LLOYDS BANKING GROUP

ANNUAL REPORT AND ACCOUNTS 2011

BECOMING THE BEST BANK FOR CUSTOMERS

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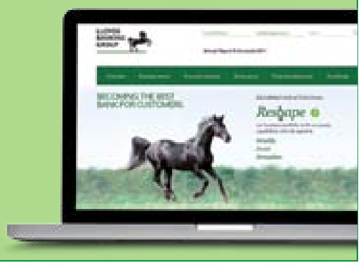
www.lloydsbankinggroup.com



Lloyds Banking Group is proud to be the official banking and insurance partner for the London 2012 Olympic and Paralympic Games.

INTRODUCTION

OUR AIM IS TO BECOME THE BEST BANK FOR CUSTOMERS

We are creating a simpler, more agile and responsive organisation, and are making a big investment in products and services.

This will offer more to our customers, as well as delivering strong, stable and sustainable returns for our shareholders.

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

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

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

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

Through investing in our branches, such as the Lloyds TSB branch in Stratford, East London, we are reinvigorating our brands and enabling better customer service.

GROUP PERFORMANCE

DELIVERING RESILIENT PERFORMANCE

"In 2011, we established our longer term strategy for the Group, acted quickly and decisively to mitigate the effects of a challenging environment and put in place the right foundations to deliver on our objectives over the next 3-5 years. We delivered a resilient performance and made good progress against the key elements of our strategic plan to become the best bank for our customers."

António Horta-Osório
Group Chief Executive

Key highlights

Good progress against strategy creating new opportunities for growth

→ Balance sheet further strengthened

- Capital position strengthened: Core tier 1 capital ratio of 10.8 per cent, improved by 60 basis points
- Strong deposit growth: customer deposits (excluding repos) increased 6 per cent to £406 billion
- Funding position significantly improved: wholesale funding reduced to £251 billion, down 16 per cent
- Strong progress against term funding objectives with £35 billion of wholesale term issuance
- Loan to deposit ratio substantially improved to 135 per cent (31 December 2010: 154 per cent)

→ Reshaping our business portfolio: reducing risk, focusing on the core, and exiting non-core areas

- Substantial non-core asset reduction of £53 billion to £141 billion
- Conservative approach to, and prudent appetite for, risk fully embedded across the business
- Increased focus on the core business, while substantially decreasing non-core assets
- Announced exit from operations in seven overseas countries

→ Simplifying the Group: reducing costs and creating a new operational model

- Integration successfully executed, realising annual run-rate savings of more than £2 billion
- Strong initial progress on delivery of simplification initiatives, using our proven capabilities from Integration
- Simplification run-rate cost savings of £242 million at end 2011

→ Invest to be the best bank for our customers: creating new opportunities for growth

- Successful launch of multi-brand strategy, including relaunch of Halifax as a challenger brand
- Support for Small and Medium-sized Enterprises (SMEs) strengthened: Merlin commitments exceeded, and Commercial loan growth of 3 per cent against UK market, down 6 per cent
- Good Bancassurance progress with Retail and Commercial (SME) customers
- Increased market shares in key, capital-light Wholesale products, facilitated by Arena platform
- New Wealth propositions developed covering 80 per cent of customers, and processes simplified

GROUP PERFORMANCE

Key highlights (continued)

Resilient underlying trading performance in 2011, in line with expectations

- Growth initiatives, cost and impairment reductions, and funding mix improvements mitigated the effects of a subdued UK economy, risk and asset reductions, and higher wholesale funding costs
  - Combined businesses profit before tax increased 21 per cent to £2,685 million in 2011
  - Core combined businesses profit before tax increased 3 per cent to £6,349 million
  - Statutory loss before tax was £3,542 million (2010: profit of £281 million), and includes a £3.2 billion non-recurring provision for Payment Protection Insurance (PPI) contact and redress costs
- Income decreased 10 per cent to £21,123 million, reflecting subdued lending demand and continued customer deleveraging in the core, a smaller non-core portfolio, and a lower margin
- Banking net interest margin reduced by 14 basis points to 2.07 per cent, in line with expectations, with increased funding costs partially offset by the benefits of asset repricing and funding mix; core net interest margin declined only 6 basis points to 2.42 per cent given the better funding mix in the core business
- Total costs fell 4 per cent, primarily driven by Integration and Simplification related savings and lower bonus accruals, partially offset by inflationary pressures and UK bank levy and FSCS costs
- The impairment charge reduced significantly, by 26 per cent to £9,787 million, with improvements seen across all divisions, reflecting improving portfolio credit quality

Outlook and financial guidance

- Expect the external environment to remain challenging in 2012
- Remain confident that our medium-term financial targets, as set out in our June 2011 Strategic Review are achievable over time
  - As anticipated in our Q3 2011 Interim Management Statement, now expect the attainment of income related targets, including for other operating income, to be delayed beyond 2014 as a result of the weaker than expected economic outlook
  - As a consequence, also expect the attainment of our return on equity target to be delayed beyond 2014
  - Continue to expect to deliver our balance sheet, cost and impairment targets in 2014, and in some cases sooner
  - In-year cost savings target for 2014 increased by £200 million to £1.7 billion; end 2014 run-rate target increased to £1.9 billion
  - Given expectation of further deposit growth, expect to reach medium-term Group loan-to-deposit ratio target of 130 per cent or below by the end of 2012, two years ahead of plan
- In 2012, on a combined businesses basis, we expect:
  - Income to be lower than in 2011 given the economic outlook, further non-core asset reductions, subdued demand in the core loan book, higher wholesale funding costs, and interest rates likely to remain at low levels for longer
  - Full year banking net interest margin to be below 2 per cent in 2012, falling year-on-year by approximately the same amount in 2012 as in 2011, primarily driven by continuing high wholesale funding costs
  - A further reduction in costs, and a similar percentage reduction in Group impairment as seen in 2011, with the largest improvement coming from International
  - The benefit from fair value unwind to reduce to approximately £0.5 billion
  - To continue to strengthen our balance sheet through: non-core asset reduction of approximately £25 billion, further deposit growth, at least in line with the market, and strengthening our funding position and our core tier 1 ratio

