**	**Total £m**
Debt securities classified as loans and receivables	**6,967**	**–**	**6,967**

At 31 December 2009	Grampian £m	Landale £m	Total £m
Debt securities classified as loans and receivables	9,924	698	10,622

21 Debt securities classified as loans and receivables of the Group

Debt securities accounted for as loans and receivables comprise:

	2010 £m	2009 £m
Asset-backed securities:		
Mortgage-backed securities	**12,276**	15,555
Other asset-backed securities	**11,989**	16,705
Corporate and other debt securities	**658**	1,208
Total debt securities classified as loans and receivables before allowance for impairment losses	**24,923**	33,468
Allowance for impairment losses (note 22)	**(1,291)**	(2,000)
Total debt securities classified as loans and receivables	**23,632**	31,468

At 31 December 2010, £23,572 million (2009: £31,063 million) of debt securities classified as loans and receivables of the Group had a contractual residual maturity of greater than one year.

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £8,020 million (2009: £12,238 million); the value of the related liability is £7,081 million (2009: £8,396 million). In all cases the transferee has the right to sell or repledge the assets concerned.

22 Allowances for impairment losses on loans and receivables

	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January 2009	10,693	923	11,616
Exchange and other adjustments	162	(172)	(10)
Advances written off	(7,459)	(35)	(7,494)
Recoveries of advances written off in previous years	36	–	36
Unwinding of discount	(391)	–	(391)
Charge to the income statement (note 12)	18,231	1,284	19,515
At 31 December 2009	21,272	2,000	23,272
Exchange and other adjustments	**330**	**81**	**411**
Disposal of subsidiary undertakings	**(149)**	**–**	**(149)**
Advances written off	**(6,605)**	**(771)**	**(7,376)**
Recoveries of advances written off in previous years	**57**	**–**	**57**
Unwinding of discount	**(375)**	**–**	**(375)**
Charge (credit) to the income statement (note 12)	**10,786**	**(19)**	**10,767**
At 31 December 2010	**25,316**	**1,291**	**26,607**

Of the Group's total allowance in respect of loans and advances to customers, £22,086 million (2009: £18,440 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, £4,900 million (2009: £4,220 million) was assessed on a collective basis.

23 Available-for-sale financial assets of the Group

	2010 £m	2009 £m
Debt securities:		
Government securities	**142**	326
Bank and building society certificates of deposit	**129**	285
Asset-backed securities:		
Mortgage-backed securities	**15**	17
Other asset-backed securities	**181**	79
Corporate and other debt securities	**10,717**	18,935
	11,184	19,642
Equity shares:		
Listed	**65**	98
Unlisted	**2,111**	1,851
	2,176	1,949
Treasury and other bills	**483**	–
Total available-for-sale financial assets	**13,843**	21,591

At 31 December 2010 £10,189 million (2009: £18,817 million) of available-for-sale financial assets had a contractual residual maturity of greater than one year.

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £3,007 million (2009: £10,628 million); the value of the related liability is £2,840 million (2009: £9,957 million). In all cases the transferee has the right to sell or repledge the assets concerned.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2h(2). Included in available-for-sale assets at 31 December 2010 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £160 million (2009: £329 million) and in respect of which no collateral was held.

24 Investment properties

	2010 £m	2009 £m
At 1 January	**2,417**	3,045
Additions:		
Acquisitions of new properties	**262**	163
Consolidation of new subsidiary undertakings	**921**	–
Additional expenditure on existing properties	**37**	69
Total additions	**1,220**	232
Disposals	**(514)**	(700)
Changes in fair value (note 7)	**233**	(112)
Disposal of businesses	**–**	(48)
At 31 December	**3,356**	2,417

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:

	2010 £m	2009 £m
Rental income (note 9)	**158**	177
Direct operating expenses arising from investment properties that generate rental income	**45**	25
Capital expenditure in respect of investment properties:		
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	**66**	48

25 Investment in subsidiary undertakings

	2010 £m	2009 £m
At 1 January	**26,128**	15,783
Additional capital injections and transfers	**795**	20,189
Impairment	**–**	(9,844)
At 31 December	**26,923**	26,128

A reassessment of the carrying value of the Company's investment in Bank of Scotland plc at 31 December 2010 concluded that the carrying value of the Company's investment has not fallen below its recoverable amount.

Recoverable amount is based on the fair value less cost to sell and was determined by using a discounted cash flow valuation technique. This calculation uses projections of future cash flows based on management's plans covering a five year period. These cash flows are based on past experience and have been adjusted to take into account expected future market conditions. Cash flows beyond the five year period have been extrapolated using a steady 2.2 per cent rate of increase. The expected cash flows have been discounted at a rate of 17.75 per cent which has been determined to be in line with available market information.

The impairment charge of £9,844 million in 2009 was in respect of the Company's investment in Bank of Scotland plc and was triggered by the continued deterioration in the financial performance of Bank of Scotland plc at that time, principally due to increased impairment losses in its lending portfolios.

The principal group undertakings, all of which have prepared accounts to 31 December and whose results are included in the consolidated accounts of HBOS plc, are:

	Company's interest in ordinary share capital and voting rights	Country of incorporation	Principal business
Bank of Scotland plc	100%	UK	Banking, financial and related services
HBOS Insurance & Investment Group Limited	100%	UK	Investment holding

The principal area of operation for each of the above group undertakings is the United Kingdom.

In November 2009, as part of the restructuring plan that was a requirement for European Community (EC) approval of state aid received, Lloyds Banking Group plc agreed to suspend the payment of coupons and dividends on certain Group preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. Lloyds Banking Group plc has 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 may be prevented from making dividend payments on ordinary shares during this period. In addition, certain subsidiary companies currently have insufficient distributable reserves to make dividend distributions.

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 payments.

26 Goodwill

	2010 £m	2009 £m
At 1 January	**850**	1,556
Exchange and other adjustments	**–**	1
Acquired through business combinations	**–**	99
Disposals	**–**	(42)
Impairment charged to the income statement (note 11)	**–**	(764)
At 31 December	**850**	850
Cost[1]	**1,838**	1,838
Accumulated impairment losses	**(988)**	(988)
At 31 December	**850**	850

[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. This compares the recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £850 million (2009: £850 million), £478 million (or 56 per cent of the total) has been allocated to insurance and investment businesses and £356 million (or 42 per cent of the total) to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2010 has been based upon value in use. This calculation uses cash flow projections based upon the five year business plan where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows for the period subsequent to the term of the business plan are extrapolated using a growth rate of 2.5 per cent reflecting management's view of the expected future long-term trend in growth rate of the respective economies concerned, predominantly being in the UK, and the long-term performances of the businesses concerned. The discount rate used in discounting the projected cash flows is 12.5 per cent (pre-tax) reflecting, inter alia, the perceived risks within those businesses. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount to fall below the balance sheet carrying value.

26 Goodwill (continued)

The goodwill impairment charge of £764 million in 2009 included the write-down, triggered primarily by deteriorating economic conditions, of the goodwill arising on the acquisition of Equitable Life Assurance Services (£368 million) and Lex Vehicle Leasing Services (£265 million).

27 Value of in-force business

The gross value of in-force business asset in the consolidated balance sheet is as follows:

	2010 £m	2009 £m
Acquired value of in-force non-participating investment contracts	136	148
Value of in-force insurance and participating investment contracts	3,035	2,838
Total value of in-force business	3,171	2,986

The movement in the acquired value of in-force non-participating investment contracts over the year is as follows:

	2010 £m	2009 £m
At 1 January	148	201
Amortisation taken to income statement (note 11)	(12)	(53)
At 31 December	136	148

The movement in the value of in-force insurance and participating investment contracts over the year is as follows:

	2010 £m	2009 £m
At 1 January	2,838	3,083
New business	242	376
Existing business:		
Expected return	(318)	(342)
Experience variances	49	53
Non-economic assumption changes	173	(419)
Economic variance	81	154
Movement in the value of in-force business taken to income statement (note 9)	227	(178)
Exchange and other adjustments	(30)	(67)
At 31 December	3,035	2,838

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, which would also contain changes in the other assets and liabilities of the relevant businesses. Economic variance is the element of earnings which is generated from changes to economic experience in the period and to economic assumptions over time. 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 in line with FSA realistic balance sheet assumptions.

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. 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 these corporate bond holdings. The illiquidity premium is estimated to be 75 basis points as at 31 December 2010 (31 December 2009: 75 basis points).

27 Value of in-force business (continued)

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:

	2010 **%**	2009 %
Risk-free rate (value of in-force non-annuity business)	**3.99**	4.45
Risk-free rate (value of in-force annuity business)	**4.66**	5.05
Risk-free rate (financial options and guarantees)	**0.63-4.50**	0.87-4.76
Retail price inflation	**3.56**	3.64
Expense inflation	**4.20**	4.42

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 there are asymmetries in the range of potential outcomes for which an explicit allowance is made.

Non-economic assumptions
Future mortality, morbidity, 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 likely future experience. These assumptions are intended to represent a best estimate of future experience.

Further information about the effect of changes in key assumptions is given in note 36.

28 Other intangible assets

Group	Brands £m	Capitalised software enhance-ments £m	Total £m
Cost:			
At 1 January 2009	24	320	344
Exchange and other adjustments	4	–	4
Additions	–	15	15
Disposals	(4)	(25)	(29)
At 31 December 2009	24	310	334
Exchange and other adjustments	**–**	**(1)**	**(1)**
Additions	**–**	**23**	**23**
Disposals	**–**	**(29)**	**(29)**
At 31 December 2010	**24**	**303**	**327**
Accumulated amortisation:			
At 1 January 2009	14	213	227
Exchange and other adjustments	2	–	2
Charge for the year (note 11)	7	27	34
Disposals	(4)	(22)	(26)
At 31 December 2009	19	218	237
Exchange and other adjustments	**2**	**2**	**4**
Charge for the year (note 11)	**3**	**24**	**27**
Disposals	**–**	**(15)**	**(15)**
At 31 December 2010	**24**	**229**	**253**
Balance sheet amount at 31 December 2010	**–**	**74**	**74**
Balance sheet amount at 31 December 2009	5	92	97

Company	Brands £m
Cost:	
At 1 January 2009	10
At 31 December 2009	10
At 31 December 2010	**10**
Accumulated amortisation:	
At 1 January 2009	6
Charge for the year	2
At 31 December 2009	8
Charge for the year	**2**
At 31 December 2010	**10**
Balance sheet amount at 31 December 2010	**–**
Balance sheet amount at 31 December 2009	2

Capitalised software enhancements principally comprise identifiable and directly associated internal staff and other costs.

29 Tangible fixed assets

	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:				
At 1 January 2009	1,675	2,775	6,334	10,784
Exchange and other adjustments	(2)	(10)	(78)	(90)
Additions	59	132	1,478	1,669
Disposals	(123)	(139)	(2,511)	(2,773)
At 31 December 2009	1,609	2,758	5,223	9,590
Exchange and other adjustments	**–**	**4**	**(89)**	**(85)**
Transfers to fellow Lloyds Banking Group undertakings	**–**	**–**	**(1,263)**	**(1,263)**
Additions	**43**	**130**	**782**	**955**
Disposals	**(189)**	**(259)**	**(1,084)**	**(1,532)**
At 31 December 2010	**1,463**	**2,633**	**3,569**	**7,665**
Accumulated depreciation and impairment:				
At 1 January 2009	664	1,943	2,367	4,974
Exchange and other adjustments	2	(7)	5	–
Depreciation charge for the year (note 11)	57	195	835	1,087
Disposals	(17)	(103)	(1,454)	(1,574)
At 31 December 2009	706	2,028	1,753	4,487
Exchange and other adjustments	**(1)**	**(57)**	**18**	**(40)**
Transfers to fellow Lloyds Banking Group undertakings	**–**	**–**	**(258)**	**(258)**
Impairment charged to the income statement (note 11)	**–**	**52**	**–**	**52**
Depreciation charge for the year (note 11)	**57**	**257**	**525**	**839**
Disposals	**(21)**	**(244)**	**(632)**	**(897)**
At 31 December 2010	**741**	**2,036**	**1,406**	**4,183**
Balance sheet amount at 31 December 2010	**722**	**597**	**2,163**	**3,482**
Balance sheet amount at 31 December 2009	903	730	3,470	5,103

At 31 December the future minimum rentals receivable by the Group under non-cancellable operating leases were as follows:

	2010 £m	2009 £m
Receivable within 1 year	**480**	428
1 to 5 years	**986**	1,376
Over 5 years	**588**	51
Total future minimum rentals receivable	**2,054**	1,855

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2010 and 2009 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £nil at 31 December 2010 (2009: £7 million) is expected to be received under non-cancellable sub-leases of the Group's premises.

30 Other assets

	Group		Company	
	2010 £m	2009 £m	2010 £m	2009 £m
Assets arising from reinsurance contracts held (notes 35 and 37)	**1,643**	1,456	**–**	–
Deferred acquisition costs (see below)	**1,047**	1,023	**–**	–
Settlement balances	**729**	1,435	**–**	–
Other assets and prepayments	**2,904**	6,213	**5**	1,780
Total other assets	**6,323**	10,127	**5**	1,780

Deferred acquisition costs of the Group:	2010 £m	2009 £m
At 1 January	**1,023**	1,181
Acquisition costs deferred, net of amounts amortised to the income statement	**24**	(158)
At 31 December	**1,047**	1,023

31 Deposits from banks of the Group

	2010 £m	2009 £m
Liabilities in respect of securities sold under repurchase agreements	**6,155**	70,935
Other deposits from banks	**136,982**	108,129
Total deposits from banks	**143,137**	179,064

At 31 December 2010 £25,994 million (2009: £11,099 million) of deposits from banks had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £55,394 million (2009: £66,441 million) and a fair value of £56,450 million (2009: £74,166 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £nil (2009: £19 million).

32 Customer deposits of the Group

	2010 £m	2009 £m
Non-interest bearing current accounts	**5,646**	2,471
Interest bearing current accounts	**35,776**	46,149
Savings and investment accounts	**137,188**	137,902
Liabilities in respect of securities sold under repurchase agreements	**8,079**	35,330
Other customer deposits	**29,715**	10,171
Total customer deposits	**216,404**	232,023

At 31 December 2010 £33,268 million (2009: £19,011 million) of customer deposits had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £8,279 million (2009: £35,330 million) and a fair value of £8,455 million (2009: £35,294 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £122 million (2009: £203 million).

33 Trading liabilities

	2010 £m	2009 £m
Liabilities in respect of securities sold under repurchase agreements	**17,906**	26,852
Short positions in securities	**860**	–
Other	**20**	520
Trading liabilities	**18,786**	27,372

At 31 December 2010 £608 million (2009: £131 million) of trading liabilities had a contractual residual maturity of greater than one year.

34 Debt securities in issue

	2010 £m	2009 £m
Medium-term notes issued	**26,963**	36,455
Covered bonds (note 19)	**29,432**	29,560
Certificates of deposit	**3,062**	6,413
Securitisation notes (note 19)	**29,983**	33,943
Commercial paper	**11,320**	12,786
Total debt securities in issue	**100,760**	119,157

At 31 December 2010 £68,143 million (2009: £76,483 million) of debt securities in issue had a contractual residual maturity of greater than one year.

35 Liabilities arising from insurance contracts and participating investment contracts

Insurance contract and participating investment contract liabilities are comprised as follows:

	2010			2009		
	Gross £m	Reinsurance[1] £m	Net £m	Gross £m	Reinsurance[1] £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	**34,440**	**(1,546)**	**32,894**	32,735	(1,425)	31,310
Participating investment contracts	**4,984**	–	**4,984**	5,815	(2)	5,813
	39,424	**(1,546)**	**37,878**	38,550	(1,427)	37,123
Non-life insurance contracts (see (2) below):						
Unearned premiums	**329**	**(19)**	**310**	402	(20)	382
Claims outstanding	**323**	**(13)**	**310**	282	(9)	273
	652	**(32)**	**620**	684	(29)	655
Total	**40,076**	**(1,578)**	**38,498**	39,234	(1,456)	37,778

[1]Reinsurance balances are reported within other assets (note 30).

(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 2009	30,004	6,161	36,165	(1,387)	34,778
New business	2,255	10	2,265	(1)	2,264
Changes in existing business	638	(333)	305	(132)	173
Change in liabilities charged to the income statement (note 10)	2,893	(323)	2,570	(133)	2,437
Exchange and other adjustments	(162)	(23)	(185)	93	(92)
At 31 December 2009	32,735	5,815	38,550	(1,427)	37,123
New business	**1,522**	**243**	**1,765**	**(31)**	**1,734**
Changes in existing business	**260**	**(1,160)**	**(900)**	**(131)**	**(1,031)**
Change in liabilities charged to the income statement (note 10)	**1,782**	**(917)**	**865**	**(162)**	**703**
Exchange and other adjustments	**(77)**	**86**	**9**	**43**	**52**
At 31 December 2010	**34,440**	**4,984**	**39,424**	**(1,546)**	**37,878**

35 Liabilities arising from insurance contracts and participating investment contracts (continued)

Liabilities for life 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:

	2010			2009		
	With-profit fund £m	**Non-profit fund £m**	**Total £m**	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	**5,445**	**28,995**	**34,440**	4,283	28,452	32,735
Participating investment contracts	**4,954**	**30**	**4,984**	5,785	30	5,815
Total	**10,399**	**29,025**	**39,424**	10,068	28,482	38,550

With-profit fund realistic liabilities
(i) Business description
The Group has a with-profit fund within 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 fund is to provide a long-term smoothed investment vehicle to the policyholder, protecting them against short-term market fluctuations. 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 maturity.

