HBOS plc

Report and Accounts
2011

Member of Lloyds Banking Group

Contents

Registered office: The Mound, Edinburgh, EH1 1YZ Registered in Scotland no 218813

Directors' report

Results

The consolidated income statement on page 17 shows a loss attributable to equity shareholders for the year ended 31 December 2011 of £3,763 million.

Principal activities

HBOS plc (the Company) and its subsidiary undertakings (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 Group's loss before tax increased by £1,843 million to £3,894 million for 2011 from £2,051 million in 2010. This was primarily due to a £1,155 million charge in respect of payment protection insurance and a loss of £1,739 million on disposal of the Group's wholly owned life, pensions and general insurance subsidiaries.

The trading surplus decreased by £4,002 million, or 45 per cent, from £8,925 million to £4,923 million, comprising a £28 million increase in net interest income, a £4,236 million decrease in other income, net of insurance claims, and a £206 million reduction in operating expenses.

Net interest income increased by £28m, from £8,370 million to £8,398 million. A reduction in margins, reflecting increased funding costs, was offset by a lower income statement charge relating to the amounts allocated to unit holders in the Open-Ended Investment Companies included in the consolidated results of the Group.

Other income declined by £12,866 million from £15,841 million in 2010 to £2,975 million in 2011, largely due to a reduction in net trading income in the Group's life, pensions and insurance subsidiaries arising as a result of the effect of market conditions on policyholder assets. In addition, net trading income in the Group's banking operations also reduced significantly as a result of unfavourable market conditions.

Offsetting the decline in the life, pensions and insurance subsidiaries' net trading income is a decrease in the insurance claims expense from £9,605 million in 2010 to £975 million in the current year, also reflecting the impact of adverse market conditions.

Total operating expenses decreased to £5,475 million in 2011, compared to £5,681 million in 2010. The decrease reflects integration savings, the non-recurrence of a provision of £500 million for customer goodwill payments in 2010 and lower depreciation and amortisation charges, largely as a result of reductions in operating lease assets, offset by a £1,155 million charge in respect of payment protection insurance in 2011 and the non-repetition of the pension curtailment gain of £316 million arising in 2010.

A reduction of £3,774 million in impairment losses, from £10,878 million in 2010 to £7,104 million in the current year, reflects continued improving business quality and portfolio trends resulting from the Group's prudent risk appetite, together with a significant reduction in impairment losses incurred by the Group's international businesses.

Total assets at 31 December 2011 were £567,999 million, £73,753 million, or 11 per cent, lower compared to £641,752 million at 31 December 2010. The majority of the decrease reflects disposal of the Group's wholly owned life, pensions and general insurance subsidiaries, with the remainder resulting from the continuing disposal of assets which are outside of the Group's risk appetite, customer deleveraging and de-risking and subdued demand in lending markets.

Debt securities in issue decreased by £25,303 million, or 25 per cent, to £75,457 million compared to £100,760 million at 31 December 2010 as funding requirements decreased in line with reductions in asset balances, reflecting the strategy of disposing of exposures outside of the Group's risk appetite.

Shareholders' equity decreased by £2,089 million, from £25,860 million to £23,771 million at 31 December 2011, reflecting the loss for the year, offset by gains on cash flow hedges.

The Group's capital ratios at 31 December 2011 improved with a total capital ratio of 16.0 per cent, compared to 14.1 per cent at 31 December 2010, and a tier 1 capital ratio of 12.3 per cent, compared to 11.4 per cent at 31 December 2010. During the year, risk-weighted assets were reduced by £53,289 million, or 21 per cent, from £252,613 million to £199,324 million at 31 December 2011.

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 54 on page 97. A discussion of the principal risks and uncertainties faced by the Group is set out on pages 8 to 14. This information is incorporated into this report by reference. Additional information can be found in the annual report of Lloyds Banking Group plc, the Company's ultimate parent, which does not form part of this report.

Group structure

In July 2011, the Lloyds Banking Group completed a restructuring of the legal ownership of its insurance businesses, as a result of which the Group's subsidiary, HBOS Insurance & Investment Group Limited, sold its wholly owned life, pensions and general insurance subsidiaries to Lloyds TSB General Insurance Holdings Limited and Scottish Widows Financial Services Holdings Limited, which are also wholly owned by Lloyds TSB Bank plc for a total consideration of £3,013 million. This resulted in a consolidated loss on disposal of £1,739 million.

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 on page 26 and additionally have considered projections for the Group's capital and funding position. Having considered these, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Directors

The names of the directors of the Company are shown on page 6. Changes to the composition of the Board since 1 January 2011 up to the date of this report are shown below:

	Joined the Board	Retired from the Board
Mr A Horta-Osório (became Group Chief Executive on 1 March 2011)	17 January 2011	
Mr J E Daniels		28 February 2011
Mr A G Kane		18 May 2011
Mrs H A Weir		18 May 2011
Ms S V Weller	1 February 2012	
Mr G T Tate		6 February 2012

Mr T J W Tookey, Lord Leitch and Sir Julian Horn-Smith will retire from the Board on 24 February, 29 February and 17 May 2012, respectively.

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

Directors' indemnities

The directors of the Company, including the former directors who retired during the year and since the year end, have entered into individual deeds of indemnity with 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. In addition, Lloyds Banking Group plc has granted a deed of indemnity through deed poll which constitued 'third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' to the directors of the Company's subsidiary companies, including to former directors who retired during the year and since the year end. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the directors who joined the boards in 2011 and 2012. The indemnities remain in force for the duration of a director's period of office. The deeds indemnify the directors to the maximum extent permitted by law. Deeds for existing directors are available for inspection at the Company's registered office.

Share capital

Information about share capital and dividends is shown in notes 45 and 49 on pages 73 and 75 and is incorporated into this report by reference.

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

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

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

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 2011 bears to the aggregate of the amounts invoiced by suppliers during the year.

Essential business contracts

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

Significant contracts

Details of related party transactions are set out in note 51 on pages 82 to 84.

Research and development activities

During the ordinary course of business the Company develops new products and services.

Directors' report

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

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements 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 UK 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, which have been prepared in accordance with IFRSs 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 8 to 14.

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 2012 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
23 February 2012

Company Number 218813

Directors

Sir Winfried Bischoff *Chairman*

A Horta-Osório *Group Chief Executive*

T J W Tookey *Group Finance Director* (until 24 February 2012)

A M Frew

Sir Julian Horn-Smith (until 17 May 2012)

Lord Leitch (until 29 February 2012)

G R Moreno

D L Roberts

T T Ryan, Jr

M A Scicluna

A Watson CBE

S V Weller

Forward looking statements

This annual report includes certain forward looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995 with respect to the business, strategy and plans of HBOS plc and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about HBOS plc or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will occur in the future.

Examples of such forward looking statements include, but are not limited to, projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, expenditures or any other financial items or ratios; statements of plans, objectives or goals of the Group or its management including in respect of certain synergy targets; statements about the future business and economic environments in the United Kingdom (UK) and elsewhere including future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; inflation, deflation, interest rates and policies of the Bank of England, the European Central Bank and other G8 central banks; fluctuations in exchange rates, stock markets and currencies; the ability to access sufficient funding to meet the Group's liquidity needs; changes to the Group's, Lloyds Banking Group plc's or Lloyds TSB Bank plc's credit ratings; the ability to derive cost savings and other benefits including, without limitation, as a result of the integration of HBOS into Lloyds Banking Group and the Group's Simplification Programme; changing demographic developments including mortality and changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets including Eurozone instability; technological changes; natural and other disasters, adverse weather and similar contingencies outside the Group's control; inadequate or failed internal or external processes, people and systems; terrorist acts and other acts of war or hostility and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, taxation, accounting standards or practices; regulatory capital or liquidity requirements and similar contingencies outside the Group's control; the policies and actions of governmental or regulatory authorities in the UK, the European Union (EU), the US or elsewhere; the ability to attract and retain senior management and other employees; requirements or limitations imposed on Lloyds Banking Group plc, Lloyds TSB Bank plc and the Group as a result of HM Treasury's investment in the Lloyds Banking Group plc; the ability to complete satisfactorily the disposal of certain assets as part of the Lloyds Banking Group plc's EU State Aid obligations; the extent of any future impairment charges or write-downs caused by depressed asset valuations; market related trends and developments; exposure to regulatory scrutiny, legal proceedings or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors; and the success of the Group in managing the risks of the foregoing. Please refer to the latest Annual Report on Form 20-F filed with the US Securities and Exchange Commission for a discussion of certain factors.

The Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of the Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this annual report are made as of the date hereof, and HBOS plc expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this annual report to reflect any change in HBOS plc's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

At present the significant risks faced by the Group are:

LIQUIDITY AND FUNDING

Risk Definition

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

Principal Risks

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

The combination of right-sizing the Lloyds Banking Group balance sheet and continued development of the retail deposit base has seen the Lloyds Banking Group's wholesale funding requirement reduce in the past year. The progress Lloyds Banking Group has made to date in diversifying its funding sources has further strengthened its funding base.

During the first half of 2011 the Lloyds Banking Group accelerated term funding initiatives and the run down of certain non-core asset portfolios allowing a further reduction in total government and central bank facilities. Lloyds Banking Group repaid its remaining drawings under the Bank of England SLS scheme in full during 2011. Outstandings under the Credit Guarantee Scheme reduced in line with their contractual maturities, with £23.5 billion remaining at end December. The outstanding amount matures during 2012.

The second half of 2011 has seen more difficult funding markets as investor confidence was impacted by concerns over the US debt ceiling and subsequent downgrade This was followed by increased fears over Eurozone sovereign debt levels, downgrades and possible defaults and concerns are ongoing over the potential downside effects from financial market volatility. Despite this Lloyds Banking Group continued to fund adequately, maintaining a broadly stable stock of primary liquid assets during the year and meeting its regulatory liquidity ratio targets at all times.

Liquidity is managed at the aggregate Lloyds Banking Group level, with active monitoring at both business unit and Group level. Monitoring and control processes are in place to address both internal and regulatory requirements. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event.

The Lloyds Banking Group carries out stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. Lloyds Banking Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

Lloyds Banking Group's stress testing framework considers these factors, including the impact of a range of economic and liquidity stress scenarios over both short and longer term horizons. Internal stress testing results at 31 December 2011 show that Lloyds Banking Group has liquidity resources representing more than 130 per cent of modelled outflows from all wholesale funding sources, corporate deposits and rating dependent contracts under the Group's severe liquidity stress scenario. In 2011, Lloyds Banking Group has maintained its liquidity levels in excess of the ILG regulatory minimum (FSA's Individual Liquidity Adequacy Standards) at all times. Funding projections show Lloyds Banking Group will achieve the proposed Basel 3 liquidity and funding requirements in advance of expected implementation dates.

Lloyds Banking Group's stress testing shows that further credit rating downgrades may reduce investor appetite for some of the Group's liability classes and therefore funding capacity. In the fourth quarter of 2011, Lloyds Banking Group experienced downgrades in its long-term rating of between one and two notches from three of the major rating agencies. The impact that Lloyds Banking Group experienced following the downgrades were consistent with the Group's modelled outcomes based on the stress testing framework. Lloyds Banking Group has materially reduced its wholesale funding in recent years and operates a well diversified funding platform which together lessen the impact of stress events.

Lloyds Banking Group's borrowing costs and issuance in the capital markets are dependent on a number of factors, and increased cost or reduction of capacity could materially adversely affect the Group's results of operations, financial condition and prospects. In particular, reduction in the credit rating of Lloyds Banking Group or deterioration in the capital markets' perception of the Group's financial resilience, could significantly increase its borrowing costs and limit its issuance capacity in the capital markets. The impact on the Lloyds Banking Group's funding cost is subject to a number of assumptions and uncertainties and is therefore impossible to quantify precisely.

The downgrades that Lloyds Banking Group experienced in the fourth quarter of 2011, did not significantly change its borrowing costs, reduce its issuance capacity or require significant collateral posting. Lloyds Banking Group notes the recent announcements from Moody's placing the ratings of 114 European financial institutions, including Lloyds Banking Group, on review for downgrade. Even in the case of a simultaneous two notch downgrade from all rating agencies, the Group would remain investment grade.

At 31 December, Lloyds Banking Group had £202 billion of highly liquid unencumbered assets in its liquidity portfolio which are available to meet cash and collateral outflows. This liquidity is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of the Group's liquidity management process.

Mitigating Actions
The Group takes many mitigating actions with respect to this principal risk, key examples include:

Lloyds Banking Group has maintained its liquidity levels in excess of the ILG regulatory minimum (FSA's Individual Liquidity Adequacy Standards) at all times. Funding projections show that Lloyds Banking Group will achieve the proposed Basel III liquidity and funding metrics in advance of expected implementation dates. The Liquidity Coverage Ratio (LCR) is due to be implemented on 1 January 2015 and the Net Stable Funding Ratio (NSFR) has a 1 January 2018 implementation date. The European Commission released its proposal for implementing Basel III into Europe (CRDIV) in July 2011 and we note that discussions over the final detail are ongoing.

The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The key dependencies on successfully funding the Lloyds Banking Group's balance sheet include the continued functioning of the money and capital markets; successful right-sizing of Lloyds Banking Group's balance sheet; the repayment of the government Credit Guarantee Scheme facilities in accordance with the agreed terms; no more than limited further deterioration in the UK's and Lloyds Banking Group's credit rating; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets. Additionally, 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. These are assumed within Lloyds Banking Group's funding plan. The requirement to meet this deadline may result in the Lloyds Banking Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

CREDIT
Risk 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).

Principal Risks
Arising in the retail, wholesale, commercial 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, lower consumer spending, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates or higher tenant defaults. Over the last four 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): where companies continue to face difficult business conditions. Impairment levels have reduced materially since the peak of the economic downturn and more aggressive risk appetite in the HBOS businesses when elevated corporate default levels and illiquid commercial property markets resulted in heightened impairment charges. The reduction in public sector spending is deepening and exports are failing to offset domestic weakness. The possibility of further economic weakness remains. Financial market instability represents an additional downside risk. The Group has exposure in both the UK and internationally, including Europe, Ireland, USA and Australia, particularly in commercial real estate lending, where we have a high level of lending secured on secondary and tertiary assets.

– Retail customers: This portfolio will remain strongly linked to the economic environment, with inter alia house price falls, unemployment increases, consumer over-indebtedness and rising interest rates possible impacts to the secured and unsecured retail exposures.

Mitigating Actions

The Group takes many mitigating actions with respect to this principal risk, key examples being that the Group follows a relationship based business model with risk management processes, appetites and experienced staff in place.

REGULATORY

Risk Definition

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

Principal Risks

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. This is particularly the case in the current market environment, which continues to witness high levels of government and regulatory intervention in the banking sector.

Lloyds Banking Group faces increased political and regulatory scrutiny as a result of the Group's perceived size and systemic importance following the acquisition of HBOS Group.

Independent Commission on Banking

The Government appointed an independent Commission on Banking (ICB) to review possible measures to reform the banking system and promote stability and competition. The ICB published its final report on September 2011 putting forward recommendations to require ring-fencing of the retail activities of banks from their investment banking activities and additional capital requirements beyond those required under current drafts of the Capital Requirements Directive IV. The Report also makes recommendations in relation to the competitiveness of the UK banking market, including enhancing the competition remit of the new Financial Conduct Authority (FCA), implementing a new industry-wide switching solution by September 2013, and improving transparency. The ICB, which following the final report was disbanded, had the authority only to make recommendations, which the Government could choose to accept or reject.

The ICB specifically recommended in relation to Lloyds Banking Group's EU mandated branch disposal (Project Verde), that, to create a strong challenger in the UK banking market, the entity which results from the divestiture should have a share of the personal current account (PCA) market of at least 6 per cent (although this does not need to arise solely from the current accounts acquired from the Company) and a funding position at least as strong as its peers. The ICB did not specify a definitive timeframe for the divested entity to achieve a 6 per cent market share of PCAs but recommended that a market investigation should be carefully considered by competition authorities if 'a strong and effective challenger' has not resulted from Lloyd Banking Group's divestiture by 2015. The ICB did not recommend explicitly that Lloyds Banking Group should increase the size of the Project Verde disposal agreed with the European Commission but recommended that the Government prioritise the emergence of a strong new challenger over reducing market concentration through a 'substantially enhanced' divestiture by Lloyds Banking Group.

The Government published its response to the ICB recommendations on 19 December 2011. The Government supported the recommendation that an entity with a larger share of the PCA market than the 4.6 per cent originally proposed might produce a more effective competitor. In relation to Lloyds Banking Group's announcement that it was to pursue exclusive negotiations with the Co-operative Group, the Government commented that such a transaction would deliver a significant enhancement of the PCA market share, with the share divested by Lloyds Banking Group combining with the Co-operative Group's existing share to create a competitor with approximately 7-8 per cent. The Government also stated that the execution of the divestment is a commercial matter, and it has no intention of using its shareholding to deliver an enhancement.

New Regulatory Regime

On 27 January 2012, the Government published the Financial Services Bill. The proposed new UK regulatory architecture will see the transition of regulatory and supervisory powers from the FSA to the new Financial Conduct Authority (FCA) and Prudential

Regulatory Authority (PRA). The PRA will be responsible for supervising banks, building societies and other large firms. The FCA will focus on consumer protection and market regulation. The Bill is also proposing new responsibilities and powers for the FCA. The most noteworthy are the proposed greater powers for the FCA in relation to competition and the proposal to widen its scope to include consumer credit. The Bill is expected to take effect in early 2013.

In April 2011, the FSA commenced an internal reorganisation as a first step in a process towards the formal transition of regulatory and supervisory powers from the FSA to the new FCA and PRA in 2013. Until this time the responsibility for regulating and supervising the activities of the subsidiaries will remain with the FSA. On 2 April the FSA will introduce a new 'twin peaks' model and the intention is to move the FSA as close as possible to the new style of regulation outlined in the Bill. There will be two independent groups of supervisors for banks, insurers and major investment firms covering prudential and conduct. (All other firms (those not dual regulated) will be solely supervised by the conduct supervisors).

In addition, 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 matters across the EU.

Capital and Liquidity
Evolving capital and liquidity requirements continue to be a priority for Lloyds Banking Group. The Basel Committee on Banking Supervision has 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 2013 and 2018.

Anti Bribery
The Bribery Act 2010 came fully into force on 1 July 2011. It enhances previous laws on bribery and is supported by some detailed guidance issued by the Ministry of Justice on the steps a business needs to take to embed 'adequate procedures' to prevent bribery. A company convicted of failing to have 'adequate procedures' to prevent bribery could receive an unlimited fine. The Group operates a group-wide Anti-Bribery Policy, applicable to all of its businesses, operations and employees, which incorporates the requirements of the UK Bribery Act 2010.

Sanctions
The Group takes very seriously its responsibilities for complying with legal and regulatory sanctions requirements in all the jurisdictions in which it operates. In order to assist adherence to relevant economic sanctions legislation, the Group has enhanced its internal compliance processes including those associated with customer and payment screening. The Group has continued the delivery of a programme of staff training regarding policies and procedures for detecting and preventing economic sanctions non-compliance.

US Regulation
Significant regulatory initiatives from the US impacting the Group include the Dodd-Frank Act (which imposes specific requirements for systemic risk oversight, securities market conduct and oversight, bank capital standards, arrangements for the liquidation of failing systemically significant financial institutions and restrictions to the ability of banks to engage in proprietary trading activities known as the 'Volcker Rule'). The Act will have both business and operational implications for the Group within and beyond the US. In addition the Foreign Account Tax Compliance Act (FATCA) requires non-US financial institutions to enter into disclosure agreements with the US Treasury and all non-financial non-US entities to report and or certify their ownership of US assets in foreign accounts or be subject to 30 per cent withholding tax.

European Regulation
At a European level, the pace of regulatory reform has increased with a number of new directives or changes to existing directives planned in the next 12 months including a revised Markets in Financial Instruments Directive, Transparency Directive, Insurance Mediation Directive and a Fifth Undertakings in Collective Investments in Transferable Securities Directive as well as a proposed Directive regulating Packaged Retail Investment Products.

Mitigating Actions
The Group takes many mitigating actions with respect to this principal risk, key examples include:

Independent Commission on Banking
Lloyds Banking Group continues to play a constructive role in the debate with the government and other stakeholders on all issues under consideration in relation to the ICB's recommendations.

New Regulatory Regime
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 regulatory changes and mitigate against risks to the Group and its stakeholders.

Capital and Liquidity
Lloyds Banking Group is continuously assessing the impacts of regulatory developments which could have a material effect on the Group and is progressing its plans to implement regulatory changes and directives through change management programmes.

Anti Bribery
The Group has no appetite for bribery and explicitly prohibits the payment, offer, acceptance or request of a bribe, including 'facilitation payments'.

The Group has enhanced its internal compliance processes including those associated with payment screening, colleague training and hospitality.

US and European Regulation
Lloyds Banking Group is continuously assessing the impacts of regulatory developments which could have a material effect on the Group and is progressing with its plans to implement regulatory changes and directives through change management programmes. The Group is also continuing to progress its plans to achieve Solvency II compliance.

MARKET RISK
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.

Principal Risks
The Group has a number of Market risks, the principal ones being:

- 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.
- Equity market movements and changes in credit spreads impact the Group's results.
  - 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.

Continuing concerns about the fiscal position in Eurozone 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.

Mitigating Actions
The Group takes many mitigating actions with respect to this principal risk, key examples include:

Market risk is managed within a Lloyds Banking Board approved framework using a range of metrics to monitor against stated appetite and potential market conditions.

Market Risk is reported regularly to appropriate committees.

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

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

Principal Risks
Customer treatment and how the Group manages its customer relationships affect all aspects of the Group's operations and are closely aligned with achievement of Lloyds Banking Group's strategic vision to be the best bank for customers. As a provider of a wide range of financial services products and numerous distribution channels to an extremely broad and varied customer base, we

face significant conduct risks, such as: products or services not meeting the needs of our customers; sales processes which could result in selling products to customers which do not meet their needs; failure to deal with a customer's complaint effectively where we have got it wrong and not met customer expectations.

There remains a high level of scrutiny regarding the treatment of customers by financial institutions from regulatory bodies, the press and politicians. The FSA in particular continues to drive focus on conduct of business activities through its supervision activity.

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

Mitigating Actions
The Group takes many mitigating actions with respect to this principal risk, key examples include:

Lloyds Banking Group's Conduct Risk Strategy and supporting framework have been designed to support our vision and strategic aim to put the customer at the heart of everything we do. Lloyds Banking Group have developed and implemented a framework to enable us to deliver for our customers, which is supported by Policies and Standards in key areas, including product governance, sales, responsible lending, customers in financial difficulties, claims and complaints handling.

Lloyds Banking Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns.

PEOPLE
Risk Definition
The risk of reductions in earnings or value through financial or reputational loss arising from ineffectively leading colleagues responsibly and proficiently, managing people resource, supporting and developing colleague talent, or meeting regulatory obligations related to our people.