GROUP PERFORMANCE

Combined businesses – results summary

	2011 £m	2010 £m
Net interest income	12,233	14,143
Other income	9,307	9,936
Effects of liability management, volatile items and asset sales[1]	(74)	(93)
Total income	21,466	23,986
Insurance claims	(343)	(542)
Total income, net of insurance claims	21,123	23,444
Costs:		
Operating expenses	(10,253)	(10,882)
Other costs[2]	(368)	(196)
	(10,621)	(11,078)
Trading surplus	10,502	12,366
Impairment	(9,787)	(13,181)
Share of results of joint ventures and associates	27	(91)
Profit (loss) before tax and fair value unwind	742	(906)
Fair value unwind	1,943	3,118
Profit before tax – combined businesses	2,685	2,212

Reconciliation of combined businesses profit before tax to statutory (loss) profit before tax

	2011 £m	2010 £m
Profit before tax – combined businesses	2,685	2,212
Integration, simplification and EC mandated retail business disposal costs	(1,452)	(1,653)
Volatility arising in insurance businesses	(838)	306
Amortisation of purchased intangibles	(562)	(629)
Provision in relation to German insurance business litigation	(175)	–
Payment protection insurance provision	(3,200)	–
Customer goodwill payments provision	–	(500)
Pension curtailment gain	–	910
Loss on disposal of businesses	–	(365)
(Loss) profit before tax – statutory	(3,542)	281

[1] Includes the gains from liability management exercises, the net effect of banking volatility, changes in the fair valuation of the equity conversion feature of the Group's Enhanced Capital Notes, net derivative valuation adjustments and gains or losses on disposals of assets which are not part of normal business operations.

[2] Other costs include FSCS costs and UK bank levy in 2011, and FSCS costs and impairment of tangible fixed assets in 2010.

GROUP PERFORMANCE

Summary consolidated balance sheet

At 31 December	2011 £ million	2010 £ million
Assets		
Cash and balances at central banks	**60,722**	38,115
Trading and other financial assets at fair value through profit or loss	**139,510**	156,191
Derivative financial instruments	**66,013**	50,777
Loans and receivables:		
Loans and advances to customers	**565,638**	592,597
Loans and advances to banks	**32,606**	30,272
Debt securities	**12,470**	25,735
	610,714	648,604
Available-for-sale financial assets	**37,406**	42,955
Held-to-maturity investments	**8,098**	7,905
Other assets	**48,083**	47,027
Total assets	**970,546**	991,574
Liabilities		
Deposits from banks	**39,810**	50,363
Customer deposits	**413,906**	393,633
Trading and other financial liabilities at fair value through profit or loss	**24,955**	26,762
Derivative financial instruments	**58,212**	42,158
Debt securities in issue	**185,059**	228,866
Liabilities arising from insurance and investment contracts	**128,927**	132,735
Subordinated liabilities	**35,089**	36,232
Other liabilities	**37,994**	33,923
Total liabilities	**923,952**	944,672
Total equity	**46,594**	46,902

Presentation of information

In order to provide more meaningful and relevant comparatives, the results of the Group and divisions are presented on a 'combined businesses' basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described below.

In order to reflect the impact of the acquisition of HBOS, the amortisation of purchased intangible assets has been excluded; and the unwind of acquisition-related fair value adjustments is shown as one line in the combined businesses income statement.

In order to better present business performance the effects of liability management, volatile items and asset sales are shown on a separate line in the combined businesses income statement and the following items, not related to acquisition accounting, have also been excluded:

- integration, simplification and EC mandated retail business disposal costs;
- volatility arising in insurance businesses;
- insurance gross up;
- provision in relation to German insurance business litigation;
- payment protection insurance provision;
- customer goodwill payments provision;
- curtailment gains and losses in respect of the Group's defined benefit pension schemes; and
- loss on disposal of businesses.

To enable a better understanding of the Group's core business trends and outlook, certain income statement, balance sheet and regulatory capital information is analysed between core and non-core portfolios. The non-core portfolios consist of businesses which deliver below-hurdle returns, which are outside the Group's risk appetite or may be distressed, are subscale or have an unclear value proposition, or have a poor fit with the Group's customer strategy. The EC mandated retail business disposal (Project Verde) is included in core portfolios. A full reconciliation of the combined businesses basis to the statutory basis is given in note 4 on pages 231 to 236. Unless otherwise stated, the commentaries on pages 21 to 97 are on a combined businesses basis.

KEY PERFORMANCE INDICATORS

MEASURING STRATEGIC PERFORMANCE

Our corporate strategy

Our strategy is built around becoming the best bank for individual, commercial and corporate customers across the UK and creating value by investing in areas that make a real difference to these customers. Customer leadership driven by superior customer insight, tailored products, better service and relationship focus is the overriding priority. This customer focus will enable delivery of strong, stable and sustainable returns for shareholders over time.

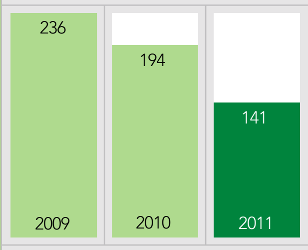
We have over 30 million customers, iconic brands, including Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows, and high-quality, committed people. We are looking to create a simpler, more agile, efficient and responsive organisation with a real focus on operating sustainably and responsibly.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

24–29
More on our corporate strategy

Unlocking the Group's potential

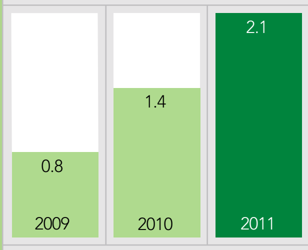
We are **reshaping** our business portfolio to fit our assets, capabilities and risk appetite, **simplifying** the Group to improve agility and efficiency, **investing** to be the best bank for customers and **strengthening** the Group's balance sheet and liquidity position. A comprehensive set of Key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

Balance sheet reduction (non-core assets) £bn



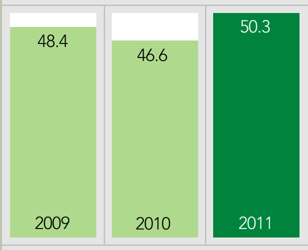
Excellent progress continues to be made in reshaping the business through the reduction of our non-core assets which now stand at £141 billion, following a £53 billion reduction in the year.