(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;
– 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 27.

(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.

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 the key assumptions in determining the cost of the 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.

35 Liabilities arising from insurance contracts and participating investment contracts (continued)

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.

(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 2010 resulted in the following key impacts on profit before tax:

– Change in persistency assumptions (£20 million increase)
– Change in assumed future mortality rates (£43 million increase)

These amounts include the impacts of movements in liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts.

35 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:

	2010 £m	2009 £m
Credit protection	**231**	307
Home	**421**	377
Total gross non-life insurance contract liabilities	**652**	684

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 2009	488	(5)	483
Increase in the year	670	(66)	604
Release in the year	(756)	51	(705)
Change in provision for unearned premiums charged to income statement (note 8)	(86)	(15)	(101)
At 31 December 2009	402	(20)	382
Increase in the year	**636**	**(90)**	**546**
Release in the year	**(709)**	**91**	**(618)**
Change in provision for unearned premiums charged to income statement (note 8)	**(73)**	**1**	**(72)**
At 31 December 2010	**329**	**(19)**	**310**

35 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	105	(2)	103
Incurred but not reported	115	(2)	113
At 1 January 2009	220	(4)	216
Cash paid for claims settled in the year	(275)	13	(262)
Increase (decrease) in liabilities:			
Arising from current year claims	329	(16)	313
Arising from prior year claims	8	(2)	6
Change in liabilities charged to income statement (note 10)	62	(5)	57
At 31 December 2009	282	(9)	273
Cash paid for claims settled in the year	**(248)**	**11**	**(237)**
Increase (decrease) in liabilities:			
Arising from current year claims	**301**	**(14)**	**287**
Arising from prior year claims	**(12)**	**(1)**	**(13)**
Change in liabilities charged to income statement (note 10)	**41**	**(4)**	**37**
At 31 December 2010	**323**	**(13)**	**310**
Notified claims	**207**	**(2)**	**205**
Incurred but not reported	**116**	**(11)**	**105**
At 31 December 2010	**323**	**(13)**	**310**
Notified claims	127	(5)	122
Incurred but not reported	155	(4)	151
At 31 December 2009	282	(9)	273

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

	Accident year						
	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	**2010 £m**	**Total £m**
Estimate of ultimate claims costs:							
At end of accident year	340	378	495	317	380	**362**	**2,272**
One year later	287	326	399	270	302		
Two years later	285	323	391	263			
Three years later	282	321	394				
Four years later	283	326					
Five years later	284						
Current estimate in respect of above claims	284	326	394	263	302	**362**	**1,931**
Cumulative payments to date	(273)	(321)	(388)	(251)	(255)	**(132)**	**(1,620)**
Liability recognised in the balance sheet	11	5	6	12	47	**230**	**311**
Liability in respect of earlier years							**12**
Total liability included in the balance sheet							**323**

36 Insurance sensitivities analysis

The following table demonstrates the effect of 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.

31 December 2010	**Change in variable**	**Increase (reduction) in profit before tax £m**	**Increase (reduction) in equity £m**
Non-annuitant mortality[1]	**5% reduction**	**29**	**21**
Annuitant mortality[2]	**5% reduction**	**(42)**	**(31)**
Lapse rates[3]	**10% reduction**	**122**	**87**
Future maintenance and investment expenses[4]	**10% reduction**	**102**	**73**
Risk-free rate[5]	**0.25% reduction**	**11**	**7**
Guaranteed annuity option take-up[6]	**5% addition**	**–**	**–**
Equity investment volatility[7]	**1% addition**	**(3)**	**(2)**
Widening of credit default spreads on corporate bonds[8]	**0.25% addition**	**(43)**	**(31)**
Increase in illiquidity premia[9]	**0.10% addition**	**20**	**14**

31 December 2009	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
Non-annuitant mortality[1]	5% reduction	55	39
Annuitant mortality[2]	5% reduction	(38)	(27)
Lapse rates[3]	10% reduction	129	93
Future maintenance and investment expenses[4]	10% reduction	110	79
Risk-free rate[5]	0.25% reduction	8	5
Guaranteed annuity option take-up[6]	5% addition	(2)	(1)
Equity investment volatility[7]	1% addition	(4)	(3)
Widening of credit default spreads on corporate bonds[8]	0.25% addition	(39)	(28)
Increase in illiquidity premia[9]	0.10% addition	21	15

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 liquidity premium 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 corporate bond spreads 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.

37 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 2009	29,057	–	29,057
New business	3,227	–	3,227
Changes in existing business	(1,666)	–	(1,666)
Exchange and other adjustments	(4)	–	(4)
At 31 December 2009	30,614	–	30,614
New business	**3,693**	**(65)**	**3,628**
Changes in existing business	**838**	**–**	**838**
Exchange and other adjustments	**(9)**	**–**	**(9)**
At 31 December 2010	**35,136**	**(65)**	**35,071**

38 Unallocated surplus within insurance businesses

The movement in the unallocated surplus within long-term insurance businesses over the year can be analysed as follows:

	2010 £m	2009 £m
At 1 January	**772**	551
Change in unallocated surplus recognised in the income statement (note 10)	**(451)**	254
Exchange and other adjustments	**–**	(33)
At 31 December	**321**	772

39 Other liabilities

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Settlement balances	**1,078**	1,709	**–**	–
Unitholders' interest in Open Ended Investment Companies	**7,951**	6,508	**–**	–
Other creditors and accruals	**7,532**	9,257	**363**	432
	16,561	17,474	**363**	432

At 31 December 2010 £6,645 million (2009: £1,357 million) of other liabilities of the Group and £nil (2009: £nil) of the Company had a contractual residual maturity of greater than one year.

40 Retirement benefit obligations

	2010 £m	2009 £m
(Credit) charge to the Group income statement		
Defined benefit pension schemes[1]	**(154)**	190
Other post-retirement benefit schemes	**4**	1
Total defined benefit schemes	**(150)**	191
Defined contribution pension schemes	**91**	88
Total (credit) charge to the Group income statement	**(59)**	279

[1]In 2010, the amount is shown net of a credit of £316 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 (see note 11).

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Amounts recognised in the balance sheet:				
Defined benefit pension schemes	**108**	(346)	**108**	(358)
Other post-retirement benefit schemes	**(56)**	(54)	**(56)**	(54)
Total amounts recognised in the balance sheet	**52**	(400)	**52**	(412)

40 Retirement benefit obligations (continued)

Amounts recognised in the balance sheet:

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Retirement benefit assets	**152**	67	**150**	67
Retirement benefit obligations	**(100)**	(467)	**(98)**	(479)
Total amounts recognised in the balance sheet	**52**	(400)	**52**	(412)

Pension schemes

Defined benefit schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas, the most significant being the HBOS Final Salary Pension Scheme (HFSPS). This scheme provides retirement benefits calculated as a percentage of final salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2010 was generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The latest full valuation of the HFSPS was carried out as at 31 December 2008; the results have been updated to 31 December 2010 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates by qualified independent actuaries.

The Group's obligations in respect of its defined benefit schemes are funded. The Group currently expects to pay contributions of approximately £330 million to its defined benefit schemes in 2011.

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Amount included in the balance sheet				
Present value of funded obligations	**(8,382)**	(8,276)	**(8,219)**	(8,164)
Fair value of scheme assets	**8,483**	7,442	**8,355**	7,351
	101	(834)	**136**	(813)
Unrecognised actuarial losses (gains)	**7**	488	**(28)**	455
Net amount recognised in the balance sheet	**108**	(346)	**108**	(358)

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Movements in the defined benefit obligation				
At 1 January	**(8,276)**	(6,709)	**(8,164)**	(6,559)
Current service cost	**(171)**	(175)	**(165)**	(170)
Employee contributions	**(5)**	(2)	**(2)**	(2)
Interest cost	**(448)**	(418)	**(440)**	(413)
Actuarial losses	**(84)**	(1,272)	**(79)**	(1,278)
Benefits paid	**262**	285	**258**	283
Benefits paid directly by the Group	**–**	2	**–**	–
Past service cost	**(12)**	(36)	**(12)**	(36)
Curtailments	**380**	8	**380**	8
Exchange and other adjustments	**(28)**	41	**5**	3
At 31 December	**(8,382)**	(8,276)	**(8,219)**	(8,164)

40 Retirement benefit obligations (continued)

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Changes in the fair value of scheme assets				
At 1 January	**7,442**	7,241	**7,351**	7,139
Expected return	**466**	405	**459**	399
Curtailment	**–**	(12)	**–**	(11)
Employer contributions	**309**	293	**301**	286
Actuarial gains (losses)	**509**	(176)	**506**	(182)
Benefits paid	**(260)**	(285)	**(256)**	(282)
Employee contributions	**5**	2	**2**	2
Exchange and other adjustments	**12**	(26)	**(8)**	–
At 31 December	**8,483**	7,442	**8,355**	7,351
Actual return on scheme assets	**975**	229	**956**	217

Assumptions

The principal actuarial and financial assumptions used in valuations of the defined benefit pension schemes were as follows:

	Group and Company 2010 %	Group and Company 2009 %
Discount rate	**5.50**	5.70
Rate of inflation		
Retail Prices Index	**3.40**	3.40
Consumer Price Index	**2.90**	–
Rate of salary increases	**2.00**	3.75
Rate of increase for pensions in payment	**3.20**	3.20

	Years	Years
Life expectancy for member aged 60, on the valuation date:		
Men	**26.6**	26.5
Women	**28.4**	28.3
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**28.2**	28.1
Women	**30.0**	29.9

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 as at 31 December 2010 is assumed to live for, on average, 26.6 years for a male and 28.4 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 is set out below:

	Increase (decrease) in the income statement charge 2010 £m	Increase (decrease) in the income statement charge 2009 £m	Increase (decrease) in the net defined benefit pension scheme asset 2010 £m	Increase (decrease) in the net defined benefit pension scheme asset 2009 £m
Inflation[1]:				
Increase of 0.2 per cent	**7**	22	**(272)**	(284)
Decrease of 0.2 per cent	**(6)**	(22)	**262**	274
Discount rate[2]:				
Increase of 0.2 per cent	**(11)**	(14)	**336**	333
Decrease of 0.2 per cent	**11**	14	**(353)**	(350)
Expected life expectancy of members:				
Increase of one year	**14**	15	**(198)**	(197)
Decrease of one year	**(14)**	(15)	**206**	204

[1]At 31 December 2010, the assumed rate of inflation is 3.4 per cent (31 December 2009 3.4 per cent)

[2]At 31 December 2010, the assumed discount rate is 5.5 per cent (31 December 2009 5.7 per cent)

40 Retirement benefit obligations (continued)

The expected return on scheme assets has been calculated using the following assumptions:

	Group and Company	
	2010 %	2009 %
Equities and alternative assets	**8.3**	8.4
Fixed interest gilts	**4.5**	3.7
Index linked gilts	**4.1**	4.0
Non-Government bonds	**6.0**	6.7
Property	**7.5**	6.4
Money market instruments and cash	**4.3**	3.8

The expected return on scheme assets in 2011 will be calculated using the following assumptions:

	2011 %
Equities and alternative assets	**8.3**
Fixed interest gilts	**4.0**
Index linked gilts	**3.9**
Non-Government bonds	**4.9**
Property	**7.3**
Money market instruments and cash	**3.9**

Composition of scheme assets:

	Group		Company	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Equities	**3,657**	3,246	**3,581**	3,189
Fixed interest gilts	**1,643**	709	**1,643**	691
Index linked gilts	**701**	1,407	**701**	1,400
Non-Government bonds	**379**	231	**339**	231
Property	**256**	185	**252**	182
Money market instruments, cash and other assets and liabilities	**1,847**	1,664	**1,839**	1,658
At 31 December	**8,483**	7,442	**8,355**	7,351

The assets of all the funded plans are held independently of the Group's assets in separate trustee administered funds.

The expected return on plan 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 investment 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 plans. Some of the funded plans 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 for the HFSPS and other schemes (since the date of adoption of IAS 19):

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Present value of defined benefit obligation	**(8,382)**	(8,276)	(6,709)	(7,623)	(7,501)
Fair value of scheme assets	**8,483**	7,442	7,241	7,329	6,644
	101	(834)	532	(294)	(857)
Experience (losses) gains on scheme liabilities	**(32)**	38	(22)	(95)	143
Experience gains (losses) on scheme assets	**330**	(176)	(615)	76	174

The expense recognised in the Group income statement for the year ended 31 December comprises:

	2010 £m	2009 £m
Current service cost	**171**	175
Interest cost	**448**	418
Expected return on scheme assets	**(466)**	(405)
Amortisation – outside corridor	**57**	(38)
Settlements	**4**	–
Curtailments (see below)	**(380)**	4
Past service cost	**12**	36
Total defined benefit pension expense	**(154)**	190

40 Retirement benefit obligations (continued)

Following changes by the Group to the terms of its principal UK defined benefit 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 the year there was a change in the commutation factors in certain defined benefit schemes.The combined effect of these changes is a reduction in the Group's unrecognised actuarial losses of £64 million, resulting in a net curtailment gain of £316 million and an equivalent reduction in the balance sheet liability.

Defined contribution schemes
The Group operates a number of defined contribution schemes in the UK and overseas.

During the year ended 31 December 2010 the charge to the income statement in respect of defined contribution schemes was £91 million (2009: £88 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.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 4 November 2009; this valuation has been updated to 31 December 2010 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 5.50 per cent (2009: 6.25 per cent).

Movements in the other post-retirement benefits obligation:

	Group and Company	
	2010 £m	2009 £m
At 1 January	**(54)**	(55)
Exchange and other adjustments	**–**	2
Charge for the year	**(2)**	(1)
Benefits paid	**–**	–
At 31 December	**(56)**	(54)

41 Deferred tax

	Group		Company	
The movement in the net deferred tax balance is as follows:	**2010 £m**	2009[1] £m	**2010 £m**	2009 £m
Asset at 1 January	**4,516**	2,605	**113**	120
Exchange and other adjustments	**75**	69	**–**	–
Adjustment on acquisition	**–**	3	**–**	–
Disposals	**–**	1	**–**	–
Income statement (charge) credit (note 14):				
Due to change in UK corporation tax rate	**(119)**	–	**1**	–
Other	**(58)**	2,969	**(141)**	(7)
	(177)	2,969	**(140)**	(7)
Amount charged to equity:				
Available-for-sale financial assets (note 46)	**(228)**	(1,048)	**–**	–
Cash flow hedges (note 46)	**(171)**	(79)	**–**	–
Other	**–**	(4)	**–**	–
	(399)	(1,131)	**–**	–
Asset at 31 December	**4,015**	4,516	**(27)**	113

[1]Restated – see note 1.

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.

	Group		Company	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Statutory position				
Deferred tax asset	**4,062**	4,724	**–**	113
Deferred tax liability	**(47)**	(208)	**(27)**	–
Net deferred tax asset (liability)	**4,015**	4,516	**(27)**	113
Tax disclosure				
Deferred tax asset	**5,314**	5,443	**–**	113
Deferred tax liability	**(1,299)**	(927)	**(27)**	–
Net deferred tax asset (liability)	**4,015**	4,516	**(27)**	113

41 Deferred tax (continued)

The deferred tax credit in the consolidated income statement comprises the following temporary differences:

	2010 £m	2009[1] £m
Accelerated capital allowances	**(316)**	546
Pensions and other post-retirement benefits	**(140)**	14
Unrealised gains and losses	**(6)**	1
Tax on long-term assurance business	**(37)**	(121)
Effective interest rate	**14**	–
Tax losses carried forward	**274**	2,277
Provisions	**(77)**	(121)
Other temporary differences	**111**	373
Deferred tax credit in the income statement	**(177)**	2,969

Deferred tax assets and liabilities are comprised as follows:

	Group		Company	
	2010 £m	2009[1] £m	2010 £m	2009 £m
Deferred tax assets:				
Employee benefits	**7**	147	**–**	112
Other provisions	**309**	386	**–**	–
Derivatives	**159**	329	**–**	1
Available-for-sale asset revaluation	**378**	247	**–**	–
Tax losses carried forward	**3,899**	3,625	**–**	–
Other temporary differences	**562**	709	**–**	–
Total deferred tax assets	**5,314**	5,443	**–**	113

	Group		Company	
	2010 £m	2009 £m	2010 £m	2009 £m
Deferred tax liabilities:				
Accelerated capital allowances	**(351)**	(35)	**–**	–
Tax on long-term assurance business	**(805)**	(768)	**–**	–
Effective interest rate	**(72)**	(86)	**–**	–
Other temporary differences	**(71)**	(38)	**(27)**	–
Total deferred tax liabilities	**(1,299)**	(927)	**(27)**	–

[1] Restated – see note 1.

The Finance (No. 2) Act 2010 includes legislation to reduce the main rate of corporation tax from 28 per cent to 27 per cent with effect from 1 April 2011. This resulted in a reduction in the Group's net deferred tax asset at 31 December 2010 of £156 million.

The proposed further reductions in the rate of corporation tax by 1 per cent per annum to 24 per cent by 1 April 2014 are expected to be enacted separately each year starting in 2011. The effect of these further changes upon the Group's deferred tax balances and leasing business cannot be reliably quantified at this stage.

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 a deferred tax asset of £3,899 million for the Group and £nil for the Company (2009: £3,625 million for the Group and £nil for the Company) in relation to 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.

Deferred tax assets of £330 million for the Group and £nil for the Company (2009: £396 million for the Group and £nil for the Company) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits to offset them. Capital losses can be carried forward indefinitely.