Principal Risks
The quality and effectiveness of our people are fundamental to its success. Consequently, the Group's management of material people risks is critical to deliver against its long-term strategic objectives. Over the next year the Group's ability to manage people risks successfully may be affected by the following key drivers:

– Lloyds Banking Group's continuing structural consolidation and the sale of part of our branch network under Project Verde may result in disruption to our ability to lead and manage our people effectively
– The continually changing, more rigorous regulatory environment may impact people strategy, remuneration practices and retention
– Macroeconomic conditions and negative media attention on the banking sector may impact retention, colleague sentiment and engagement.

Mitigating Actions
The Group takes many mitigating actions with respect to this principal risk, key examples include:

– Strong focus on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre staff together with implementation of rigorous succession planning
– A continued focus on people risk management across the Group
– Ensuring compliance with regulatory requirements related to Approved Persons and the FSA Remuneration Code, and embedding compliant and appropriate colleague behaviours in line with Group policies, values and people risk priorities
– Strengthening risk management culture and capability across the Group, together with further embedding of risk objectives in the colleague performance and reward process.

INSURANCE RISK
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.

Principal risks and uncertainties

Principal Risks
The major sources of insurance risk are within the insurance businesses and the Group's defined benefit staff pension schemes ('pension schemes'). Insurance risk is inherent in the insurance business and can be affected by customer behaviour. Insurance risks accepted relate primarily to mortality, longevity, morbidity, persistency, expenses, property and unemployment. The primary insurance risk of the Group's pension schemes is related to longevity.

Insurance risk within the insurance businesses has the potential to significantly impact the earnings and capital position of the Insurance Division of the Group. For the Group's pension schemes, insurance risk could significantly increase the cost of pension provision and impact the balance sheet of the Group.

Mitigating Actions
The Group takes many mitigating actions with respect to this principal risk, key examples include:

Insurance risk is reported regularly to appropriate committees and boards.

Actuarial assumptions are reviewed in line with experience and in-depth reviews are conducted regularly. Longevity assumptions for the Group's pension schemes are reviewed annually together with other IFRS assumptions. Expert judgement is required.

Insurance risk is controlled by robust processes including underwriting, pricing-to-risk, claims management, reinsurance and other risk mitigation techniques.

STATE FUNDING AND STATE AID

HM Treasury currently holds approximately 40.2 per cent of Lloyds Banking Group plc's ordinary share capital. United Kingdom Financial Investments Limited (UKFI) as manager of HM Treasury's shareholding continues to operate in line with the framework document between UKFI and HM Treasury managing the investment in Lloyds Banking Group plc on a commercial basis without interference in day-to-day management decisions. There is a risk that a change in Government priorities could result in the framework currently in place being replaced leading to interference in the operations of the Group, although there have been no indications that the Government intends to change the existing operating arrangements.

Lloyds Banking Group made a number of undertakings to HM Treasury arising from the capital and funding support, including the provision of additional lending to certain mortgage and business sectors for the two years to 28 February 2011, and other matters relating to corporate governance and colleague remuneration. The lending commitments were subject to prudent commercial lending and pricing criteria, the availability of sufficient funding and sufficient demand from creditworthy customers. These lending commitments were delivered in full in the second year.

The subsequent agreement (known as 'Merlin') between five major UK banks (including Lloyds Banking Group) and the Government in relation to gross business lending capacity in the 2011 calendar year was subject to a similar set of criteria. Lloyds Banking Group delivered in full its share of the commitments by the five banks, both in respect of lending to Small and Medium Sized Enterprises (SMEs) and in respect of overall gross business lending. Lloyds Banking Group has made a unilateral lending pledge for 2012 as part of its publicly announced SME charter.

In addition, Lloyds Banking Group is subject to European state aid obligations in line with the Restructuring Plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of the Group and remedy any distortion of competition and trade in the European Union (EU) arising from the State aid given to Lloyds Banking Group.

This has placed a number of requirements on the Lloyds Banking Group including an asset reductions target from a defined pool of assets by the end of 2014 and the disposal of a certain portion of its retail business by the end of November 2013. In June 2011 Lloyds Banking Group issued an Information Memorandum to potential bidders of this retail banking business, which the European Commission confirmed met the requirements to commence the formal sale process for the sale no later than 30 November 2011. On 14 December 2011 Lloyds Banking Group announced that having reviewed the formal offers made, its preferred option was for a direct sale and that it was entering into exclusive discussions with The Co-operative Group. Lloyds Banking Group is also continuing to progress an Initial Public Offering (IPO) in parallel. Lloyds Banking Group continues to work closely with the EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission to ensure the successful implementation of the Restructuring Plan.

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 2011 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 page 5, 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. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion:

- the 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 2011 and of the Group's loss and the 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.

Independent auditors' report

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.

Philip Rivett
Senior Statutory Auditor
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
23 February 2012

(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 2011

	Note	**2011 £ million**	2010 £ million
Interest and similar income		**16,565**	18,061
Interest and similar expense		**(8,167)**	(9,691)
Net interest income	5	**8,398**	8,370
Fee and commission income		**1,814**	1,934
Fee and commission expense		**(727)**	(964)
Net fee and commission income[1]	6	**1,087**	970
Net trading income	7	**(894)**	9,095
Insurance premium income	8	**1,657**	3,649
Other operating income	9	**1,125**	2,127
Other income		**2,975**	15,841
Total income		**11,373**	24,211
Insurance claims[1]	10	**(975)**	(9,605)
Total income, net of insurance claims		**10,398**	14,606
Payment protection insurance provision		**(1,155)**	–
Other operating expenses		**(4,320)**	(5,681)
Total operating expenses	11	**(5,475)**	(5,681)
Trading surplus		**4,923**	8,925
Impairment	12	**(7,104)**	(10,878)
Share of results of joint ventures and associates	13	**26**	(98)
Loss on disposal of businesses	14	**(1,739)**	–
Loss before tax		**(3,894)**	(2,051)
Taxation	15	**173**	(264)
Loss for the year		**(3,721)**	(2,315)
Profit attributable to non-controlling interests		**42**	36
Loss attributable to equity shareholders		**(3,763)**	(2,351)
Loss for the year		**(3,721)**	(2,315)

[1]See notes 6 and 10.

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

Consolidated statement of comprehensive income

for the year ended 31 December 2011

The Group	2011 £ million	2010 £ million
Loss for the year	**(3,721)**	(2,315)
Other comprehensive income		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	**(77)**	205
Income statement transfers in respect of disposals	**(72)**	(52)
Income statement transfers in respect of impairment	**749**	641
Other income statement transfers	**(76)**	(62)
Taxation	**(128)**	(231)
	396	501
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	**1,350**	(781)
Net income statement transfers	**373**	1,378
Taxation	**(447)**	(174)
	1,276	423
Currency translation differences (tax: nil)	**(6)**	(204)
Other comprehensive income for the year, net of tax	**1,666**	720
Total comprehensive income for the year	**(2,055)**	(1,595)
Total comprehensive income attributable to non-controlling interests	**42**	36
Total comprehensive income attributable to equity shareholders	**(2,097)**	(1,631)
Total comprehensive income for the year	**(2,055)**	(1,595)

The Company	2011 £ million	2010 £ million
(Loss) profit for the year	**(297)**	1,944
Other comprehensive income		
Movements in cash flow hedging reserve:		
Net income statement transfers (tax: nil)	**1**	–
Total comprehensive income for the year	**(296)**	1,944

Consolidated balance sheet

at 31 December 2011

	Note	**2011 £ million**	2010 £ million
Assets			
Cash and balances at central banks		**3,075**	2,375
Items in the course of collection from banks		**379**	319
Trading and other financial assets at fair value through profit or loss	16	**45,347**	103,086
Derivative financial instruments	17	**36,253**	30,000
Loans and receivables:			
Loans and advances to banks	18	**91,210**	65,170
Loans and advances to customers	19	**357,110**	381,365
Debt securities	22	**11,276**	23,632
		459,596	470,167
Available-for-sale financial assets	24	**10,498**	13,843
Investment properties	25	**1,686**	3,356
Investments in joint ventures and associates	13	**330**	428
Goodwill	27	**859**	850
Value of in-force business	28	**147**	3,171
Other intangible assets	29	**76**	74
Tangible fixed assets	30	**2,372**	3,482
Current tax recoverable		**338**	64
Deferred tax assets	42	**3,977**	4,062
Retirement benefit assets	41	**394**	152
Other assets	31	**2,672**	6,323
Total assets		**567,999**	641,752

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

Consolidated balance sheet

at 31 December 2011

	Note	2011 £ million	2010 £ million
Equity and liabilities			
Liabilities			
Deposits from banks	32	**150,042**	143,137
Customer deposits	33	**217,048**	216,404
Items in course of transmission to banks		**332**	251
Trading liabilities	34	**20,805**	18,786
Derivative financial instruments	17	**33,385**	25,075
Notes in circulation		**1,145**	1,074
Debt securities in issue	35	**75,457**	100,760
Liabilities arising from insurance contracts and participating investment contracts	36	**385**	40,076
Liabilities arising from non-participating investment contracts	38	**22,207**	35,136
Unallocated surplus within insurance businesses	39	**–**	321
Other liabilities	40	**8,184**	16,561
Retirement benefit obligations	41	**107**	100
Current tax liabilities		**54**	134
Deferred tax liabilities	42	**1**	47
Other provisions	43	**1,064**	806
Subordinated liabilities	44	**13,613**	16,674
Total liabilities		**543,829**	615,342
Equity			
Share capital	45	**3,763**	3,763
Share premium account	46	**18,655**	18,655
Other reserves	47	**10,523**	8,857
Retained profits	48	**(9,170)**	(5,415)
Shareholders' equity		**23,771**	25,860
Non-controlling interests		**399**	550
Total equity		**24,170**	26,410
Total equity and liabilities		**567,999**	641,752

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

The directors approved the consolidated financial statements on 23 February 2012.

Sir Winfried Bischoff
Chairman

António Horta-Osório
Chief Executive

Tim J W Tookey
Finance Director

Consolidated statement of changes in equity

for the year ended 31 December 2011

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2010	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
Value of employee services:						
Share option schemes	–	–	7	7	–	7
Change in 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
Comprehensive income						
(Loss) profit for the year	**–**	**–**	**(3,763)**	**(3,763)**	**42**	**(3,721)**
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	**–**	**396**	**–**	**396**	**–**	**396**
Movements in cash flow hedging reserve, net of tax	**–**	**1,276**	**–**	**1,276**	**–**	**1,276**
Currency translation differences, net of tax	**–**	**(6)**	**–**	**(6)**	**–**	**(6)**
Total other comprehensive income	**–**	**1,666**	**–**	**1,666**	**–**	**1,666**
Total comprehensive income	**–**	**1,666**	**(3,763)**	**(2,097)**	**42**	**(2,055)**
Transactions with owners						
Dividends	**–**	**–**	**–**	**–**	**(15)**	**(15)**
Value of employee services:						
Share option schemes	**–**	**–**	**8**	**8**	**–**	**8**
Change in non-controlling interests	**–**	**–**	**–**	**–**	**(178)**	**(178)**
Total transactions with owners	**–**	**–**	**8**	**8**	**(193)**	**(185)**
Balance at 31 December 2011	**22,418**	**10,523**	**(9,170)**	**23,771**	**399**	**24,170**

Further details of movements in the Group's share capital and reserves are provided in notes 45, 46, 47 and 48.

Consolidated cash flow statement

for the year ended 31 December 2011

	Note	**2011 £ million**	2010 £ million
Loss before tax		**(3,894)**	(2,051)
Adjustments for:			
Change in operating assets	56(a)	**2,110**	57,056
Change in operating liabilities	56(b)	**(6,854)**	(70,686)
Non-cash and other items	56(c)	**2,128**	5,624
Tax received		**16**	486
Net cash used in operating activities		**(6,494)**	(9,571)
Cash flows from investing activities			
Purchase of available-for-sale financial assets		**(6,747)**	(1,561)
Proceeds from sale and maturity of available-for-sale financial assets		**9,743**	10,293
Purchase of fixed assets		**(593)**	(1,277)
Proceeds from sale of fixed assets		**1,559**	1,021
Acquisition of businesses, net of cash acquired		**(61)**	(65)
Disposal of businesses, net of cash disposed	56(e)	**3,145**	2,783
Net cash provided by investing activities		**7,046**	11,194
Cash flows from financing activities			
Dividends paid to non-controlling interests		**(15)**	(24)
Interest paid on subordinated liabilities		**(750)**	(809)
Repayment of subordinated liabilities		**(2,696)**	(331)
Change in stake of non-controlling interests		**7**	–
Net cash used in financing activities		**(3,454)**	(1,164)
Effects of exchange rate changes on cash and cash equivalents		**1**	–
Change in cash and cash equivalents		**(2,901)**	459
Cash and cash equivalents at beginning of year		**9,543**	9,084
Cash and cash equivalents at end of year	56(d)	**6,642**	9,543

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

Company balance sheet

at 31 December 2011

	Note	2011 £ million	2010 £ million
Assets			
Amounts owed by Group entities		**47,378**	49,687
Derivative financial instruments	17	**1,857**	2,061
Deferred tax assets	42	**–**	–
Retirement benefit assets	41	**375**	150
Other assets	31	**17**	5
Investments in subsidiary undertakings	26	**23,000**	26,923
Total assets		**72,627**	78,826
Liabilities			
Amounts owed to Group entities		**35,237**	39,226
Derivative financial instruments	17	**10**	–
Other liabilities	40	**457**	363
Current tax liabilities		**283**	66
Retirement benefit obligations	41	**107**	98
Deferred tax liabilities	42	**82**	27
Subordinated liabilities	44	**9,318**	11,617
Total liabilities		**45,494**	51,397
Equity			
Issued share capital	45	**3,763**	3,763
Share premium account	46	**18,655**	18,655
Other reserves	47	**9,693**	9,692
Retained profits	48	**(4,978)**	(4,681)
Shareholders' equity		**27,133**	27,429
Total equity and liabilities		**72,627**	78,826

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

Approved by the Board on 23 February 2012 and signed on its behalf by:

Sir Winfried Bischoff
Chairman

António Horta-Osório
Chief Executive

Tim J W Tookey
Finance Director

Company statement of changes in equity

for the year ended 31 December 2011

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
Balance at 1 January 2010	19,819	9,692	(6,625)	22,886
Comprehensive income[1]				
Total comprehensive income	–	–	1,944	1,944
Transactions with owners				
Issue of ordinary and preference shares	2,599	–	–	2,599
Balance at 31 December 2010	22,418	9,692	(4,681)	27,429
Comprehensive income				
Loss for the year	**–**	**–**	**(297)**	**(297)**
Other comprehensive income				
Movements in cash flow hedging reserves, net of tax	**–**	**1**	**–**	**1**
Total comprehensive income	**–**	**1**	**(297)**	**(296)**
Balance at 31 December 2011	**22,418**	**9,693**	**(4,978)**	**27,133**

[1]Total comprehensive income in 2010 comprised only the profit for the year.

There were no transactions with owners in 2011.

Company cash flow statement

for the year ended 31 December 2011

	2011 £ million	2010 £ million
Profit before tax	**42**	2,005
Adjustments for:		
Dividend income	**(3,126)**	(986)
Change in operating assets	**(2,760)**	(10,319)
Change in operating liabilities	**(3,887)**	1,326
Non-cash and other items	**4,775**	(366)
Tax paid	**(66)**	–
Net cash used in operating activities	**(5,022)**	(8,340)
Cash flows from investing activities	**–**	–
Cash flows from financing activities		
Dividends received from subsidiaries	**3,126**	986
Repayment of subordinated liabilities	**(2,602)**	–
Interest paid on subordinated liabilities	**(334)**	(364)
Net cash provided by financing activities	**190**	622
Change in cash and cash equivalents	**(4,832)**	(7,718)
Cash and cash equivalents at beginning of year	**30,395**	38,113
Cash and cash equivalents at end of year	**25,563**	30,395

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

Notes to the accounts

1 Basis of preparation

The financial statements of HBOS plc have been prepared in accordance with International Financial Reporting Standards (IFRS) 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.

In previous years the Group has included annual management charges on non-participating investment contracts within insurance claims. In light of developing industry practice, these amounts (2011: £444 million; 2010: £454 million) are now included within net fee and commission income.

The Group has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2011. None of these standards or amendments have had a material impact on these financial statements.

(i) 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.

(ii) 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.

(iii) Improvements to IFRSs (issued May 2010). Amends IFRS 7 *Financial Instruments: Disclosure* to require further disclosures in respect of collateral held by the Group as security for financial assets and sets out minor amendments to other standards as part of the annual improvements process.

(iv) Amendment to IFRIC 14 *Prepayments of a Minimum Funding Requirement*. Applies when an entity is subject to minimum funding requirements 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.

(v) IAS 24 *Related Party Disclosures (Revised)*. Simplifies the definition of a related party and provides a partial exemption from the requirement to disclose transactions and outstanding balances with the government and government-related entities. The Group has taken advantage of an exemption in respect of government and government-related transactions that permits an entity to disclose only transactions that are individually or collectively significant. Details of related party transactions are disclosed in note 51.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2011 and which have not been applied in preparing these financial statements are given in note 57.

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 26.

Investment vehicles, such as Open Ended Investment Companies (OEICs), where the Group has control are consolidated. Control arises when the Group manages the funds and also has a majority beneficial interest. In circumstances where the Group holds a majority beneficial interest, but is not the fund manager, the Group does not consolidate the entity as it does not have the fund manager's decision-making powers over the investment activities of the OEIC necessary to establish control. The interests of parties other than the Group are reported in other liabilities.

Special purpose entities (SPEs) are consolidated if, in substance, the Group controls the entity. A key indicator of such control, amongst others, is where the Group is exposed to the risks and benefits of the SPE.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary

2 Accounting policies (continued)

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 both internally and externally generated capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 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).

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

2 Accounting policies (continued)

are held at fair value. Purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either:

– substantially all of the risks and rewards of ownership have been transferred; or
– the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

(1) Financial instruments at fair value through profit or loss
Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see f below).

Trading securities are debt securities and equity shares acquired principally for the purpose of selling in the short term or which are part of a portfolio which is managed for short-term gains. Such securities are classified as trading securities and recognised in the balance sheet at their fair value. Gains and losses arising from changes in their fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

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 53 (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.

2 Accounting policies (continued)

(3) Loans and receivables
Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see d above) less provision for impairment (see h below).

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. In cases where the securitisation vehicles are funded by the issue of debt, on terms whereby the majority of the risks and rewards of the portfolio of securitised lending are retained by the Group, these loans and advances continue to be recognised by the Group, together with a corresponding liability for the funding.

(4) 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.

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 53(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

Changes in the fair value of any derivative instrument that is not part of a hedging relationship are recognised immediately in the income statement.

Derivatives embedded in financial instruments and insurance contracts (unless the embedded derivative is itself an insurance contract) are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement. In accordance with IFRS 4 Insurance Contracts, a policyholder’s option to surrender an insurance contract for a fixed amount is not treated as an embedded derivative.

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

The Group designates certain derivatives as either: (1) hedges of the fair value of the particular risks inherent in recognised assets or liabilities (fair value hedges); (2) hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges); or (3) hedges of net investments in foreign operations (net investment hedges). These are accounted for as follows:

(1) Fair value hedges
Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as an available-for-sale financial asset. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

(2) Cash flow hedges
The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedge reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

2 Accounting policies (continued)

(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
Impairment is assessed on a collective basis for (1) homogenous groups of loans that are not considered individually impaired and (2) to cover losses which have been incurred but have not yet been identified on loans subject to individual impairment.

Homogenous groups of loans
In respect of portfolios of smaller balance, homogenous loans, 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, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data about economic and credit conditions (including unemployment rates and borrowers' behaviour) to

2 Accounting policies (continued)

reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

Incurred but not yet identified impairment
The collective provision also includes provision for inherent losses, that is losses that have been incurred but have not been separately identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. Risk drivers for secured retail lending include the current indexed loan-to-value, previous mortgage arrears, internal cross-product delinquency data and external credit bureau data; for unsecured retail lending they include whether the account is up-to-date and, if not, the number of payments that have been missed; and for wholesale lending they include factors such as observed default rates and loss given default. An assessment is made of the likelihood of each account becoming recognised as impaired within the loss emergence period, with the economic loss that each portfolio is likely to generate were it to become impaired. The loss emergence period is determined by local management for each portfolio and the Group has a range of loss emergence periods which are dependent upon the characteristics of the portfolios. Emergence periods are reviewed regularly and updated when appropriate. In general the periods used across the Group vary between one month and twelve months based on historical experience. Unsecured portfolios tend to have shorter loss emergence periods than secured portfolios.

Loan renegotiations and forbearance
In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. 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, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

Write offs
A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. For both secured and unsecured retail balances, the write-off takes place only once an extensive set of collections processes has been completed, or the status of the account reaches a point where policy dictates that forbearance is no longer appropriate. For wholesale lending, a write-off occurs if the loan facility with the customer is restructured, the asset is under administration and the only monies that can be received are the amounts estimated by the administrator, the underlying assets are disposed and a decision is made that no further settlement monies will be received, or external evidence (for example, third party valuations) is available that there has been an irreversible decline in expected cash flows.

Debt for equity exchanges
Equity securities acquired in exchange for loans in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of equity securities, held as available-for-sale. Where control is obtained over an entity as a result of the transaction, the entity is consolidated; where the Group has significant influence over an entity as a result of the transaction, the investment is accounted for by the equity method of accounting (see a above). Any subsequent impairment of the assets or business acquired is treated as an impairment of the relevant asset or business and not as an impairment of the original instrument.

(2) Available-for-sale financial assets
The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer, assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; 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:

2 Accounting policies (continued)

– Fixtures and furnishings: 10-20 years
– Other equipment and motor vehicles: 2-8 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

k Leases
(1) As lessee
The leases entered into by the Group are primarily operating leases. Operating lease rentals payable are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

(2) As lessor
Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment 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.

2 Accounting policies (continued)

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.

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. Insurance and participating investment contracts are accounted for under IFRS 4 *Insurance Contracts,* which permits (with certain exceptions) the continuation of accounting practices for measuring insurance and participating investment contracts that applied prior to the adoption of IFRS. The Group, therefore, continues to account for these products using UK GAAP, including FRS 27 *Life Assurance* and UK established practice.

Products sold by the life insurance business are classified into three categories:

Insurance contracts – these contracts transfer significant insurance risk and may also transfer financial risk. The Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. These contracts may or may not include discretionary participation features.

Investment contracts containing a discretionary participation feature ('participating investment contracts') – these contracts do not transfer significant insurance risk, but contain a contractual right which gives the holder the right to receive, in addition to the guaranteed benefits, further additional discretionary benefits or bonuses that are likely to be a significant proportion of the total contractual benefits and the amount and timing of which is at the discretion of the Group, within the constraints of the terms and conditions of the instrument and based upon the performance of specified assets.

Non-participating investment contracts – these contracts do not transfer significant insurance risk or contain a discretionary participation feature.

The general insurance business issues only insurance contracts.

(1) Life insurance business
(i) Accounting for insurance and participating investment contracts
Premiums and claims
Premiums received in respect of insurance and participating investment contracts are recognised as revenue when due except for unit-linked contracts on which premiums are recognised as revenue when received. Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified.