Integration cost synergies (run-rate) £bn



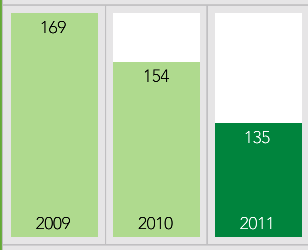
The integration programme is now largely complete and successfully delivered more than £2 billion per annum of cost synergies. We are now progressing the simplification initiatives.

Cost:income ratio %



Although the cost:income ratio increased in 2011, largely as a result of income reduction associated with the risk and balance sheet reduction, we continue to expect simplification initiatives to help reduce this over time.

Loan to deposit ratio %



We have made good progress in reducing our loan-to-deposit ratio, thereby strengthening our balance sheet.

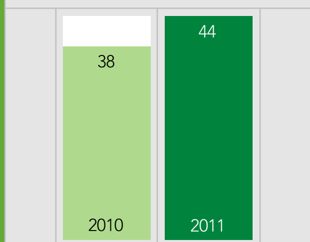
24–29
More on strategy and KPIs

Building customer relationships

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

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

Customer satisfaction (net promoter score) %

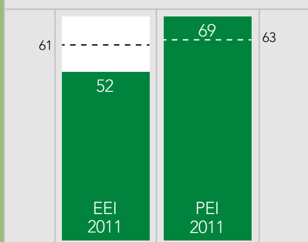


We have developed a comprehensive customer experience program measuring customer service at key touch points and likelihood to recommend through the cross industry Net Promoter Score metric.

31–33
More on customer satisfaction

Staff engagement score %

UK industry average



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

34–37
More on our staff engagement score

KEY PERFORMANCE INDICATORS

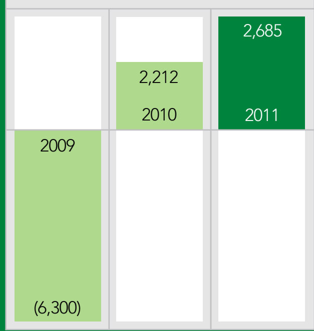
Alignment with remuneration

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

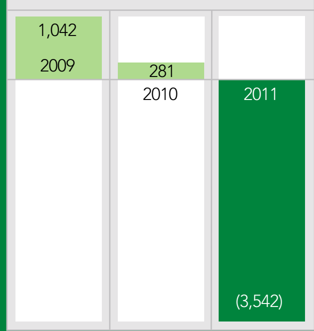
Output measures

Although significant progress has been made against our strategic priorities during 2011 this is yet to be seen in the statutory profit numbers and earnings per share due to a number of one off items including the £3.2 billion provision for PPI. Further detail on these measures is contained within the business review.

Profit (loss) before tax (combined businesses basis) £m

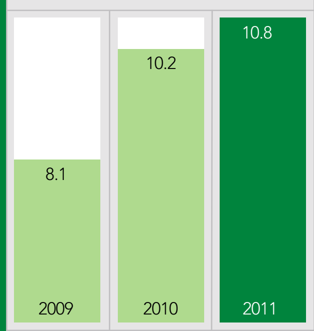


Statutory profit (loss) before tax £m



Earnings per share pence

Core tier 1 ratio %



44–53
More on our Group results

AT A GLANCE

CUSTOMER-FOCUSED OPERATING DIVISIONS…

Retail

Retail operates the largest retail bank in the UK and is the leading provider of current accounts, savings, personal loans, credit cards and mortgages. With its strong stable of brands, including Lloyds TSB, Halifax, Bank of Scotland and Cheltenham & Gloucester, it serves customers through one of the largest branch networks in the UK. Retail is also a major general insurance and bancassurance distributor, offering a wide range of long-term savings, investment and general insurance products.

54

47% of total Group income[1]

Key product markets
- Secured lending – mortgages
- Unsecured lending – credit cards, loans and overdrafts
- Internet and telephone banking
- Current accounts
- Savings accounts

Wholesale

The division comprises Wholesale Banking and Markets along with our Asset Finance business. The Wholesale Banking and Market business serves corporates with turnover above £15 million with a range of relationship focused propositions, segmented according to customer need.

59

21% of total Group income[1]

Key product markets
- Corporate Banking Services
- Treasury and Trading
- Asset Finance

Commercial

Commercial serves in excess of a million small and medium-sized enterprises and community organisations with a turnover of up to £15 million. Customers range from start-up enterprises to established corporations, with a range of propositions aligned to customer needs. Commercial comprises Commercial Banking and Commercial Finance, the invoice discounting and factoring business.

66

9% of total Group income[1]

Key product markets
- Commercial Banking
- Commercial Finance
- Invoice discounting and factoring

Wealth and International

Wealth and International focuses on the private banking and asset management businesses of the Group and also operates the Group's international business.

70

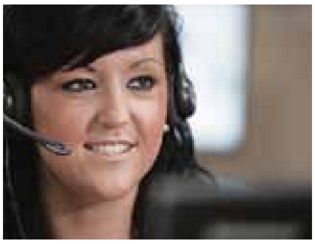
10% of total Group income[1]

Key product markets
- Wealth management
- Asset management
- International Banking

Insurance

The Life, Pensions and Investments business is the leading bancassurance provider in the UK and has one of the largest intermediary channels in the industry. The general insurance business is a leading distributor of home insurance in the UK and also offers a range of other general insurance products.

77



13% of total Group income[1]

Key product markets
- Life assurance, pensions and investments
- General Insurance

[1] Excludes Group Operations, central items and insurance claims

AT A GLANCE

…LEVERAGED THROUGH OUR STRATEGIC ASSETS

Iconic and distinct brands

The Group operates a range of well recognised brands across our five operating divisions with different brands utilised for different customer segments, geographies and markets. The main four brands operated by the Group are Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows though a number of other brands are used in specialist markets.