Deferred tax assets of £227 million for the Group and £nil for the Company (2009: £349 million for the Group and £nil for the Company) have not been recognised in respect of trading losses carried forward, mainly in overseas companies, as there are limited predicted future trading profits. Trading losses can be carried forward indefinitely.

In addition, deferred tax assets have not been recognised in respect of Unrelieved Foreign Tax carried forward as at 31December 2010 of £40 million for the Group and £nil for the Company (2009: £40 million for the Group and £nil for the Company), 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.

42 Other provisions

	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Customer goodwill payments £m	Vacant leasehold property and other £m	Total £m
At 1 January 2010	**5**	**196**	**–**	**57**	**258**
Exchange and other adjustments	**15**	**–**	**–**	**(2)**	**13**
Transfers	**–**	**129**	**–**	**–**	**129**
Provisions applied	**–**	**(124)**	**–**	**(3)**	**(127)**
Charge (release) for the year	**11**	**(4)**	**500**	**26**	**533**
At 31 December 2010	**31**	**197**	**500**	**78**	**806**

Provisions for contingent liabilities and 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.

Customer remediation provisions
The Group establishes provisions for the estimated cost of making redress payments to customers in respect of past product sales where the original sales processes have been found to be deficient or where fees and premiums have been overcharged.

Customer goodwill payments
The Lloyds Banking Group has been in discussion with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the 'Halifax' brand. In February 2011, the Lloyds Banking Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000. The Group has made a provision of £500 million in relation to this programme.

Vacant leasehold property and other
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 biennial basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging five years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

43 Subordinated liabilities

	Group		Company	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Preferred securities	**3,260**	3,827	**–**	–
Undated subordinated liabilities	**1,212**	2,945	**2,118**	4,787
Dated subordinated liabilities	**12,202**	12,306	**9,499**	9,767
Total subordinated liabilities	**16,674**	19,078	**11,617**	14,554

	Group	
Preferred securities	**2010 £m**	2009 £m
US$750 million 6.071% Non-cumulative Perpetual Preferred Securities of US$1,000 each	**544**	507
US$1,000 million 6.85% Non-cumulative Perpetual Preferred Securities of US$1,000 each	**736**	657
£600 million 6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities Series A of £1,000 each	**603**	603
£250 million 8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1,000 each (Class A)	**253**	252
£150 million 7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B)	**151**	151
£245 million 7.881% Guaranteed Non-voting Non-cumulative Preferred Securities	**272**	255
€415 million 7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities	**372**	389
€750 million 4.939% Non-voting Non-cumulative Perpetual Preferred Securities	**28**	713
£300 million Perpetual Regulatory Tier One Securities	**301**	300
Total preferred securities	**3,260**	3,827

43 Subordinated liabilities (continued)

Undated subordinated liabilities	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
£500 million 5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes	**3**	4	**3**	3
US$750 million 6.071% Undated Subordinated Fixed to Floating Rate Instruments	**–**	–	**482**	462
€750 million 4.875% Undated Fixed to Floating Rate Subordinated Notes	**88**	183	**88**	183
€500 million Floating Rate Undated Subordinated Notes	**53**	103	**53**	101
US$1,000 million 5.375% Undated Fixed to Floating Rate Subordinated Notes	**11**	684	**11**	621
€750 million 5.125% Undated Subordinated Fixed to Floating Notes	**66**	285	**66**	285
£600 million 5.75% Undated Subordinated Step-up Notes	**4**	3	**4**	3
US$1,000 million 6.85% Undated Subordinated Notes	**–**	–	**635**	608
£600 million Fixed to Floating Rate Undated Subordinated Notes	**–**	–	**603**	603
€500 million 6.05% Fixed to Floating Rate Undated Subordinated Notes	**67**	71	**67**	71
£300 million 7.5% Undated Subordinated Step-up Notes	**4**	5	**4**	6
JPY 42.5 billion 3.50% Undated Subordinated Yen Step-up Notes	**–**	309	**–**	287
£200 million 8.625% Perpetual Notes	**24**	62	**–**	–
£200 million 7.375% Undated Subordinated Guaranteed Bonds	**51**	51	**–**	–
€300 million Floating Rate Undated Subordinated Step-up Notes	**63**	65	**63**	65
US$250 million Floating Rate Primary Capital Notes	**118**	146	**–**	–
£150 million 7.375% Instruments	**76**	77	**–**	–
JPY 17 billion 4.25% Instruments	**161**	135	**–**	–
£100 million 10.25% Instruments	**1**	60	**–**	–
£100 million 12% Perpetual Subordinated Bonds	**22**	104	**–**	–
£100 million 8.75% Perpetual Subordinated Bonds	**5**	103	**–**	–
£75 million 13.625% Perpetual Subordinated Bonds	**16**	77	**–**	–
£50 million 9.375% Perpetual Subordinated Bonds	**16**	54	**–**	–
£500 million 5.75% Undated Subordinated Step-up Notes	**6**	6	**6**	6
€750 million 4.25% Perpetual Fixed/Floating Rate Reset Subordinated Guaranteed Notes	**357**	358	**–**	–
€750 million 4.939% Undated Fixed to Floating Rate Subordinated Notes	**–**	–	**33**	713
£750 million Undated Perpetual Preferred Securities	**–**	–	**–**	770
Total undated subordinated liabilities	**1,212**	2,945	**2,118**	4,787

43 Subordinated liabilities (continued)

No exercise of any redemption option or purchase by the relevant entity of any of the undated subordinated liabilities may be made without the consent of the Financial Services Authority. On a winding up of the Company or subsidiary, the claims of the holders of undated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Company or subsidiary other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the undated loan capital. The undated loan capital is junior in point of subordination to the dated loan capital referred to above.

	Group		Company	
Dated subordinated liabilities	**2010 £m**	2009 £m	**2010 £m**	2009 £m
US$500 million 7.70% Notes 2010	**–**	326	**–**	–
US$150 million 6.50% Notes 2011	**99**	101	**–**	–
€750 million 5.50% Subordinated Fixed Rate Notes 2012	**699**	724	**–**	–
€12.8 million 6.25% Instruments 2012	**10**	10	**–**	–
€325 million 6.125% Notes 2013	**296**	306	**–**	–
US$1,000 million 4.25% Subordinated Guaranteed Notes 2013	**688**	650	**–**	619
£250 million 11% Subordinated Bonds 2014	**276**	276	**–**	–
€1,000 million 4.875% Subordinated Notes 2015	**974**	989	**974**	927
€500 million Callable Floating Rate Subordinated Notes 2016	**431**	444	**431**	447
€500 million Subordinated Notes 2016	**431**	444	**431**	444
US$750 million Notes 2016	**481**	459	**481**	459
€1,000 million Subordinated Lower Tier II Notes 2017	**861**	887	**861**	887
US$1,000 million Subordinated Callable Notes 2017	**640**	611	**640**	610
Aus$400 million Subordinated Callable Floating Rate Instruments 2017	**263**	222	**263**	222
Aus$200 million 6.75% Subordinated Callable Fixed/Floating Rate Instruments 2017	**135**	114	**135**	114
Can$500 million 5.109% Callable Fixed to Floating Rate Notes 2017	**338**	317	**338**	317
£500 million 6.305% Lower Tier II Subordinated Notes 2017	**545**	548	**545**	548
£150 million 10.5% Subordinated Bonds 2018	**163**	164	**–**	–
US$2,000 million 6.75% Subordinated Fixed Rate Notes 2018	**1,465**	1,384	**1,465**	1,397
£250 million 6.375% Instruments 2019	**301**	287	**–**	–
€750 million 4.375% Callable Fixed to Floating Rate Subordinated Notes 2019	**712**	712	**712**	671
£500 million 9.375% Subordinated Bonds 2021	**608**	580	**–**	–
€160 million 5.374% Subordinated Fixed Rate Notes 2021	**164**	159	**164**	159
€400 million 6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023	**195**	201	**–**	–
€175 million 7.07% Subordinated Fixed Rate Notes 2023	**162**	156	**162**	155
€750 million 4.50% Fixed Rate Step-up Subordinated Notes due 2030	**682**	706	**682**	706
US$750 million 6.00% Subordinated Notes 2033	**583**	529	**583**	461
£245 million 7.881% Subordinated Extendable Maturity Notes 2048	**–**	–	**273**	254
€415 million Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048	**–**	–	**359**	370
Total dated subordinated liabilities	**12,202**	12,306	**9,499**	9,767

At 31 December 2010 £16,575 million (2009: £18,752 million) of subordinated liabilities of the Group and £11,617 million (2009: £14,554 million) of the Company has a contractual residual maturity of greater than one year.

No repayment, for whatever reason, of dated subordinated liabilities prior to their stated maturity and no purchase by the relevant entity of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the Company or subsidiary, the claims of the holders of dated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Company or subsidiary, other than creditors whose claims are expressed to rank pari passu with, or junior to, the claims of the holders of the dated loan capital.

Since 2009, the Company has had in issue 100 6% non-cumulative preference shares of £1 each. The shares 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 annum; no dividend shall be paid in the event that the directors determine that prudential 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 100 £1 6% preference shares has waived its right to payment for the period from 1st March 2010 to 1st March 2012.

44 Share capital

(1) Authorised share capital

	Group and Company			
	2010 Number of shares	2009 Number of shares	**2010 £m**	2009 £m
Sterling				
Ordinary shares of 25p	**15,139,999,999**	15,139,999,999	**3,785**	3,785
6.125% non-cumulative redeemable preference shares of £1	**200,000,000**	200,000,000	**200**	200
8.117% non-cumulative perpetual preference shares class 'A' of £10 each	**250,000**	250,000	**3**	3
7.754% non-cumulative perpetual preference shares class 'B' of £10 each	**150,000**	150,000	**2**	2
Preference shares of £1 each	**2,596,834,398**	2,596,834,398	**2,597**	2,597
			6,587	6,587
US dollars			**US$m**	US$m
Preference shares of US$1 each	**4,997,750,000**	4,997,750,000	**4,998**	4,998
Euro			**€m**	€m
Preference shares of €1 each	**3,000,000,000**	3,000,000,000	**3,000**	3,000
Japanese yen			**¥m**	¥m
Preference shares of ¥250 each	**400,000,000**	400,000,000	**100,000**	100,000
Canadian dollars			**CAD$m**	CAD$m
Preference shares of CAD$1 each	**1,000,000,000**	1,000,000,000	**1,000**	1,000
Australian dollars			**AUD$m**	AUD$m
Preference shares of AUD$1 each	**1,000,000,000**	1,000,000,000	**1,000**	1,000

44 Share capital (continued)

(2) Issued share capital

	Group and Company			
	2010 Number of shares	2009 Number of shares	**2010 £m**	2009 £m
Ordinary shares of 25p each				
At 1 January	**15,050,663,336**	5,406,574,275	**3,763**	1,352
HM Treasury placing and open offer in January 2009	–	7,482,394,360	–	1,870
Rights issue in June 2009	–	2,000,000,000	–	500
Share issue in October 2009	–	158,116,500	–	40
Rights issue in December 2009	–	3,500,000	–	1
Issued under employee share schemes	–	78,201	–	–
Share issuances in 2010 (see below)	**2,599,505**	–	–	–
At 31 December	**15,053,262,841**	15,050,663,336	**3,763**	3,763
Issued and fully paid preference shares				
6.475% fixed-rate non-cumulative preference shares of £1 each				
At 1 January	–	198,065,600	–	197
Redeemed during the year	–	(198,065,600)	–	(197)
At 31 December	–	–	–	–
6.0884% fixed-rate non-cumulative preference shares of £1 each				
At 1 January	–	750,002	–	1
Redeemed during the year	–	(750,002)	–	(1)
At 31 December	–	–	–	–
6.3673% fixed-to-floating rate non-cumulative preference shares of £1 each				
At 1 January	–	350,000	–	–
Redeemed during the year	–	(350,000)	–	–
At 31 December	–	–	–	–
12.0% fixed-to-floating rate non-cumulative preference shares of £0.25 each				
At 1 January	–	–	–	–
Issued during year	–	3,000,000	–	1
Redeemed during the year	–	(3,000,000)	–	(1)
At 31 December	–	–	–	–
Preference shares of £1 each				
At 1 January	**100**	–	–	–
Issued during year	–	100	–	–
At 31 December	**100**	100	–	–
Total share capital at 31 December	**15,053,262,941**	15,050,663,436	**3,763**	3,763

Share issuances during 2010

During 2010, a total of 2,599,505 ordinary shares were issued as consideration for the redemption of certain preference shares and other subordinated liabilities issued by the Group.

45 Share premium account

	Group and Company	
	2010 £m	2009 £m
At 1 January	**16,056**	6,709
Issue of ordinary and preference shares	**2,599**	13,415
Redemption of preference shares	**–**	(4,068)
At 31 December	**18,655**	16,056

46 Other reserves

	Group		Company	
	2010 £m	2009[1] £m	**2010 £m**	2009 £m
Other reserves comprise:				
Merger and other reserves	**10,051**	10,051	**9,537**	9,537
Capital redemption reserve	**141**	141	**141**	141
Revaluation reserve in respect of available-for-sale financial assets[1]	**(894)**	(1,395)	**–**	–
Cash flow hedging reserve	**(417)**	(840)	**(2)**	(2)
Foreign currency translation reserve	**(24)**	180	**16**	16
At 31 December	**8,857**	8,137	**9,692**	9,692

[1]Restated – see note 1.

Movements in other reserves were as follows:

	Group		Company	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Merger and other reserves				
At 1 January	**10,051**	583	**9,537**	69
Issue of ordinary shares	**–**	6,629	**–**	6,629
Issue of preference shares	**–**	2,839	**–**	2,839
At 31 December	**10,051**	10,051	**9,537**	9,537

	Group		Company	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Capital redemption reserve				
At 1 January	**141**	–	**141**	–
Redemption of preference shares	**–**	141	**–**	141
At 31 December	**141**	141	**141**	141

46 Other reserves (continued)

	Group 2010 £m	Group 2009[1] £m
Revaluation reserve in respect of available-for-sale financial assets		
At 1 January:		
As previously stated		(5,335)
Prior year adjustment (note 1)		1,065
Restated	**(1,395)**	(4,270)
Change in fair value of available-for-sale financial assets	**205**	2,588
Deferred tax	**(95)**	(673)
Current tax	**(3)**	–
	107	1,915
Income statement transfers:		
Disposals	**(52)**	3
Deferred tax	**7**	(1)
	(45)	2
Impairment	**641**	1,479
Deferred tax	**(157)**	(415)
	484	1,064
Other transfers to income statement	**(62)**	(147)
Deferred tax	**17**	41
	(45)	(106)
At 31 December	**(894)**	(1,395)

[1]Restated – see note 1.

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Cash flow hedging reserve				
At 1 January	**(840)**	(1,043)	**(2)**	(2)
Effective portion of changes in fair value of hedging derivatives	**(781)**	(613)	**–**	–
Deferred tax	**201**	171	**–**	–
Current tax	**(3)**	–	–	–
	(583)	(442)	**–**	–
Income statement transfer	**1,378**	895	**–**	–
Deferred tax	**(372)**	(250)	**–**	–
	1,006	645	**–**	–
At 31 December	**(417)**	(840)	**(2)**	(2)

	Group 2010 £m	Group 2009 £m	Company 2010 £m	Company 2009 £m
Foreign currency translation reserve				
At 1 January	**180**	179	**16**	–
Currency translation differences arising in the year	**(204)**	1	**–**	16
At 31 December	**(24)**	180	**16**	16

47 Retained profits

	Group 2010 £m	Group 2009[1] £m	Company 2010 £m	Company 2009 £m
At 1 January:				
As previously stated		8,839		
Prior year adjustment (note 1)		(1,065)		
Restated	**(3,071)**	7,774	**(6,625)**	1,082
(Loss) profit for the year[2]	**(2,351)**	(10,491)	**1,944**	(7,322)
Dividends	**–**	(355)	**–**	(355)
Capital redemption	**–**	(141)	**–**	(141)
Purchase/sale of treasury shares	**–**	36	**–**	12
Employee share option schemes – value of employee services	**7**	106	**–**	99
At 31 December	**(5,415)**	(3,071)	**(4,681)**	(6,625)

[1]Restated – see note 1.

[2]No income statement has been prepared for the Company as permitted by section 408 of the Companies Act 2006.

48 Dividends

No dividends were paid on the Company's ordinary shares in 2010 or 2009.

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Lloyds Banking Group, Lloyds Banking Group plc agreed to suspend the payment of coupons and dividends on certain preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. Lloyds Banking Group plc has 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, the Company is prevented from making dividend payments on its ordinary shares during this period.

49 Share-based payments

Share-based payment scheme details
During the year ended 31 December 2010 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the HBOS Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group plc are set out below.

Deferred bonus plan
Bonuses in respect of the performance in 2010 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.

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 April 2001 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. Prior to 18 April 2001, the normal limit was equal to one year's remuneration and no performance multiplier was applied.

Performance conditions for executive options
For options granted up to March 2001
The performance condition was that growth in earnings per share must be equal to the aggregate percentage change in the Retail Prices Index plus three percentage points for each complete year of the relevant period together with a further condition that Lloyds Banking Group plc's ranking based on total shareholder return (calculated by reference to both dividends and growth in share price) over the relevant period should be in the top fifty companies of the FTSE 100.

The relevant period for the performance conditions began at the end of the financial year preceding the date of grant and continued until the end of the third subsequent year following commencement or, if not met, the end of such later year in which the conditions were met. Once the conditions were satisfied the options remained exercisable without further conditions. If they were not satisfied by the tenth anniversary of the grant the options would lapse.