Liabilities
– Insurance and participating investment contracts in the Group's with-profit funds
Liabilities of the Group's with-profit funds, including guarantees and options embedded within products written by these funds, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in the unallocated surplus (see below). 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

2 Accounting policies (continued)

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.

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.

Allowance for impairment losses on loans and receivables
At 31 December 2011 gross loans and receivables totalled £484,095 million (2010: £496,774 million) against which impairment allowances of £24,499 million (2010: £26,607 million) had been made (see note 23). 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 such as the Retail portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were ten per cent lower than those estimated at 31 December 2011, the impairment charge would increase by approximately £240 million in respect of UK mortgages and a further £75 million in respect of Irish mortgages.

3 Critical accounting estimates and judgements (continued)

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 £135 million (at 31 December 2010, in one month increase in the loss emergence period would have increased the collective unimpaired provision by an estimated £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 valuation techniques involve management judgement and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information.

Valuation techniques for level 2 financial instruments use inputs that are largely based on observable market data. Level 3 financial instruments are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Determining the appropriate assumptions to be used for level 3 financial instruments requires significant management judgement.

At 31 December 2011, the Group classified £2,608 million of financial assets and £48 million of financial liabilities as level 3. Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out in note 53.

Recoverability of deferred tax assets
At 31 December 2011 the Group carried deferred tax assets on its balance sheet of £3,977 million (2010: £4,062 million) and deferred tax liabilities of £1 million (2010: £47 million) (note 42). 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 42 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward.

The recoverability of the Group's deferred tax assets in respect of carry forward losses is based on an assessment of future levels of taxable profit expected to arise that can be offset against these losses. The Group's expectations as to the level of future taxable profits take into account the Group's long-term financial and strategic plans, and anticipated future tax adjusting items.

In making this assessment account is taken of, business plans, *the five year board approved operating plan* and the following future risk factors:

- The expected future economic outlook as set out in the Group Chief Executive's Statement contained in the Annual Report of Lloyds Banking Group.
- The retail banking business disposal as required by the European Commission; and
- Future regulatory change.

The Group's total deferred tax asset includes £3,568 million (2010 £3,899 million) in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc. The deferred tax asset will be utilised over different time periods in each of the entities in which the tax losses arise. The Group's assessment is that these tax losses will be fully used within eight years.

Under current UK tax law there is no expiry date for unused tax losses.

As disclosed in note 42, deferred tax assets totalling £571 million (2010: £597 million) have not been recognised in respect of certain capital losses carried forward, trading losses carried forward (mainly in certain overseas companies) and unrelieved foreign tax credits as there are no predicted future capital or taxable profits against which these losses can be recognised.

Payment protection insurance
The Group has charged a provision of £1,155 million in April 2011 in respect of payment protection insurance (PPI) policies as a result of discussions with the FSA and a judgment handed down by the UK High Court (see note 43 for more information).

The provision represents management's best estimate of the anticipated costs of related customer contact and/or redress, including administration expenses. However, there are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties of assessing the impact of detailed implementation of the FSA Policy Statement of 10 August 2010 for all PPI complaints, uncertainties around the ultimate emergence period for complaints, the availability of supporting evidence and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

The provision requires significant judgement by management in determining appropriate assumptions, which include the level of complaints, uphold rates, proactive contact and response rates, Financial Ombudsman Service referral and uphold rates as well as redress costs for each of the many different populations of customers identified by the Group in its analyses used to determine the best estimate of the anticipated costs of redress. If the level of complaints had been one percentage point higher (lower) than estimated for all policies open within the last six years then the provision made in 2011 would have increased (decreased) by approximately £25 million. There are a large number of inter-dependent assumptions under-pinning the provision; the above sensitivity assumes that all assumptions, other than the level of complaints, remain constant. The sensitivity is, therefore, hypothetical and should be used with caution.

The Group will re-evaluate the assumptions underlying its analysis at each reporting date as more information becomes available. As noted above, there is inherent uncertainty in making estimates; actual results in future periods may differ from the amount provided.

3 Critical accounting estimates and judgements (continued)

Retirement benefit obligations

The net asset recognised in the balance sheet at 31 December 2011 in respect of the Group's retirement benefit obligations was £287 million (2010: net asset £52 million). In 2011, this comprised an asset of £394 million and a liability of £107 million; (2010: an asset of £152 million and a liability of £100 million) of which an asset of £350 million (2010: an asset of £108 million) related to defined benefit pension schemes. As explained in note 2, 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 gains of £532 million (2010: losses of £7 million). After allowing for this, the defined benefit pension schemes' net accounting surplus totalled £882 million (2010: surplus of £101 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The value of the Group's defined benefit pension schemes' liabilities requires management to make a number of assumptions. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The accounting surplus or deficit is sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variation. The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience and extrapolate the improving trend, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience.

The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in note 41.

Valuation of assets and liabilities arising from life insurance business

At 31 December 2011, the Group recognised a value of in-force business asset of £42 million (2010: £3,035 million) and an acquired value of in-force business asset of £105 million (2010: £136 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 2011 are set out in note 28.

At 31 December 2011, the Group carried liabilities arising from insurance contracts and participating investment contracts of £385 million (2010: £40,076 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 36.

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 37.

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.

	2011			2010		
	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
Total income	9,402	1,971	11,373	20,220	3,991	24,211
Total assets	514,190	53,809	567,999	552,485	89,267	641,752

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

Notes to the accounts

5 Net interest income

	Weighted average effective interest rate 2011 %	Weighted average effective interest rate 2010[1] %	2011 £m	2010 £m
Interest and similar income:				
Loans and advances to customers, excluding lease and hire purchase receivables	**3.77**	4.31	**14,779**	16,732
Loans and advances to banks	**1.06**	0.27	**811**	211
Debt securities held as loans and receivables	**3.15**	2.41	**507**	713
Lease and hire purchase receivables	**3.21**	4.41	**174**	24
Interest receivable on loans and receivables	**3.32**	3.56	**16,271**	17,680
Available-for-sale financial assets	**3.06**	2.28	**294**	381
Total interest and similar income	**3.32**	3.52	**16,565**	18,061
Interest and similar expense:				
Deposits from banks, excluding liabilities under sale and repurchase agreements	**0.94**	0.24	**(1,422)**	(340)
Customer deposits, excluding liabilities under sale and repurchase agreements	**2.27**	2.48	**(4,525)**	(4,484)
Debt securities in issue	**1.39**	2.36	**(1,241)**	(2,694)
Subordinated liabilities	**5.22**	5.36	**(780)**	(918)
Liabilities under sale and repurchase agreements	**2.15**	1.11	**(96)**	(548)
Interest payable on liabilities held at amortised cost	**1.75**	1.79	**(8,064)**	(8,984)
Other	**1.82**	12.18	**(103)**	(707)
Total interest and similar expense	**1.76**	1.91	**(8,167)**	(9,691)
Net interest income			**8,398**	8,370

[1]During 2011 the Group has revised its treatment of offset accounts; average balances for 2010 have been restated accordingly.

Included within interest and similar income is £1,041 million (2010: £916 million) in respect of impaired financial assets. Net interest income also includes a charge of £373 million (2010: £1,378 million) transferred from the cash flow hedging reserve.

6 Net fee and commission income

	2011 £m	2010 £m
Fee and commission income:		
Current accounts	**357**	343
Credit and debit card fees	**214**	203
Other[1]	**1,243**	1,388
Total fee and commission income	**1,814**	1,934
Fee and commission expense	**(727)**	(964)
Net fee and commission income	**1,087**	970

[1]In previous years the Group has included annual management charges in non-participating investment contracts within insurance claims. In light of developing industry practice, these amounts (2011: £444 million; 2010: £454 million) are now included within net fee and commission income.

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

	2011 £m	2010 £m
Foreign exchange translation gains	**465**	207
Gains on foreign exchange trading transactions	**97**	160
Total foreign exchange	**562**	367
Investment property (losses) gains (note 25)	**(65)**	233
Securities and other (losses) gains (see below)	**(1,391)**	8,495
Net trading (expense) income	**(894)**	9,095

7 Net trading income (continued)

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

	2011 £m	2010 £m
Net income arising on assets held at fair value through profit or loss:		
Debt securities, loans and advances	504	905
Equity shares	(1,038)	6,697
Total net (expense) income arising on assets held at fair value through profit or loss	(534)	7,602
Net (losses) gains on financial instruments held for trading	(857)	893
Securities and other (losses) gains	**(1,391)**	8,495

8 Insurance premium income

	2011 £m	2010 £m
Life insurance		
Gross premiums	1,441	3,116
Ceded reinsurance premiums	(104)	(188)
Net earned premiums	1,337	2,928
Non-life insurance		
Gross written premiums	320	739
Ceded reinsurance premiums	(3)	(90)
Net written premiums	317	649
Change in provision for unearned premiums (note 36(2))	16	73
Change in provision for ceded unearned premiums (note 36(2))	(13)	(1)
Net earned premiums	320	721
Total net earned premiums	**1,657**	3,649

Life insurance gross premiums can be further analysed as follows:

	2011 £m	2010 £m
Life and pensions	1,366	2,961
Annuities	73	154
Other	2	1
Gross premiums	**1,441**	3,116

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

	2011 £m	2010 £m
Credit protection	74	243
Home	246	496
Gross written premiums	**320**	739

9 Other operating income

	2011 £m	2010 £m
Operating lease rental income	254	807
Rental income from investment properties (note 25)	135	158
Other rents receivable	10	9
Gains on disposal of available-for-sale financial assets	73	52
Liability management gains	610	359
Movement in value of in-force business (note 28)	9	227
Other income	34	515
Total other operating income	**1,125**	2,127

During December 2011, the Lloyds Banking Group completed the exchange of certain subordinated debt securities issued by Lloyds TSB Bank plc and the Company for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call before

9 Other operating income (continued)

31 December 2012. This exchange resulted in a gain for the Group on extinguishment of the existing securities of £610 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.

During 2010, as part of the Lloyds Banking Group's management of capital, the Group had exchanged certain existing subordinated debt securities for new securities and ordinary shares. These exchanges resulted in a gain on extinguishment of the existing liabilities of £359 million in the year ended 31 December 2010.

10 Insurance claims

Insurance claims comprise:

	2011 £m	2010 £m
Life insurance and participating investment contracts		
Claims and surrenders:		
Gross (see below)	**2,395**	5,285
Reinsurers' share	**(81)**	(102)
	2,314	5,183
Change in insurance and participating investment contract liabilities (note 36(1)):		
Change in gross liabilities[1]	**(837)**	865
Change in reinsurers' share of liabilities	**(187)**	(162)
	(1,024)	703
Change in gross non-participating investment contract liabilities:		
Change in gross liabilities[1]	**(435)**	3,925
Change in reinsurers' share of liabilities	**(42)**	(65)
	(477)	3,860
Change in unallocated surplus (note 39)	**41**	(451)
Total life insurance and participating investment contracts	**854**	9,295
Non-life insurance		
Claims and claims paid:		
Gross	**158**	282
Reinsurers' share	**(3)**	(9)
	155	273
Change in liabilities (note 36(2)):		
Gross	**(42)**	41
Reinsurers' share	**8**	(4)
	(34)	37
Total non-life insurance	**121**	310
Total insurance claims	**975**	9,605

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

	2011 £m	2010 £m
Deaths	**239**	414
Maturities	**244**	466
Surrenders	**1,689**	3,968
Annuities	**89**	178
Other	**134**	259
Total life insurance gross claims	**2,395**	5,285

[1]In previous years, the Group has included annual management charges on non-participating investment contracts within insurance claims. In light of developing industry practice, these amounts (2011: £444 million; 2010: £454 million) are now included within net fee and commission income.

11 Operating expenses

	2011 £m	2010[1] £m
Staff costs:		
Salaries	**1,723**	1,916
Social security costs	**162**	168
Pensions and other post-retirement benefit schemes (note 41):		
Curtailment gain[2]	**–**	(316)
Other	**182**	257
	182	(59)
Restructuring costs	**62**	56
Other staff costs	**90**	235
	2,219	2,316
Premises and equipment:		
Rent and rates	**264**	275
Hire of equipment	**3**	4
Repairs and maintenance	**37**	39
Other	**156**	155
	460	473
Other expenses:		
Communications and data processing	**263**	292
Advertising and promotion	**159**	162
Professional fees	**88**	159
Payment protection insurance provision (note 43)	**1,155**	–
Financial services compensation scheme management expenses levy (note 52)	**86**	28
Customer goodwill payments provision (note 43)	**–**	500
Other	**625**	821
	2,376	1,962
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 30)	**326**	839
Amortisation of acquired value of in-force non-participating investment contracts (note 28)	**11**	12
Amortisation of other intangible assets (note 29)	**18**	27
	355	878
Impairment of tangible fixed assets (note 30)	**65**	52
Total operating expenses	**5,475**	5,681

[1]During 2011, the Group has reviewed the analysis of certain cost items and as a result has reclassified some items of expenditure; comparatives for 2010 have been restated accordingly.

[2]During the year ended 31 December 2010, 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 employee's actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of 2010 there was a change in commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group's defined benefit obligation in 2010 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 in the year ended 31 December 2010 and a reduction in the balance sheet liability.

11 Operating expenses (continued)

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

	2011	2010
UK	**50,340**	53,646
Overseas	**1,689**	2,876
Total	**52,029**	56,522

Fees payable to the Company's auditors
During the year the auditors earned the following fees:

	2011 £m	2010 £m
Fees payable for the audit of the Company's current year annual report	**0.6**	2.6
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	**8.2**	6.6
Other services supplied pursuant to legislation	**1.0**	0.8
Other services – audit related fees	**0.4**	0.1
Services relating to taxation	**0.6**	0.5
Services relating to corporate finance transactions	**0.5**	–
All other services	**0.5**	0.1
Total fees payable to the Company's auditors by the Group	**11.8**	10.7

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

	2011 £m	2010 £m
Audits of Group pension schemes	**0.1**	0.1
Reviews of the financial position of corporate and other borrowers	**3.7**	13.5

12 Impairment

	2011 £m	2010 £m
Impairment losses on loans and receivables (note 23):		
Loans and advances to customers	**6,961**	10,786
Debt securities classified as loans and receivables	**60**	(19)
Total impairment losses on loans and receivables	**7,021**	10,767
Impairment of available-for-sale financial assets	**78**	100
Other credit risk provisions (note 43)	**5**	11
Total impairment charged to the income statement	**7,104**	10,878

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	
	2011 £m	2010 £m	**2011 £m**	2010 £m	**2011 £m**	2010 £m
Share of income statement amounts:						
Income	**312**	313	**160**	132	**472**	445
Expenses	**(262)**	(209)	**(161)**	(91)	**(423)**	(300)
Impairment	**(20)**	(126)	**1**	(92)	**(19)**	(218)
Profit (loss) before tax	**30**	(22)	**–**	(51)	**30**	(73)
Tax	**(4)**	(24)	**–**	(1)	**(4)**	(25)
Share of post-tax results	**26**	(46)	**–**	(52)	**26**	(98)
Share of balance sheet amounts:						
Current assets	**3,341**	3,369	**246**	376	**3,587**	3,745
Non-current assets	**2,148**	2,868	**976**	1,184	**3,124**	4,052
Current liabilities	**(713)**	(588)	**(293)**	(433)	**(1,006)**	(1,021)
Non-current liabilities	**(4,471)**	(5,323)	**(904)**	(1,025)	**(5,375)**	(6,348)
Share of net assets at 31 December	**305**	326	**25**	102	**330**	428
Movement in investments over the year:						
At 1 January	**326**	282	**102**	111	**428**	393
Additional investments	**8**	71	**3**	6	**11**	77
Disposals	**(47)**	(12)	**(79)**	(2)	**(126)**	(14)
Share of post-tax results	**26**	(46)	**–**	(52)	**26**	(98)
Dividends paid	**(5)**	–	**–**	(1)	**(5)**	(1)
Exchange and other adjustments	**(3)**	31	**(1)**	40	**(4)**	71
Share of net assets at 31 December	**305**	326	**25**	102	**330**	428

During 2011, the Group recognised a net £8 million of losses of associates not previously recognised. The Group's unrecognised share of losses of associates during 2010 was £8 million and of joint ventures is £85 million in 2011 (2010: £180 million). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £56 million (2010: £104 million) and of joint ventures is £299 million (2010: £339 million).

The Group's principal joint venture investment at 31 December 2011 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 Disposal of businesses

In July 2011, the Lloyds Banking Group completed a restructuring of the legal ownership of its insurance businesses, as a result of which the Group's subsidiary, HBOS Insurance & Investment Group Limited, sold its wholly owned life, pensions and general insurance subsidiaries to Lloyds TSB General Insurance Holdings Limited and Scottish Widows Financial Services Holdings Limited, which are also wholly owned by Lloyds TSB Bank plc for a total consideration of £3,013 million. This resulted in a consolidated loss on disposal of £1,739 million.

15 Taxation

a Analysis of tax credit (charge) for the year

	2011 £m	2010 £m
UK corporation tax:		
Current tax on loss for the year	322	(190)
Adjustments in respect of prior years	(95)	104
	227	(86)
Foreign tax:		
Current tax on loss for the year	(23)	(39)
Adjustments in respect of prior years	19	38
	(4)	(1)
Current tax credit (charge)	223	(87)
Deferred tax (note 42):		
Origination and reversal of temporary differences	209	(28)
Reduction in UK corporation tax rate	(332)	(119)
Adjustments in respect of prior years	73	(30)
	(50)	(177)
Tax credit (charge)	173	(264)

The tax credit (charge) for 2011 is based on a UK corporation tax rate of 26.5 per cent (2010: 28.0 per cent).

	2011 £m	2010 £m
The above income tax credit (charge) is made up as follows:		
Tax credit (charge) attributable to policyholders	190	(151)
Shareholder tax charge	(17)	(113)
Tax credit (charge)	173	(264)

b Factors affecting the tax credit (charge) 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 actual tax credit (charge) for the year is given below:

	2011 £m	2010 £m
Loss before tax	(3,894)	(2,051)
Tax credit thereon at UK corporation tax rate of 26.5 per cent (2010: 28.0 per cent)	1,032	574
Factors affecting credit:		
UK corporation tax rate change	(332)	(119)
Disallowed and non-taxable items	23	48
Overseas tax rate differences	(12)	109
Gains exempted or covered by capital losses	(459)	54
Policyholder interests	140	(109)
Adjustments in respect of previous years	(3)	112
Effect of results of joint ventures and associates	7	(27)
Tax losses surrendered for no payment	(1)	(421)
Tax losses where no deferred tax recognised	(246)	(526)
Deferred tax on tax losses not previously recognised	40	–
Other items	(16)	41
Tax credit (charge) on loss on ordinary activities	173	(264)

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

	2011 £m	2010 £m
Trading assets	**21,840**	23,751
Other financial assets at fair value through profit or loss	**23,507**	79,335
Total	**45,347**	103,086

These assets are comprised as follows:

	2011		2010	
	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	**17,381**	**54**	11,759	–
Loans and advances to banks	**1,355**	**–**	3,936	–
Debt securities:				
Government securities	**992**	**1,471**	1,403	10,301
Other public sector securities	**–**	**185**	–	797
Bank and building society certificates of deposit	**1,384**	**92**	3,692	606
Asset-backed securities:				
Mortgage-backed securities	**–**	**9**	–	106
Other asset-backed securities	**203**	**–**	973	195
Corporate and other debt securities	**301**	**2,543**	1,755	6,555
	2,880	**4,300**	7,823	18,560
Equity shares	**–**	**19,153**	6	60,775
Treasury and other bills	**224**	**–**	227	–
Total	**21,840**	**23,507**	23,751	79,335

At 31 December 2011 £28,113 million (2010: £79,947 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 £23,474 million (2010: £81,013 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 reverse repurchase agreements treated as collateralised loans with a carrying value of £18,729 million for the Group (2010: £15,513 million). Collateral is held with a fair value of £23,655 million for the Group (2010: £17,632 million), all of which the Group is able to repledge. At 31 December 2011, £20,055 million had been repledged by the Group (2010: £7,261 million).

For amounts included above which are subject to repurchase agreements see note 54.

17 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 54; 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 53.

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

17 Derivative financial instruments (continued)

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:

	2011			2010		
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	**1,294**	**112**	**55**	11,561	203	235
Currency swaps	**55,004**	**1,595**	**996**	59,990	3,126	843
Options purchased	**56**	**1**	**–**	103	8	–
Options written	**138**	**–**	**4**	100	–	4
	56,492	**1,708**	**1,055**	71,754	3,337	1,082
Interest rate contracts:						
Interest rate swaps	**496,685**	**23,026**	**23,666**	951,706	18,338	18,491
Forward rate agreements	**203,645**	**80**	**66**	729,594	238	216
Options purchased	**11,629**	**823**	**–**	15,682	661	–
Options written	**14,143**	**–**	**1,002**	21,872	–	779
Futures	**113,213**	–	–	21,259	3	–
	839,315	**23,929**	**24,734**	1,740,113	19,240	19,486
Credit derivatives	**204**	**10**	**75**	1,377	51	16
Equity and other contracts	**6,890**	**1,018**	**811**	6,462	1,344	810
Total derivative assets/liabilities held for trading	**902,901**	**26,665**	**26,675**	1,819,706	23,972	21,394
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**35,757**	**4,165**	**581**	39,631	3,417	470
Cross currency swaps	**19,100**	**557**	**138**	9,418	606	35
	54,857	**4,722**	**719**	49,049	4,023	505
Derivatives designated as cash flow hedges:						
Interest rate swaps	**161,463**	**4,690**	**5,901**	97,812	1,770	3,055
Cross currency swaps	**25,732**	**176**	**90**	17,911	232	121
Options	**–**	**–**	**–**	–	–	–
Futures	**103,467**	–	–	1,299	1	–
	290,662	**4,866**	**5,991**	117,022	2,003	3,176
Derivatives designated as net investment hedges:						
Cross currency swaps	**–**	**–**	**–**	86	2	–
Total derivative assets/liabilities held for hedging	**345,519**	**9,588**	**6,710**	166,157	6,028	3,681
Total recognised derivative assets/liabilities	**1,248,420**	**36,253**	**33,385**	1,985,863	30,000	25,075

17 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.

2011	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	52	140	377	277	136	260	5	28	1,275
Forecast payable cash flows	(154)	(173)	(94)	(65)	(28)	(119)	(409)	(55)	(1,097)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	117	147	328	263	167	221	4	28	1,275
Forecast payable cash flows	(207)	(144)	(70)	(65)	(43)	(130)	(408)	(30)	(1,097)

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)

There were no transactions for which cash flow hedge accounting had to be ceased in 2011 or 2010 as a result of the highly probable cash flows no longer being expected to occur.

At 31 December 2011 £32,892 million of total recognised derivative assets of the Group and £30,209 million of total recognised derivative liabilities of the Group (2010: £27,299 million of assets and £22,124 million of liabilities) had a contractual residual maturity of greater than one year.