Lloyds TSB

HALIFAX

BANK OF SCOTLAND

SCOTTISH WIDOWS

Broad multi-channel distribution

The Group operates a comprehensive multi-channel distribution network, enabling our customers to access products and services at any time and in a style which suits their individual preferences.

8.3 million active internet users

With 2,900 branches we have the largest branch network in the UK. This allows a greater number of customers to talk to us face-to-face, building trust and understanding, and strengthening our relationship with them. Our investment programme to reinvigorate our branch network will help ensure these relationships are fostered in a suitable, comfortable and functional environment. We also operate one of the largest fee free ATM networks in the UK.

We provide a comprehensive suite of services through other channels including telephony and the internet.

Our telephony system gives, with 24/7 access, the ability to either use automated facilities for speed or speak to an operator, meaning that customers can complete their banking needs day or night, at home or abroad.

Our industry leading and award winning internet platform allows people to access and view all their products via a secure network. We have developed and launched innovative internet tools such as Money Manager, which breaks down customer spending in to specific categories, allowing customers to track their spending more effectively.

Digital banking has also taken advantage of other technological and social changes. Our mobile banking apps have had over 1.5 million downloads and have been some of the most popular free financial apps in the Apple App Store in recent months. We are also using social media to reach our customers, gaining praise for our use of Twitter and Facebook and Lloyds TSB was the first UK bank to launch a branded YouTube channel.

High-quality committed colleagues

Our colleagues have continued to perform well despite the challenges of the economic environment and the significant changes progressing in the Group. We recognise the importance of our colleagues as the face of the bank and the fulcrum of our relationship strategy. We therefore strive to attract, retain and develop the best talent and are committed to making significant investment in our people.

103,000 employees

34
More on our colleagues

Strong customer relationships

Over the years we have developed long lasting and strong relationships with our customers. By listening to our customers and acting accordingly we will continue to build upon these relationships and become the best bank for customers.

30 million customers

31
More on our customers

An integrated platform

In 2011, the Group successfully completed the majority of its integration activity, the largest financial services IT integration ever undertaken. This has not only resulted in significant cost savings but has provided us with a single banking platform which we can leverage off to simplify the business further and invest in areas which provide value for both customers and shareholders. Aligning branch counter systems, ATMs and Intelligent Deposit Machines, both reduces training costs and improves the quality of training received, increasing returns and enhancing the customer experience.

>£2 billion of integration savings

The integrated platform is allowing us to target further simplification benefits, as announced in June's Strategic Review, and re-invest in the Group. Through redesigning our operations and processes, to reduce bottlenecks and errors, streamlining our product suite and using a breadth of distribution channels, optimising our sourcing and delayering our management structure we will be able to quickly and efficiently react to external pressures and provide improved services to customers. An element of the savings produced from simplification will enable us to invest further in the group, creating long lasting value, improving our strategic outlook and positioning us to deliver strong and sustainable returns.

CHAIRMAN'S STATEMENT

Sir Winfried Bischoff

A YEAR OF CHANGE AND ENCOURAGING PROGRESS

Overview

2011 was a year of low economic growth and challenging markets in many parts of the world, which resulted in a difficult year for the banking industry as a whole. The UK sector in particular was affected by a weakening UK economic environment, continuing regulatory uncertainty and the impact of the Euro crisis.

Despite this environment, we made progress against our objective of being the best bank for customers and on the key actions we are taking to deliver strong, stable and sustainable returns for shareholders over time. We created a new management team, presented our new strategy and are refocusing the business to meet our customers' needs. We also delivered a resilient performance in the core business, and made good progress on the reduction of non-core assets.

Having largely completed one of the biggest integrations ever undertaken in banking, we are now working hard against a demanding set of targets to simplify the Group to improve our agility and efficiency, thereby realising cost savings which we will invest to enhance our service to customers. By delivering against this plan, we will seek to unlock the potential in our franchise and deliver increased value to our shareholders.

We accelerated the EC mandated disposal, the transaction known as 'Verde', and made significant progress in strengthening the balance sheet and our funding position whilst delivering a resilient underlying trading performance. We took responsible position on Payment Protection Insurance (PPI), continue to improve switching for current accounts and have made excellent progress, with more to come, in reducing the number of complaints. As a result we believe the Group is in a stronger position as we move into 2012.

Despite the progress made there were a number of challenges. In particular our share price performance, down 61 per cent over the year, although partially due to external factors, is not acceptable. This decline compares with a fall of 30 per cent of an index of UK banks and of 38 per cent of European banks. Nor are the financial results satisfactory, particularly given a number of one off items, including the £3.2 billion provision for PPI. This provision has had a significant impact on our statutory results but the decision to take this approach reflects the Bank's desire to do the right thing for customers.

CHAIRMAN'S STATEMENT

Supporting the UK economic recovery

Lloyds Banking Group plays a vital role in supporting a substantial number of corporates and smaller and medium-sized businesses, helping them to weather the economic uncertainty and build for the future. In doing so we play an active part in supporting the strength and prosperity of the UK, given that, as a largely domestic institution, our success is inextricably linked to the health of the UK: as the nation recovers we can thrive.

For this reason I am pleased to note that our involvement in Project Merlin has been successful: We met and continue to exceed our agreed lending levels. We provided £45.3 billion of committed gross lending to UK businesses in 2011, and helped 124,000 new start up businesses. All of this has been achieved while acting as a responsible lender. We have more than delivered on our promise to provide gross new lending for credit-worthy UK businesses and have pledged yet more lending for the UK economy in 2012.

At the same time, our Insurance business, including Scottish Widows, has continued to perform well through its established value rather than volume strategy and through its focus on customers. Our Bancassurance business continues to highlight the importance of meeting our customers' protection needs and has had a successful year doing so.

We are also well aware of the public concern around the banking industry and recognise that further progress needs to be made in rebuilding public trust industry-wide. We can only earn that trust by addressing the fundamental requirements of all our stakeholders, and by being open, transparent and engaged in the broader debate about the role of banking in the UK. We will continue to demonstrate that we are meeting our obligations to customers and society in a responsible and appropriate way. At the same time we believe, whatever the sector's shortcomings, the debate about the banking industry has become one-sided which is unhelpful in achieving what those both inside and outside the banking industry want: a growing, strong economy supported by a strong banking sector.