For options granted from August 2001 to August 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.

49 Share-based payments (continued)

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 up to August 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.

Movements in the number of share options outstanding under the executive share option schemes during 2009 and 2010 are set out below:

	2010		2009	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**8,784,978**	**476.56**	11,203,628	490.05
Rebasement adjustment[1]	**7,523,547**	**(26.43)**	–	–
Exercised	**–**	**–**	–	–
Forfeited	**(2,945,224)**	**296.36**	(2,418,650)	536.46
Outstanding at 31 December	**13,363,301**	**233.09**	8,784,978	476.56
Exercisable at 31 December	**13,363,301**	**233.09**	8,784,978	476.56

[1]Options granted under this plan were adjusted on 13 August 2010 as a result of the Capitalisation Issue, the Placing and Compensatory Open Offer and the Rights Issue of 2009. The adjustment was made using a standard Her Majesty's Revenue & Customs (HMRC) formula, to negate the dilutionary impact of the above corporate actions.

No options were exercised during 2010 or 2009. The weighted average remaining contractual life of options outstanding at the end of the year was 3.6 years (2009: 4.3 years).

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:

	2010		2009	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**130,133,992**	**177.60**	190,478,449	152.54
Adjustment on acquisition	**–**	**–**	53,755,275	415.21
Rebasement adjustment[1]	**22,382,641**	**(416.83)**	–	–
Granted	**655,712,663**	**46.78**	–	–
Exercised	**(195,339)**	**49.30**	–	–
Forfeited	**(13,922,185)**	**57.34**	(9,581,800)	400.93
Cancelled	**(107,144,275)**	**66.53**	(93,599,380)	206.07
Expired	**(18,923,463)**	**179.35**	(10,918,552)	470.16
Outstanding at 31 December	**668,044,034**	**49.59**	130,133,992	177.60
Exercisable at 31 December	**663,942**	**172.93**	754,554	317.32

[1]Options granted under these plans were adjusted on 13 August 2010 as a result of the Capitalisation Issue, the Placing and Compensatory Open Offer and the Rights Issue of 2009. The adjustment was made using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

The weighted average share price at the time that options were exercised during 2010 was £0.69 (2009: £nil). The weighted average remaining contractual life of options outstanding at the end of the year was 2.7 years (2009: 2.7 years).

49 Share-based payments (continued)

The weighted average fair value of SAYE options granted during 2010 was £0.33 (2009: £nil). The values for the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2010 or 2009. The options outstanding at 31 December 2010 had an exercise price of £1.8066 (2009: £3.64) and a weighted average remaining contractual life of 2.9 years (2009: 4.0 years).

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.

	2010		2009	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**26,099,185**	**Nil**	857,611	Nil
Granted	**13,429,561**	**Nil**	24,704,070	Nil
Rebasement adjustment[1]	**12,501,246**	**Nil**	1,876,005	Nil
Exercised	**(2,661,703)**	**Nil**	(157,105)	Nil
Forfeited	**(1,673,532)**	**Nil**	(1,181,396)	Nil
Outstanding at 31 December	**47,694,757**	**Nil**	26,099,185	Nil
Exercisable at 31 December	**–**	**Nil**	33,794	Nil

[1]Options granted under this plan were adjusted on 2 July 2009 as a result of the Placing and Compensatory Open Offer and on 13 August 2010 as a result of the Capitalisation Issue and Rights Issue of 2009. The adjustments were made, where applicable, using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

The weighted average fair value of options granted in the year was £0.63 (2009: £0.68). The weighted average share price at the time that the options were exercised during 2010 was £0.63 (2009: £0.71). The weighted average remaining contractual life of options outstanding at the end of the year was 2.4 years (2009: 3.0 years).

HBOS share option plans
The table below details the outstanding options for the HBOS Share Option Plan, the St James's Place Share Option Plan, and the 1995 and 1996 Bank of Scotland Executive Stock Option schemes. 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 grants 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:

	2010		2009	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January (16 January 2009)	**14,301,748**	**880.27**	13,040,430	1,167.26
Rebasement adjustment[1]	**12,899,990**	**(61.23)**	–	–
Granted	**–**	**–**	4,040,555	104.50
Forfeited	**(2,506,244)**	**611.90**	(2,779,237)	1,099.02
Outstanding at 31 December	**24,695,494**	**415.70**	14,301,748	880.27
Exercisable at 31 December	**15,320,780**	**593.79**	9,198,557	1,169.14

[1]Options granted under these plans were adjusted on 13 August 2010 as a result of the Capitalisation Issue, the Placing and Compensatory Open Offer and the Rights Issue of 2009. The adjustment was made using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

No options were exercised during 2010 or 2009. The options outstanding under the HBOS Share Option Plan and St James's Place Share Option Plan at 31 December 2010 had exercise prices in the range of £0.5183 to £8.7189 (2009: £1.05 to £17.576) and a weighted average remaining contractual life of 3.0 years.

No options were outstanding under the Bank of Scotland Executive Stock Option schemes at 31 December 2010. Options outstanding at 31 December 2009 had exercise prices in the range of £8,834 to £10.009 and a weighted average remaining contractual life of 0.8 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.

The performance conditions for awards made in March and August 2007 are as follows:

(i) For 50 per cent of the award (the EPS Award) – the percentage increase in earnings per share of the Group (on a compound annualised basis) over the relevant period needed to be at least an average of 6 percentage points per annum greater than the percentage increase (if any) in the Retail Prices Index over the same

49 Share-based payments (continued)

period. If it was less than 3 per cent per annum the EPS Award would lapse. If the increase was more than 3 per cent but less than 6 per cent per annum then the proportion of shares released would be on a straight line basis between 17.5 per cent and 100 per cent. The relevant period commenced on 1 January 2007 and ended on 31 December 2009.

(ii) For the other 50 per cent of the award (the TSR Award) – it was necessary for the Group's total shareholder return (calculated by reference to both dividends and growth in share price) to exceed the median of a comparator group (14 companies) over the relevant period by an average of 7.5 per cent per annum for the TSR Award to vest in full. 17.5 per cent of the TSR Award would vest where the Group's total shareholder return was equal to median and vesting would occur on a straight line basis in between these points. Where the Group's total shareholder return was below the median of the comparator group, the TSR Award would lapse. The relevant period commenced on 8 March 2007 and ended on 7 March 2010.

As a consequence of the acquisition of HBOS and the general market turmoil, in March 2009 the Remuneration Committee decided that the performance test for the 2007 awards should be based on the performance of the Group up to 17 September 2008, the date prior to the announcement of the HBOS acquisition. The performance test was on a fair value basis, on the estimated probability, as at that date, of achieving the performance conditions. As a consequence, for all participants, other than those who were executive directors at the time the award was granted and a small number of other senior executives, the share awards vested at 31 per cent in March 2010.

The performance conditions for awards made in March, April and August 2008 are as follows:

(i) For 50 per cent of the award (the EPS Award) – the performance condition is as described for the 2007 awards with the relevant performance period commencing on 1 January 2008 and ending on 31 December 2010.

(ii) For the other 50 per cent of the award (the TSR Award) – the performance condition is as described for the 2007 awards, except that the comparator group comprises of 13 companies, with the relevant performance period commencing on 6 March 2008 (the date of the first award) and ending on 5 March 2011.

The current LTIP rules allow for awards to be made of up to 400 per cent of base salary. Under normal circumstances awards are made of 300 per cent of salary with the additional 100 per cent available for circumstances that the Remuneration Committee deems to be exceptional. In 2008, awards were made of 375 per cent of base salary to the chief executive and two of the executive directors for retention purposes, and in light of data reviewed by the committee which showed total remuneration to be behind median both for the FTSE 20, and the other major UK banks.

As for the 2007 LTIP awards, as a consequence of the acquisition of HBOS and the general market turmoil, in March 2009 the Remuneration Committee decided that the performance test for the 2008 awards should be based on the performance of the Group up to 17 September 2008, the date prior to the announcement of the HBOS acquisition. The performance test was on a fair value basis, on the estimated probability, as at that date, of achieving the performance conditions. As a consequence, for all participants, other than those who were executive directors at the time the award was granted and a small number of other senior executives, the share awards will vest at 29 per cent in March 2011.

The performance conditions for awards made in April, May and September 2009 are as follows:

(i) **EPS:** relevant to 50 per cent of the award. Performance will be measured on the extent to which the growth in EPS achieves cumulative EPS targets over the three-year period.

If the growth in EPS reaches 26 per cent, 25 per cent of this element of the award, being the threshold, will vest. If growth in EPS reaches 36 per cent, 100 per cent of this element will vest.

(ii) **Economic profit:** relevant to 50 per cent of the award. Performance will be measured based on the extent to which cumulative economic profit targets are achieved over the three-year period.

If the absolute improvement in adjusted economic profit reaches 100 per cent, 25 per cent of this element of the award, being the threshold, will vest. If the absolute improvement in adjusted economic profit reaches 202 per cent, 100 per cent of this element will vest.

The EPS and economic profit 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 is not participating in the Government Asset Protection Scheme, in June 2010 the Remuneration Committee approved restated performance measures on a basis consistent with the EPS and economic profit measures used for the 2010 LTIP awards.

An additional discretionary award was made in April, May and September 2009. The performance conditions for those awards are as follows:

(i) **Synergy savings**: The release of 50 per cent of the shares will be 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 will be broken down into three equally weighted annual tranches. Performance will be 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 have been achieved will determine the proportion of shares to be banked each year. Any release of shares will be 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 will be 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 will be broken down into three equally weighted tranches. The tranches will be 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.

Performance against the first two years of the award has been assessed and all targets have been met or exceeded.

The performance conditions for awards made in March and August 2010 are as follows:

(i) **EPS:** relevant to 50 per cent of the award. Performance will 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.

If the absolute improvement in adjusted EPS reaches 158 per cent, 25 per cent of this element of the award, being the threshold, will vest. If absolute improvement in adjusted EPS reaches 180 per cent, 100 per cent of this element will vest.

49 Share-based payments (continued)

Vesting between threshold and maximum will be on a straight line basis.

(ii) **Economic profit:** relevant to 50 per cent of the award. Performance will 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 an adjusted 2009 economic profit base.

If the compounded annual growth rate of adjusted economic profit reaches 57 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest. If the compounded annual growth rate of adjusted economic profit reaches 77 per cent per annum, 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 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 economic profit performance measures have been satisfied at the threshold level or above. The EPS and economic profit performance conditions will each relate to 36 per cent of the total award.

	2010 Number of shares	2009 Number of shares
Outstanding at 1 January	**223,233,052**	22,237,282
Granted	**148,810,591**	199,293,192
Rebasement adjustment	**106,990,259**	10,443,102
Forfeited	**(31,891,411)**	(8,740,524)
Outstanding at 31 December	**447,142,491**	223,233,052

The fair value of the share awards granted in 2010 was £0.61 (2009: £0.68).

Conditional awards of shares made under this plan were adjusted on 2 July 2009 as a result of the Placing and Compensatory Open Offer and on 13 August 2010 as a result of the Capitalisation Issue and Rights Issue of 2009. The adjustments were made, where applicable, using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

Performance share plan

Under the performance share plan, introduced during 2005, participating executives would have been eligible for an award of free shares, known as performance shares, to match the bonus shares awarded as part of their 2004 and 2005 bonus. The maximum match was two performance shares for each bonus share, awarded at the end of a three year period. The actual number of shares which would have been awarded was dependent on the Group's total shareholder return performance measured over a three year period, compared to other companies in the comparator group. The maximum of two performance shares for each bonus share would have been awarded only if the Group's total shareholder return performance placed it first in the comparator group; one performance share for each bonus share would have been granted if the Group was placed fifth; and one performance share for every two bonus shares if the Group was placed eighth (median). Between first and fifth position, and fifth and eighth position, sliding scales would have applied. If the total shareholder return performance was below median, no performance shares would have been awarded. There was no retest. Whilst income tax and national insurance was deducted from the bonus before deferral into the plan, where a match of performance shares was justified, these shares would have been awarded as if income tax and national insurance had not been deducted.

The performance condition attached to the March 2006 award was not met, with Lloyds Banking Group ranked in ninth place. Bonus shares were released on 20 March 2009, at which time the performance shares lapsed.

	2010 Number of shares	2009 Number of shares
Outstanding at 1 January	**–**	941,324
Lapsed	**–**	(941,324)
Outstanding at 31 December	**–**	–

49 Share-based payments (continued)

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**
31 December 2010									
Exercise price range									
£0 to £1	**–**	**–**	**–**	**47.74**	**2.7**	**658,912,847**	**7.41**	**2.5**	**55,656,496**
£1 to £2	**199.91**	**3.6**	**262,725**	**178.74**	**2.8**	**7,984,764**	**–**	**–**	**–**
£2 to £3	**225.83**	**3.9**	**12,052,934**	**210.74**	**1.4**	**1,146,423**	**–**	**–**	**–**
£3 to £4	**324.92**	**0.2**	**1,047,642**	**–**	**–**	**–**	**–**	**–**	**–**
£5 to £6	**–**	**–**	**–**	**–**	**–**	**–**	**567.65**	**2.9**	**15,462,949**

	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
31 December 2009									
Exercise price range									
£0 to £1	–	–	–	–	–	–	Nil	3.1	26,099,185
£1 to £2	–	–	–	139.00	2.5	107,939,699	104.50	2.3	4,019,026
£2 to £3	–	–	–	220.98	3.9	18,054,765	–	–	–
£3 to £4	–	–	–	349.18	2.0	2,842,644	394.64	5.2	721,886
£4 to £5	464.19	4.9	7,526,441	427.04	1.8	1,296,884	499.91	0.2	273,986
£5 to £6	552.02	0.2	515,527	–	–	–	573.60	0.6	53,328
£6 to £7	653.55	1.2	743,010	–	–	–	640.00	0.0	2,388,026
£7 to £8	–	–	–	–	–	–	707.40	0.2	6,845,496

The fair value calculations at 31 December 2010 for grants made in the year are based on the following assumptions:

	SAYE	**Other option schemes**	**Other share plans**
Risk-free interest rate	**1.80%**	**0.76%**	**1.33%**
Expected life	**3.0 years**	**1-5 years**	**2-4 years**
Expected volatility	**85%**	**83%**	**70%**
Expected dividend yield	**1.4%**	**0.5%**	**0.9%**
Weighted average share price	**0.59**	**0.67**	**0.67**
Weighted average exercise price	**0.48**	**Nil**	**Nil**
Expected forfeitures	**4%**	**4%**	**4%**

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.

No free shares were awarded in 2009 or 2010.

49 Share-based payments (continued)

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £30 per month; these shares are held in trust for a mandatory period of three years on the employees' 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 2010 was 17,411,651 (2009: 16,746,310), with an average fair value of £0.63 (2009: £0.69), based on market prices at the date of award.

50 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. At 31 December 2010, 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. The compensation of key management personnel has been allocated to the Company on an estimated basis.

	2010 £m	2009 £m
Compensation		
Salaries and other short-term benefits	**8**	8
Post-employment benefits	**1**	1
Share-based payments	**–**	–
Total compensation	**9**	9

The aggregate of the emoluments of the directors was £5.3 million (2009: £5.0 million). The total for the highest paid director (J E Daniels) was £1,286,000 (2009: (G T Tate) £903,000).

As a result of the acquisition of HBOS plc by Lloyds Banking Group on 16 January 2009, the Board of the Group changed in its entirety. Accordingly, the disclosures for 2009 begin with the balances of key management personnel on 16 January 2009.

	2010 million	2009 million
Share options over Lloyds Banking Group plc shares		
At 1 January 2010/16 January 2009	**2**	2
Granted, including certain adjustments[1] (includes entitlement of appointed directors)	**4**	–
At 31 December	**6**	2

[1]Adjustments have been made, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.

	2010 million	2009 million
Share incentive plans settled in Lloyds Banking Group plc shares		
At 1 January 2010/16 January 2009	**19**	7
Granted, including certain adjustments[1] (includes entitlements of appointed directors)	**39**	17
Exercised/lapsed (includes entitlements of former directors)	**(2)**	(5)
At 31 December	**56**	19

[1]Adjustments have been made, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.

50 Related party transactions (continued)

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 Lloyds Banking Group and its key management personnel:

	2010 £m	2009 million
Loans		
At 16 January 2009/1 January 2010	**2**	3
Advanced (includes loans of appointed directors)	**2**	–
Repayments (includes loans of former directors)	**(1)**	(1)
At 31 December	**3**	2

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 0.50 per cent and 17.90 per cent in 2010 (2009: 1.28 per cent and 24.90 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2009: £nil).

	2010 £m	2009 million
Deposits		
At 16 January 2009/1 January 2010	**4**	6
Placed (includes deposits of appointed directors)	**12**	12
Withdrawn (includes deposits of former directors)	**(12)**	(14)
At 31 December	**4**	4

Deposits placed by key management personnel attracted interest rates of up to 4.25 per cent in 2010 (2009: 6.50 per cent).

At 31 December 2010, the Group did not provide any guarantees in respect of key management personnel (2009: none).

At 31 December 2010, transactions, arrangements and agreements entered into by the Lloyds Banking Group's banking subsidiaries with directors and connected persons of the Group included amounts outstanding in respect of loans and credit card transactions of £2 million with six directors and four connected persons. (2009: £2 million with seven directors and four connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings

Balances and transactions between members of the HBOS group
In accordance with IAS 27, transactions and balances between the Company and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

The Company has a significant number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Company as follows:

	2010 £m	2009 £m
Assets, included within:		
Amounts owed by Group entities	**41,818**	46,186
Derivative financial instruments	**2,061**	301
	43,879	46,487
Liabilities, included within:		
Amounts owed to Group entities	**33,749**	37,450

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2010 the Company earned interest income on the above asset balances of £1,551 million (2009: £1,952 million) and incurred interest expense on the above liability balances of £573 million (2009: £888 million).