	2011			2010		
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	**5,600**	**1,715**	**10**	5,686	1,895	–
Interest rate swaps	**508**	**142**	**–**	496	166	–
Total recognised derivative assets/liabilities, held for hedging	**6,108**	**1,857**	**10**	6,182	2,061	–

At 31 December 2011 £1,687 million of total recognised derivative assets of the Company and £nil of total recognised derivative liabilities of the Company (2010: £1,889 million of assets and £nil 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 54.

18 Loans and advances to banks of the Group

	2011 £m	2010 £m
Lending to banks	**85,854**	55,053
Money market placements with banks	**5,356**	10,117
Total loans and advances to banks	**91,210**	65,170

No allowance for impaired loans was carried against these exposures at 31 December 2011 or 31 December 2010.

At 31 December 2011 £50,614 million (2010: £11,808 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 £2,950 million (2010: £20,664 million). Collateral is held with a fair value of £2,950 million (2010: £20,626 million), all of which the Group is able to repledge.

Included in the amounts reported above in 2010 are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £4 million.

19 Loans and advances to customers of the Group

	2011 £m	2010 £m
Agriculture, forestry and fishing	**588**	602
Energy and water supply	**1,670**	1,145
Manufacturing	**2,946**	3,881
Construction	**6,818**	6,983
Transport, distribution and hotels	**20,135**	23,232
Postal and telecommunications	**357**	1,032
Property companies	**42,418**	58,092
Financial, business and other services	**33,077**	32,029
Personal:		
Mortgages	**243,222**	246,690
Other	**12,920**	16,974
Lease financing	**3,840**	4,458
Hire purchase	**772**	1,358
Due from fellow Group undertakings	**11,698**	10,205
Total loans and advances to customers before allowance for impairment losses	**380,461**	406,681
Allowance for impairment losses (note 23)	**(23,351)**	(25,316)
Total loans and advances to customers	**357,110**	381,365

At 31 December 2011 £290,167 million (2010: £324,975 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 £14,250 million (2010: £2,579 million). Collateral is held with a fair value of £14,254 million (2010: £2,477 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 £34 million (2010: £42 million).

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

	2011 £m	2010 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**497**	614
Later than 1 year and not later than 5 years	**1,293**	1,395
Later than 5 years	**2,184**	2,581
	3,974	4,590
Unearned future finance income on finance leases	**(134)**	(132)
Net investment in finance leases	**3,840**	4,458

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

	2011 £m	2010 £m
Not later than 1 year	**444**	671
Later than 1 year and not later than 5 years	**1,215**	1,224
Later than 5 years	**2,181**	2,563
Net investment in finance leases	**3,840**	4,458

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 2011 and 2010 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 £89 million (2010: £227 million).

The unguaranteed residual values included in finance lease receivables were as follows:

	2011 £m	2010 £m
Not later than 1 year	**35**	34
Later than 1 year and not later than 5 years	**73**	57
Later than 5 years	**12**	14
Total unguaranteed residual values	**120**	105

20 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 a conduit programme, Grampian (note 21).

Covered bond programmes
Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value on the notes in issue at 31 December, are listed below. The notes in issue are reported in note 35.

	2011		2010	
	Loans and advances securitised £m	**Notes in issue £m**	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	**91,246**	**68,425**	102,801	83,367
US residential mortgage-backed securities	**4,659**	**6,351**	7,197	7,221
Irish residential mortgages	**5,531**	**5,661**	6,061	6,191
Credit card receivables	**6,792**	**4,810**	7,372	3,856
Dutch residential mortgages	**4,960**	**4,817**	4,551	4,415
Personal loans	**–**	**–**	3,012	2,011
Commercial loans	**680**	**631**	667	633
Motor vehicle loans	**1,573**	**1,341**	926	975
	115,441	**92,036**	132,587	108,669
Less held by the Group		**(65,118)**		(78,686)
Total securitisation programmes (note 35)		**26,918**		29,983
Covered bond programmes				
Residential mortgage-backed	**48,521**	**38,882**	55,032	44,271
Social housing loan-backed	**3,370**	**2,605**	3,377	2,400
	51,891	**41,487**	58,409	46,671
Less held by the Group		**(13,515)**		(17,239)
Total covered bond programmes (note 35)		**27,972**		29,432
Total securitisation and covered bond programmes		**54,890**		59,415

Cash deposits of £13,381 million (2010: £25,139 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.

21 Special purpose entities

In addition to the SPEs discussed in note 20, which are used for securitisation and covered bond programmes, the Group sponsors an asset-backed conduit, Grampian, which invests in debt securities. All the external assets in this conduit are consolidated in the Group's financial statements. The total consolidated exposures in these conduits are set out in the table below:

At 31 December 2011	**Grampian £m**
Loans and advances	**197**
Debt securities:	
Classified as loans and receivables – asset-backed securities (note 22)	**2,004**
Classified as available-for-sale financial assets – asset-backed securities (note 24)	**796**
Total debt securities	**2,800**
Total assets	**2,997**

At 31 December 2010	Grampian £m
Debt securities classified as loans and receivables – asset-backed securities	6,967

22 Debt securities classified as loans and receivables of the Group

Debt securities accounted for as loans and receivables comprise:

	2011 £m	2010 £m
Asset-backed securities:		
Mortgage-backed securities	**7,258**	12,276
Other asset-backed securities	**4,738**	11,989
Corporate and other debt securities	**428**	658
Total debt securities classified as loans and receivables before allowance for impairment losses	**12,424**	24,923
Allowance for impairment losses (note 23)	**(1,148)**	(1,291)
Total debt securities classified as loans and receivables	**11,276**	23,632

At 31 December 2011, £11,065 million (2010: £23,572 million) of debt securities classified as loans and receivables of the Group had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 54.

23 Allowances for impairment losses on loans and receivables

	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January 2010	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 (release) to the income statement (note 12)	10,786	(19)	10,767
At 31 December 2010	25,316	1,291	26,607
Exchange and other adjustments	**(385)**	**11**	**(374)**
Advances written off	**(8,428)**	**(222)**	**(8,650)**
Recoveries of advances written off in previous years	**58**	**8**	**66**
Unwinding of discount	**(171)**	**–**	**(171)**
Charge to the income statement (note 12)	**6,961**	**60**	**7,021**
At 31 December 2011	**23,351**	**1,148**	**24,499**

Of the Group's total allowance in respect of loans and advances to customers, £21,876 million (2010: £22,086 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, £4,075 million (2010: £4,900 million) was assessed on a collective basis.

24 Available-for-sale financial assets of the Group

	2011 £m	2010 £m
Debt securities:		
Government securities	**163**	142
Bank and building society certificates of deposit	**32**	129
Asset-backed securities:		
Mortgage-backed securities	**789**	15
Other asset-backed securities	**83**	181
Corporate and other debt securities	**7,550**	10,717
	8,617	11,184
Equity shares	**1,881**	2,176
Treasury and other bills	**–**	483
Total available-for-sale financial assets	**10,498**	13,843

At 31 December 2011 £8,457 million (2010: £10,189 million) of available-for-sale financial assets had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 54.

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 2011 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £2 million (2010: £160 million) and in respect of which no collateral was held.

25 Investment properties

	2011 £m	2010 £m
At 1 January	**3,356**	2,417
Additions:		
Acquisitions of new properties	**183**	262
Consolidation of new subsidiary undertakings	**920**	921
Additional expenditure on existing properties	**10**	37
Total additions	**1,113**	1,220
Disposals	**(713)**	(514)
Changes in fair value (note 7)	**(65)**	233
Disposal of businesses (note 14)	**(2,005)**	–
At 31 December	**1,686**	3,356

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:

	2011 £m	2010 £m
Rental income (note 9)	**135**	158
Direct operating expenses arising from investment properties that generate rental income	**7**	45

Capital expenditure in respect of investment properties:	2011 £m	2010 £m
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	**6**	66

26 Investment in subsidiary undertakings

	2011 £m	2010 £m
At 1 January	**26,923**	26,128
Exchange and other adjustments	**128**	–
Additional capital injections and transfers	**–**	795
Impairment	**(4,051)**	–
At 31 December	**23,000**	26,923

A reassessment of the carrying value of the Company's investment in Bank of Scotland plc at 31 December 2011 concluded that the carrying value of the Company's investment has not fallen below its recoverable amount.

A reassessment of the carrying value of the Company's investment in HBOS Insurance & Investment Group Limited, taking into account the disposal of that subsidiary's wholly owned life, pensions and general insurance subsidiaries to other Lloyds Banking Group companies during the year (see note 14), resulted in the recognition of an impairment charge of £4,051 million.

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 17.75 per cent rate of increase. The expected cash flows have been discounted at a rate of 2.4 per cent which has been determined to be in line with available market information.

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.

27 Goodwill

	2011 £m	2010 £m
At 1 January	**850**	850
Adjustment on acquisition	**9**	–
At 31 December	**859**	850
Cost[1]	**1,847**	1,838
Accumulated impairment losses	**(988)**	(988)
At 31 December	**859**	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 £859 million (2010: £850 million), £478 million (or 55 per cent of the total) has been allocated to insurance and investment businesses and £356 million (or 41 per cent of the total) to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2011 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 2.4 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 (post-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.

28 Value of in-force business

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

	2011 £m	2010 £m
Acquired value of in-force non-participating investment contracts	**105**	136
Value of in-force insurance and participating investment contracts	**42**	3,035
Total value of in-force business	**147**	3,171

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

	2011 £m	2010 £m
At 1 January	**136**	148
Amortisation taken to income statement (note 11)	**(11)**	(12)
Disposal of businesses (note 14)	**(20)**	–
At 31 December	**105**	136

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

	2011 £m	2010 £m
At 1 January	**3,035**	2,838
Exchange and other adjustments	**48**	(30)
New business	**108**	242
Existing business:		
Expected return	**(168)**	(318)
Experience variances	**(30)**	49
Non-economic assumption changes	**51**	173
Economic variance	**48**	81
Movement in the value of in-force business taken to income statement (note 9)	**9**	227
Disposal of businesses (note 14)	**(3,050)**	–
At 31 December	**42**	3,035

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown contributes to profit before tax. This will also contain changes in the other assets and liabilities, including the effects of changes in assumptions used to value 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.

Prior to the disposal of its annuity business in July 2011 the liabilities in respect of the Group's UK annuity business were 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 was calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings. The illiquidity premium was estimated to be 75 basis points as at 31 December 2010.

28 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 table below shows the risk-free rate and other key assumptions at 31 December for UK business:

	2011 %	2010 %
Risk-free rate (value of in-force non-annuity business)	**2.48**	3.99
Retail price inflation	**3.35**	3.56
Expense inflation	**4.01**	4.20

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, expenses, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and on management's view of likely future experience.

Mortality and morbidity
The mortality and morbidity assumptions, including allowances for improvements in longevity, are set with regard to the Group's actual experience where this provides a reliable basis and relevant industry data otherwise. For German business, appropriate industry tables have been considered.

Lapse (persistency) and paid-up rates
Lapse and paid up rates assumptions are reviewed each year. The most recent experience is considered along with the results of previous analyses and management's views on future experience. In determining this best estimate view, a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration and any known or expected trends in underlying data.

Maintenance expenses
Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

These assumptions are intended to represent a best estimate of future experience, and further information about the effect of changes in key assumptions is given in note 37.

29 Other intangible assets

Group	Brands £m	Capitalised software enhance-ments £m	Total £m
Cost:			
At 1 January 2010	24	310	334
Exchange and other adjustments	–	(1)	(1)
Additions	–	23	23
Disposals	–	(29)	(29)
At 31 December 2010	24	303	327
Exchange and other adjustments	**–**	**6**	**6**
Additions	**–**	**35**	**35**
Disposals	**–**	**(12)**	**(12)**
Disposal of businesses (note 14)	**–**	**(30)**	**(30)**
At 31 December 2011	**24**	**302**	**326**
Accumulated amortisation:			
At 1 January 2010	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
Exchange and other adjustments	**–**	**(1)**	**(1)**
Charge for the year (note 11)	**–**	**18**	**18**
Disposals	**–**	**(12)**	**(12)**
Disposal of businesses (note 14)	**–**	**(8)**	**(8)**
At 31 December 2011	**24**	**226**	**250**
Balance sheet amount at 31 December 2011	**–**	**76**	**76**
Balance sheet amount at 31 December 2010	–	74	74

Company	Brands £m
Cost:	
At 1 January 2010	10
At 31 December 2010	10
At 31 December 2011	**10**
Accumulated amortisation:	
At 1 January 2010	8
Charge for the year	2
At 31 December 2010	10
Charge for the year	**–**
At 31 December 2011	**10**
Balance sheet amount at 31 December 2011	**–**
Balance sheet amount at 31 December 2010	–

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

30 Tangible fixed assets

	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:				
At 1 January 2010	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
Exchange and other adjustments	**–**	**(10)**	**(27)**	**(37)**
Additions	**34**	**147**	**184**	**365**
Disposals	**(59)**	**(150)**	**(1,563)**	**(1,772)**
Disposal of businesses (note 14)	**(38)**	**(114)**	**(330)**	**(482)**
At 31 December 2011	**1,400**	**2,506**	**1,833**	**5,739**
Accumulated depreciation and impairment:				
At 1 January 2010	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
Exchange and other adjustments	**–**	**10**	**(8)**	**2**
Impairment charged to the income statement (note 11)	**–**	**65**	**–**	**65**
Depreciation charge for the year (note 11)	**57**	**114**	**155**	**326**
Disposals	**(5)**	**(108)**	**(799)**	**(912)**
Disposal of businesses (note 14)	**(12)**	**(90)**	**(195)**	**(297)**
At 31 December 2011	**781**	**2,027**	**559**	**3,367**
Balance sheet amount at 31 December 2011	**619**	**479**	**1,274**	**2,372**
Balance sheet amount at 31 December 2010	722	597	2,163	3,482

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

	2011 £m	2010 £m
Receivable within 1 year	**171**	480
1 to 5 years	**464**	986
Over 5 years	**627**	588
Total future minimum rentals receivable	**1,262**	2,054

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2011 and 2010 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 2011 (2010: £nil) is expected to be received under non-cancellable sub-leases of the Group's premises.

31 Other assets

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
Assets arising from reinsurance contracts held (notes 36 and 38)	**38**	1,643	**–**	–
Deferred acquisition costs (see below)	**772**	1,047	**–**	–
Settlement balances	**357**	729	**–**	–
Other assets and prepayments	**1,505**	2,904	**17**	5
Total other assets	**2,672**	6,323	**17**	5

Deferred acquisition costs of the Group:	2011 £m	2010 £m
At 1 January	**1,047**	1,023
Exchange and other adjustments	**(1)**	–
Acquisition costs deferred, net of amounts amortised to the income statement	**(274)**	24
At 31 December	**772**	1,047

32 Deposits from banks of the Group

	2011 £m	2010 £m
Liabilities in respect of securities sold under repurchase agreements	**952**	6,155
Other deposits from banks	**149,090**	136,982
Total deposits from banks	**150,042**	143,137

At 31 December 2011 £120,160 million (2010: £25,994 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 £28,040 million (2010: £55,394 million) and a fair value of £28,180 million (2010: £56,450 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £nil (2010: £nil).

33 Customer deposits of the Group

	2011 £m	2010 £m
Non-interest bearing current accounts	**11,204**	5,646
Interest bearing current accounts	**26,093**	35,776
Savings and investment accounts	**147,004**	137,188
Liabilities in respect of securities sold under repurchase agreements	**3,662**	8,079
Other customer deposits	**29,085**	29,715
Total customer deposits	**217,048**	216,404

At 31 December 2011 £41,670 million (2010: £33,268 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 £5,306 million (2010: £8,279 million) and a fair value of £5,655 million (2010: £8,455 million).

34 Trading liabilities of the Group

	2011 £m	2010 £m
Liabilities in respect of securities sold under repurchase agreements	**19,069**	17,906
Short positions in securities	**1,736**	860
Other	**–**	20
Trading liabilities	**20,805**	18,786

At 31 December 2011 £5,937 million (2010: £608 million) of trading liabilities had a contractual residual maturity of greater than one year.

35 Debt securities in issue

	2011 £m	2010 £m
Medium-term notes issued	**14,048**	26,963
Covered bonds (note 20)	**27,972**	29,432
Certificates of deposit	**350**	3,062
Securitisation notes (note 20)	**26,918**	29,983
Commercial paper	**6,169**	11,320
Total debt securities in issue	**75,457**	100,760

At 31 December 2011 £59,830 million (2010: £68,143 million) of debt securities in issue had a contractual residual maturity of greater than one year.

36 Liabilities arising from insurance contracts and participating investment contracts

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

	2011			2010		
	Gross £m	Reinsurance[1] £m	Net £m	Gross £m	Reinsurance[1] £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	**385**	**(38)**	**347**	34,440	(1,546)	32,894
Participating investment contracts	**–**	**–**	**–**	4,984	–	4,984
	385	**(38)**	**347**	39,424	(1,546)	37,878
Non-life insurance contracts (see (2) below):						
Unearned premiums	**–**	**–**	**–**	329	(19)	310
Claims outstanding	**–**	**–**	**–**	323	(13)	310
	–	**–**	**–**	652	(32)	620
Total	**385**	**(38)**	**347**	40,076	(1,578)	38,498

[1] Reinsurance balances are reported within other assets (note 31).

(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 2010	32,735	5,815	38,550	(1,427)	37,123
Exchange and other adjustments	(77)	86	9	43	52
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
At 31 December 2010	34,440	4,984	39,424	(1,546)	37,878
Exchange and other adjustments	**(15)**	**(2)**	**(17)**	**2**	**(15)**
New business	**803**	**4**	**807**	**(164)**	**643**
Changes in existing business	**(1,185)**	**(459)**	**(1,644)**	**(23)**	**(1,667)**
Change in liabilities charged to the income statement (note 10)	**(382)**	**(455)**	**(837)**	**(187)**	**(1,024)**
Disposal of business (note 14)	**(33,658)**	**(4,527)**	**(38,185)**	**1,693**	**(36,492)**
At 31 December 2011	**385**	**–**	**385**	**(38)**	**347**

36 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:

	2011			2010		
	With-profit fund £m	**Non-profit fund £m**	**Total £m**	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	**–**	**385**	**385**	5,445	28,995	34,440
Participating investment contracts	**–**	**–**	**–**	4,954	30	4,984
Total	**–**	**385**	**385**	10,399	29,025	39,424

With-profit fund realistic liabilities
In July 2011 the Group disposed of its with-profit fund within Clerical Medical Investment Group Limited.

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.

(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, 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.

Lapse rates (persistency)
Lapse rates are allowed for on some non-profit fund contracts. 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 purpose 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. 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.

Key changes in assumptions
A detailed review of the Group's assumptions in 2011 resulted in no significant impacts on profit before tax. This takes into account the impacts of movements in liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts.

36 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:

	2011 £m	2010 £m
Credit protection	–	231
Home	–	421
Total gross non-life insurance contract liabilities	**–**	652

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 2010	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
Increase in the year	**271**	**(3)**	**268**
Release in the year	**(287)**	**16**	**(271)**
Change in provision for unearned premiums charged to income statement (note 8)	**(16)**	**13**	**(3)**
Disposal of businesses (note 14)	**(313)**	**6**	**(307)**
At 31 December 2011	**–**	**–**	**–**

36 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	127	(5)	122
Incurred but not reported	155	(4)	151
At 1 January 2010	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
Cash paid for claims settled in the year	**(161)**	**24**	**(137)**
Increase (decrease) in liabilities:			
Arising from current year claims	**123**	**(13)**	**110**
Arising from prior year claims	**(4)**	**(3)**	**(7)**
Change in liabilities charged to income statement (note 10)	**(42)**	**8**	**(34)**
Disposal of businesses (note 14)	**(281)**	**5**	**(276)**
At 31 December 2011	**–**	**–**	**–**
Notified claims	**–**	**–**	**–**
Incurred but not reported	**–**	**–**	**–**
At 31 December 2011	**–**	**–**	**–**
Notified claims	207	(2)	205
Incurred but not reported	116	(11)	105
At 31 December 2010	323	(13)	310

37 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 2011	**Change in variable**	**Increase (reduction) in profit before tax £m**	**Increase (reduction) in equity £m**
Non-annuitant mortality[1]	**5% reduction**	**1**	**1**
Lapse rates[3]	**10% reduction**	**(3)**	**(2)**
Future maintenance and investment expenses[4]	**10% reduction**	**–**	**–**
Risk-free rate[5]	**0.25% reduction**	**(1)**	**(1)**

Following the disposal of the Group's wholly owned insurance businesses (see note 14) the sensitivities as at 31 December 2011 reflect only the retained business.

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

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.

38 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 2010	30,614	–	30,614
Exchange and other adjustments	(9)	–	(9)
New business	3,693	(65)	3,628
Changes in existing business	838	–	838
At 31 December 2010	35,136	(65)	35,071
Exchange and other adjustments	**1**	**–**	**1**
New business	**3,916**	**(1)**	**3,915**
Changes in existing business	**(3,617)**	**4**	**(3,613)**
Disposal of businesses (note 14)	**(13,229)**	**62**	**(13,167)**
At 31 December 2011	**22,207**	**–**	**22,207**

39 Unallocated surplus within insurance businesses

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

	2011 £m	2010 £m
At 1 January	**321**	772
Exchange and other adjustments	**2**	–
Change in unallocated surplus recognised in the income statement (note 10)	**41**	(451)
Disposal of businesses (note 14)	**(364)**	–
At 31 December	**–**	321

40 Other liabilities

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Settlement balances	**1,239**	1,078	**–**	–
Unitholders' interest in Open Ended Investment Companies	**2,505**	7,951	**–**	–
Other creditors and accruals	**4,440**	7,532	**457**	363
	8,184	16,561	**457**	363

41 Retirement benefit obligations

	2011 £m	2010 £m
Charge (credit) to the Group income statement		
Defined benefit pension schemes[1]	**77**	(154)
Other post-retirement benefit schemes	**4**	4
Total defined benefit schemes	**81**	(150)
Defined contribution pension schemes	**101**	91
Total charge (credit) to the Group income statement	**182**	(59)

[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		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Amounts recognised in the balance sheet:				
Defined benefit pension schemes	**350**	108	**331**	108
Other post-retirement benefit schemes	**(63)**	(56)	**(63)**	(56)
Total amounts recognised in the balance sheet	**287**	52	**268**	52

41 Retirement benefit obligations (continued)

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
Amounts recognised in the balance sheet:				
Retirement benefit assets	**394**	152	**375**	150
Retirement benefit obligations	**(107)**	(100)	**(107)**	(98)
Total amounts recognised in the balance sheet	**287**	52	**268**	52

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 2011 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 2011 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 2012.