Remuneration

The Remuneration Committee undertook a further review of executive remuneration in 2011. Anthony Watson, the chairman of the Remuneration Committee, comments on detailed aspects of our remuneration policy elsewhere in this Report. I want to give shareholders some additional explanation of our philosophy and the deliberations underlying incentive compensation for 2011 and for the 2009-2011 Long-Term Incentive Plan.

Remuneration remains an important issue for our stakeholders and the Group. As we are primarily a retail and commercial bank the awards under our Group bonus schemes in 2011 are a very small percentage of our revenues at less than 2 per cent, and at less than 12.5 per cent of the profits before tax and bonus on a Combined Businesses basis. Additionally, compensation fell this year in total and average terms. The bonuses paid, greater than half in shares, averaged less than £3,900 per employee. We firmly believe that remuneration policy at all levels, including senior executives, needs to incentivise staff to deliver strong, sustainable growth whilst reflecting the work required to reshape the business to fit the new, challenging environment. We also need, however to be mindful of public concerns about equality and that remuneration reflects financial results. In asking not to be considered for a bonus in 2011, António made a principled decision with regard to his remuneration, a decision the Board fully supported.

We believe that it is fair and reasonable that the activities which led to the PPI provision are reflected in the Long-Term Incentive Plan (LTIP) for the years 2009 to 2011 in spite of the longer term nature of the issue. Our current shareholders who may not have been shareholders at the time the income on PPI arose have been affected by the impact of the provision in 2011 and therefore the Board, on the recommendation of the Remuneration Committee, decided that the provision should also impact the awards to our senior executives.

With respect to the LTIP, Shareholders will recall that awards for Executive Directors have not paid out in any of the past three years. The annual pay-out of the LTIP, averaged over the last four years, is under 0.2 per cent of total pay, in stark contrast to what is the general perception.

Regulation

The level of regulatory scrutiny across all areas of the business remains high, but there is some expectation that in 2012 we will start to see more clarity in a number of the key areas which will shape the industry's future. I believe robust and stable regulation of the sector is an important component in rebuilding confidence and creating a healthy and sound financial system. Changes to the regulatory framework are necessary in the wake of the financial crisis. The reforms proposed by the Vickers Commission in its Independent Commission on Banking (ICB) report are an important step towards a safer and stronger sector. Further clarity is still required on some of the specific detail, and implementation will have many challenges. However I remain hopeful that the proposed changes will strengthen the banking sector and safeguard the interests of individuals and institutions. At the same time we forget at our peril the importance of financial services in all parts of the UK to our economy.

In December we were pleased to announce that the Co-operative Group is our preferred bidder for the EC mandated disposal (Project Verde). The acquisition will significantly enhance their banking operations, producing a new and effective competitor in the market, as the EC mandate envisaged. This transaction combined with complementary measures to improve current account switching and actions taken to improve the transparency and comparability of retail products will, I believe, further enhance the UK's competitive retail banking market.

Equity Dividends

The European Commission's restriction on dividend payments was, initially placed on us as part of the State Aid restructuring plan which expired in early 2012. We understand that the absence of dividends has created difficulties for many of our shareholders and we remain committed to recommencing progressive dividend payments as soon as we are able.

It is our intention to do so when the financial position of the Group and market conditions permit and after regulatory capital requirements are defined and prudently met. At this time those requirements remain unclear and although we have made good progress against our strategic priorities during the year we are not yet able to forecast when we will be able to resume dividend payments.

CHAIRMAN'S STATEMENT

Management and Board

The year has seen significant management change within the Group as we enter the next stage of our development. We have a strong and experienced management team, which proved its effectiveness throughout the year.

António Horta-Osório started as Group Chief Executive on 1 March 2011 and we were pleased to recruit someone with his knowledge and experience of financial services, particularly in the retail and commercial area. The actions taken by him have already had a positive impact on the Group. António took a two month leave of absence at the end of last year and the Board was pleased that he was able to return to his role on 9 January 2012. In conjunction with the Board, António has implemented a number of changes to the structure of the management team since his return to ensure that the most important aspects of our business are prioritised and the responsibility of managing our Group is effectively shared.

We announced in September 2011 that Tim Tookey, our Group Finance Director, would leave the organisation at the end of February 2012. Tim has been an important member of our Board since October 2008 and helped guide us through the largest merger in UK banking history and subsequent capital raisings. I thank Tim for his commitment throughout that time, not least in the last two months of 2011, when he took on the role of Group Chief Executive on an interim basis in addition to his responsibilities as Group Finance Director.

I am pleased that we were able to announce that George Culmer will join us as our new Group Finance Director in time for the annual general meeting on 17 May 2012 His knowledge and experience of insurance and his track record as a highly regarded FTSE 100 Finance Director will be of great value to us.

I would also like to thank Helen Weir and Archie Kane, who left the Group in 2011, for their significant contribution to the Group over many years. Helen was Group Finance Director and then led our Retail business. Archie was the Group Executive Director of our successful Insurance business, Scottish Widows.

Since the year end a number of additional changes have been announced. Lord Leitch will relinquish his role as Deputy Chairman at the end of February 2012 to focus on his other commitments. His wise counsel to the Board and his empathy and involvement with colleagues across the business will be missed. I am pleased he has agreed to continue as an advisor to the Boards of Scottish Widows and of Lloyds Banking Group until the end of 2012.

Sara Weller joined as a Non-Executive Director on 1 February 2012. Her background in retail and in the application of new technology such as the internet directly support our strategy.

Sir Julian Horn-Smith, Independent Director since 2005 will not be standing for re-election at the annual general meeting. His counsel and advice on aspects of technology, marketing and customers will be much missed.

Glen Moreno, our Senior Independent Director and Deputy Chairman, will not be seeking re-election at the annual general meeting. He has been a tower of strength on our Board and his wide knowledge of banking and financial services developed over many years in senior executive positions has been of great benefit to our strategy and operations. His constructive and informed contribution will be missed by all.