Balances and transactions with Lloyds Banking Group plc and fellow subsidiaries of the Lloyds Banking Group
The Company and its subsidiaries have balances due to and from the Company's ultimate parent company, Lloyds Banking Group plc, and fellow subsidiaries of the Lloyds Banking Group. These are included on the balance sheet as follows:

	Group		Company	
	2010 £m	2009 £m	2010 £m	2009 £m
Assets included within:				
Derivative financial instruments	**1,437**	663	**–**	–
Loans and receivables:				
Loans and advances to banks	**55,053**	85,498	**–**	–
Loans and advances to customers	**10,205**	5,647	**7,869**	3,121
Other	**4,241**	1,835	**–**	1,805
	70,936	93,643	**7,869**	4,926

50 Related party transactions (continued)

	Group		Company	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Liabilities included within:				
Deposits from banks	**131,133**	150,338	**–**	–
Customer deposits	**16,489**	4,672	**7,862**	4,643
Derivative financial instruments	**1,853**	853	**–**	–
Subordinated liabilities	**312**	2,445	**273**	–
Other liabilities	**5,831**	1,644	**–**	–
	155,618	159,952	**8,135**	4,643

These balances include Lloyds Banking Group plc's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2010 the Group earned £658 million and the Company earned £32 million of interest income on the above asset balances (2009: Group £1,551 million; Company £4 million); the Group incurred £1,249 million and the Company incurred £245 million of interest expense on the above liability balances (2009: Group £573 million; Company £135 million).

HM Treasury
In January 2009, HM Treasury became a related party of Lloyds Banking Group plc, the Company's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 31 December 2010, HM Treasury held a 41 per cent interest (December 2009: 43 per cent) in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of the Company and its subsidiaries throughout 2010.

Capital transactions
During 2010 there were no further subscriptions by HM Treasury for Lloyds Banking Group plc's ordinary or preference share capital, with the decline in the percentage of ordinary shares held by HM Treasury reflecting the issuance by Lloyds Banking Group plc of ordinary shares.

Lending commitments
On 23 March 2010, Lloyds Banking Group plc entered into a deed poll in favour of HM Treasury, the Department for Business, Innovation and Skills and the Departments for Communities and Local Government confirming its lending commitments for the 12 month period commencing 1 March 2010. Lloyds Banking Group plc agreed, subject to, amongst other things, sufficient customer demand, to provide gross new lending to UK businesses of £44,000 million and to adjust the undertakings (but not the level of lending agreed in 2009) given in connection with lending to homeowners for the 12 month period. This additional lending is expressed to be subject to the Group's prevailing commercial terms and conditions (including pricing and risk assessment) and, in relation to mortgage lending, the Group's standard credit and other acceptance criteria.

Credit Guarantee Scheme
HM Treasury launched the Credit Guarantee Scheme in October 2008 as part of a range of measures announced by the UK Government intended to ease the turbulence in the UK banking system. It charges a commercial fee for the guarantee of new short and medium-term debt issuance. The fee payable to HM Treasury on guaranteed issues is based on a per annum rate of 50 basis points plus the median five-year credit default swap spread. At 31 December 2010, the Group had £6,030 million (2009: £8,725 million) of debt issued under the Credit Guarantee Scheme. During 2010, the Group redeemed £2,695 million of bonds. The Group's income statement includes fees of £89 million (2009: £236 million) payable to HM Treasury in respect of guaranteed funding.

There were no other material transactions between the Group and HM Treasury during 2010 that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Other related party disclosures
At 31 December 2010 there were customer deposits of £35 million (2009: £39 million) and investment and insurance contract liabilities of £850 million (2009: £320 million) related to the Group's pension arrangements.

The Group manages 291 (2009: 273) Open Ended Investment Companies (OEICs), and of these 65 (2009: 61) are consolidated. The Group invested £613 million (2009: £859 million) and redeemed £239 milliom (2009: £714 milllion) in the unconsolidated OEICs during the year and had investments, at fair value, of £4,317 million (2009: £3,589 million) at 31 December. The Group earned fees of £42 million from the unconsolidated OEICs (2009: £30 million). The Company held no investments in OEICs at any time during 2009 or 2010.

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 £31 million (2009: £34 million), of which £8 million is outstanding at the year end (2009: £10 million). At 31 December 2010, Sainsbury's Bank plc also had balances with the Group that were included in loans and advances to banks of £1,277 million (2009: £1,218 million) and deposits by banks of £1,358 million (2009: £1,405 million).

At 31 December 2010 there were loans and advances to customers of £5,660 million (2009: £12,235 million) outstanding and balances within customer deposits of £151 million (2009: £254 million) relating to joint ventures and associates.

The Group has a number of associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2010, these companies had total assets of approximately £4,713 million (2009: £11,816 million), total liabilities of approximately £4,199 million (2009: £12,106 million) and for the year ended 31 December 2010 had turnover of approximately £744 million (2009: £8,766 million) and made a net profit of approximately £164 million (2009: net loss of £557 million). In addition, the Group has provided £1,406 million (2009: £5,245 million) of financing to these companies on which it received £19 million (2009: £140 million) of interest income in the year.

Taxation: Group relief was surrendered for no payment, as per note 14.

51 Contingent liabilities and commitments

Legal proceedings

Unarranged overdraft charges

In April 2007, the Office of Fair Trading (OFT) commenced an investigation into the fairness of personal current accounts and unarranged overdraft charges. At the same time, it commenced a market study into wider questions about competition and price transparency in the provision of personal current accounts.

The Supreme Court published its judgement in respect of the fairness of unarranged overdraft charges on personal current accounts on 25 November 2009, finding in favour of the litigant banks. On 22 December 2009, the OFT announced that it will not continue its investigation into the fairness of these charges. The Group is working with the regulators to ensure that outstanding customer complaints are concluded as quickly as possible and anticipates that most cases in the county courts will be discontinued. The Group expects that some customers will argue that despite the test case ruling they are entitled to a refund of unarranged overdraft charges on the basis of other legal arguments or challenges. It is not practicable to quantify the claims. The Group is robustly defending any such complaints or claims and does not expect any such complaints or claims to have a material adverse effect on the Group.

The OFT however continued to discuss its concerns in relation to the personal current account market with the banks, consumer groups and other organisations under the auspices of its Market Study into personal current accounts. In October 2009, the OFT published voluntary initiatives agreed with the industry and consumer groups to improve transparency of the costs and benefits of personal current accounts and improvements to the switching process. On 16 March 2010 the OFT published a further update announcing several further voluntary industry-wide initiatives to improve a customer's ability to control whether they used an unarranged overdraft and to assist those in financial difficulty. However, in light of the progress it noted in the unarranged overdraft market since July 2007 and the progress it expects to see over the next two years, it has decided to take no further action at this time and will review the unarranged overdraft market again in 2012.

Interchange fees

The European Commission has adopted a formal decision finding that an infringement of European Commission competition laws has arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the fee be reduced to zero for relevant cross-border transactions within the European Economic Area. This decision has been appealed to the General Court of the European Union (the 'General Court'). Lloyds TSB Bank plc and Bank of Scotland plc (along with certain other MasterCard issuers) have successfully applied to intervene in the appeal in support of MasterCard's position that the arrangements for the charging of a uniform fallback interchange fee are compatible with European Commission competition laws. MasterCard has announced that it has reached an understanding with the European Commission on a new methodology for calculating intra European Economic Area multi-lateral interchange fees on an interim basis pending the outcome of the appeal. Meanwhile, the European Commission and the UK's OFT are pursuing investigations with a view to deciding whether arrangements adopted by other payment card schemes for the levying of uniform fallback interchange fees in respect of domestic and/or cross-border payment transactions also infringe European Commission and/or UK competition laws. As part of this initiative, the OFT will also intervene in the General Court appeal supporting the European Commission's position and Visa reached an agreement with the European Commission to reduce the level of interchange for cross-border debit card transactions to the interim levels agreed by MasterCard. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

Payment protection insurance

There has been extensive scrutiny of the Payment Protection Insurance (PPI) market in recent years.

In October 2010, the UK Competition Commission (Competition Commission) confirmed its decision to prohibit the active sale of PPI by a distributor to a customer within seven days of a sale of credit. This followed the completion of its formal investigation into the supply of PPI services (other than store card PPI) to non-business customers in the UK in January 2009 and a referral of the proposed prohibition to the Competition Appeal Tribunal. Following an earlier decision to stop selling single premium PPI products, the Group ceased to offer PPI products to its customers in July 2010.

On 1 July 2008, the Financial Ombudsman Service (FOS) referred concerns regarding the handling of PPI complaints to the Financial Services Authority (FSA) as an issue of wider implication. On 29 September 2009 and 9 March 2010, the FSA issued consultation papers on PPI complaints handling. The FSA proposed new guidance on the fair assessment of a complaint and the calculation of redress and a new rule requiring firms to reassess historically rejected complaints. The FSA published its Policy Statement on 10 August 2010, setting out a new set of rules for PPI complaints handling and redress which had to be implemented by 1 December 2010.

On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA is seeking an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. The Judicial hearing was held in late January 2011 and the judgment (which may be subject to appeal) is expected shortly.

This legal challenge has affected the implementation of the Policy Statement, since the challenge has called into question the standards to be applied when assessing PPI complaints. As a result of that challenge, a large number of complaints cannot be decided until the outcome of the legal challenge is clear and implemented.

The ultimate impact on the Group of the FSA's complaints handling policy (if implemented in full) and the FOS's most recent approach to PPI complaints could be material to the Group's financial position, although the precise effect can only be assessed once the legal proceedings have been finally determined and the steps the Group may be required to take identified and implemented. In addition, it is not practicable to quantify the potential financial impact of the implementation of the Policy Statement given the material uncertainties around, for example, applicable time periods, the extent of application of root cause analysis, the treatment of evidence and the ultimate emergence period for complaints, driven in large part by the activities of the claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs. No provision has been made in these financial statements to reflect implementation of the FSA's complaint handling policy in its current form.

51 Contingent liabilities and commitments (continued)

Following concerns expressed by the FSA, it announced in its statement on 29 September 2009 that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. Lloyds Banking Group has agreed in principle that it will undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. The precise details of the review are still being discussed with the FSA. The ultimate impact on Lloyds Banking Group of any review could be material but can only be known at the conclusion of these discussions.

European Union gender directive
An opt-out clause to the European Union Gender Directive currently permits insurers to take gender into account as a risk factor when pricing contracts. In March 2011, the European Court of Justice is expected to rule on whether this infringes fundamental European rights for equal treatment. If the European Court of Justice rules that the opt-out clause does infringe such rights, it could alter the market and alter prices for insurance products to a significant extent. At the date of these financial statements, no provision has been made for the potential costs of rectifying contracts in existence at 31 December 2010, should this ultimately be required. The ultimate impact on the Group can only be known following the European Court of Justice's ruling. However, the Group does not expect the final outcome of this matter to have a material adverse effect on its financial position.

Other legal proceedings and regulatory matters
In the course of its business, the Group is engaged in discussions with the FSA in relation to a range of conduct of business matters, especially in relation to retail products including packaged bank accounts, mortgages, structured products and pensions. The Group is keen to ensure that any regulatory concerns regarding product governance or contract terms are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

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 advisors 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 matter to have a material adverse effect on its financial position.

Contingent liabilities and commitments arising from the banking business
Acceptances and endorsements arise where the Group agrees to guarantee payment on a negotiable instrument drawn up by a customer.

Other items serving as direct credit substitutes include standby letters of credit, or other irrevocable obligations, where the Group has an irrevocable obligation to pay a third party beneficiary if the customer fails to repay an outstanding commitment; they also include acceptances drawn under letters of credit or similar facilities where the acceptor does not have specific title to an identifiable underlying shipment of goods.

Performance bonds and other transaction-related contingencies (which include bid or tender bonds, advance payment guarantees, VAT Customs & Excise bonds and standby letters of credit relating to a particular contract or non-financial transaction) are undertakings where the requirement to make payment under the guarantee depends on the outcome of a future event.

The Group's maximum exposure to loss is represented by the contractual nominal amount detailed in the table below. Consideration has not been taken of any possible recoveries from customers for payments made in respect of such guarantees under recourse provisions or from collateral held.

	Group	
	2010 £m	2009 £m
Contingent liabilities		
Acceptances and endorsements	**1**	5
Other:		
Other items serving as direct credit substitutes	**103**	99
Performance bonds and other transaction-related contingencies	**568**	1,263
	671	1,362
Total contingent liabilities	**672**	1,367

The contingent liabilities of the Group, as detailed above, arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

	Group	
	2010 £m	2009 £m
Commitments		
Documentary credits and other short-term trade-related transactions	**2**	69
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	**6,875**	6,188
Other commitments	**32,144**	30,148
	39,019	36,336
1 year or over original maturity	**17,323**	17,673
Total commitments	**56,344**	54,078

51 Contingent liabilities and commitments (continued)

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £22,476 million (2009: £30,150 million) was irrevocable.

Operating lease commitments
Where a Group company is the lessee the future minimum lease payments under non-cancellable premises operating leases were as follows:

	2010 £m	2009 £m
Not later than 1 year	**160**	188
Later than 1 year and not later than 5 years	**564**	659
Later than 5 years	**1,025**	1,195
Total operating lease commitments	**1,749**	2,042

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 of the Group in respect of investment property (see note 25), capital expenditure contracted but not provided for at 31 December 2010 amounted to £89 million (2009: £127 million). Of the capital commitments of the Group, £44 million (2009: £107 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.

52 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						
Group	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
As at 31 December 2010								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	2,375	–	2,375
Items in the course of collection from banks	–	–	–	–	–	319	–	319
Trading and other financial assets at fair value through profit or loss	–	23,751	79,335	–	–	–	–	103,086
Derivative financial instruments	6,028	23,972	–	–	–	–	–	30,000
Loans and receivables:								
Loans and advances to banks	–	–	–	–	65,170	–	–	65,170
Loans and advances to customers	–	–	–	–	381,365	–	–	381,365
Debt securities	–	–	–	–	23,632	–	–	23,632
					470,167	–	–	470,167
Available-for-sale financial assets	–	–	–	13,843	–	–	–	13,843
Total financial assets	6,028	47,723	79,335	13,843	470,167	2,694	–	619,790
Financial liabilities								
Deposits from banks	–	–	–	–	–	143,137	–	143,137
Customer deposits	–	–	–	–	–	216,404	–	216,404
Items in course of transmission to banks	–	–	–	–	–	251	–	251
Trading liabilities	–	18,786	–	–	–	–	–	18,786
Derivative financial instruments	3,681	21,394	–	–	–	–	–	25,075
Debt securities in issue	–	–	–	–	–	100,760	–	100,760
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	40,076	40,076
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	35,136	35,136
Unallocated surplus within insurance businesses	–	–	–	–	–	–	321	321
Subordinated liabilities	–	–	–	–	–	16,674	–	16,674
Total financial liabilities	3,681	40,180	–	–	–	477,226	75,533	596,620

52 Financial instruments (continued)

Group	Derivatives designated as hedging instruments £m	At fair value through profit or loss: Held for trading £m	At fair value through profit or loss: Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
As at 31 December 2009								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	2,905	–	2,905
Items in the course of collection from banks	–	–	–	–	–	534	–	534
Trading and other financial assets at fair value through profit or loss	–	27,611	74,297	–	–	–	–	101,908
Derivative financial instruments	8,934	21,985	–	–	–	–	–	30,919
Loans and receivables:								
Loans and advances to banks	–	–	–	–	98,524	–	–	98,524
Loans and advances to customers	–	–	–	–	404,075	–	–	404,075
Debt securities	–	–	–	–	31,468	–	–	31,468
	–	–	–	–	534,067	–	–	534,067
Available-for-sale financial assets	–	–	–	21,591	–	–	–	21,591
Total financial assets	8,934	49,596	74,297	21,591	534,067	3,439	–	691,924
Financial liabilities								
Deposits from banks	–	–	–	–	–	179,064	–	179,064
Customer deposits	–	–	–	–	–	232,023	–	232,023
Items in course of transmission to banks	–	–	–	–	–	495	–	495
Trading liabilities	–	27,372	–	–	–	–	–	27,372
Derivative financial instruments	8,028	17,773	–	–	–	–	–	25,801
Debt securities in issue	–	–	–	–	–	119,157	–	119,157
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	39,234	39,234
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	30,614	30,614
Unallocated surplus within insurance businesses	–	–	–	–	–	–	772	772
Subordinated liabilities	–	–	–	–	–	19,078	–	19,078
Total financial liabilities	8,028	45,145	–	–	–	549,817	70,620	673,610

52 Financial instruments (continued)

Company	**Derivatives designated as hedging instruments £m**	**Loans and receivables £m**	**Held at amortised cost £m**	**Total £m**
As at 31 December 2010				
Financial assets				
Derivative financial instruments	**2,061**	**–**	**–**	**2,061**
Loans and receivables:				
Amounts due from fellow Lloyds Banking Group undertakings	**–**	**49,687**	**–**	**49,687**
Total financial assets	**2,061**	**49,687**	**–**	**51,748**
Financial liabilities				
Subordinated liabilities	**–**	**–**	**11,617**	**11,617**
Total financial liabilities	**–**	**–**	**11,617**	**11.617**

Company	Derivatives designated as hedging instruments £m	Loans and receivables £m	Held at amortised cost £m	Total £m
As at 31 December 2009				
Financial assets				
Derivative financial instruments	1,711	–	–	1,711
Loans and receivables:				
Amounts due from fellows Lloyds Banking Group undertakings	–	46,186	–	46,186
Debt securities	–	1	–	1
Total financial assets	1,711	46,187	–	47,898
Financial liabilities				
Derivative financial instruments	43	–	–	43
Subordinated liabilities	–	–	14,554	14,554
Total financial liabilities	43	–	14,554	14,597

Interest rate risk and currency risk
The Company is exposed to interest rate risk and currency risk on its subordinated debt.