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
Amount included in the balance sheet				
Present value of funded obligations	**(8,999)**	(8,382)	**(8,832)**	(8,219)
Fair value of scheme assets	**9,881**	8,483	**9,748**	8,355
	882	101	**916**	136
Unrecognised actuarial (gains) losses	**(532)**	7	**(585)**	(28)
Net amount recognised in the balance sheet	**350**	108	**331**	108

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
Movements in the defined benefit obligation				
At 1 January	**(8,382)**	(8,276)	**(8,219)**	(8,164)
Current service cost	**(145)**	(171)	**(144)**	(165)
Employee contributions	**(1)**	(5)	**(1)**	(2)
Interest cost	**(453)**	(448)	**(445)**	(440)
Actuarial losses	**(285)**	(84)	**(274)**	(79)
Benefits paid	**252**	262	**249**	258
Past service cost	**(10)**	(12)	**(10)**	(12)
Curtailments	**12**	380	**4**	380
Exchange and other adjustments	**13**	(28)	**8**	5
At 31 December	**(8,999)**	(8,382)	**(8,832)**	(8,219)

41 Retirement benefit obligations (continued)

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
Changes in the fair value of scheme assets				
At 1 January	**8,483**	7,442	**8,355**	7,351
Expected return	**520**	466	**511**	459
Employer contributions	**321**	309	**311**	301
Actuarial gains (losses)	**823**	509	**830**	506
Benefits paid	**(252)**	(260)	**(249)**	(256)
Employee contributions	**1**	5	**1**	2
Exchange and other adjustments	**(15)**	12	**(11)**	(8)
At 31 December	**9,881**	8,483	**9,748**	8,355
Actual return on scheme assets	**1,343**	975	**1,341**	956

Assumptions

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

	Group and Company 2011 %	Group and Company 2010 %
Discount rate	**5.00**	5.50
Rate of inflation		
Retail Prices Index	**3.00**	3.40
Consumer Price Index	**2.00**	2.90
Rate of salary increases	**2.00**	2.00
Rate of increase for pensions in payment	**3.20**	3.20

	Years	Years
Life expectancy for member aged 60, on the valuation date:		
Men	**26.8**	26.6
Women	**28.5**	28.4
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**28.3**	28.2
Women	**30.1**	30.0

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 as at 31 December 2011 is assumed to live for, on average, 26.8 years for a male and 28.5 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 2011 £m	Increase (decrease) in the income statement charge 2010 £m	Increase (decrease) in the net defined benefit pension scheme asset 2011 £m	Increase (decrease) in the net defined benefit pension scheme asset 2010 £m
Inflation[1]:				
Increase of 0.2 per cent	**3**	7	**(284)**	(272)
Decrease of 0.2 per cent	**(3)**	(6)	**274**	262
Discount rate[2]:				
Increase of 0.2 per cent	**(7)**	(11)	**315**	336
Decrease of 0.2 per cent	**6**	11	**(332)**	(353)
Expected life expectancy of members:				
Increase of one year	**14**	14	**(214)**	(198)
Decrease of one year	**(14)**	(14)	**222**	206

[1]At 31 December 2011, the assumed rate of inflation is 3.00 per cent (31 December 2010 3.4 per cent)

[2]At 31 December 2011, the assumed discount rate is 5.00 per cent (31 December 2010 5.5 per cent)

41 Retirement benefit obligations (continued)

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

	Group and Company	
	2011 %	2010 %
Equities and alternative assets	**8.3**	8.3
Fixed interest gilts	**4.0**	4.5
Index linked gilts	**3.9**	4.1
Non-Government bonds	**4.9**	6.0
Property	**7.3**	7.5
Money market instruments and cash	**3.9**	4.3

The expected return on scheme assets in 2012 will be calculated using the following assumptions:

	2012 %
Equities and alternative assets	**7.3**
Fixed interest gilts	**3.0**
Index linked gilts	**2.8**
Non-Government bonds	**4.9**
Property	**6.6**
Money market instruments and cash	**2.6**

Composition of scheme assets:

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Equities	**3,588**	3,657	**3,510**	3,581
Fixed interest gilts	**501**	1,643	**501**	1,643
Index linked gilts	**1,089**	701	**1,089**	701
Non-Government bonds	**1,162**	379	**1,121**	339
Property	**333**	256	**329**	252
Money market instruments, cash and other assets and liabilities	**3,208**	1,847	**3,198**	1,839
At 31 December	**9,881**	8,483	**9,748**	8,355

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):

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Present value of defined benefit obligation	**(8,999)**	(8,382)	(8,276)	(6,709)	(7,623)
Fair value of scheme assets	**9,881**	8,483	7,442	7,241	7,329
	882	101	(834)	532	(294)
Experience (losses) gains on scheme liabilities	**(19)**	(32)	38	(22)	(95)
Experience gains (losses) on scheme assets	**1,153**	330	(176)	(615)	76

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

	2011 £m	2010 £m
Current service cost	**145**	171
Interest cost	**453**	448
Expected return on scheme assets	**(520)**	(466)
Amortisation – outside corridor	**1**	57
Settlements	**–**	4
Curtailments (see below)	**(12)**	(380)
Past service cost	**10**	12
Total defined benefit pension expense	**77**	(154)

41 Retirement benefit obligations (continued)

Following changes by the Group to the terms of its principal UK defined benefit schemes in 2010, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee's actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of the year there was a change in the commutation factors in certain defined benefit schemes.The combined effect of these changes was a reduction in the Group's unrecognised actuarial losses of £64 million, resulting in a net curtailment gain of £316 million in the year ended 31 December 2010 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 2011 the charge to the income statement in respect of defined contribution schemes was £101 million (2010: £91 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 2011 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 (2010: 5.50 per cent).

Movements in the other post-retirement benefits obligation:

	Group and Company	
	2011 £m	2010 £m
At 1 January	**(56)**	(54)
Exchange and other adjustments	**(6)**	–
Charge for the year	**(4)**	(2)
Benefits paid	**3**	–
At 31 December	**(63)**	(56)

42 Deferred tax

	Group		Company	
The movement in the net deferred tax balance is as follows:	**2011 £m**	2010 £m	**2011 £m**	2010 £m
Asset at 1 January	**4,015**	4,516	**(27)**	113
Exchange and other adjustments	**(19)**	75	**–**	–
Disposal of businesses (note 14)	**606**	–	**–**	–
Income statement (charge) credit (note 15):				
Due to change in UK corporation tax rate	**(332)**	(119)	**6**	1
Other	**282**	(58)	**(61)**	(141)
	(50)	(177)	**(55)**	(140)
Amount charged to equity:				
Available-for-sale financial assets (note 47)	**(129)**	(228)	**–**	–
Cash flow hedges (note 47)	**(447)**	(171)	**–**	–
	(576)	(399)	**–**	–
Asset at 31 December	**3,976**	4,015	**(82)**	(27)

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	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Statutory position				
Deferred tax asset	**3,977**	4,062	**–**	–
Deferred tax liability	**(1)**	(47)	**(82)**	(27)
Net deferred tax asset (liability)	**3,976**	4,015	**(82)**	(27)
Tax disclosure				
Deferred tax asset	**4,668**	5,314	**–**	–
Deferred tax liability	**(692)**	(1,299)	**(82)**	(27)
Net deferred tax asset (liability)	**3,976**	4,015	**(82)**	(27)

42 Deferred tax (continued)

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

	2011 £m	2010 £m
Accelerated capital allowances	**105**	(316)
Pensions and other post-retirement benefits	**(56)**	(140)
Unrealised gains and losses	**4**	(6)
Tax on long-term assurance business	**188**	(37)
Effective interest rate	**28**	14
Tax losses carried forward	**(277)**	274
Provisions	**(38)**	(77)
Other temporary differences	**(4)**	111
Deferred tax credit in the income statement	**(50)**	(177)

Deferred tax assets and liabilities are comprised as follows:

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Deferred tax assets:				
Employee benefits	**7**	7	**–**	–
Other provisions	**277**	309	**–**	–
Derivatives	**–**	159	**–**	–
Available-for-sale asset revaluation	**269**	378	**–**	–
Tax losses carried forward	**3,568**	3,899	**–**	–
Other temporary differences	**547**	562	**–**	–
Total deferred tax assets	**4,668**	5,314	**–**	–

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Deferred tax liabilities:				
Accelerated capital allowances	**(230)**	(351)	**–**	–
Tax on long-term assurance business	**(9)**	(805)	**–**	–
Derivatives	**(274)**	–	**–**	–
Effective interest rate	**(44)**	(72)	**–**	–
Other temporary differences	**(135)**	(71)	**(82)**	(27)
Total deferred tax liabilities	**(692)**	(1,299)	**(82)**	(27)

On 23 March 2011, the Government announced that the corporation tax rate applicable from 1 April 2011 would be 26 per cent. This change passed into legislation on 29 March 2011. In addition, the Finance Act 2011, which passed into law on 19 July 2011, included legislation to reduce the main rate of corporation tax from 26 per cent to 25 per cent with effect from 1 April 2012. The change in the main rate of corporation tax from 27 per cent to 25 per cent has resulted in a reduction in the Group's net deferred tax asset at 31 December 2011 of £325 million, comprising the £332 million charge included in the income statement and an £7 million credit included in equity.

The proposed further reductions in the rate of corporation tax by 1 per cent per annum to 23 per cent by 1 April 2014 are expected to be enacted separately each year. 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
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 £3,568 million for the Group and £nil for the Company (2010: £3,899 million for the Group and £nil for the Company) in relation to trading tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset.

Deferred tax assets of £43 million for the Group and £nil for the Company (2010: £330 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 £488 million for the Group and £nil for the Company (2010: £227 million for the Group and £nil for the Company) have not been recognised in respect of trading losses carried forward, arising 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 2011 of £40 million for the Group and £nil for the Company (2010: £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.

43 Other provisions

	Provisions for commitments £m	Customer remediation provisions £m	Customer goodwill payments £m	Vacant leasehold property and other £m	Total £m
At 1 January 2011	**31**	**197**	**500**	**78**	**806**
Exchange and other adjustments	**(6)**	**20**	**–**	**36**	**50**
Provisions applied	**(4)**	**(470)**	**(497)**	**(14)**	**(985)**
Charge for the year	**5**	**1,155**	**–**	**47**	**1,207**
Disposal of businesses (note 14)	**(10)**	**–**	**–**	**(4)**	**(14)**
At 31 December 2011	**16**	**902**	**3**	**143**	**1,064**

Provisions for commitments
Provisions are held in cases where the Group is irrevocably committed to advance additional funds, but where there is doubt as to the customer's ability to meet its repayment obligations.

Customer remediation provisions
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 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. The Competition Commission consulted on the wording of a draft Order to implement its findings from October 2010, and published the final Order on 24 March 2011 which became effective on 6 April 2011. 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 29 September 2009 the FSA announced that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. Lloyds Banking Group agreed in principle that it would undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. That review will now form part of the ongoing PPI work referred to below.

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 published its Policy Statement on 10 August 2010, setting out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress, as well as a requirement for firms to reassess historically rejected complaints 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 sought 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 Review hearing was held in late January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA's application. On 9 May 2011, the BBA confirmed that the banks and the BBA did not intend to appeal the judgment.

After publication of the judgment, the Group has entered into discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group has conducted of compliance with applicable sales standards, which is continuing, the Group has concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group has made a provision in its income statement for the year ended 31 December 2011 of £1,155 million in respect of the anticipated costs of such contact and/or redress, including administration expenses. During 2011, the Group made redress payments of £375 million to customers. The Group anticipates that all claims will be settled by 2015. However, there are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties of assessing the impact of the detailed implementation of the Policy Statement for all PPI complaints, uncertainties around the ultimate emergence period for complaints, the availability of supporting evidence and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

Other
The Group establishes provisions for the estimated cost of making redress payments to customers in respect of past product sales, in those cases where the original sales processes have been found to be deficient. During 2011 management has again reviewed the adequacy of the provisions held having regard to current complaint volumes and the level of payments being made. At 31 December 2011 the remaining such provisions held relate to past sales of a number of products, including mortgage endowment policies, sold through the branch networks.

Customer goodwill payments
Following discussions with the FSA regarding the application of an interest rate variation clause in certain Bank of Scotland plc variable rate mortgage contracts Bank of Scotland plc applied for a Voluntary Variation of Permission (VVOP) in February 2011 and agreed to initiate a customer review and contact programme and to make goodwill payments to affected customers. The Group made a provision of £500 million within its 2010 accounts in respect of this matter. Since that time further information has become available which has resulted in Bank of Scotland plc applying for, and being granted, an amended VVOP by the FSA in November 2011. No additional charge is required at this time.

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

44 Subordinated liabilities

The movement in subordinated liabilities during the year was as follows:	Group £m
At 1 January 2011	**16,674**
Repurchases and redemptions during the year	**(2,696)**
Foreign exchange and other movements	**(365)**
At 31 December 2011	**13,613**

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Preference shares	**–**	–	**–**	–
Preferred securities	**3,472**	3,260	**–**	–
Undated subordinated liabilities	**759**	1,212	**2,071**	2,118
Dated subordinated liabilities	**9,382**	12,202	**7,247**	9,499
Total subordinated liabilities	**13,613**	16,674	**9,318**	11,617

	Group		Company	
Preference shares	**2011 £m**	2010 £m	**2011 £m**	2010 £m
6% Non-cumulative Redeemable preference shares	**–**	–	**–**	–

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

		Group	
Preferred securities	Note	**2011 £m**	2010 £m
6.071% Non-cumulative Perpetual Preferred Securities (US$750 million)		**537**	544
6.85% Non-cumulative Perpetual Preferred Securities (US$1,000 million)	b	**918**	736
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities (£600 million)		**603**	603
8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million)	b, c	**260**	253
7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million)		**151**	151
7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million)		**322**	272
7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million)	b, d	**350**	372
4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million)	a	**30**	28
7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million)		**151**	151
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)		**150**	150
Total preferred securities		**3,472**	3,260

44 Subordinated liabilities (continued)

Undated subordinated liabilities	Note	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019 (£500 million)	a	**4**	3	**4**	3
6.071% Undated Subordinated Fixed to Floating Rate Instruments (US$750 million)		**–**	–	**484**	482
4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	a	**90**	88	**90**	88
Floating Rate Undated Subordinated Notes (€500 million)	a	**53**	53	**53**	53
5.375% Undated Fixed to Floating Rate Subordinated Notes (US$1,000 million)	a	**11**	11	**11**	11
5.125% Undated Subordinated Fixed to Floating Notes (€750 million)	a	**67**	66	**67**	66
5.75% Undated Subordinated Step-up Notes (£600 million)		**4**	4	**4**	4
6.85% Undated Subordinated Notes (US$1,000 million)		**–**	–	**640**	635
Fixed to Floating Rate Undated Subordinated Notes (£600 million)		**–**	–	**603**	603
6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	b, e, f	**22**	67	**22**	67
7.5% Undated Subordinated Step-up Notes (£300 million)		**6**	4	**6**	4
8.625% Perpetual Subordinated Notes (£200 million)	a	**26**	24	**–**	–
7.375% Undated Subordinated Guaranteed Bonds (£200 million) (Clerical Medical Finance plc)		**–**	51	**–**	–
Floating Rate Undated Subordinated Step-up Notes (€300 million)	b, f	**33**	63	**33**	63
Floating Rate Primary Capital Notes (US$250 million)		**118**	118	**–**	–
7.375% Subordinated Undated Instruments (£150 million)	a	**78**	76	**–**	–
4.25% Instruments (¥17 billion)		**174**	161	**–**	–
10.25% Subordinated Undated Instruments (£100 million)	a	**1**	1	**–**	–
12% Perpetual Subordinated Bonds (£100 million)	a	**26**	22	**–**	–
8.75% Perpetual Subordinated Bonds (£100 million)	a	**5**	5	**–**	–
13.625% Perpetual Subordinated Bonds (£75 million)	a	**17**	16	**–**	–
9.375% Perpetual Subordinated Bonds (£50 million)	a	**18**	16	**–**	–
5.75% Undated Subordinated Step-up Notes (£500 million)		**6**	6	**6**	6
4.25% Perpetual Fixed to Floating Rate Reset Subordinated Guaranteed Notes (€750 million) (Clerical Medical Finance plc)		**–**	357	**–**	–
4.939% Undated Fixed to Floating Rate Subordinated Notes (€750 million)		**–**	–	**34**	33
Undated Perpetual Preferred Securities (£750 million)		**–**	–	**14**	–
Total undated subordinated liabilities		**759**	1,212	**2,071**	2,118

44 Subordinated liabilities (continued)

		Group		Company	
Dated subordinated liabilities	Note	**2011 £m**	2010 £m	**2011 £m**	2010 £m
6.50% Notes 2011 (US$150 million)		**–**	99	**–**	–
5.50% Subordinated Fixed Rate Notes 2012 (€750 million)		**658**	699	**–**	–
6.25% Instruments 2012 (€12.8 million)		**8**	10	**–**	–
6.125% Notes 2013 (€325 million)		**287**	296	**–**	–
4.25% Subordinated Guaranteed Notes 2013 (US$1,000 million)		**676**	688	**649**	–
11% Subordinated Bonds 2014 (£250 million)		**276**	276	**–**	–
4.875% Subordinated Notes 2015 (€1,000 million)		**951**	974	**868**	974
Step-up Floating Rate Subordinated Notes 2016 (€500 million)	f, g	**143**	431	**143**	431
Callable Floating Rate Subordinated Notes 2016 (€500 million)	f, g	**198**	431	**198**	431
Subordinated Callable Notes 2016 (US$750 million)	f, g	**321**	481	**321**	481
Subordinated Callable Notes 2017 callable 2012 (€1,000 million)	f	**385**	861	**385**	861
Subordinated Callable Notes 2017 callable 2012 (US$1,000 million)	f	**315**	640	**315**	640
Subordinated Callable Floating Rate Instruments 2017 callable 2012 (Aus$400 million)	f	**44**	263	**44**	263
6.75% Subordinated Callable Fixed to Floating Rate Instruments 2017 callable 2012 (Aus$200 million)	f	**11**	135	**11**	135
5.109% Callable Fixed to Floating Rate Notes 2017 callable 2012 (Can$500 million)	f	**18**	338	**18**	338
6.305% Subordinated Callable Fixed to Floating Rate Notes 2017 callable 2012 (£500 million)	f	**37**	545	**37**	545
10.5% Subordinated Bonds 2018 (£150 million)		**164**	163	**–**	–
6.75% Subordinated Fixed Rate Notes 2018 (US$2,000 million)		**1,455**	1,465	**1,455**	1,465
6.375% Instruments 2019 (£250 million)		**328**	301	**–**	–
4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)		**700**	712	**633**	712
9.375% Subordinated Bonds 2021 (£500 million)		**667**	608	**–**	–
5.374% Subordinated Fixed Rate Notes 2021 (€160 million)		**172**	164	**172**	164
6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023 (€400 million) (Clerical Medical Finance plc)		**–**	195	**–**	–
7.07% Subordinated Fixed Rate Notes 2023 (€175 million)		**174**	162	**174**	162
4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)		**667**	682	**667**	682
6.00% Subordinated Notes 2033 (US$750 million)		**727**	583	**484**	583
7.881% Subordinated Extendable Maturity Notes 2048 (£245 million)		**–**	–	**248**	273
Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048 (€415 million)		**–**	–	**425**	359
Total dated subordinated liabilities		**9,382**	12,202	**7,247**	9,499

a) In November 2009, as part of the state aid restructuring plan, the Group agreed to suspend the payment of coupons on these instruments for the two year period from 31 January 2010 to 31 January 2012.

b) These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012.

c) The fixed rate on this security was reset from 8.117 per cent to 6.059 per cent with effect from 31 May 2010.

d) The fixed rate on this security was reset from 7.627 per cent to 3 months Euribor plus 2.875 per cent with effect from 9 December 2011.

e) The fixed rate on this security was reset from 6.05 per cent to 3 months Euribor plus 2.25 per cent with effect from 23 November 2011.

f) Following an exchange, on 1 December 2011, certain holders elected to exchange some or all of the notes they held for new dated subordinated liabilities issued by Lloyds TSB Bank plc.

g) These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval of the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012. The interest rate payable on these securities reset during 2011.

At 31 December 2011 £12,947 million (2010: £16,575 million) of subordinated liabilities of the Group and £9,318 million (2010: £11,617 million) of the Company has a contractual residual maturity of greater than one year.

44 Subordinated liabilities (continued)

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.

45 Share capital

(1) Authorised share capital

	Group and Company			
	2011 Number of shares	2010 Number of shares	**2011 £m**	2010 £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

(2) Issued share capital

	Group and Company			
	2011 Number of shares	2010 Number of shares	**2011 £m**	2010 £m
Ordinary shares of 25p each				
At 1 January	**15,053,262,841**	15,050,663,336	**3,763**	3,763
Share issuances in 2010 (see below)	**–**	2,599,505	**–**	–
At 31 December	**15,053,262,841**	15,053,262,841	**3,763**	3,763
Issued and fully paid preference shares				
Preference shares of £1 each				
At 1 January and 31 December	**100**	100	**–**	–
Total share capital at 31 December	**15,053,262,941**	15,053,262,941	**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.

46 Share premium account

	Group and Company 2011 £m	2010 £m
At 1 January	**18,655**	16,056
Issue of ordinary and preference shares (see note 45)	**–**	2,599
At 31 December	**18,655**	18,655

47 Other reserves

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £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	**(498)**	(894)	**–**	–
Cash flow hedging reserve	**859**	(417)	**(1)**	(2)
Foreign currency translation reserve	**(30)**	(24)	**16**	16
At 31 December	**10,523**	8,857	**9,693**	9,692

Movements in other reserves were as follows:

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Merger and other reserves				
At 1 January and 31 December	**10,051**	10,051	**9,537**	9,537

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Capital redemption reserve				
At 1 January and 31 December	**141**	141	**141**	141

	Group	
	2011 £m	2010 £m
Revaluation reserve in respect of available-for-sale financial assets		
At 1 January	**(894)**	(1,395)
Change in fair value of available-for-sale financial assets	**(77)**	205
Deferred tax	**45**	(95)
Current tax	**1**	(3)
	(31)	107
Income statement transfers:		
Disposals	**(72)**	(52)
Deferred tax	**(28)**	7
	(100)	(45)
Impairment	**749**	641
Deferred tax	**(166)**	(157)
	583	484
Other transfers to income statement	**(76)**	(62)
Deferred tax	**20**	17
	(56)	(45)
At 31 December	**(498)**	(894)

47 Other reserves (continued)

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
Cash flow hedging reserve				
At 1 January	**(417)**	(840)	**(2)**	(2)
Change in fair value of hedging derivatives	**1,350**	(781)	**–**	–
Deferred tax	**(354)**	201	**–**	–
Current tax	–	(3)	–	–
	996	(583)	**–**	–
Income statement transfer	**373**	1,378	**1**	–
Deferred tax	**(93)**	(372)	**–**	–
	280	1,006	**1**	–
At 31 December	**859**	(417)	**(1)**	(2)

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
Foreign currency translation reserve				
At 1 January	**(24)**	180	**16**	16
Currency translation differences arising in the year	**(6)**	(204)	**–**	–
At 31 December	**(30)**	(24)	**16**	16

48 Retained profits

	Group 2011 £m	Group 2010 £m	Company 2011 £m	Company 2010 £m
At 1 January	**(5,415)**	(3,071)	**(4,681)**	(6,625)
(Loss) profit for the year[1]	**(3,763)**	(2,351)	**(297)**	1,944
Employee share option schemes – value of employee services	**8**	7	**–**	–
At 31 December	**(9,170)**	(5,415)	**(4,978)**	(4,681)

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

49 Dividends

No dividends were paid on the Company's ordinary shares in 2011 or 2010.