The Board has appointed Anthony Watson as Senior Independent Director and David Roberts as Deputy Chairman with effect from the annual general meeting.

Finally, Truett Tate, Executive Director for Wholesale, has retired from the Group. He made a major contribution in a number of senior roles since joining the Group in 2003. He is the quintessential client advocate and in addition he was a great ambassador for many of our corporate responsibility and charitable programmes. I enjoyed working with him and we wish him well for the future.

As a Board and throughout the organisation we continue to focus on our commitment to meeting the targets set by the Review on Gender Diversity on Boards by Lord Davies, and are working proactively to promote diversity in ethnicity, gender and skills.

People

We employ over 100,000 people. Our colleagues have performed well in a year which was characterised by much change and a difficult economic environment for both customers and themselves. Customer service is at the heart of our activities and I applaud their efforts to reduce complaints, evidenced by the data for 2011 which show a 24 per cent reduction in year over year FSA reportable banking complaints excluding PPI. Our colleagues share the Board's view that more needs to be done and I feel confident that 2012 will bring further progress in this area.

More generally, I would like to thank them for their commitment and loyalty in what were challenging circumstances and in a climate of unfavourable public commentary on their work and livelihood. We are all determined to demonstrate the utility and usefulness of banking, specifically our type of banking, concentrated as it is on the UK and within that on retail and commercial banking.

Community

The principal means by which Lloyds Banking Group can benefit society and the communities where we operate is to be a successful business. Lloyds Banking Group plays a part in the lives of nearly everyone in the UK, as a supplier of financial services, a major employer, and a customer. We look after the financial needs of over 30 million retail and business customers. In addition we employ 100,000 people and are a significant buyer of goods and services to support our business. We therefore have a relationship with nearly every home and with many businesses in the UK. We have a presence in most communities and our brands are well recognised across the country. At a time when the banking sector is under increased public scrutiny, we acknowledge our responsibility to provide the proper flow of credit to the economy by delivering simple products, great customer service and secure banking every day. We do this for more customers and businesses than any other bank in the UK.

We also continue to invest actively in the communities where we operate both directly through our community giving programme, and indirectly through our charity activities and staff giving days. In 2011, we invested £85 million in local communities, including support for financial inclusion and donations through the Group's charitable foundations. Over the last 25 years, the Group has contributed in excess of £510 million through its Foundations. Our new programmes supporting financial literacy, *Money for Life*, and our funding of university places through *Lloyds Scholars* show our continued commitment to support our communities.

We are excited to be the Official Banking and Insurance Partner of the London 2012 Olympic and Paralympic Games. We have played a key role in bringing London 2012 to communities across the UK, by inspiring children to do more sport through National School Sport Week, by giving our customers the chance to take part in the Olympic Torch Relay and by funding and mentoring future stars of Team GB and

CHAIRMAN'S STATEMENT

ParalympicsGB through our Local Heroes programme. We have also supported one in three of all businesses who have won London 2012 Games related contracts. We are now entering the final few months before the Games start and I fully expect that the country at large will enjoy this historic event, be inspired by its achievements and benefit from the legacy of this once-in-a-lifetime event.

Outlook

Lloyds Banking Group has made significant structural and strategic progress during 2011 but there remains much to be done against the background of the current economic and regulatory environment.

It remains our intention over time to operate as a wholly privately owned, self-supporting, dividend paying, commercial enterprise. I believe our approach of focusing on customers in the UK whilst capitalising on our strong relationships, on our iconic and distinct brands, on our broad multi-channel distribution and on the clear operating model we have created is the right one. We saw the early benefits of this approach in 2011 through the resilient performance of our core business and the good progress in reducing our non-core assets.

Our support for the wider economy and the communities where we operate, in conjunction with our prudent risk appetite, a strengthened balance sheet and integrated systems are a sound platform for a positive financial trajectory.

Our Board is grateful for the support of our shareholders in 2011 and is very conscious that they – including most of our staff who themselves are shareholders – have suffered through the decline of the share price and the absence of a dividend. We have the right strategy in place and given our significant assets, our committed leadership team and the skill of our dedicated workforce we are well positioned over time to deliver sound performance for our customers, shareholders, colleagues and communities.

Sir Winfried Bischoff
Chairman

A commitment to good Governance

The Board and I place great importance on Corporate Governance. Not just because of increasing focus on this area, but because good governance is in the best interests of the company. The Board is ultimately responsible for the Group's success through setting strategy, devising sound governance arrangements, and establishing the values and standards of the Group. Throughout the year ending 31 December 2011, the Group complied with all relevant provisions of the Financial Reporting Council's UK Corporate Governance Code. This is an important base level but in undertaking its responsibilities the Board seeks to exceed these minimum standards, as we believe that good governance is a key contributor to the Group's long term success.

Our Board

There have been significant changes to the composition of the Board this year. Though experience and a detailed understanding of financial services will remain important attributes for Board members, a broader mix of skills is key to the overall effectiveness of the Board. I believe that the current Board provides the Group with a good balance of skills and experience, which helps the quality of our decision-making. We remain committed to keeping this balance right as we respond to further Board changes in 2012. I continue to ensure that the majority of Directors are independent and that sufficient emphasis is placed on ensuring that the Board's membership reflects appropriate diversity. In the interests of good governance, all directors now retire voluntarily each year and submit themselves for re-election at every AGM.

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More on Corporate Governance

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More on Directors' Remuneration

Board oversight in 2011

The Board's governance processes have placed us in a good position to deal with key issues which arose during the course of the year, including with respect to:

- the review and approval of the Group's new strategy;
- the change of Group Chief Executive and other significant management changes;
- the short leave of absence for António Horta-Osório, including ensuring that effective interim arrangements were in place and that a rigorous process was followed with respect to his return to work; and
- the decision to take a significant provision with respect to PPI.

Ensuring that the right mechanisms are in place at the time of change is critical and I believe that the decisions made in these areas, and others, have helped ensure that the Group is effectively positioned to deliver sound performance for all of the Group's stakeholders over time.