The Company has entered into interest rate and currency swaps with its subsidiary, Bank of Scotland plc, to manage these risks.

Credit risk
The majority of the Company's credit risk arises from amounts due from its wholly owned subsidiary and subsidiaries of that company.

(2) Reclassification of financial assets
No assets were reclassified in 2010.

In accordance with the amendment to IAS 39 that became applicable during 2008, 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, the Group reclassified the following financial assets:

– In January 2009, the Group reclassified £1,825 million of debt securities classified as held for trading to debt securities classified as loans and receivables.
– In addition, the Group reclassified £649 million of securities classified as available-for-sale to debt securities classified as loans and receivables.
– With effect from 1 July 2008, the Group transferred £12,210 million of assets previously classified as held for trading into available-for-sale financial assets.
– With effect from 1 November 2008, the Group transferred £35,446 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 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 0.7 per cent to 9.5 per cent with the estimated recoverable cash flows of £56,743 million.

52 Financial instruments (continued)

Carrying value and fair value of reclassified assets
The table below sets out the carrying value and fair value of reclassified financial assets.

	31 December 2010		31 December 2009		31 December 2008	
	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	**949**	**965**	1,428	1,120	–	–
From held for trading to available-for-sale	**6,116**	**6,431**	10,478	10,176	13,542	13,542
From available-for-sale financial assets to loans and receivables	**21,508**	**21,522**	29,153	27,820	37,173	36,191
Total carrying value and fair value	**28,573**	**28,918**	41,059	39,116	50,715	49,733

During the year ended 31 December 2010, the carrying value of reclassified assets decreased by £12,486 million due to sales and maturities of £13,603 million, accretion of discount of £420 million and foreign exchange and other movements of £697 million.

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 since the date of reclassification in the Group's income statement or through the Group's available-for-sale revaluation reserve if the reclassifications had not occurred.

	2010				2009			2008	
	Reclassified in 2010 £m	**Reclassified in 2009 £m**	**Reclassified in 2008 £m**	**Total £m**	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables	**–**	**14**	**–**	**14**	13	–	13	–	–
From held for trading to available-for-sale financial assets	**–**	**–**	**136**	**136**	–	904	904	981	981
From available-for-sale financial assets to loans and receivables	**–**	**–**	**(134)**	**(134)**	70	1,147	1,217	708	708
Total additional fair value gains	**–**	**14**	**2**	**16**	83	2,051	2,134	1,689	1,689

Actual amounts recognised in respect of reclassified assets
After reclassification the reclassified financial assets contributed the following amounts to the Group income statement:

	2010				2009			2008	
	Reclassified in 2010 £m	**Reclassified in 2009 £m**	**Reclassified in 2008 £m**	**Total £m**	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables:									
Net interest income	**–**	**23**	**–**	**23**	45	–	45	–	–
Impairment losses	**–**	**–**	**–**	**–**	(110)	–	(110)	–	–
Gains on disposal	**–**	**109**	**–**	**109**	17	–	17	–	–
Total amounts recognised	**–**	**132**	**–**	**132**	(48)	–	(48)	–	–

	2010				2009			2008	
	Reclassified in 2010 £m	**Reclassified in 2009 £m**	**Reclassified in 2008 £m**	**Total £m**	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to available-for-sale financial assets:									
Net interest income	**–**	**–**	**184**	**184**	–	281	281	442	442
Impairment losses	**–**	**–**	**1**	**1**	–	(305)	(305)	(215)	(215)
Gains on disposal	**–**	**–**	**95**	**95**	–	70	70	–	–
Total amounts recognised	**–**	**–**	**280**	**280**	–	46	46	227	227

52 Financial instruments (continued)

	2010				2009			2008	
	Reclassified in 2010 £m	**Reclassified in 2009 £m**	**Reclassified in 2008 £m**	**Total £m**	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From available-for-sale financial assets to loans and receivables:									
Net interest income	**–**	**14**	**443**	**457**	25	377	402	82	82
Impairment losses	**–**	**–**	**(33)**	**(33)**	–	(371)	(371)	(558)	(558)
Gains (losses) on disposal	**–**	**(9)**	**(128)**	**(137)**	–	(152)	(152)	16	16
Total amounts recognised	**–**	**5**	**282**	**287**	25	(146)	(121)	(460)	(460)

(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.

Group	**Carrying value 2010 £m**	Carrying value 2009 £m	**Fair value 2010 £m**	Fair value 2009 £m
Financial assets				
Trading and other financial assets at fair value through profit or loss	**103,086**	101,908	**103,086**	101,908
Derivative financial instruments	**30,000**	30,919	**30,000**	30,919
Loans and receivables:				
Loans and advances to banks	**65,170**	98,524	**65,190**	98,588
Loans and advances to customers	**381,365**	404,075	**367,404**	382,542
Debt securities	**23,632**	31,468	**23,790**	29,848
Available-for-sale financial assets	**13,843**	21,591	**13,843**	21,591
Financial liabilities				
Deposits from banks	**143,137**	179,064	**143,631**	179,137
Customer deposits	**216,404**	232,023	**217,462**	232,057
Trading liabilities	**18,786**	27,372	**18,786**	27,372
Derivative financial instruments	**25,075**	25,801	**25,075**	25,801
Debt securities in issue	**100,760**	119,157	**98,215**	116,133
Liabilities arising from non-participating investment contracts	**35,136**	30,614	**35,136**	30,614
Subordinated liabilities	**16,674**	19,078	**16,966**	14,213

Company	**Carrying value 2010 £m**	Carrying value 2009 £m	**Fair value 2009 £m**	Fair value 2009 £m
Financial assets				
Derivative financial instruments	**2,061**	1,711	**2,061**	1,711
Amounts due from subsidiaries	**49,687**	46,186	**49,687**	43,567
Financial liabilities				
Derivative financial instruments	**–**	43	**–**	43
Subordinated liabilities	**11,617**	14,554	**11,661**	10,764

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 estimated using market prices for instruments held by the Group. Where 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. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics either identical or similar to those of the instruments held by the Group. These estimation techniques are necessarily subjective in nature and involve several assumptions.

Because a variety of estimation techniques are employed and significant estimates made, comparisons of fair values between financial institutions may not be meaningful. Readers of these financial statements are thus advised to use caution when using this data to evaluate the Group's financial position.

Fair value information is not provided for items that do not meet the definition of a financial instrument. These items include intangible assets, premises, 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.

52 Financial instruments (continued)

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.

Fair value of financial instruments carried at amortised cost

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 the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. 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 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.

Deposits from banks and customer accounts
The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits and customer accounts is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

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.

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 government securities.

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.

52 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	2010 Total £m
At 31 December 2010				
Trading and other financial assets at fair value through profit or loss	**72,184**	**29,906**	**996**	**103,086**
Available-for-sale financial assets	**344**	**11,432**	**2,067**	**13,843**
Derivative financial instruments	**12**	**29,723**	**265**	**30,000**
Financial assets	**72,540**	**71,061**	**3,328**	**146,929**
Trading liabilities	**864**	**17,922**	**–**	**18,786**
Derivative financial instruments	**15**	**25,026**	**34**	**25,075**
Financial guarantees	**–**	**–**	**12**	**12**
Financial liabilities	**879**	**42,948**	**46**	**43,873**

	Level 1 £m	Level 2 £m	Level 3 £m	2009 Total £m
At 31 December 2009				
Trading and other financial assets at fair value through profit or loss	69,167	31,421	1,320	101,908
Available-for-sale financial assets	1,842	17,882	1,867	21,591
Derivative financial instruments	43	30,802	74	30,919
Financial assets	71,052	80,105	3,261	154,418
Trading liabilities	511	26,861	–	27,372
Derivative financial instruments	60	25,545	196	25,801
Financial liabilities	571	52,406	196	53,173

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 2009	3,386	2,292	569	6,247
Losses recognised in the income statement	(293)	(600)	(555)	(1,448)
Gains recognised in other comprehensive income	-	141	-	141
Purchases	34	403	60	497
Sales	(65)	(259)	-	(324)
Transfers into the level 3 portfolio	-	11	-	11
Transfers out of the level 3 portfolio	(1,742)	(121)	-	(1,863)
At 31 December 2009	1,320	1,867	74	3,261
Exchange and other adjustments	**27**	**11**	**2**	**40**
Gains (losses) recognised in the income statement	**101**	**(56)**	**(37)**	**8**
Gains recognised in other comprehensive income	**–**	**265**	**–**	**265**
Purchases	**499**	**497**	**–**	**996**
Sales	**(224)**	**(502)**	**–**	**(726)**
Transfers into the level 3 portfolio	**11**	**–**	**226**	**237**
Transfers out of the level 3 portfolio	**(738)**	**(15)**	**–**	**(753)**
At 31 December 2010	**996**	**2,067**	**265**	**3,328**
Gains (losses) recognised in the income statement relating to those assets held at 31 December 2010	89	(88)	(37)	(36)
Gains recognised in other comprehensive income relating to those assets held at 31 December 2010	–	269	–	269

52 Financial instruments (continued)

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 2009	1,102	–	1,102
Gains recognised in the income statement	(123)	–	(123)
Transfers out of the level 3 portfolio	(783)	–	(783)
At 31 December 2009	196	–	196
Exchange and other adjustments	**14**	**–**	**14**
Purchases	**–**	**12**	**12**
Sales	**(210)**	**–**	**(210)**
Transfers into the level 3 portfolio	**34**	**–**	**34**
At 31 December 2010	**34**	**12**	**46**
Gains (losses) recognised in the income statement relating to those liabilities held at 31 December 2010	**–**	**–**	**–**
Gains (losses) recognised in other comprehensive income relating to those liabilities held at 31 December 2010	**–**	**–**	**–**

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 £37 million (2009: £1,010 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 gains of £269 million (2009: £118 million) related to financial instruments that are held in the level 3 portfolio at the year end.

There were no significant transfers between Level 1 and Level 2 portfolios during the year.

52 Financial instruments (continued)

Level 3 portfolio

	Valuation basis/technique	Main assumptions	At 31 December 2010 Carrying value £m	At 31 December 2010 Effect of reasonably possible alternative assumptions: Favourable changes £m	At 31 December 2010 Effect of reasonably possible alternative assumptions: Unfavourable changes £m	At 31 December 2009 Carrying value £m	At 31 December 2009 Effect of reasonably possible alternative assumptions £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	**191**	**6**	**(6)**	891	74
Equity investments	Various valuation techniques	Earnings, net asset value and earnings multiples, forecast cash flows	**390**	**74**	**(58)**	234	–
Unlisted equities and property partnerships in the life funds	Third party valuations	n/a	**415**	**–**	–	195	–
			996			1,320	
Available-for-sale financial assets							
Equity investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	**2,067**	**141**	**(91)**	1,867	–
Derivative financial assets	Industry standard model/ consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**265**	**34**	**(8)**	74	31
Financial assets			**3,228**			3,261	
Derivative financial liabilities	Industry standard model/ consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**34**	**–**	**–**	196	8
Financial guarantees			**12**	**–**	–	–	–
Financial liabilities			**46**			196	

The main products where level 3 valuations have been used are described below:

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 valuation is reported as level 3. Asset classes classified as level 3 mainly comprise certain residential mortgage-backed securities, collateralised loan obligations and collateralised debt obligations.

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 (EBITDA). 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.

52 Financial instruments (continued)

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, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves; the Group uses standard models with observable inputs.
- 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.

Sensitivity of level 3 valuations
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
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
The valuation techniques used for unlisted equities and venture capital investments vary depending on the nature of the investment. Further details of these are given below. Third party valuers have been used to determine the value of unlisted equities and property partnerships included in the Group's life insurance funds. As these factors differ for each investment depending on the nature of the valuation technique used and the inputs there is no single common factor that could be adjusted to provide a reasonable alternative valuation for these investment 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.

Valuation adjustments are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These valuation adjustments reflect the different credit and funding exposures that such counterparties represent.

A Credit Valuation Adjustment (CVA) is applied to the Group's over-the-counter uncollateralised derivative exposures to adjust the derivative valuations provided by standard interbank lending rate curves. The Group uses a bilateral simulation model to develop expected future exposures. This calculates a CVA for scenarios where the Group has a positive future exposure (asset) and a Debit Valuation Adjustment (DVA) where the Group has a negative future exposure (liability).

At 31 December 2010, the total reserve booked was £388 million (31 December 2009: £585 million).

53 Financial risk management

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 Group has adopted the heritage Lloyds TSB approach to risk management.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and currency risk; and liquidity risk. Qualitative and quantitative information about the Group's management of these risks is given below.

QUALITATIVE INFORMATION

(1) Credit risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational 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).

Risk appetite

Credit risk appetite is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio performance measures, which in turn use the various credit risk rating systems as inputs. These metrics are supported 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.

Exposures

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions and corporate clients. The credit risk exposures of the Group are set out in the quantitative information section of this note.

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 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 commitments to extend credit can be cancelled and the creditworthiness of customers is monitored frequently. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards, which are regularly monitored.

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 16 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2010. 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 16.

Credit risk exposures in the insurance businesses 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.

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').

The Group's rating systems assess probability of default and if Advanced, exposure at default and loss given default, in order to derive an expected loss. (If not Advanced, 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 (see note 22 to the financial statements). 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 and a number of wholesale lending 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 Model Governance Committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. 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.

Mitigation

The Group uses a range of approaches to mitigate credit risk.

Internal control

The Group follows a through the economic cycle, relationship based, business model with risk management processes, appetites and experienced staff in place. 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.

– Credit principles and policy: risk specialists set out the Group credit principles and policy according to which credit risk is managed, which in turn is the basis for business unit credit policy. Principles and policies are reviewed at least annually, and any changes are subject to a review and approval process. Business unit policies include lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions.

53 Financial risk management (continued)

- 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.
- Credit scoring: In the principal retail portfolios statistically-based decisioning techniques (primarily credit scoring models) are used. Risk departments review model effectiveness, while new models and model changes are referred by them to model governance committees for approval. The most material changes are referred to the Lloyds Banking Group Model Governance Committee.
- Individual credit assessment and sanction: Credit risk in wholesale 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. 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 are the same as that for assets intended to be held over the period to maturity.
- Controls over rating systems: An independent team 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 by risk functions with the business unit managing directors having ownership of the systems. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by independent specialist functions.
- Cross-border and cross-currency exposures: Country limits are authorised by the country limits panel, 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.
- Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to risk appetites and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 18 to the financial statements 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. 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. Large exposures are reported in accordance with regulatory reporting requirements.
- Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group-wide level and business unit level and by rating model and portfolio, for example, within a specific industry sector.
- Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control, 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.
- 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 market transactions on any single day.
- Risk assurance and oversight: 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. Lloyds Banking Group credit risk assurance, a group level function comprising experienced credit professionals, is also in place. In conjunction with group 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 and retail businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical ('standard') credit reviews, non-standard reviews, project reviews, credit risk rating model reviews and bespoke assignments, including impairment reviews as required. The work of group credit risk assurance continues to provide executive and senior management with assurance and guidance on credit quality, effectiveness of credit risk controls and accuracy of impairments.

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.

Guidelines on the acceptability of specific classes of collateral are maintained.

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. Collateral or other security is also not usually obtained for credit risk exposures on derivative instruments, except where the Group requires margin deposits from counterparties.

It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of 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. In order to minimise the credit loss, additional collateral may be sought 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.

53 Financial risk management (continued)

Master netting agreements
Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), master netting agreements are put in place. 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
Asset sales, securitisations and credit derivative based transactions are also undertaken 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 Lloyds Banking Group 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. Lloyds Banking Group Risk in turn produces an aggregated review of credit risk throughout Lloyds Banking Group, including reports on significant credit exposures, which are presented to the Lloyds Banking Group Credit Risk Committee, Lloyds Banking Group Business Risk Committee and the Lloyds Banking Group 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 monthly monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated.

(2) Market Risk
Definition
The risk of reductions in earnings, value and/or reserves, through financial or reputational loss, arising from unexpected changes in financial prices, including interest rates, inflation rates, exchange rates, credit spreads and prices for bonds, commodities, equities, property and other instruments. It arises in all areas of the Group's activities and is managed by a variety of different techniques.

Risk appetite
Market risk appetite is defined with regard to the quantum and composition of market risk that exists currently in the Group and the direction in which the Group wishes to manage this.

Exposures
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.

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. However, some interest rate, exchange rate and credit spread positions are taken using derivatives and other on-balance sheet instruments with the objective of earning a profit from favourable movements in market rates.

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.

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 see note 27)
- 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.
- Surplus assets are held primarily in four portfolios: (a) in the long term funds of Clerical Medical Investment Group Limited and its subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group's defined benefit staff 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 pension scheme assets and liabilities please refer to note 40.