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 was prevented from making dividend payments on its ordinary shares during this period.

50 Share-based payments

Share-based payment scheme details
During the year ended 31 December 2011 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; these are managed and operated on a Lloyds Banking Group-wide basis.

The amount charged to the Group's income statement in respect of Lloyds Banking Group share-based payment schemes, and which is included within staff costs (note 11), was £155 million (2010: £244 million).

Deferred bonus plans
Bonuses in respect of the performance in 2011 of employees within certain of the Group's bonus plans have been recognised in these financial statements in full.

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.

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.

50 Share-based payments (continued)

Movements in the number of share options outstanding under the executive share option schemes during 2010 and 2011 are set out below:

	2011		2010	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	13,363,301	233.09	8,784,978	476.56
Rebasement adjustment	–	–	7,523,547	(26.43)
Exercised	–	–	–	–
Forfeited	(2,140,790)	225.91	(2,945,224)	296.36
Lapsed	(1,047,642)	324.92	–	–
Outstanding at 31 December	10,174,869	225.15	13,363,301	233.09
Exercisable at 31 December	10,174,869	225.15	13,363,301	233.09

No options were exercised during 2011 or 2010. The weighted average remaining contractual life of options outstanding at the end of the year was 2.9 years (2010: 3.6 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:

	2011		2010	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	668,044,034	49.59	130,133,992	177.60
Rebasement adjustment	–	–	22,382,641	(416.83)
Granted	–	–	655,712,663	46.78
Exercised	(2,497,658)	47.34	(195,339)	49.30
Forfeited	(18,408,624)	50.52	(13,922,185)	57.34
Cancelled	(181,350,614)	47.78	(107,144,275)	66.53
Expired	(12,768,106)	69.08	(18,923,463)	179.35
Outstanding at 31 December	453,019,032	49.74	668,044,034	49.59
Exercisable at 31 December	25,490,233	77.82	663,942	172.93

The weighted average share price at the time that the options were exercised during 2011 was £0.54 (2010: £0.69). The weighted average remaining contractual life of options outstanding at the end of the year was 1.7 years (2010: 2.7 years).

No SAYE options were granted in 2011. The weighted average fair value of SAYE options granted during 2010 was £0.33. 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 2011 or 2010. The options outstanding at 31 December 2011 had an exercise price of £1.8066 (2010: £1.8066) and a weighted average remaining contractual life of 2.0 years (2010: 2.9 years).

50 Share-based payments (continued)

Other share option plans

Lloyds Banking Group executive share plan 2003

The plan was adopted in December 2003 and under the plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The plan's usage has now been extended to not only compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

	2011		2010	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**47,694,757**	**Nil**	26,099,185	Nil
Granted	**16,395,016**	**Nil**	13,429,561	Nil
Rebasement adjustment	**–**	**–**	12,501,246	Nil
Exercised	**(7,591,526)**	**Nil**	(2,661,703)	Nil
Forfeited	**(3,498,178)**	**Nil**	(1,673,532)	Nil
Outstanding at 31 December	**53,000,069**	**Nil**	47,694,757	Nil
Exercisable at 31 December	**2,310,418**	**Nil**	–	Nil

The weighted average fair value of options granted in the year was £0.46 (2010: £0.63). The weighted average share price at the time that the options were exercised during 2011 was £0.51 (2010: £0.63). The weighted average remaining contractual life of options outstanding at the end of the year was 2.1 years (2010: 2.4 years).

Lloyds Banking Group Share Buy Out Awards

As part of arrangements to facilitate the recruitment of certain Executives, options have been granted by individual deed and, where appropriate, in accordance with the Listing Rules of the UK Listing Authority.

The awards were granted in recognition that the Executives' outstanding awards over shares in their previous employing company lapsed on accepting employment with the Group.

Movements in the number of options outstanding are set out below:

	2011	
	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**–**	**–**
Granted	**21,728,172**	**Nil**
Exercised	**(406,935)**	**Nil**
Outstanding at 31 December	**21,321,237**	**Nil**
Exercisable at 31 December	**2,398,593**	**Nil**

The weighted average fair value of options granted in the year was £0.38. The weighted average share price at the time that the options were exercised during 2011 was £0.54. The weighted average remaining contractual life of options outstanding at the end of the year was 9.6 years.

HBOS share option plans

The table below details the outstanding options for the HBOS Share Option Plan and the St James's Place Share Option Plan. The final award under the HBOS Share Option Plan was made in 2004. Under this plan, options over shares, at market value with a face value equal to 20 per cent of salary, were granted to employees with the exception of certain senior executives. A separate option plan exists for some partners of St James's Place, which granted options in respect of Lloyds Banking Group plc shares. The final award under the St James's Place Share Option Plan was made in 2009. Movements in the number of share options outstanding under these schemes are set out below:

	2011		2010	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**24,695,494**	**415.70**	14,301,748	880.27
Rebasement adjustment	**–**	**–**	12,899,990	(61.23)
Forfeited	**(213,498)**	**253.88**	(2,506,244)	611.90
Lapsed	**(2,423,444)**	**624.75**	–	–
Outstanding at 31 December	**22,058,552**	**394.30**	24,695,494	415.70
Exercisable at 31 December	**14,227,020**	**582.82**	15,320,780	593.79

50 Share-based payments (continued)

No options were exercised during 2011 or 2010. The options outstanding under the HBOS Share Option Plan and St James's Place Share Option Plan at 31 December 2011 had exercise prices in the range of £0.5183 to £8.7189 (2010: £0.5183 to £8.7189) and a weighted average remaining contractual life of 2.0 years (2010: 3.0 years).

Other share plans

Lloyds Banking Group long-term incentive plan

The Long-Term Incentive Plan (LTIP) introduced in 2006 is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Group over a three year period. Awards are made within limits set by the rules of the plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

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 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 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 2008 and ended on 31 December 2010.

(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 (13 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 6 March 2008 and ended on 5 March 2011.

In 2008, awards were made of 375 per cent of base salary to the Group Chief Executive and two of the Executive Directors for retention purposes, and in light of data reviewed by the Remuneration Committee which showed total remuneration to be behind median both for the FTSE 20, and the other major UK banks.

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 vested at 29 per cent in March 2011.

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

(i) **Earnings per share (EPS):** relevant to 50 per cent of the award. Performance will be measured based on EPS growth over a three-year period from the baseline EPS of 2008.

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

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

The EPS and EP performance measures applying to this 2009 LTIP award were set on the basis that the Group would enter into the Government Asset Protection Scheme. As the Group 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 EP 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 for each of the three years of the award has been assessed and all targets have been met or exceeded.

(i) **EPS:** relevant to 50 per cent of the award. Performance will be measured based on EPS growth over a three-year period from the baseline EPS of 2009.

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.

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

50 Share-based payments (continued)

(ii) **EP:** relevant to 50 per cent of the award. Performance will be measured based on the compound annual growth rate of adjusted EP over the three financial years starting on 1 January 2010 relative to an adjusted 2009 EP base.

If the compounded annual growth rate of adjusted EP 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 EP 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 EP performance measures have been satisfied at the threshold level or above. The EPS and EP performance conditions will each relate to 36 per cent of the total award.

The performance conditions for awards made in March and September 2011 are as follows:

(i) **EPS:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EPS outcome.

If the adjusted EPS reaches 6.4p, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted EPS reaches 7.4p, 100 per cent of this element will vest.

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

(ii) **EP:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EP outcome.

If the adjusted EP reaches £567 million, 25 per cent of this element of the award, being the threshold, will vest. If the adjusted EP reaches £1,234 million, 100 per cent of this element will vest.

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

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Total Shareholder Return, relevant to one third of the award. Performance will be measured based on the annualised Absolute Total Shareholder Return over the three year performance period. If the annualised Absolute Total Shareholder Return at the end of the performance period is less than 8 per cent, none of this element of the award will vest. If the Absolute Total Shareholder Return is 8 per cent, 25 per cent of this element of the award, being the threshold, will vest. If the Absolute Total Shareholder Return is 14 per cent or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis. The EPS and EP performance conditions will each relate to 33.3 per cent of the total award.

	2011 Number of shares	2010 Number of shares
Outstanding at 1 January	**447,142,491**	223,233,052
Granted	**147,280,077**	148,810,591
Rebasement adjustment	**–**	106,990,259
Vested	**(3,918,013)**	(1,985,339)
Forfeited	**(46,766,369)**	(29,906,072)
Outstanding at 31 December	**543,738,186**	447,142,491

The fair value of the share awards granted in 2011 was £0.54 (2010: £0.61).

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

	Executive schemes			**SAYE schemes**			**Other share option plans**		
	Weighted average exercise price (pence)	**Weighted average remaining life (years)**	**Number of options**	**Weighted average exercise price (pence)**	**Weighted average remaining life (years)**	**Number of options**	**Weighted average exercise price (pence)**	**Weighted average remaining life (years)**	**Number of options**
At 31 December 2011									
Exercise price range									
£0 to £1	**–**	**–**	**–**	**47.94**	**1.7**	**446,965,447**	**4.94**	**4.1**	**82,152,838**
£1 to £2	**199.91**	**2.6**	**233,714**	**179.16**	**2.0**	**5,563,072**	**–**	**–**	**–**
£2 to £3	**225.74**	**2.9**	**9,941,155**	**214.16**	**0.9**	**490,513**	**–**	**–**	**–**
£3 to £4	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
£5 to £6	**–**	**–**	**–**	**–**	**–**	**–**	**582.82**	**1.8**	**14,227,020**

50 Share-based payments (continued)

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
At 31 December 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

The fair value calculations at 31 December 2011 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	Executive Share Plan 2003	**LTIP**	**Share Buy Out Awards**
Risk-free interest rate	**0.73%**	**1.77%**	**0.86%**
Expected life	**1.4 years**	**3.0 years**	**1.3 years**
Expected volatility	**54%**	**86%**	**51%**
Expected dividend yield	**1.7%**	**2.9%**	**1.6%**
Weighted average share price	**0.48**	**0.62**	**0.41**
Weighted average exercise price	**Nil**	**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.

The last award of free shares was made in 2008.

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £30 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100 per cent of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2011 was 30,999,387 (2010: 17,411,651), with an average fair value of £0.42 (2010: £0.63), based on market prices at the date of award.

51 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 2011, 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.

	2011 £m	2010 £m
Compensation		
Salaries and other short-term benefits	**6**	4
Post-employment benefits	**–**	1
Share-based payments	**6**	4
Total compensation	**12**	9

The aggregate of the emoluments of the directors was £4.3 million (2010: £5.3 million). The total for the highest paid director (António Horta-Osório) was £2,061,000,(2010: (J E Daniels) £1,286,000).

	2011 million	2010 million
Share options over Lloyds Banking Group plc shares		
At 1 January	**6**	2
Granted, including certain adjustments[1] (includes entitlement of appointed directors)	**20**	4
Exercised/lapsed (includes entitlements of former director)	**(4)**	–
At 31 December	**22**	6

[1]2010 includes adjustments, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.

	2011 million	2010 million
Share incentive plans settled in Lloyds Banking Group plc shares		
At 1 January	**56**	19
Granted, including certain adjustments[1] (includes entitlements of appointed directors)	**35**	39
Exercised/lapsed (includes 31 million entitlements of former directors)	**(33)**	(2)
At 31 December	**58**	56

[1]2010 includes adjustments, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between the Lloyds Banking Group and its key management personnel:

	2011 £m	2010 million
Loans		
At 1 January	**3**	2
Advanced (includes loans of appointed directors)	**1**	2
Repayments (includes loans of former directors)	**(1)**	(1)
At 31 December	**3**	3

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 1.09 per cent and 27.5 per cent in 2011 (2010: 0.50 per cent and 17.90 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2010: £nil).

	2011 £m	2010 million
Deposits		
At 1 January	**4**	4
Placed (includes deposits of appointed directors)	**17**	12
Withdrawn (includes deposits of former directors)	**(15)**	(12)
At 31 December	**6**	4

Deposits placed by key management personnel attracted interest rates of up to 5 per cent in 2011 (2010: 4.25 per cent).

At 31 December 2011, the Group did not provide any guarantees in respect of key management personnel (2010: none).

At 31 December 2011, 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 £3 million with four directors and three connected persons. (2010: £2 million with six directors and four connected persons).

51 Related party transactions (continued)

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:

	2011 £m	2010 £m
Assets, included within:		
Amounts owed by Group entities	**36,607**	41,818
Derivative financial instruments	**1,857**	2,061
	38,464	43,879
Liabilities, included within:		
Amounts owed to Group entities	**27,509**	33,749
Subordinated liabilities	**3,035**	–
	30,544	33,749

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 2011 the Company earned interest income on the above asset balances of £1,539 million (2010: £1,551 million) and incurred interest expense on the above liability balances of £654 million (2010: £573 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	
	2011 £m	2010 £m	**2011 £m**	2011 £m
Assets included within:				
Derivative financial instruments	**4,196**	1,437	**–**	–
Loans and receivables:				
Loans and advances to banks	**85,800**	55,053	**–**	–
Loans and advances to customers	**11,698**	10,205	**8,611**	7,869
Trading and other financial assets at fair value through profit or loss	**7,515**	3,475	**–**	–
Other	**2,681**	766	**2,160**	–
	111,890	70,936	**10,771**	7,869
Liabilities included within:				
Deposits from banks	**144,502**	131,133	**–**	–
Customer deposits	**16,460**	16,489	**7,394**	7,862
Derivative financial instruments	**6,703**	1,853	**–**	–
Subordinated liabilities	**272**	312	**18**	273
Trading financial liabilities	**6,690**	3,294	**–**	–
Other liabilities	**1,559**	2,537	**345**	–
	176,186	155,618	**7,757**	8,135

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 2011 the Group earned £920 million and the Company earned £103 million of interest income on the above asset balances (2010: Group £658 million; Company £32 million); the Group incurred £1,974 million and the Company incurred £200 million of interest expense on the above liability balances (2010: Group £1,249 million; Company £245 million).

In July 2011, as a result of a restructuring of the insurance operations of the Lloyds Banking Group, the life, pensions and general insurance subsidiaries of the Group were sold to fellow subsidiaries of the Lloyds Banking Group. Further details are provided in note 14.

UK Government
In January 2009, the UK Government through HM Treasury became a related party of Lloyds Banking Group plc, the Bank's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 31 December 2011, HM Treasury held a 40.2 per cent (31 December 2010: 40.6 per cent) interest in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of the Company during the year ended 31 December 2011.

From 1 January 2011, in accordance with IAS 24 (Revised), UK Government-controlled entities became related parties of the Group. The Group regards the Bank of England and entities controlled by the UK Government, including The Royal Bank of Scotland Group plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc, as related parties.

Since 31 December 2010, the Group has had the following significant transactions with the UK Government or UK Government-related entities:

51 Related party transactions (continued)

Government and central bank facilities
During the year ended 31 December 2011, the Lloyds Banking Group participated in a number of schemes operated by the UK Government and central banks and made available to eligible banks and building societies.

Special liquidity scheme and credit guarantee scheme
The Bank of England's UK Special Liquidity Scheme was launched in April 2008 to allow financial institutions to swap temporarily illiquid assets for treasury bills, with fees charged based on the spread between 3-month LIBOR and the 3-month gilt repo rate. The scheme will operate for up to three years after the end of the drawdown period (30 January 2009) at the Bank of England's discretion. At 31 December 2011, the Lloyds Banking Group did not utilise the Special Liquidity 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 charged a commercial fee for the guarantee of new short and medium term debt issuance. The fee payable to HM Treasury on guaranteed issues was based on a per annum rate of 50 basis points plus the median five-year credit default swap spread. The drawdown window for the Credit Guarantee Scheme closed for new issuance at the end of February 2010. At 31 December 2011, the Lloyds Banking Group had £23.5 billion of debt in issue under the Credit Guarantee Scheme (31 December 2010: £45.4 billion). During the year, fees of £28 million paid to HM Treasury in respect of guaranteed funding were included in the Lloyds Banking Group's income statement.

Lending commitments
The formal lending commitments entered into in connection with the Group's proposed participation in the Government Asset Protection Scheme have now expired and in February 2011, Lloyds Banking Group plc (together with Barclays, Royal Bank of Scotland, HSBC and Santander) announced, as part of the 'Project Merlin' agreement with HM Treasury, its capacity and willingness to increase business lending (including to small and medium-sized enterprises) during 2011.

Business Growth Fund
In May 2011 the Lloyds Banking Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to subscribe for shares in the Business Growth Fund plc which is the company created to fulfil the role of the Business Growth Fund as set out in the British Bankers' Association's Business Taskforce Report of October 2010. During 2011 the Lloyds Banking Group has incurred sunk costs of £4 million which have been written-off.

As at 31 December 2011, the Lloyds Banking Group's investment in the Business Growth Fund was £20 million.

Other government-related entities
Other than the transactions referred to above, there were no other significant transactions with the UK Government and UK Government-controlled entities (including UK Government-controlled banks) during the period that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Other related party disclosures
Pension Funds
At 31 December 2011 there were customer deposits of £32 million (2010: £35 million) and investment and insurance contract liabilities of £383 million (2010: £850 million) related to the Group's pension arrangements. During 2011, the Group sold at fair value certain non-government bonds, equities and alternative assets to Lloyds TSB Group Pension Scheme No 1 for £79 million and to Lloyds TSB Group Pension Scheme No 2 for £43 million.

Open Ended Investment Companies (OEICs)
The Group manages 30 (2010: 291) Open Ended Investment Companies (OEICs), and of these 22 (2010: 65) are consolidated. The Group invested £649 million (2010: £613 million) and redeemed £393 million (2010: £239 milllion) in the unconsolidated OEICs during the year and had investments, at fair value, of £933 million (2010: £4,317 million) at 31 December. The Group earned fees of £65 million from the unconsolidated OEICs (2010: £42 million).

Joint Ventures and associates
The Group provides both administration and processing services to its principal joint venture, Sainsbury's Bank plc. The amounts receivable by the Group during the year were £21 million (2010: £31 million), of which £10 million is outstanding at the year end (2010: £8 million). At 31 December 2011, Sainsbury's Bank plc also had balances with the Group that were included in loans and advances to banks of £1,173 million (2010: £1,277 million) deposits by banks of £780 million (2010: £1,358 million) and trading liabilities of £340 million (2010: nil).

At 31 December 2011 there were loans and advances to customers of £5,185 million (2010: £5,660 million) outstanding and balances within customer deposits of £88 million (2010: £151 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 2011, these companies had total assets of approximately £7,330 million (2010: £4,713 million), total liabilities of approximately £6,528 million (2010: £4,199 million) and for the year ended 31 December 2011 had turnover of approximately £3,950 million (2010: £744 million) and made a net loss of approximately £86 million (2010: net profit of £164 million). In addition, the Group has provided £4,588 million (2010: £1,406 million) of financing to these companies on which it received £27 million (2010: £19 million) of interest income in the year.

Taxation
Group relief was surrendered for no payment, as per note 15.

52 Contingent liabilities and commitments

Legal proceedings
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 set a uniform multilateral interchange fee (MIF) 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 MIF 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

52 Contingent liabilities and commitments (continued)

issuers) have successfully applied to intervene in the appeal in support of MasterCard's position that the arrangements for the charging of the MIF are compatible with European Union competition laws. The UK Government has also intervened in the General Court appeal supporting the European Commission position. An oral hearing took place on 8 July 2011 but judgment is not expected for six to twelve months. MasterCard has reached an understanding with the European Commission on a new methodology for calculating intra-European Economic Area MIF on an interim basis pending the outcome of the appeal.

Meanwhile, the European Commission is pursuing an investigation with a view to deciding whether arrangements adopted by Visa for the levying of the MIF in respect of cross-border payment transactions also infringe European Union competition laws. In this regard 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 UK's Office of Fair Trading has also commenced similar investigations relating to the MIF in respect of domestic transactions in relation to both the MasterCard and Visa payment schemes. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

Interbank offered rate setting investigations

Several government agencies in the UK, US and overseas, including the US Commodity Futures Trading Commission, the US SEC, the US Department of Justice and the FSA as well as the European Commission, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates. The Group, and/or its subsidiaries, were (at the relevant time) and remain members of various panels that submit data to these bodies. The Group has received requests from some government agencies for information and is co-operating with their investigations. In addition, the Group has been named in private lawsuits, including purported class action suits in the US with regard to the setting of London interbank offered rates (LIBOR). It is currently not possible to predict the scope and ultimate outcome of the various regulatory investigations or private lawsuits, including the timing and scale of the potential impact of any investigations and private lawsuits on the Group.

Financial Services Compensation Scheme (FSCS)

The FSCS is the UK's independent statutory compensation fund for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS is funded by levies on the industry (and recoveries and borrowings where appropriate). The levies raised comprise both management expenses levies and, where necessary, compensation levies on authorised firms.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. The borrowings with HM Treasury, which total circa £20 billion, are on an interest-only basis until 31 March 2012 and the FSCS and HM Treasury are currently discussing the terms for refinancing these borrowings to take effect from 1 April 2012. Each deposit-taking institution contributes towards the management expenses levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March. In determining an appropriate accrual in respect of the management expenses levy, certain assumptions have been made including the proportion of total protected deposits held by the Group, the level and timing of repayments to be made by the FSCS to HM Treasury and the interest rate to be charged by HM Treasury. For the year ended 31 December 2011, the Group has charged £86 million (2010: £28 million) to the income statement in respect of the costs of the FSCS.

Whilst it is expected that the substantial majority of the principal will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, to the extent that there remains a shortfall, the FSCS will raise compensation levies on all deposit-taking participants. The amount of any future compensation levies also depends on a number of factors including the level of protected deposits and the population of deposit-taking participants and will be determined at a later date. As such, although the Group's share of such compensation levies could be significant, the Group has not recognised a provision in respect of them in these financial statements.

Shareholder complaints

Lloyds Banking Group plc and two former members of Lloyds Banking Group plc's Board of Directors have been named as defendants in a purported securities class action pending in the United States District Court for the Southern District of New York. The complaint, dated 23 November 2011, asserts claims under the Securities Exchange Act of 1934 in connection with alleged material omissions from statements made in 2008 in connection with the acquisition of HBOS by Lloyds Banking Group plc. No quantum is specified.

In addition, a UK-based shareholder action group has threatened multi-claimant claims on a similar basis against the Lloyds Banking Group plc and two former directors in the UK. No claim has yet been issued.

Lloyds Banking Group plc considers that the claims are without merit and will defend them vigorously. The claims have not been quantified and it is not possible to estimate the ultimate financial impact on Lloyds Banking Group plc or the Group at this early stage.

FSA investigation into Bank of Scotland

In 2009 the FSA commenced a supervisory review into HBOS. The supervisory review has now been superseded as the FSA has commenced enforcement proceedings against Bank of Scotland plc in relation to its Corporate division pre 2009. The proceedings are ongoing and the Group is co-operating fully. It is too early to predict the outcome or estimate reliably any potential financial effects of the enforcement proceedings but they are not currently expected to be material to the Group.