Executive Remuneration

As I have already referenced in my statement, remuneration remains an important issue for shareholders, and other key stakeholders. This is a sensitive area, but the Board is committed to ensuring that the right balance is struck between the need to incentivise staff, at all levels of the organisation, to deliver strong, sustainable growth, whilst reflecting the work required to reshape the business, and broader concerns about fairness.

As a Group we are committed to meeting the regulatory and other requirements that apply to this topic, including the FSA Code, and more generally improving the transparency of remuneration disclosure. We always look to align reward with the Group's long term performance and the interests of its shareholders. We fully endorse a stringent deferral process, as an important element of this alignment. We maintain an open dialogue with our major shareholders to help ensure appropriate remuneration policies are developed, and that shareholder concerns are taken into account.

During 2011 we have continued to be mindful of the need to exercise restraint as part of the effective governance of executive pay and as a result a number of actions have been taken, including not increasing fixed pay for Directors.

GROUP CHIEF EXECUTIVE'S REVIEW

António Horta-Osório

BECOMING THE BEST BANK FOR CUSTOMERS

"In 2011, we delivered a resilient performance and made good progress against the key elements of our strategic plan to become the best bank for customers."

GROUP CHIEF EXECUTIVE'S REVIEW

Summary

In 2011, we established our longer term strategy for the Group, acted quickly and decisively to mitigate the effects of a challenging environment and put in place the right foundations to deliver on our objectives over the next 3-5 years, whilst continuing to support the UK economy. Using the framework set out in our Strategic Review, we accelerated strengthening our balance sheet, decreasing risk and reducing costs. The investments we made behind our brands, distribution, customer relationships and people have strengthened our franchise, and created new opportunities which will enable us to realise over time the Group's full potential for growth. We also made good progress on the EC mandated business disposal (Project Verde), and saw greater clarity emerge on the future UK regulatory framework following the publication of the Independent Commission on Banking's (ICB's) final report and the Government's response on 19 December 2011.

As a result, in 2011, we delivered a resilient performance and made good progress against the key elements of our strategic plan to become the best bank for our customers, despite a weakening UK economy, ongoing financial market volatility, continued high levels of regulatory scrutiny and competitive markets. We are now better positioned to adapt to the changing economic environment and to realise over time the full potential of our franchise, brands and capabilities, and therefore to deliver strong, stable and sustainable returns for our shareholders.

2011 results overview

The results reflect our focus on rapidly improving the Group's risk profile and further strengthening the balance sheet, through improving the Group's capital and funding position and making substantial progress on non-core asset reductions, deposit growth, and our funding programme.

While this means that we now have a much more resilient balance sheet, our income performance was affected by these risk and asset reductions, as well as by the subdued UK economic environment. On a statutory basis, our results were affected by, amongst other things, the responsible position we took on Payment Protection Insurance (PPI), which resulted in a £3.2 billion provision. In addition, with over £2 billion of run-rate cost savings now realised from integration, we have now commenced the simplification initiatives which will significantly improve our efficiency and are allowing us to invest in growing our core customer business.

In reducing risk and strengthening the balance sheet, our proactive management of the non-core portfolio and of our funding position meant that we reduced non-core assets by £53 billion to £141 billion, against a commitment to decrease the non-core portfolio to less than £90 billion by the end of 2014, and significantly strengthened our funding position, raising £35 billion of total term wholesale funding, around £10 billion more than initially budgeted.

The new pricing management of savings products we introduced in the year and our multi-brand strategy resulted in customer deposit growth (excluding repos) of 6 per cent, significantly above market growth, and without leading the market on rates. We had a particularly strong performance in our Halifax challenger brand as a result of innovative products launched in the year. As a consequence of our actions in reducing non-core loans and increasing deposits, we substantially improved our loan to deposit ratio, by 19 percentage points to 135 per cent.

Deposit growth and our progress in funding and non-core asset reductions facilitated further substantial pay-down of government and central bank facilities from £97 billion at the 2010 year end to £24 billion at the end of 2011 (with nothing outstanding under the UK Special Liquidity Scheme). Non-core asset reductions, which were made broadly in line with book value, were a substantial driver behind the improvement in our core tier 1 capital ratio from 10.2 per cent at the 2010 year end to 10.8 per cent, notwithstanding the impact of the PPI provision of around 60 basis points.

The Group reported a combined businesses profit before tax of £2,685 million in 2011 (2010: £2,212 million), and excluding the effects of liability management, volatile items and asset sales, profit before tax was £2,022 million (2010: £1,651 million). The core business delivered a resilient performance, with profit before tax of £6,349 million (2010: £6,152 million), and excluding volatile items, liability management effects and asset sales profit before tax was £5,746 million (2010: £6,101 million). On a statutory basis, the Group reported a loss before tax of £3,542 million in the year, which includes the PPI related provision.

Subdued markets in the core business and the effect of non-core asset reductions resulted in a reduction in income (excluding volatile items, liability management effects and asset sales, and net of insurance claims) of 10 per cent to £21,197 million. This was partly offset by a 6 per cent reduction in operating expenses, despite the headwinds of inflation and higher taxes, as a result of the management actions we took during the year, and a 26 per cent reduction in the impairment charge, reflecting improving credit quality in our portfolios.

The benefits from the improvements we achieved in the Group's funding mix, increasing deposit balances and reducing the proportion of wholesale funding, were most clearly evident in our core net interest margin. This declined by only 6 basis points to 2.42 per cent, despite the impact of higher funding costs, the effect of refinancing a significant amount of government and central bank facilities and lower interest rates in general. However, our Group net interest margin declined by 14 basis points to 2.07 per cent, in line with guidance, given that it reflected the full impact of these effects on our predominantly wholesale funded non-core business.

Our strategy and action plan to deliver for customers and shareholders

Our strategy, which we set out on 30 June 2011 following an extensive and detailed review of the business, is focused on the UK, where we have distinctive assets and capabilities including our valuable customer franchise and market position, and multiple strong brands.