53 Financial risk management (continued)

Measurement
The following market risk measures are used for risk reporting and setting risk appetite limits and triggers:

– Value at Risk (VaR): for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used

– Standard Stresses: Interest Rates 25bp; Equities 10 per cent; Credit Spreads relative 30 per cent widening

– Bespoke Extreme Stress Scenarios: e.g. stock market crash

Both VaR and standard stress measures are also used in setting market risk appetite limits and triggers.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and 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 extreme conditions to supplement these core measures. Trading book VaR (1-day 99 per cent) is back-tested daily against profit and loss.

Banking – trading assets and other treasury positions
It is the policy of Lloyds Banking Group to monitor and report its trading and other treasury positions on a consolidated basis to facilitate management and control and capture diversification benefits. It is therefore not appropriate to report this data separately for HBOS plc.

Banking – non-trading
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.

Base case market value is calculated on the basis of the Lloyds Banking Group current 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.

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 pensions exposure holistically using a variety of metrics including accounting and economic deficits and contribution rates. These and other measures are regularly reviewed by the Lloyds Banking Group Pensions Strategy 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 pension schemes under International Accounting Standard (IAS) 19 spreads any adverse impacts of these risks over time.

Insurance portfolios
The Group's market risk exposure in respect of insurance activities described above is measured using EEV as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2010 and 2009. Foreign exchange risk arises predominantly from overseas holdings of equities. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently is not tracked on a daily basis.

As at 31 December	**2010 £m**	2009 £m
Equity risk (impact of 10 per cent fall pre-tax)	**(175)**	(188)
Interest rate risk (impact of 25 basis point reduction pre-tax)	**13**	(1)
Credit spread risk (impact of relative 30 per cent widening)	**(31)**	14

53 Financial risk management (continued)

Mitigation
Various mitigation activities are undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits.

Banking – non-trading activities
Interest rate risk arising from the different repricing characteristics of non-trading assets and liabilities, and from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets, is managed centrally. Matching assets and liabilities are offset against each other and internal interest rate swaps are also used.

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.

Insurance activities
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 Lloyds Banking Group Senior Asset and Liability Committee and the Lloyds Banking Group Market Risk Forum regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Lloyds Banking 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 are monitored locally by independent risk functions and at a high level by Lloyds Banking Group Risk. Where appropriate, escalation procedures are in place.

Banking activities
Trading is restricted to a number of specialist centres, the most important centre being the Lloyds Banking Group 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 retail portfolios and in capital and funding activities is managed centrally within limits defined in the detailed Lloyds Banking Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

Insurance activities
Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the overall risk appetites and regularly reviewed by the Lloyds Banking Group Senior Asset and Liability Committee and the Lloyds Banking Group Market Risk Forums:

- 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.

The Group also agrees strategies for the overall mix of pension assets with the pension scheme trustees.

(3) Insurance risk
Definition
The risk of reductions in earnings 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.

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 direction in which the Group wishes to manage this. 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.

Exposures
The major sources of insurance risk within the Group are the insurance businesses and the Group's defined benefit staff pension schemes. The nature of insurance business involves the accepting of insurance risks which relate primarily to mortality, longevity, morbidity, persistency, expenses, property damage and unemployment. The prime insurance risk carried by the Group's staff 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-20 year stresses and other supporting measures where appropriate.

Mitigation
A key element of the control framework is the consideration of insurance risk by a suitable combination of high level Committees/Boards. For the life assurance businesses the key control bodies are the board of Scottish Widows Group Limited and the board of HBOS Financial Services Limited with the more significant risks also being subject to review by the Group Executive Committee and/or Lloyds Banking Group Board. For the general insurance businesses the key control bodies are the boards of the legal entities including Lloyds TSB General Insurance Limited, St. Andrew's Insurance plc and the Irish subsidiaries, with the more significant risks again being subject to Group Executive Committee and/or Lloyds Banking Group Board review. All Group staff pension schemes issues are covered by the Group Asset and Liability Committee and the Group Business Risk Committee.

53 Financial risk management (continued)

The overall insurance risk is mitigated through pooling and through diversification across large numbers of uncorrelated individuals, geographical areas, and different types of risk exposure.

Insurance risk is primarily controlled via the following processes:

– 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
– Policy wording
– Product management
– The use of reinsurance or other risk mitigation techniques.

In addition, limits are used as a control mechanism for insurance risk at policy level.

At all times, close attention is paid to the adequacy of reserves, solvency management and regulatory requirements.

The most significant insurance risks in the life assurance companies are longevity risk and persistency risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed. By their nature persistency risks are difficult to hedge.

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 our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present. In respect of insurance risks in the staff 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 normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk. Reasons for any significant divergence from experience are investigated and remedial action is taken.

Insurance risk exposures are reported and monitored regularly by the Group Executive Committee.

(4) Liquidity and funding risk
Definition
Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost.

Funding risk is further 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 defined and reported through various metrics that enable the Group to manage liquidity and funding constraints.

Exposure
Liquidity exposure represents the amount of potential outflows in any future period less committed inflows. Liquidity is considered from both an internal and regulatory perspective.

Measurement
A series of measures are used 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. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

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 long-term funding strategy. 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 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 inter-bank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's 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.

53 Financial risk management (continued)

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 the Group Asset and Liability Committee and the Senior Asset and Liability Committee which meet 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 oversight.

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements. In addition, the framework has two other important components:

– Firstly, the Lloyds Banking Group stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed, evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both Lloyds Banking Group name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.
– Secondly, the Lloyds Banking Group has a contingency funding plan embedded within the Lloyds Banking 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.

During the year, the individual entities within the Group, and the Group, complied with all of the externally imposed liquidity and funding requirements to which they are subject.

QUANTITATIVE INFORMATION

(1) Credit risk
The Group's credit risk exposure arises predominantly in the United Kingdom, the European Union, Australia and the United States.

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 is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	Group	
	2010 £m	2009 £m
Loans and receivables:		
Loans and advances to customers	**406,681**	425,347
Loans and advances to banks	**65,170**	98,524
Debt securities	**24,923**	33,468
Deposit amounts available for offset[1]	**(3,920)**	(9,257)
Impairment losses	**(26,607)**	(23,272)
	466,247	524,810
Available-for-sale financial assets (excluding equity shares)	**11,667**	19,642
Trading and other financial assets at fair value through profit or loss (excluding equity shares)	**42,305**	45,574
Derivative assets, before netting	**30,000**	30,919
Amounts available for offset under master netting arrangements[1]	**(18,839)**	(19,941)
	11,161	10,978
Assets arising from reinsurance contracts held	**1,643**	1,456
Financial guarantees	**12,248**	8,025
Irrevocable loan commitments and other credit-related contingencies[2]	**23,148**	31,517
Maximum credit risk exposure	**568,419**	642,002
Maximum credit risk exposure before offset items	**591,178**	671,200

[1]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.

[2]See note 51 – Contingent liabilities and commitments for further information.

A general description of collateral held in respect of financial instruments is disclosed on page 96.

Loans and advances to banks – the Group may require collateral before entering into a credit commitment with another bank, depending on the type of the financial product and the counterparty involved, and netting agreements are obtained whenever possible and to the extent that such agreements are legally enforceable.

Available-for-sale debt securities, treasury and other bills, and trading and other financial assets at fair value through profit or loss – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 15 and a similar analysis for available-for-sale financial assets is included in note 23. The Group's non-participating investment contracts are all unit-linked.

Derivative assets – the Group reduces exposure to credit risk by using master netting agreements and by obtaining cash collateral. An analysis of derivative assets is given in note 16. Of the net derivative assets of £11,161 million (2009: £10,978 million), cash collateral of £1,354 million (2009: £568 million) was held and a further £2,974 million was due from OECD banks (2009: £4,048 million).

53 Financial risk management (continued)

Assets arising from reinsurance contracts held – of the assets arising from reinsurance contracts held at 31 December 2010 of £1,643 million (2009: £1,456 million), £355 million (2009: £278 million) were due from insurers with a credit rating of AA or above.

Financial guarantees – these 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.

Reverse repurchase and repurchase transactions – for reverse repurchase transactions which are accounted for as collateralised loans, it is the Group's policy to seek collateral which is at least equal to the amount loaned. At 31 December 2010, the fair value of collateral accepted under reverse repurchase transactions that the Group is permitted by contract or custom to sell or repledge was £40,735 million (2009: £53,072 million). Of this, £22,590 million (2009: £50,138 million) was sold or repledged as at 31 December 2010. 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 £85,077 million (2009: £138,728 million).

Stock lending – in addition to the financial assets on the Group's balance sheet which are subject to repurchase agreements, there were financial assets on the Group's balance sheet pledged as collateral as part of securities lending transactions which amounted to £75,363 million at 31 December 2010 (2009: £87,191 million).

Stock borrowing – Securities held as collateral for stock borrowed or under reverse repurchase agreements amounted to £106,501 million at 31 December 2010 (2009: £137,635 million). Of which £94,739 million at 31 December 2010 (2009: £128,236 million) had been resold or repledged.

Loans and advances

	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	
31 December 2010						
Neither past due nor impaired	**10,117**	**230,124**	**14,889**	**85,275**	**330,288**	**12,220**
Past due but not impaired	**–**	**10,729**	**429**	**2,992**	**14,150**	**–**
Impaired – no provision required	**–**	**1,532**	**61**	**4,394**	**5,987**	**–**
– provision held	**–**	**4,358**	**1,291**	**40,402**	**46,051**	**–**
Gross	**10,117**	**246,743**	**16,670**	**133,063**	**396,476**	**12,220**
Allowance for impairment losses (note 22)	**–**	**(1,783)**	**(683)**	**(22,850)**	**(25,316)**	**–**
Net	**10,117**	**244,960**	**15,987**	**110,213**	**371,160**	**12,220**
Due from fellow Lloyds Banking Group undertakings	**55,053**				**10,205**	**3,475**
	65,170				**381,365**	**15,695**
31 December 2009						
Neither past due nor impaired	9,904	236,050	17,672	109,039	362,761	18,372
Past due but not impaired	–	9,793	805	4,708	15,306	–
Impaired – no provision required	–	1,515	26	5,015	6,556	–
– provision held	–	4,405	1,438	34,620	40,463	–
Gross	9,904	251,763	19,941	153,382	425,086	18,372
Allowance for impairment losses (note 22)	–	(1,412)	(749)	(19,111)	(21,272)	–
Net	9,904	250,351	19,192	134,271	403,814	18,372
Due from fellow Lloyds Banking Group undertakings	88,620				261	1,147
	98,524				404,075	19,519

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.

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 wholesale and corporate businesses, 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 individually determined to be impaired with a gross amount before impairment allowances of £44,969 million (2009: £39,788 million) which have associated collateral with a fair value of £13,022 million (2009: £9,558 million).

53 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: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2010						
Good quality	**9,977**	**224,271**	**10,490**	**16,481**		**12,219**
Satisfactory quality	**–**	**4,217**	**2,934**	**19,046**		**1**
Lower quality	**–**	**834**	**513**	**37,748**		**–**
Below standard, but not impaired	**140**	**802**	**952**	**12,000**		**–**
Total loans and advances which are neither past due nor impaired	**10,117**	**230,124**	**14,889**	**85,275**	**330,288**	**12,220**
31 December 2009						
Good quality	9,167	227,558	11,237	20,424		18,372
Satisfactory quality	–	6,296	4,212	32,262		–
Lower quality	–	746	632	38,712		–
Below standard, but not impaired	737	1,450	1,591	17,641		–
Total loans and advances which are neither past due nor impaired	9,904	236,050	17,672	109,039	362,761	18,372

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.

Loans and advances which are past due but not impaired

	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
31 December 2010						
0-30 days	**–**	**5,256**	**293**	**1,098**	**6,647**	**–**
30-60 days	**–**	**2,183**	**108**	**478**	**2,769**	**–**
60-90 days	**–**	**1,483**	**25**	**350**	**1,858**	**–**
90-180 days	**–**	**1,807**	**3**	**313**	**2,123**	**–**
Over 180 days	**–**	**–**	**–**	**753**	**753**	**–**
Total loans and advances which are past due but not impaired	**–**	**10,729**	**429**	**2,992**	**14,150**	**–**
Fair value of collateral held		**9,286**	**n/a**	**n/a**	**n/a**	
31 December 2009						
0-30 days	–	4,693	503	2,123	7,319	–
30-60 days	–	2,087	150	787	3,024	–
60-90 days	–	1,337	47	740	2,124	–
90-180 days	–	1,676	47	538	2,261	–
Over 180 days	–	–	58	520	578	–
Total loans and advances which are past due but not impaired	–	9,793	805	4,708	15,306	–
Fair value of collateral held		8,578	n/a	n/a	n/a	

A financial asset is 'past due' if a counterparty has failed to make a payment when contractually due.

Collateral held against retail mortgage lending is principally comprised of residential properties; their fair value 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. The resulting valuation has been limited to the principal amount of the outstanding advance in order to provide a clearer representation of the Group's credit exposure.

Lending decisions are based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values for non-mortgage lending are assessed more rigorously at the time of loan origination or when taking enforcement action and may fluctuate, as in the case of floating charges, according to the level of assets held by the customer. Whilst collateral is reviewed on a regular basis in accordance with business unit credit policy, this varies according to the type of lending and collateral involved. It is therefore not practicable to estimate and aggregate current fair values of collateral for non-mortgage lending.

53 Financial risk management (continued)

Renegotiated loans and advances
Loans and advances that were renegotiated during the year and that would otherwise have been past due or impaired at 31 December 2010 totalled £4,820 million (2009: £3,702 million).

Repossessed collateral

	2010 £m	2009 £m
Residential property	**822**	1,143
Other	**8**	17
Total repossessed collateral	**830**	1,160

In respect of retail portfolios, the Group does not normally 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.

Loan-to-value ratio of mortgage lending

	2010 £m	2009 £m
Analysis by loan-to-value ratio of the Group's residential mortgage lending which is neither past due nor impaired:		
Less than 70 per cent	**85,718**	88,795
70 per cent to 80 per cent	**39,600**	37,214
80 per cent to 90 per cent	**38,799**	37,177
Greater than 90 per cent	**66,007**	72,864
Total residential mortgage lending which is neither past due nor impaired	**230,124**	236,050

53 Financial risk management (continued)

Debt securities, treasury and other bills and derivative financial instruments – analysis by credit rating:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2010							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets							
Government securities	518	885	–	–	–	–	1,403
Bank and building society certificates of deposit	–	3,086	506	100	–	–	3,692
Asset-backed securities	191	633	149	–	–	–	973
Corporate and other debt securities	1,126	200	411	18	–	–	1,755
Total debt securities held as trading assets	1,835	4,804	1,066	118	–	–	7,823
Treasury and other bills	219	8	–	–	–	–	227
Total held as trading assets	2,054	4,812	1,066	118	–	–	8,050
Other assets held at fair value through profit or loss:							
Government securities	9,531	494	132	–	6	138	10,301
Other public sector securities	729	39	28	1	–	–	797
Bank and building society certificates of deposit	52	107	447	–	–	–	606
Asset-backed securities:							
Mortgage-backed securities	92	6	4	4	–	–	106
Other asset-backed securities	110	40	27	6	12	–	195
	202	46	31	10	12	–	301
Corporate and other debt securities	1,482	1,034	1,683	1,130	850	376	6,555
Total held at fair value through profit or loss	14,050	6,532	3,387	1,259	868	514	26,610
Derivative financial instruments							
Trading	50	5,683	11,492	457	–	4,854	22,536
Hedging	35	1,985	3,938	46	–	24	6,028
	85	7,668	15,430	503	–	4,878	28,564
Due from fellow Group undertakings							1,436
Total derivative financial instruments							30,000
Debt securities classified as loans and receivables							
Asset-backed securities:							
Mortgage-backed securities	6,746	2,832	1,143	869	58	85	11,733
Other asset-backed securities	7,467	2,265	1,237	330	596	94	11,989
	14,213	5,097	2,380	1,199	654	179	23,722
Corporate and other debt securities	–	–	–	–	–	658	658
	14,213	5,097	2,380	1,199	654	837	24,380
Due from fellow Group undertakings							543
Total debt securities classified as loans and receivables before allowance for impairment losses							24,923
Available-for-sale financial assets							
Debt securities:							
Government securities	64	78	–	–	–	–	142
Bank and building society certificates of deposit	–	–	129	–	–	–	129
Asset-backed securities:							
Mortgage-backed securities	15	–	–	–	–	–	15
Other asset-backed securities	61	–	105	–	–	15	181
	76	–	105	–	–	15	196
Corporate and other debt securities	1,135	3,990	4,745	734	42	32	10,678
	1,275	4,068	4,979	734	42	47	11,145
Treasury and other bills	483	–	–	–	–	–	483
	1,758	4,068	4,979	734	42	47	11,628
Due from fellow Group undertakings:							
Corporate and other debt securities							39
Total held as available-for-sale financial assets							11,667

53 Financial risk management (continued)

Debt securities and derivative financial instruments – analysis by credit rating:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2009							
Debt securities held at fair value through profit or loss							
Trading assets							
Government securities	2,059	805	–	–	–	–	2,864
Corporate and other debt securities	1,331	1,613	2,608	283	28	–	5,863
Total held as trading assets	3,390	2,418	2,608	283	28	–	8,727
Other assets held at fair value through profit or loss:							
Government securities	8,528	442	155	24	1	9	9,159
Other public sector securities	650	16	–	–	–	–	666
Asset-backed securities:							
Mortgage-backed securities	117	6	3	–	–	–	126
Other asset-backed securities	149	31	118	31	14	–	343
	266	37	121	31	14	–	469
Corporate and other debt securities	1,521	777	1,876	991	458	1,411	7,034
Total held at fair value through profit or loss	14,355	3,690	4,760	1,329	501	1,420	26,055
Derivative financial instruments							
Trading	803	3,793	10,871	526	118	5,213	21,324
Hedging	628	2,526	5,672	91	–	15	8,932
	1,431	6,319	16,543	617	118	5,228	30,256
Due from fellow Group undertakings							663
Total derivative financial instruments							30,919
Debt securities classified as loans and receivables							
Asset-backed securities:							
Mortgage-backed securities	9,192	2,917	1,524	890	1,032	–	15,555
Other asset-backed securities	11,767	2,308	1,383	412	835	–	16,705
	20,959	5,225	2,907	1,302	1,867	–	32,260
Corporate and other debt securities	–	–	–	–	–	1,208	1,208
Total debt securities classified as loans and receivables	20,959	5,225	2,907	1,302	1,867	1,208	33,468
Available-for-sale financial assets							
Debt securities:							
Government securities	12	314	–	–	–	–	326
Bank and building society certificates of deposit	22	142	99	22	–	–	285
Asset-backed securities:							
Mortgage-backed securities	17	–	–	–	–	–	17
Other asset-backed securities	69	10	–	–	–	–	79
	86	10	–	–	–	–	96
Corporate and other debt securities	2,011	6,653	8,667	1,350	228	26	18,935
Total held as available-for-sale financial assets	2,131	7,119	8,766	1,372	228	26	19,642

[1]This total excludes equity shares of £56,334 million and loans and advances of £19,519 million.