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, including complaints handling, packaged bank accounts, savings accounts, product terms and conditions, interest only mortgages, sales processes and remuneration schemes. The Group is keen to ensure that any regulatory concerns are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

Other legal actions and regulatory matters

In addition, during the ordinary course of business the Group is subject to other threatened and actual legal proceedings (which may include class action lawsuits brought on behalf of customers, shareholders or other third parties), regulatory investigations, regulatory challenges and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed properly to assess the merits of the case and no provisions are held against such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position.

52 Contingent liabilities and commitments (continued)

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	
	2011 £m	2010 £m
Contingent liabilities		
Acceptances and endorsements	**3**	1
Other:		
Other items serving as direct credit substitutes	**110**	103
Performance bonds and other transaction-related contingencies	**674**	568
	784	671
Total contingent liabilities	**787**	672

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	
	2011 £m	2010 £m
Commitments		
Documentary credits and other short-term trade-related transactions	**8**	2
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	**6,311**	6,875
Other commitments	**22,851**	32,144
	29,162	39,019
1 year or over original maturity	**16,442**	17,323
Total commitments	**45,612**	56,344

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £15,087 million (2010: £22,476 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:

	2011 £m	2010 £m
Not later than 1 year	**139**	160
Later than 1 year and not later than 5 years	**478**	564
Later than 5 years	**789**	1,025
Total operating lease commitments	**1,406**	1,749

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 2011 amounted to £nil (2010: £89 million). Of the capital commitments of the Group, £nil (2010: £44 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.

53 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.

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
At 31 December 2011								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	3,075	–	3,075
Items in the course of collection from banks	–	–	–	–	–	379	–	379
Trading and other financial assets at fair value through profit or loss	–	21,840	23,507	–	–	–	–	45,347
Derivative financial instruments	9,588	26,665	–	–	–	–	–	36,253
Loans and receivables:								
Loans and advances to banks	–	–	–	–	91,210	–	–	91,210
Loans and advances to customers	–	–	–	–	357,110	–	–	357,110
Debt securities	–	–	–	–	11,276	–	–	11,276
	–	–	–	–	459,596	–	–	459,596
Available-for-sale financial assets	–	–	–	10,498	–	–	–	10,498
Total financial assets	9,588	48,505	23,507	10,498	459,596	3,454	–	555,148
Financial liabilities								
Deposits from banks	–	–	–	–	–	150,042	–	150,042
Customer deposits	–	–	–	–	–	217,048	–	217,048
Items in course of transmission to banks	–	–	–	–	–	332	–	332
Trading liabilities	–	20,805	–	–	–	–	–	20,805
Derivative financial instruments	6,710	26,675	–	–	–	–	–	33,385
Notes in circulation	–	–	–	–	–	1,145	–	1,145
Debt securities in issue	–	–	–	–	–	75,457	–	75,457
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	385	385
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	22,207	22,207
Financial guarantees	–	–	17	–	–	–	–	17
Subordinated liabilities	–	–	–	–	–	13,613	–	13,613
Total financial liabilities	6,710	47,480	17	–	–	457,637	22,592	534,436

53 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
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
Notes in circulation	–	–	–	–	–	1,074	–	1,074
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
Financial guarantees	–	–	12	–	–	–	–	12
Subordinated liabilities	–	–	–	–	–	16,674	–	16,674
Total financial liabilities	3,681	40,180	12	–	–	478,300	75,533	597,706

Company	**Derivatives designated as hedging instruments £m**	**Loans and receivables £m**	**Held at amortised cost £m**	**Total £m**
At 31 December 2011				
Financial assets				
Derivative financial instruments	**1,857**	**–**	**–**	**1,857**
Loans and receivables:				
Amounts due from fellow Lloyds Banking Group undertakings	**–**	**47,378**	**–**	**47,378**
Total financial assets	**1,857**	**47,378**	**–**	**49,235**
Financial liabilities				
Derivative financial instruments	**10**	**–**	**–**	**10**
Subordinated liabilities	**–**	**–**	**9,318**	**9,318**
Total financial liabilities	**10**	**–**	**9,318**	**9,328**

53 Financial instruments (continued)

Company	Derivatives designated as hedging instruments £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2010				
Financial assets				
Derivative financial instruments	2,061	–	–	2,061
Loans and receivables:				
Amounts due from fellows 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

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 2011 or 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.

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 2011		31 December 2010		31 December 2009	
	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	**269**	**254**	949	965	1,428	1,120
From held for trading to available-for-sale	**1,980**	**1,890**	6,116	6,431	10,478	10,176
From available-for-sale financial assets to loans and receivables	**10,052**	**9,258**	21,508	21,522	29,153	27,820
Total carrying value and fair value	**12,301**	**11,402**	28,573	28,918	41,059	39,116

During the year ended 31 December 2011, the carrying value of reclassified assets decreased by £16,272 million due to sales and maturities of £16,405 million, foreign exchange and other movements of £223 million less accretion of discount of £356 million.

No financial assets were reclassified in accordance with the amendment to IAS 39 in 2011 or 2010; the following disclosures relate to those assets which were reclassified in 2008 and 2009.

53 Financial instruments (continued)

a) Additional fair value gains (losses) that would have been recognised had the reclassifications not occurred

The table below shows the additional gains (losses) that would have been recognised 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.

	2011			2010			2009			2008	
	Reclassified in 2009 £m	**Reclassified in 2008 £m**	**Total £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	**11**	**–**	**11**	14	–	14	13	–	13	–	–
From held for trading to available-for-sale financial assets	**–**	**26**	**26**	–	136	136	–	904	904	981	981
From available-for-sale financial assets to loans and receivables	**–**	**130**	**130**	–	(134)	(134)	70	1,147	1,217	708	708
Total additional fair value gains	**11**	**156**	**167**	14	2	16	83	2,051	2,134	1,689	1,689

b) Actual amounts recognised in respect of reclassified assets

After reclassification the reclassified financial assets contributed the following amounts to the Group income statement:

	2011			**2010**			2009			2008	
	Reclassified in 2009 £m	**Reclassified in 2008 £m**	**Total £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	**16**	**–**	**16**	23	–	23	45	–	45	–	–
Impairment losses	**(13)**	**–**	**(13)**	–	–	–	(110)	–	(110)	–	–
Gains on disposal	**32**	**–**	**32**	109	–	109	17	–	17	–	–
Total amounts recognised	**35**	**–**	**35**	132	–	132	(48)	–	(48)	–	–

	2011			2010			2009			2008	
	Reclassified in 2009 £m	**Reclassified in 2008 £m**	**Total £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	**–**	**141**	**141**	–	184	184	–	281	281	442	442
Impairment losses	**–**	**(8)**	**(8)**	–	1	1	–	(305)	(305)	(215)	(215)
(Losses) gains on disposal	**–**	**(26)**	**(26)**	–	95	95	–	70	70	–	–
Total amounts recognised	**–**	**107**	**107**	–	280	280	–	46	46	227	227

	2011			2010			2009			2008	
	Reclassified in 2009 £m	**Reclassified in 2008 £m**	**Total £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	**–**	**213**	**213**	14	443	457	25	377	402	82	82
Impairment losses	**–**	**(6)**	**(6)**	–	(33)	(33)	–	(371)	(371)	(558)	(558)
(Losses) gains on disposal	**–**	**(323)**	**(323)**	(9)	(128)	(137)	–	(152)	(152)	16	16
Total amounts recognised	**–**	**(116)**	**(116)**	5	282	287	25	(146)	(121)	(460)	(460)

53 Financial instruments (continued)

(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	2011 Carrying value £m	2011 Fair value £m	2010 Carrying value £m	2010 Fair value £m
Financial assets				
Cash and balances at central banks	**3,075**	**3,075**	2,375	2,375
Items in the course of collection from banks	**379**	**379**	319	319
Trading and other financial assets at fair value through profit or loss	**45,347**	**45,347**	103,086	103,086
Derivative financial instruments	**36,253**	**36,253**	30,000	30,000
Loans and receivables:				
Loans and advances to banks	**91,210**	**91,172**	65,170	65,190
Loans and advances to customers	**357,110**	**344,150**	381,365	367,404
Debt securities	**11,276**	**9,479**	23,632	23,790
Available-for-sale financial assets	**10,498**	**10,498**	13,843	13,843
Financial liabilities				
Deposits from banks	**150,042**	**150,140**	143,137	143,631
Customer deposits	**217,048**	**217,860**	216,404	217,462
Items in course of transmission to banks	**332**	**332**	251	251
Trading liabilities	**20,805**	**20,805**	18,786	18,786
Derivative financial instruments	**33,385**	**33,385**	25,075	25,075
Notes in circulation	**1,145**	**1,145**	1,074	1,074
Debt securities in issue	**75,457**	**73,167**	100,760	98,215
Liabilities arising from non-participating investment contracts	**22,207**	**22,207**	35,136	35,136
Financial guarantees	**17**	**17**	12	12
Subordinated liabilities	**13,613**	**8,447**	16,674	16,966

Company	2011 Carrying value £m	2011 Fair value £m	2010 Carrying value £m	2010 Fair value £m
Financial assets				
Derivative financial instruments	**1,857**	**1,857**	2,061	2,061
Amounts due from subsidiaries	**47,378**	**47,378**	49,687	49,687
Financial liabilities				
Derivative financial instruments	**10**	**10**	–	–
Subordinated liabilities	**9,318**	**7,516**	11,617	11,661

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.

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

53 Financial instruments (continued)

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

Cash and balances at central banks and items in the course of collection from banks
The fair value approximates carrying value due to their short-term nature.

Loans and receivables
The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of 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. These techniques also take account of expected credit losses and changes in interest rates and expected future cash flows in establishing fair value. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in 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 deposits
The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits and customer accounts is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

Items in course of transmission to banks
The fair value approximates carrying value due to their short-term nature.

Notes in circulation
The fair value of notes in circulation which are payable on demand is considered to be equal to their carrying value.

Debt securities in issue and subordinated liabilities
The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices.

Valuation of financial instruments carried at fair value
The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1 portfolios
Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise equity shares, treasury bills and other government securities.

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.

53 Financial instruments (continued)

The table below provides an analysis of the financial assets and liabilities of the Group that are carried at fair value in the Group's consolidated balance sheet, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

Valuation hierarchy

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2011				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	17,435	–	17,435
Loans and advances to banks	–	1,355	–	1,355
Debt securities:				
Government securities	992	1,471	–	2,463
Other public sector securities	–	185	–	185
Bank and building society certificates of deposit	–	1,476	–	1,476
Asset-backed securities:				
Mortgage-backed securities	–	9	–	9
Other asset-backed securities	–	–	203	203
Corporate and other debt securities	–	2,805	39	2,844
	992	5,946	242	7,180
Equity shares	18,960	3	190	19,153
Treasury and other bills	224	–	–	224
Total trading and other financial assets at fair value through profit or loss	20,176	24,739	432	45,347
Available-for-sale financial assets				
Debt securities:				
Government securities	74	89	–	163
Bank and building society certificates of deposit	–	32	–	32
Asset-backed securities:				
Mortgage-backed securities	–	789	–	789
Other asset-backed securities	–	57	26	83
Corporate and other debt securities	23	7,515	12	7,550
	97	8,482	38	8,617
Equity shares	51	43	1,787	1,881
Total available-for-sale financial assets	148	8,525	1,825	10,498
Derivative financial instruments	–	35,902	351	36,253
Total financial assets carried at fair value	20,324	69,166	2,608	92,098
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	19,069	–	19,069
Short positions in securities	1,736	–	–	1,736
Total trading liabilities	1,736	19,069	–	20,805
Derivative financial instruments	–	33,354	31	33,385
Financial guarantees	–	–	17	17
Total financial liabilities carried at fair value	1,736	52,423	48	54,207

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

53 Financial instruments (continued)

	Level 1 £m	Level 2 £m	Level 3 £m	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
Total financial assets carried at fair value	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
Total financial liabilities carried at fair value	879	42,948	46	43,873

Valuation methodology

Asset-backed securities

Where there is no trading activity in asset-backed securities, valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes are used to determine an appropriate valuation. Asset-backed securities are then classified as either level 2 or level 3 depending on whether there is more than one consistent independent source of data. If there is a single, uncorroborated market source for a significant valuation input or where there are materially inconsistent levels then the security is reported as level 3. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

Equity investments (including venture capital)

Unlisted equities and fund investments are accounted for as trading and other financial assets at fair value through profit or loss or as available-for-sale financial assets. These investments are valued using different techniques as a result of the variety of investments across the portfolio in accordance with the Group's valuation policy and are calculated using International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

- A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

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 are valued using 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.

53 Financial instruments (continued)

Movements in level 3 portfolio

The table below analyses movements in the level 3 financial assets portfolio:

	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Derivative assets £m	Total financial assets £m
At 1 January 2010	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
Exchange and other adjustments	**(6)**	**(39)**	**–**	**(45)**
Gains recognised in the income statement	**34**	**78**	**39**	**151**
Losses recognised in other comprehensive income	**–**	**(163)**	**–**	**(163)**
Purchases	**6**	**341**	**–**	**347**
Sales	**(389)**	**(474)**	**–**	**(863)**
Transfers into the level 3 portfolio	**331**	**28**	**47**	**406**
Transfers out of the level 3 portfolio	**(128)**	**(13)**	**–**	**(141)**
Disposal of businesses (note 14)	**(412)**	**–**	**–**	**(412)**
At 31 December 2011	**432**	**1,825**	**351**	**2,608**
Gains recognised in the income statement relating to those assets held at 31 December 2011	**23**	**31**	**74**	**128**
Losses recognised in other comprehensive income relating to those assets held at 31 December 2011	**–**	**(147)**	**–**	**(147)**
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

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 2010	196	–	196
Exchange and other adjustments	14	–	14
Purchases	–	12	12
Sales	(210)	–	(210)
Transfers out of the level 3 portfolio	34	–	34
At 31 December 2010	34	12	46
Losses recognised in the income statement	**3**	**5**	**8**
Transfers into the level 3 portfolio	**14**	**–**	**14**
Transfers out of the level 3 portfolio	**(20)**	**–**	**(20)**
At 31 December 2011	**31**	**17**	**48**
Losses recognised in the income statement relating to those liabilities held at 31 December 2011	**(1)**	**(5)**	**(6)**
Gains (losses) recognised in the income statement 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 gains of £128 million (2010: losses of £36 million) related to financial instruments that are held in the level 3 portfolio at the year end. These amounts are included in other operating income.

Included within the gains (losses) recognised in other comprehensive income are losses of £147 million (2010: gains of £269 million) related to financial instruments that are held in the level 3 portfolio at the year end.

53 Financial instruments (continued)

Level 3 portfolio

	Valuation basis/technique	Main assumptions	**At 31 December 2011** Carrying value £m	**Effect of reasonably possible alternative assumptions** Favourable changes £m	Unfavourable changes £m	At 31 December 2010 Carrying value £m	Effect of reasonably possible alternative assumptions Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss								
Asset-backed securities	Lead manager or broker quote/ consensus pricing from market data provider	Use of single pricing source	**203**	**1**	**(1)**	191	6	(6)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value and earnings multiples, forecast cash flows	**229**	**16**	**(19)**	390	74	(58)
Unlisted equities and property partnerships in the life funds	Third party valuations	n/a	**–**	**–**	**–**	415	–	–
			432			996		
Available-for-sale financial assets								
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	**1,825**	**183**	**(88)**	2,067	141	(91)
Derivative financial assets	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**351**	**58**	**(23)**	265	34	(8)
Financial assets			**2,608**			3,328		
Derivative financial liabilities	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**31**	**–**	**–**	34	–	–
Financial guarantees			**17**	**–**	**–**	12	–	–
Financial liabilities			**48**			46		

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

(i) In respect of the embedded equity conversion feature of the enhanced capital notes, the sensitivity was based on the absolute difference between the actual price of the enhanced capital note and the closest, alternative broker quote available plus the impact of applying a 10 bps increase/decrease in the market yield used to derive a market price for similar bonds without the conversion feature. The effect of interdependency of the assumptions is not material to the effect of applying reasonably possible alternative assumptions to the valuations of derivative financial instruments.

(ii) In respect of credit default swaps written on level 3 negative basis asset-backed securities, reasonably possible alternative valuations have been calculated by flexing the spread between the underlying asset and the credit default swap, or adjusting market yields, by a reasonable amount. The sensitivity is determined by applying a 60 bps increase/decrease in the spread between the asset and the credit default swap.

53 Financial instruments (continued)

Venture capital and equity investments
Third party valuers have been used to determine the value of unlisted equities and property partnerships included in the Group's life insurance funds.

The valuation techniques used for unlisted equities and venture capital investments vary depending on the nature of the investment, as described in the valuation methodology section above. Reasonably possible alternative valuations for these investments have been calculated by reference to the relevant approach taken as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

– for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;
– the discount rates used in discounted cash flow valuations; and
– in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

(4) Transferred financial assets that are not derecognised

Repurchase and securities lending transactions
The Group enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets concerned. The carrying value of financial assets transferred under such arrangements, that did not qualify for derecognition, and their associated liabilities are as follows:

	2011		2010	
	Carrying value of transferred assets £m	**Carrying value of associated liabilities £m**	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
Trading and other financial assets at fair value through profit or loss	**890**	**883**	864	873
Debt securities classified as loans and receivables	**7,918**	**7,559**	8,020	7,081
Available-for-sale financial assets	**2,437**	**2,260**	3,007	2,840
Total	**11,245**	**10,702**	11,891	10,794

In all cases the transferee has the right to sell or repledge the assets concerned.

Securitisations and covered bonds
Details about the Group's securitisation and covered bond programmes, which may also result in financial assets not being derecognised in full, are provided in note 20.

54 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 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.

(1) Credit risk
The Group's credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom, the European Union, Australia and the United States. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems on inputs. The Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivatise based transactions.

54 Financial risk management (continued)

A. Maximum credit exposure

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss which includes amounts held to cover unit-linked and with-profit fund liabilities, is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	Group	
	2011 £m	2010 £m
Loans and receivables:		
Loans and advances to customers, net[1]	**357,110**	381,365
Loans and advances to banks, net[1]	**91,210**	65,170
Debt securities, net[1]	**11,276**	23,632
Deposit amounts available for offset[2]	**(2)**	(3,920)
	459,594	466,247
Available-for-sale financial assets (excluding equity shares)	**8,617**	11,667
Trading and other financial assets at fair value through profit or loss (excluding equity shares)[3]:		
Loans and advances	**18,790**	15,695
Debt securities, treasury and other bills	**7,404**	26,610
	26,194	42,305
Derivative assets:		
Derivative assets, before offsetting under master netting arrangements	**36,253**	30,000
Amounts available for offset under master netting arrangements[2]	**(22,816)**	(18,839)
	13,437	11,161
Assets arising from reinsurance contracts held	**38**	1,643
Financial guarantees	**6,011**	12,248
Irrevocable loan commitments and other credit-related contingencies[4]	**15,874**	23,148
Maximum credit risk exposure	**529,765**	568,419
Maximum credit risk exposure before offset items	**552,583**	591,178

[1]Amounts shown net of related impairment allowances.

[2]Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

[3]Includes assets within the Group's unit-linked funds for which credit risk is borne by the policyholders and assets within the Group's With Profits funds for which credit risk is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back related contract liabilities.

[4]See note 52 – Contingent liabilities and commitments for further information.

54 Financial risk management (continued)

B. Credit quality of assets

Loans and receivables

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.

Loans and advances

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2011						
Neither past due nor impaired	**5,404**	**226,256**	**12,715**	**68,006**	**306,977**	**11,051**
Past due but not impaired	**–**	**10,329**	**439**	**1,821**	**12,589**	**–**
Impaired – no provision required	**6**	**940**	**689**	**2,935**	**4,564**	**–**
– provision held	**–**	**5,697**	**533**	**38,403**	**44,633**	**–**
Gross	**5,410**	**243,222**	**14,376**	**111,165**	**368,763**	**11,051**
Allowance for impairment losses (note 23)	**–**	**(2,432)**	**(499)**	**(20,420)**	**(23,351)**	**–**
Net	**5,410**	**240,790**	**13,877**	**90,745**	**345,412**	**11,051**
Due from fellow Lloyds Banking Group undertakings	**85,800**				**11,698**	**7,739**
	91,210				**357,110**	**18,790**
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 23)	–	(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

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 £41,984 million (2010: £44,969 million).

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54 Financial risk management (continued)

Loans and advances which are neither past due nor impaired

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
31 December 2011						
Good quality	**5,319**	**219,014**	**7,823**	**25,630**		**11,047**
Satisfactory quality	**38**	**5,035**	**3,858**	**17,560**		**4**
Lower quality	**–**	**951**	**410**	**17,777**		**–**
Below standard, but not impaired	**47**	**1,256**	**624**	**7,039**		**–**
Total loans and advances which are neither past due nor impaired	**5,404**	**226,256**	**12,715**	**68,006**	**306,977**	**11,051**
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

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				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
31 December 2011						
0-30 days	**–**	**4,746**	**324**	**974**	**6,044**	**–**
30-60 days	**–**	**2,120**	**91**	**386**	**2,597**	**–**
60-90 days	**–**	**1,524**	**19**	**151**	**1,694**	**–**
90-180 days	**–**	**1,939**	**4**	**114**	**2,057**	**–**
Over 180 days	**–**	**–**	**1**	**196**	**197**	**–**
Total loans and advances which are past due but not impaired	**–**	**10,329**	**439**	**1,821**	**12,589**	**–**
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	–

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

54 Financial risk management (continued)

Debt securities classified as loans and receivables

An analysis by credit rating of debt securities classified as loans and receivables is provided below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2011							
Asset-backed securities:							
Mortgage-backed securities	**1,770**	**2,043**	**1,087**	**909**	**307**	**918**	**7,034**
Other asset-backed securities	**3,603**	**374**	**331**	**126**	**304**	**–**	**4,738**
	5,373	**2,417**	**1,418**	**1,035**	**611**	**918**	**11,772**
Corporate and other debt securities	**–**	**–**	**25**	**–**	**–**	**403**	**428**
	5,373	**2,417**	**1,443**	**1,035**	**611**	**1,321**	**12,200**
Due from fellow Group undertakings: mortgage-backed securities							**224**
Total debt securities classified as loans and receivables							**12,424**
At 31 December 2010							
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: mortgage-backed securities							543
Total debt securities classified as loans and receivables							24,923

Available-for-sale financial assets (excluding equity shares)

An analysis of available-for-sale financial assets is included in note 24. The credit quality of available-for-sale financial assets (excluding equity shares) is set out below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2011							
Debt securities:							
Government securities	**89**	**74**	**–**	**–**	**–**	**–**	**163**
Bank and building society certificates of deposit	**–**	**–**	**32**	**–**	**–**	**–**	**32**
Asset-backed securities:							
Mortgage-backed securities	**469**	**121**	**116**	**83**	**–**	**–**	**789**
Other asset-backed securities	**83**	**–**	**–**	**–**	**–**	**–**	**83**
	552	**121**	**116**	**83**	**–**	**–**	**872**
Corporate and other debt securities	**1,591**	**856**	**2,315**	**303**	**–**	**67**	**5,132**
	2,232	**1,051**	**2,463**	**386**	**–**	**67**	**6,199**
Treasury and other bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	2,232	**1,051**	**2,463**	**386**	**–**	**67**	**6,199**
Due from fellow Group undertakings: corporate and other debt securities							**2,418**
Total held as available-for-sale financial assets							**8,617**
At 31 December 2010							
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

54 Financial risk management (continued)

Debt securities, treasury and other bills held at fair value growth profit or loss:

An analysis of trading and other financial assets at fair value through profit or loss is included in note 16. The credit quality of debt securities, treasury and other bills held at fair value through profit or loss is set out below.