53 Financial risk management (continued)

(2) Market risk
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 are 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 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 mortgage portfolio.

At 31 December 2010 the aggregate notional principal of interest rate swaps designated as fair value hedges was £39,631 million (2009: £55,891 million) with a net fair value asset of £2,947 million (2009: £2,549 million) (see note 16). The gains on the hedging instruments were £651 million (2009: losses of £991 million). The losses on the hedged items attributable to the hedged risk were £740 million (2009: gains of £1,091 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next five years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2010 was £97,812 million (2009: £229,390 million) with a net fair value liability of £1,285 million (2009: £2,031 million) (see note 16). In 2010, ineffectiveness recognised in the income statement that arises from cash flow hedges was £159 million gain (2009: £5 million loss). There were no transactions for which cash flow hedge accounting had to be ceased in 2010 or 2009 as a result of the highly probable cash flows no longer being expected to occur.

(3) 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 central market risk function.

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 cross currency borrowings.

The Group's main overseas operations are in the Americas, Australia and Europe. Details of the Group's structural foreign currency exposures, after net investment hedges, are as follows:

	Group	
	2010 £m	2009 £m
Functional currency of Group operations		
Euro:		
Gross exposure	**2,325**	2,651
Net investment hedge	**(3,270)**	(2,651)
	(945)	–
Australian Dollar:		
Gross exposure	**1,571**	1,869
Net investment hedge	**(1,634)**	(1,832)
	(63)	37
US Dollar:		
Gross exposure	**138**	(62)
Net investment hedge	**(145)**	62
	(7)	–
Other non-sterling	**–**	(2)
Total structural foreign currency exposures, after net investment hedges	**(1,015)**	35

53 Financial risk management (continued)

(4) Liquidity risk

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.

Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
As at 31 December 2010						
Deposits from banks	**68,614**	**37,934**	**13,912**	**23,260**	**2,214**	**145,934**
Customer deposits	**144,281**	**6,702**	**22,486**	**29,503**	**11,193**	**214,165**
Trading liabilities	**14,865**	**2,086**	**2,352**	**102**	**–**	**19,405**
Debt securities in issue	**7,451**	**10,167**	**19,159**	**50,567**	**18,581**	**105,925**
Liabilities arising from non-participating investment contracts	**12,899**	**12**	**68**	**262**	**21,895**	**35,136**
Subordinated liabilities	**84**	**117**	**3,468**	**7,450**	**7,342**	**18,461**
Total non-derivative financial liabilities	**248,194**	**57,018**	**61,445**	**111,144**	**61,225**	**539,026**
Derivative financial liabilities:						
Gross settled derivative – outflow	**11,238**	**12,300**	**8,591**	**49,162**	**29,794**	**111,085**
Gross settled derivative – inflow	**(11,131)**	**(12,522)**	**(8,679)**	**(49,381)**	**(29,714)**	**(111,427)**
Gross settled derivative – netflow	**107**	**(222)**	**(88)**	**(219)**	**80**	**(342)**
Net settled derivative liabilities	**2,029**	**1,608**	**5,884**	**11,970**	**3,464**	**24,955**
Total derivative financial liabilities	**2,136**	**1,386**	**5,796**	**11,751**	**3,544**	**24,613**
As at 31 December 2009						
Deposits from banks	83,049	71,519	16,167	2,281	7,314	180,330
Customer deposits	158,313	29,194	23,271	20,267	2,049	233,094
Trading liabilities	15,471	5,120	6,684	134	–	27,409
Debt securities in issue	14,169	11,938	18,722	69,671	20,270	134,770
Liabilities arising from non-participating investment contracts	30,306	4	58	185	186	30,739
Subordinated liabilities	42	28	1,034	10,137	13,720	24,961
Total non-derivative financial liabilities	301,350	117,803	65,936	102,675	43,539	631,303
Derivative financial liabilities:						
Gross settled derivative – outflow	14,583	6,048	8,285	37,620	37,790	104,326
Gross settled derivative – inflow	(14,399)	(6,134)	(8,364)	(37,097)	(36,202)	(102,196)
Gross settled derivative – netflow	184	(86)	(79)	523	1,588	2,130
Net settled derivative liabilities	1,293	2,240	9,613	8,970	15	22,131
Total derivative financial liabilities	1,477	2,154	9,534	9,493	1,603	24,261

Company	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
As at 31 December 2010						
Amounts owed to fellow Group undertakings	**4**	**606**	**28,290**	**8,484**	**12,269**	**49,653**
Subordinated liabilities	**60**	**–**	**3,288**	**3,648**	**4,379**	**11,375**
Total non-derivative financial liabilities	**64**	**606**	**31,578**	**12,132**	**16,648**	**61,028**
As at 31 December 2009						
Subordinated liabilities	–	89	940	8,683	9,312	19,024
Total non-derivative financial liabilities	–	89	940	8,683	9,312	19,024
Derivative financial liabilities:						
Gross settled derivative – outflow	1	–	4	35	238	278
Gross settled derivative – inflow	(1)	–	(3)	(35)	(216)	(255)
Gross settled derivative – netflow	–	–	1	–	22	23
Net settled derivative liabilities	(1)	–	7	10	9	25
Total derivative financial liabilities	(1)	–	8	10	31	48

53 Financial risk management (continued)

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £74 million (2009: £54 million) for the Group and £15 million (2009: £42 million) for the Company per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

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
As at 31 December 2010	**2,172**	**722**	**2,821**	**9,761**	**24,600**	**40,076**
As at 31 December 2009	5,759	1,100	2,901	9,907	19,567	39,234

The following tables set out the amounts and residual maturities of the Group's off balance sheet contingent liabilities and commitments.

Group	**Within 1 year £m**	**1-3 years £m**	**3-5 years £m**	**Over 5 years £m**	**Total £m**
31 December 2010					
Acceptances and endorsements	**1**	**–**	**–**	**–**	**1**
Other contingent liabilities	**433**	**46**	**99**	**93**	**671**
Total contingent liabilities	**434**	**46**	**99**	**93**	**672**
Lending commitments	**43,268**	**3,915**	**7,121**	**2,038**	**56,342**
Other commitments	**2**	**–**	**–**	**–**	**2**
Total commitments	**43,270**	**3,915**	**7,121**	**2,038**	**56,344**
Total contingents and commitments	**43,704**	**3,961**	**7,220**	**2,131**	**57,016**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2009					
Acceptances and endorsements	5	–	–	–	5
Other contingent liabilities	489	54	765	54	1,362
Total contingent liabilities	494	54	765	54	1,367
Lending commitments	36,336	3,292	10,786	3,595	54,009
Other commitments	55	–	14	–	69
Total commitments	36,391	3,292	10,800	3,595	54,078
Total contingents and commitments	36,885	3,346	11,565	3,649	55,445

54 Capital

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group's budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the Lloyds Banking Group Asset and Liability Committee. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight.

The Group's regulatory capital is divided into tiers defined by the European Community Banking Consolidation Directive as implemented in the UK by the Financial Services Authority's (FSA) General Prudential Sourcebook. Tier 1 capital comprises mainly shareholders' equity, tier 1 capital instruments and non-controlling interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected losses over accounting provisions and certain securitisation positions. During the year the FSA has defined Core Tier 1 capital. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and available-for-sale assets. Tier 2 capital mainly comprises qualifying subordinated debt after deducting 50 per cent of the excess of expected losses over accounting provisions, and certain securitisation positions. The amount of qualifying tier 2 capital cannot exceed that of tier 1 capital. Total capital is reduced by deducting investments in subsidiaries, joint ventures and associates that are not consolidated for regulatory purposes.

In the case of the Group, this means that the net assets of its life assurance and general insurance businesses are excluded from its total regulatory capital. The Group's capital resources are summarised as follows:

	2010 £m	2009[1] £m
Tier 1 capital	**28,819**	29,430
Tier 2 capital	**12,243**	12,849
	41,062	42,279
Supervisory deductions	**(5,435)**	(5,517)
Total capital	**35,627**	36,762

[1]Restated to reflect a prior year adjustment to the available-for-sale revaluation reserve (note 46).

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities. The unpredictable nature of movements in the value of the investments supporting the long-term assurance funds could cause the amount of qualifying tier 2 capital to be restricted because of falling tier 1 resources. The Group seeks to ensure that even in the event of such restrictions the total capital ratio will remain adequate.

The FSA sets Individual Capital Guidance (ICG) for each UK bank calibrated by reference to its Capital Resources Requirement, broadly equivalent to 8 per cent of risk-weighted assets and thus representing the capital required under Pillar 1 of the Basel II framework. Also a key input into the FSA's ICG setting process, which addresses the requirements of Pillar 2 of the Basel II framework, is each bank's Internal Capital Adequacy Assessment Process. The FSA's approach is to monitor the available capital resources in relation to the ICG requirement. Lloyds Banking Group has been given ICG by the FSA and the board has also agreed a formal buffer to be maintained in addition to this requirement. Any breaches of the formal buffer must be notified to the FSA, together with proposed remedial action. The FSA has made it clear that each ICG remains a confidential matter between each bank and the FSA.

During the year, the individual entities within the Group and the Group complied with all of the externally imposed capital requirements to which they are subject.

55 Cash flow statements

a Change in operating assets

	Group 2010 £m	Group 2009 £m
Change in loans and receivables	**54,639**	(42,387)
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**(1,206)**	(2,879)
Change in other operating assets	**3,623**	(3,440)
Change in operating assets	**57,056**	(48,706)

b Change in operating liabilities

	Group 2010 £m	Group 2009 £m
Change in deposits from banks	**(34,364)**	81,914
Change in customer deposits	**(12,222)**	(5,426)
Change in debt securities in issue	**(18,358)**	(69,291)
Change in derivative financial instruments and trading liabilities	**(9,300)**	7,251
Change in investment contract liabilities	**4,493**	1,557
Change in other operating liabilities	**(935)**	5,840
Change in operating liabilities	**(70,686)**	21,845

55 Cash flow statements (continued)

c Non-cash and other items

	Group 2010 £m	Group 2009[1] £m
Depreciation and amortisation	**878**	1,174
Impairment of tangible fixed assets	**52**	–
Revaluation of investment properties	**(233)**	112
Allowance for loan losses	**10,767**	19,515
Write-off of allowance for loan losses	**(7,319)**	(7,458)
Impairment of available-for-sale securities	**100**	1,557
Impairment of goodwill	**–**	764
Change in insurance contract liabilities	**391**	2,361
Customer goodwill payments provision	**500**	–
Other provision movements	**29**	111
Net charge in respect of defined benefit schemes	**(150)**	177
Contributions to defined benefit schemes	**(309)**	(293)
Other non-cash items	**(1,168)**	1,396
Total non-cash items	**3,538**	19,416
Interest expense on subordinated liabilities	**790**	1,118
Loss (profit) on disposal of businesses	**1,296**	(26)
Total other items	**2,086**	1,092
Non-cash and other items	**5,624**	20,508

[1]Restated – see note 1.

d Analysis of cash and cash equivalents as shown in the balance sheet

	Group 2010 £m	Group 2009 £m
Cash and balances with central banks	**2,375**	2,905
Less: mandatory reserve deposits[1]	**(303)**	(335)
	2,072	2,570
Loans and advances to banks	**65,170**	98,524
Less: amounts with a maturity of three months or more and balances due from fellow Lloyds Banking Group undertakings	**(57,699)**	(92,010)
	7,471	6,514
Total cash and cash equivalents	**9,543**	9,084

[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.

55 Cash flow statements (continued)

e Analysis of changes in financing during the year

	Group 2010 £m	Group 2009 £m
Share capital (including share premium account and merger reserve):		
At 1 January	**29,870**	8,842
Issue of ordinary and preference shares	**2,599**	25,295
Redemption of preference shares	**–**	(4,267)
At 31 December	**32,469**	29,870

	Group 2010 £m	Group 2009 £m
Non-controlling interests:		
At 1 January	**1,271**	1,300
Issue of equity preference shares to non-controlling shareholders	**(733)**	–
Repayment of capital to non-controlling shareholders	**–**	(35)
Non-controlling share of profit after tax	**36**	101
Dividends to non-controlling shareholders	**(24)**	(95)
At 31 December	**550**	1,271

	2010 £m	2009 £m
Subordinated liabilities:		
At 1 January	**19,078**	30,119
Exchange and other adjustments	**(2,073)**	(2,863)
Repayments of subordinated liabilities	**(331)**	(8,178)
At 31 December	**16,674**	19,078

f Disposal and closure of group undertakings, joint ventures and associates

	2010 £m	2009 £m
Derivatives, trading and other financial assets at fair value through profit or loss	**164**	(28)
Loans and advances to banks	**3,469**	–
Loans and advances to customers	**2,774**	–
Debt securities	**252**	–
Tangible fixed assets	**1,015**	–
Deposits from banks	**(1,563)**	–
Customer deposits	**(3,397)**	–
Other net assets and liabilities	**18**	23
	2,732	(5)
Profit on sale of businesses	**51**	26
Net cash inflow from disposals	**2,783**	21
Capital redemptions in joint ventures and associates	**–**	238
At 31 December	**2,783**	259

56 Future accounting developments

The following pronouncements will be relevant to the Group but were not effective at 31 December 2010 and have not been applied in preparing these financial statements. The full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	Effective date
Amendment to IAS 32 *Financial Instruments: Presentation – 'Classification of Rights Issues'*	Requires rights issues denominated in a currency other than the functional currency of the issuer to be classified as equity regardless of the currency in which the exercise price is denominated.	Annual periods beginning on or after 1 February 2010.
Improvements to IFRSs (issued May 2010)	Sets out minor amendments to IFRS standards as part of the annual improvements process.	Dealt with on a standard by standard basis but not earlier than annual periods beginning on or after 1 July 2010.
IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*	Clarifies that when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor, a gain or loss is recognised in the income statement representing the difference between the carrying value of the financial liability and the fair value of the equity instruments issued; the fair value of the financial liability is used to measure the gain or loss where the fair value of the equity instruments cannot be reliably measured. This interpretation is consistent with the Group's existing accounting policy.	Annual periods beginning on or after 1 July 2010.
Amendment to IFRIC 14 *Prepayments of a Minimum Funding Requirement*	Applies when an entity is subject to minimum funding requirements in respect of its defined benefit plans and makes an early payment of contributions to cover those requirements and permits such an entity to treat the benefit of such an early payment as an asset.	Annual periods beginning on or after 1 January 2011.
Amendments to IAS 24 *Related Party Disclosures*	Simplifies the definition of a related party and provides a partial exemption from the disclosure requirements for related party transactions with government related entities.	Annual periods beginning on or after 1 January 2011.
Amendments to IFRS 7 *Financial Instruments Disclosures – 'Disclosures-Transfers of Financial Assets'*	Requires additional disclosures in respect of risk exposures arising from transferred financial assets.	Annual periods beginning on or after 1 July 2011.
Amendments to IAS 12 *Income Taxes – 'Deferred Tax: Recovery of Underlying Assets'*	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.	Annual periods beginning on or after 1 January 2012.
IFRS 9 *Financial Instruments*[1]	Replaces those parts of IAS 39 'Financial Instruments: Recognition and Measurement' relating to the classification, measurement and derecognition of financial assets and liabilities. Requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of entity's business model for managing it financial assets and the contractual cash flow characteristics of the instrument. The available-for-sale financial asset and held-to-maturity investment categories in the existing IAS 39 will be eliminated. The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39.	Annual periods beginning on or after 1 January 2013.

[1] 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. 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. The effective date of the standard is annual periods beginning on or after 1 January 2013.

At the date of this report, IFRS 9, the Amendments to IFRS 7 and the Amendments to IAS 12 are awaiting EU endorsement.

57 Post balance sheet events

Lloyds Banking Group has been in discussion with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the 'Halifax' brand. In February 2011, the Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000. The Group has made a provision of £500 million in relation to this programme.

58 Approval of financial statements and other information

The consolidated financial statements were approved by the directors of HBOS plc on 24 February 2011.

HBOS plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services in the UK and in certain locations overseas.

HBOS plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

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