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2011							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets							
Government securities	**992**	**–**	**–**	**–**	**–**	**–**	**992**
Bank and building society certificates of deposit	**–**	**1,062**	**322**	**–**	**–**	**–**	**1,384**
Other asset-backed securities	**–**	**151**	**52**	**–**	**–**	**–**	**203**
Corporate and other debt securities	**201**	**–**	**–**	**100**	**–**	**–**	**301**
Total debt securities held as trading assets	**1,193**	**1,213**	**374**	**100**	**–**	**–**	**2,880**
Treasury and other bills	**224**	**–**	**–**	**–**	**–**	**–**	**224**
Total held as trading assets	**1,417**	**1,213**	**374**	**100**	**–**	**–**	**3,104**
Other assets held at fair value through profit or loss							
Government securities	**1,386**	**39**	**44**	**2**	**–**	**–**	**1,471**
Other public sector securities	**97**	**86**	**2**	**–**	**–**	**–**	**185**
Bank and building society certificates of deposit	**–**	**62**	**30**	**–**	**–**	**–**	**92**
Asset-backed securities							
Mortgage-backed securities	**7**	**–**	**2**	**–**	**–**	**–**	**9**
Corporate and other debt securities	**341**	**550**	**437**	**433**	**692**	**90**	**2,543**
Total other assets held at fair value through profit or loss	**1,831**	**737**	**515**	**435**	**692**	**90**	**4,300**
Total held at fair value through profit or loss	**3,248**	**1,950**	**889**	**535**	**692**	**90**	**7,404**
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
Other 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 other assets held at fair value through profit or loss	11,996	1,720	2,321	1,141	868	514	18,560
Total held at fair value through profit or loss	14,050	6,532	3,387	1,259	868	514	26,610

Credit risk in respect of trading and other financial assets at past value through profit or loss held within the Group's unit-linked funds is borne by the policyholders and credit risk in respect of With Profits funds is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back those contract liabilities.

54 Financial risk management (continued)

Derivative assets

An analysis of derivative assets is given in note 17. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's maximum credit risk relating to derivative assets of £13,437 million (2010: £11,161 million), cash collateral of £2,249 million (2010: £1,354 million) was held and a further £1,303 million was due from OECD banks (2010: £2,974 million).

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
Derivative financial instruments							
At 31 December 2011							
Trading	**166**	**10,095**	**6,117**	**2,709**	**1,769**	**1,705**	**22,561**
Hedging	**–**	**6,051**	**2,831**	**590**	**2**	**23**	**9,497**
	166	**16,146**	**8,948**	**3,299**	**1,771**	**1,728**	**32,058**
Due from fellow Group undertakings							**4,195**
Total derivative financial instruments							**36,253**
At 31 December 2010							
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

Assets arising from reinsurance contracts held

Of the assets arising from reinsurance contracts held at 31 December 2011 of £38 million (2010: £1,643 million), all (2010: £355 million) were due from insurers with a credit rating of AA or above.

Financial guarantees and irrevocable loan commitments

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.

C. Collateral held as security for financial assets

The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

Loans and receivables

The disclosures below are produced under the combined businesses approach used for the Group's segmental reporting. The Group believes that, for reporting periods immediately following a significant acquisition, such as the acquisition of HBOS in 2009, this combined businesses basis, which includes the allowance for loan losses at the acquisition on a gross basis, more fairly reflects the underlying provisioning status of the loans.

The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as loans and receivables.

Loans and advances to banks

The Group may require collateral before entering into a credit commitment with another bank, depending on the type of financial product and the counterparty involved, and netting arrangements are obtained whenever possible and to the extent that such agreements are legally enforceable. Collateral is held as part of reverse repurchase or securities borrowing transactions.

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £2,950 million (2010: £20,664 million), against which the Group held collateral with a fair value of £2,950 million (2010: £20,626 million), all of which the Group is able to repledge. Included in these amounts in 2010 are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £4 million.

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Loans and advances to customers

The Group holds collateral against loans and advances to customers in the form of mortgages over residential and commercial real estate, charges over business assets such as premises, inventory and accounts receivable, charges over financial instruments such as debt securities and equities, and guarantees received from third parties.

54 Financial risk management (continued)

Retail lending

Mortgages

An analysis by loan-to-value ratio of the Group's residential mortgage lending is provided below. The value of collateral used in determining the loan-to-value ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations.

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
31 December 2011				
Less than 70 per cent	**85,775**	**2,382**	**1,055**	**89,212**
70 per cent to 80 per cent	**42,089**	**1,532**	**672**	**44,293**
80 per cent to 90 per cent	**38,666**	**1,874**	**890**	**41,430**
90 per cent to 100 per cent	**29,329**	**1,798**	**972**	**32,099**
Greater than 100 per cent	**30,397**	**2,743**	**3,048**	**36,188**
Total	**226,256**	**10,329**	**6,637**	**243,222**

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
31 December 2010				
Less than 70 per cent	85,719	2,428	947	89,094
70 per cent to 80 per cent	39,600	1,509	591	41,700
80 per cent to 90 per cent	38,799	1,976	869	41,644
90 per cent to 100 per cent	31,558	1,992	1,015	34,565
Greater than 100 per cent	34,448	2,824	2,468	39,740
Total	230,124	10,729	5,890	246,743

Other

No collateral is held in respect of retail credit cards or overdrafts, or unsecured personal loans. For non-mortgage retail lending to small businesses, collateral will often include second charges over residential property and the assignment of life cover.

The majority of non-mortgage retail lending is unsecured. At 31 December 2011, total non-mortgage lending amounted to £14,376 million (2010: £16,670 million), against which the Group held an impairment allowance of £499 million (2010: £683 million). Gross impaired non-mortgage retail lending amounted to £1,222 million (2010: £1,352 million). The fair value of the collateral held in respect of this lending was £9 million (2010: £40 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £13,154 million (2010: £15,318 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are monitored throughout the credit lifecycle in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state. The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. Key management personnel review collateral information on a case-by-case basis; no aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

Wholesale lending

Reverse repurchase transactions

There were reverse repurchase agreements which are accounted for as collateralised loans with a carrying value of £14,250 million (2010: £2,579 million), against which the Group held collateral with a fair value of £14,254 million (2010: £2,477 million), all of which the Group is able to repledge. Included in these amounts are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £34 million (2010: £42 million). These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Impaired lending

The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt. At 31 December 2011, total wholesale lending amounted to £111,165 million (2010: £133,063 million), against which the Group held an impairment allowance of £20,420 million (2010: £22,850 million). Gross impaired wholesale lending amounted to £41,338 million (2010: £44,796 million). The fair value of the collateral held in respect of impaired wholesale lending which is secured was £12,301 million (2010: £12,805 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured wholesale lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

54 Financial risk management (continued)

Impaired secured wholesale lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

Unimpaired lending
Wholesale unimpaired secured lending amounted to £69,827 million (2010: £88,267 million). Wholesale lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination. The types of collateral taken and the frequency with which collateral is required at origination is dependent upon the size and structure of the borrower. For exposures to corporate customers and other large institutions, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a mortgagee debenture over the company's undertaking and one or more of its assets, and keyman insurance. The Group maintains policies setting out acceptable collateral, maximum loan-to-value ratios and other criteria to be considered when reviewing a loan application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the customer. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, the provision of collateral will not determine the outcome of a credit application. The fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay debt.

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor. Although lending decisions are predominantly based on expected cash flows, any collateral provided may impact the pricing and other terms of a loan or facility granted; this will have a financial impact on the amount of net interest income recognised and on internal loss-given-default estimates that contribute to the determination of asset quality.

For unimpaired wholesale lending which is secured the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

Unimpaired secured wholesale lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for impaired lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured wholesale lending portfolio is provided to key management personnel.

Trading and other financial assets at fair value through profit or loss (excluding equity shares)
In respect of trading and other financial assets at fair value through profit or loss, the fair value of collateral accepted under reverse repurchase transactions which are accounted for as collateralised loans that the Group is permitted by contract or custom to sell or repledge was £23,655 million (2010: £17,632 million). Of this, £20,055 million was sold or repledged (2010: £7,261 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £53,395 million (2010 £65,766 million). Of this amount, £44,896 million (2010: £65,435 million) had been resold or repledged as collateral for the Group's own transactions.

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Derivative assets, after offsetting of amounts under master netting arrangements
The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £13,437 million (2010: £11,161 million), cash collateral of £2,249 million (2010: £1,354 million) was held.

Irrevocable loan commitments and other credit-related contingencies
At 31 December 2011, there were irrevocable loan commitments and other credit-related contingencies of £15,874 million (2010: £23,148 million). Collateral is held as security, in the event that lending is drawn down, on £4,204 million (2010: £6,345 million) of these balances.

Lending decisions in respect of irrevocable loan commitments are based on the obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. For wholesale unimpaired lending, it is the Group's practice to request sufficient collateral for secured irrevocable loan commitments. For retail mortgage commitments, the majority are for mortgages with a loan-to-value ratio of less than 100 per cent. Aggregated collateral information covering the entire balance of irrevocable loan commitments over which security will be taken is not provided to key management personnel.

D. Collateral pledged as security
Repo and stock lending transactions
The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £57,892 million (2010: £85,077 million). In addition, the following financial assets on the balance sheet have been pledged as collateral as part of securities lending transactions:

Assets pledged

	2011 £m	2010 £m
Trading and other financial assets at fair value through profit or loss	**1,550**	3,909
Loans and advances to customers	**47,400**	62,643
Debt securities classified as loans and receivables	**1,071**	5,536
Available-for-sale financial assets	**1,733**	3,275
	51,754	75,363

54 Financial risk management (continued)

In addition to the assets defaulted above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 20 and 21.

E. Collateral repossessed

	2011 £m	2010 £m
Residential property	**801**	822
Other	**8**	8
	809	830

In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

(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 2011 the aggregate notional principal of interest rate swaps designated as fair value hedges was £35,757 million (2010: £39,631 million) with a net fair value asset of £3,584 million (2010: £2,947 million) (see note 17). The gains on the hedging instruments were £873 million (2010: gains of £651 million). The losses on the hedged items attributable to the hedged risk were £875 million (2010: losses of £740 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 2011 was £161,463 million (2010: £97,812 million) with a net fair value liability of £1,211 million (2010: £1,285 million) (see note 17). In 2011, ineffectiveness recognised in the income statement that arises from cash flow hedges was a £13 million loss (2010: £159 million gain).

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.

54 Financial risk management (continued)

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	
	2011 £m	2010 £m
Functional currency of Group operations		
Euro:		
Gross exposure	**(393)**	2,325
Net investment hedge	**(897)**	(3,270)
	(1,290)	(945)
Australian Dollar:		
Gross exposure	**1,237**	1,571
Net investment hedge	**(1,226)**	(1,634)
	11	(63)
US Dollar:		
Gross exposure	**145**	138
Net investment hedge	**(122)**	(145)
	23	(7)
Total structural foreign currency exposures, after net investment hedges	**(1,256)**	(1,015)

(3) Liquidity risk
Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses 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**
At 31 December 2011						
Deposits from banks	**1,218**	**71,230**	**5,365**	**49,210**	**62,652**	**189,675**
Customer deposits	**201,470**	**36,820**	**23,216**	**57,719**	**41,485**	**360,710**
Trading liabilities	**10,574**	**2,338**	**2,979**	**2,442**	**2,486**	**20,819**
Debt securities in issue	**116,648**	**12,562**	**8,322**	**40,880**	**9,391**	**187,803**
Liabilities arising from non-participating investment contracts	**–**	**–**	**–**	**–**	**22,207**	**22,207**
Subordinated liabilities	**30**	**449**	**2,883**	**7,794**	**19,362**	**30,518**
Total non-derivative financial liabilities	**329,940**	**123,399**	**42,765**	**158,045**	**157,583**	**811,732**
Derivative financial liabilities:						
Gross settled derivative – outflow	**1,882**	**9,485**	**7,114**	**21,670**	**20,367**	**60,518**
Gross settled derivative – inflow	**(1,401)**	**(8,680)**	**(6,741)**	**(20,487)**	**(19,324)**	**(56,633)**
Gross settled derivative – netflow	**481**	**805**	**373**	**1,183**	**1,043**	**3,885**
Net settled derivative liabilities	**24,983**	**200**	**1,302**	**4,018**	**892**	**31,395**
Total derivative financial liabilities	**25,464**	**1,005**	**1,675**	**5,201**	**1,935**	**35,280**
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

54 Financial risk management (continued)

Company	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2011						
Amounts owed to fellow Group undertakings	**606**	**24,162**	**359**	**6,682**	**8,422**	**40,231**
Subordinated liabilities	**–**	**–**	**1,167**	**4,759**	**10,159**	**16,085**
Total non-derivative financial liabilities	**606**	**24,162**	**1,526**	**11,441**	**18,581**	**56,316**
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

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £16 million (2010: £74 million) for the Group and £11 million (2010: £15 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.

The majority of the Group's non-participating investment contract liabilities are unit-lined. These unit-lined products are invested in accordance with unit fund mandates. Classes are included in policyholder contracts to permit the deferral of sales, where necessary, so that linked assets can be released without being a forced seller.

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 2011	**–**	**–**	**–**	**–**	**385**	**385**
As at 31 December 2010	2,172	722	2,821	9,761	24,600	40,076

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 2011					
Acceptances and endorsements	**3**	**–**	**–**	**–**	**3**
Other contingent liabilities	**366**	**71**	**198**	**149**	**784**
Total contingent liabilities	**369**	**71**	**198**	**149**	**787**
Lending commitments	**28,781**	**11,181**	**4,869**	**773**	**45,604**
Other commitments	**8**	**–**	**–**	**–**	**8**
Total commitments	**28,789**	**11,181**	**4,869**	**773**	**45,612**
Total contingents and commitments	**29,158**	**11,252**	**5,067**	**922**	**46,399**

	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

(4) Insurance risk

Insurance risk is the risk of reductions in earnings' capital and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/underwritten events and to fluctuations in the timing and amount of claim settlements. This includes fluctuations in profits due to customer behaviour.

The Group's appetite for solvency and earnings in insurance entities is reviewed and approved annually by the Board. Insurance risks are measured using a variety of techniques including stress and scenario testing, and, where appropriate, stochastic modelling. Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations, as well as evaluating the effectiveness of controls put in place to manage insurance risk.

55 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 depending on level of subordination and ability to absorb losses. Core tier 1 capital as defined in the FSA letter to the British Bankers' Association in May 2009, comprises mainly shareholders' equity and non-controlling interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected loss over accounting provisions and certain securitisation positions. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and Available-for-Sale assets. Tier 1 capital, as defined by the European Community Banking Consolidation Directive as implemented in the UK by the FSA's General Prudential Sourcebook (GENPRU), is core tier 1 capital plus tier 1 capital securities less 50 per cent of material holdings in financial companies. Tier 2 capital, defined by GENPRU, comprises qualifying subordinated debt and some additional Provisions and reserves after deducting 50 per cent of the excess of expected loss over accounting provisions, and certain securitisation positions and material holdings in financial companies. Total capital is the sum of tier 1 and tier 2 capital after deducting investments in subsidiaries 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 and the non-financial entities that are held by our private equity (including venture capital) businesses, are excluded from its total regulatory capital.

The Group's capital resources are summarised as follows:

	2011 £m	2010 £m
Tier 1 capital	**24,427**	28,819
Tier 2 capital	**7,963**	12,243
	32,390	41,062
Supervisory deductions	**(460)**	(5,435)
Total capital	**31,930**	35,627

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; for example the amount of qualifying tier 2 capital cannot exceed that of tier 1 capital.

The minimum total capital required under pillar 1 of the Basel II framework is the Capital Resources Requirement (CRR) calculated as 8 per cent of risk weighted assets. In addition to the minimum requirements for total capital, the FSA has made statements to explain it also operates a framework of targets and expected buffers for core tier 1 and tier 1 capital.

In order to address the requirements of pillar 2 of the Basel II framework, the FSA currently sets additional minimum requirements through the issuance of Individual Capital Guidance (ICG) for each UK bank calibrated by reference to the CRR. A key input into the FSA's ICG setting process is each bank's Internal Capital Adequacy Assessment Process. The Group has been given an ICG by the FSA. The FSA has made it clear, however, that ICG remains a confidential matter between each bank and the FSA.

The Group maintains its own buffer to ensure that the regulatory minimum requirements and regulatory targets and buffers are met at all times.

During the course of the year there have been a number of significant regulatory reform developments:

- 'CRD III' came into force on 31 December 2011 resulting in increased risk weighted assets for market risk.
- The European Commission published a draft of the new Capital Requirements Directive and Regulation ('CRDIV') which will implement within the EU the so called 'Basel III' reforms for an enhanced global capital accord developed by the Basel Committee on Banking Supervision.
- In December the Government announced that it would implement the key recommendations of the UK's Independent Commission on Banking covering the ring-fencing of certain banking activities, 'bail-in' of senior unsecured debt, higher loss absorption capability and depositor preference.
- The Group is aware that there is currently a review of the endorsed ratings that may be used in IRB models and the Group is working on the assumption that no material changes to our modelling approaches will result from the review.

Many of the details of the way these reforms will be integrated within the UK are still to be finalised. In the meantime the Group continues to monitor their development very closely and to analyse their potential impact whilst ensuring that the Group continues to have a strong loss absorption capacity exceeding regulatory requirements as currently formulated.

The impact of the reforms will gradually phase in as they are subject to a long transition period through to 2022. That allows time for the Group to further strengthen its capital position as necessary through business performance and mitigating actions.

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.

56 Cash flow statements

a Change in operating assets

	Group 2011 £m	Group 2010 £m
Change in loans and receivables	**5,332**	54,639
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**(3,427)**	(1,206)
Change in other operating assets	**205**	3,623
Change in operating assets	**2,110**	57,056

b Change in operating liabilities

	Group 2011 £m	Group 2010 £m
Change in deposits from banks	**6,905**	(34,364)
Change in customer deposits	**638**	(12,222)
Change in debt securities in issue	**(25,307)**	(18,358)
Change in derivative financial instruments and trading liabilities	**10,503**	(9,300)
Change in investment contract liabilities	**3,264**	4,493
Change in other operating liabilities	**(2,857)**	(935)
Change in operating liabilities	**(6,854)**	(70,686)

c Non-cash and other items

	Group 2011 £m	Group 2010 £m
Depreciation and amortisation	**355**	878
Impairment of tangible fixed assets	**65**	52
Revaluation of investment properties	**65**	(233)
Allowance for loan losses	**7,021**	10,767
Write-off of allowance for loan losses	**(8,584)**	(7,319)
Impairment of available-for-sale financial assets	**749**	100
Change in insurance contract liabilities	**(871)**	391
Customer goodwill payments provision	**–**	500
Payment protection insurance provision	**1,155**	–
Other provision movements	**(75)**	29
Net charge (credit) in respect of defined benefit schemes	**81**	(150)
Unwind of discount on impairment allowances	**(171)**	(375)
Foreign exchange element on balance sheet[1]	**236**	(548)
Interest expense on subordinated liabilities	**780**	790
Loss (profit) on disposal of businesses	**1,760**	(51)
Other non-cash items	**750**	1,101
Total non-cash items	**3,316**	5,932
Contributions to defined benefit schemes	**(321)**	(309)
Payments in respect of customer goodwill payments provision	**(497)**	–
Payments in respect of payment protection insurance provision	**(375)**	–
Other	**5**	1
Total other items	**(1,188)**	(308)
Non-cash and other items	**2,128**	5,624

[1]When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

56 Cash flow statements (continued)

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

	Group	
	2011 £m	2010 £m
Cash and balances with central banks	**3,075**	2,375
Less: mandatory reserve deposits[1]	**(499)**	(303)
	2,576	2,072
Loans and advances to banks	**91,210**	65,170
Less: amounts with a maturity of three months or more and balances due from fellow Lloyds Banking Group undertakings	**(87,144)**	(57,699)
	4,066	7,471
Total cash and cash equivalents	**6,642**	9,543

[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.

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

	2011 £m	2010 £m
Derivatives, trading and other financial assets at fair value through profit or loss	**56,359**	164
Loans and advances to banks	**2,318**	3,469
Loans and advances to customers	**–**	2,774
Debt securities	**6**	252
Tangible fixed assets	**185**	1,015
Deposits from banks	**–**	(1,563)
Customer deposits	**–**	(3,397)
Insurance and investment contract liabilities	**(52,371)**	–
Other net assets and liabilities	**(1,592)**	18
	4,905	2,732
(Loss) profit on sale of businesses	**(1,760)**	51
Net cash inflow from disposals	**3,145**	2,783

57 Future accounting developments

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2011 and have not been applied in preparing these financial statements. Save as disclosed the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
Amendments to IFRS 7 *Financial Instruments: Disclosures – 'Disclosures-Offsetting Financial Assets and Financial Liabilities'*	Requires an entity to disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's balance sheet.	Annual and interim periods beginning on or after 1 January 2013.
IFRS 10 *Consolidated Financial Statements*	Supersedes IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities* and establishes principles for the preparation of consolidated financial statements when an entity controls one or more entities.	Annual periods beginning on or after 1 January 2013.
IFRS 12 *Disclosure of Interests in Other Entities*	Requires an entity to disclose information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.	Annual periods beginning on or after 1 January 2013.
IFRS 13 *Fair Value Measurement*	The standard defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements. It applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements.	Annual periods beginning on or after 1 January 2013.
IAS 19 *Employee Benefits*	Prescribes the accounting and disclosure by employers for employee benefits. Actuarial gains and losses (remeasurements) in respect of defined benefit pension schemes can no longer be deferred using the corridor approach and must be recognised immediately in other comprehensive income. At 31 December 2011, unrecognised actuarial gains were £532 million. The income statement charge for 2011 would have been approximately £50 million higher under the revised standard.	Annual periods beginning on or after 1 January 2013.
Amendments to IAS 32 *Financial Instruments: Presentation – 'Offsetting Financial Assets and Financial Liabilities*	Inserts application guidance to address inconsistencies identified in applying the offsetting criteria used in the standard. Some gross settlement systems may qualify for offsetting where they exhibit certain characteristics akin to net settlement.	Annual periods beginning on or after 1 January 2014.
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 the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments. The available-for-sale financial asset and held-to-maturity investment categories in 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 2015.

[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.

At the date of this report, these pronouncements are awaiting EU endorsement.

58 Approval of financial statements and other information

The consolidated financial statements were approved by the directors of HBOS plc on 23 February 2012.

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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