It is built on being the best bank for our personal, commercial and corporate customers, creating value by investing in initiatives where we can make a real difference for them, and focusing on operating sustainably and responsibly with the objective of delivering strong, stable and sustainable returns for shareholders over time.

While our focus is on restoring the Group to sustainable profitability and delivering returns for all shareholders, we expect the delivery of our strategic targets to provide, over time, an opportunity for the UK Government to dispose of its shareholding in the Group in an orderly manner, and deliver value for taxpayers.

GROUP CHIEF EXECUTIVE'S REVIEW

Delivering our vision – managing a more agile organisation

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

Standing L to R:

David Nicholson
Group Director, Halifax Community Bank

David joined Halifax in 1995, and has over 25 years experience in Retail financial services. Having developed his career inside the Group, he now has responsibility for the Halifax Community Bank. He is also a director of Sainsburys' bank and Chairman of the 'Your Tomorrow' pension fund trustees.

Alison Brittain
Group Director, Retail

Alison joined the Group in September 2011. Alison has 25 years Retail and Commercial Banking experience, having previously been Executive Director for Retail Distribution at Santander and prior to that worked at Barclays in senior management roles across a variety of business areas and functions.

Mark Fisher
Director, Group Operations

Mark joined the Group in March 2009 as Director, Group Operations and Integration. He is a career banker having started his career in 1981 with NatWest. Over the past 15 years, Mark has run scale banking and technology operations, including complex change programmes.

Antonio Lorenzo
Group Director, Wealth & International and Group Strategy

Antonio joined the Group in March 2011. Previously at Santander, Antonio was CFO for the UK business and managed the Wealth and Intermediaries businesses, and performed in several other international roles since joining Santander in 1998. Prior to this Antonio worked for Arthur Andersen in the financial sector whilst he was also a Professor at the Universidad Europea de Madrid.

Matthew Young
Group Corporate Affairs Director

Matthew joined the Group in February 2011, having previously been Communications Director at Santander UK. Matt has worked in a variety of senior management roles within the industry, including Abbey National and NatWest.

Angie Risley
Group HR Director

Angie joined in May 2007 and outside of Lloyds Banking Group is also a Non-Executive Director of Serco Group plc and a member of the government's Employment Engagement Task-Force. Before joining the Group, Angie was Group HR Director and an Executive Director on the board for Whitbread Plc.

Tim Tookey
Group Finance Director

Tim joined the Group in 2006 as Deputy Group Finance Director, before being appointed acting Group Finance Director in April 2008. Appointed to the Board in October 2008 as Group Finance Director. Tim left the Group on 24 February 2012.

Seated L to R:

Juan Colombás
Chief Risk Officer

Juan joined the Group in January 2011 having previously been Chief Risk Officer at Santander UK. Juan has over 25 years of banking experience, with Risk, Control and Business Management roles across Corporate, Investment, Retail and Risk divisions.

António Horta-Osório
Group Chief Executive

António joined the Board in January 2011 as an Executive Director and become Group Chief Executive in March 2011. Further details can be found on page 173.

John Maltby
Group Director, Commercial

John joined Lloyds TSB in 2007 as Managing Director, Commercial and was appointed to the Group Executive Committee in September 2011. He has over 20 years experience of delivering business growth, transformation, IPOs, acquisitions and divestments in multi-national and specialist Financial Services organisations and was previously CEO Kensington Group Plc.

Toby Strauss
Group Director, Insurance

Toby joined the Group in October 2011 having previously been UK Life CEO at Aviva, joining them in 2008. He has a range of experiences in financial services and technology sectors, with much time spent at McKinsey.

GROUP CHIEF EXECUTIVE'S REVIEW

Our strategy will create shareholder value through simplifying processes, systems and products and policies, and investing a proportion of the savings realised from this simplification in growth initiatives targeted at high-return areas of our business, and by ensuring that capital is primarily allocated to core growth businesses.

The four elements of our action plan to deliver our strategy are to:

- → **Strengthen** our balance sheet and liquidity position
- → **Reshape** our business portfolio to fit our assets, capabilities and risk appetite
- → **Simplify** the Group to improve agility, service and efficiency
- → **Invest** to be the best bank for our customers and to grow our core customer businesses

Good progress against strategic initiatives

We are already making good progress against the key initiatives set out in our strategy.

In reshaping our business portfolio, we have fully embedded across the business a conservative approach to, and prudent appetite for, risk. We have in place rigorous controls over the risk profile of all new business, as evidenced, for example, in the Retail mortgage book where we have seen impaired loans decreasing but where our coverage ratio has increased, and are managing and successfully reducing our non-core assets in a disciplined manner and broadly in line with book value. In the core business, the improving quality of our portfolios and their decreasing risk profile, has been reflected in a 7 per cent decrease in risk-weighted assets. We have also reviewed our existing portfolios and confirmed them as adequately provisioned.

Given our UK-focused strategy to capitalise on the strength of our capabilities in the UK, we have also committed to reduce our international presence from 30 countries to less than 15 by 2014. To date we have announced the exit from operations in seven countries.

Our integration programme has now delivered single platforms supporting the Halifax, Bank of Scotland and Lloyds TSB brands and, by the end of 2011, had achieved more than £2 billion per annum of run-rate cost synergies and other operating efficiencies.

Simplifying the Group is a cornerstone of our strategy, not only in its delivery of cost savings, but also importantly in simplifying our products and services from the customer's point of view, and allowing us to increase investment in our franchise. We have now commenced the delivery of the simplification initiatives set out in our strategy, and by the end of 2011 had achieved initial run rate savings of £242 million in the first six months of the programme. We have also greatly improved our cost management through instituting a rigorous process overseen by a Cost Board, which has helped the Group drive significant reductions in our operating expenses.

A portion of the savings realised from our simplification programme will allow us to further invest to be the best bank for our customers, and to grow our core customer businesses which is at the heart of our strategy. We commenced the implementation of a number of key initiatives in 2011, with the revitalisation of the Halifax brand and strengthening our support for Small and Medium-sized Enterprises both resulting in a significant outperformance of those business areas against market trends.

We have also begun to invest behind increasing our share of capital-light business in our corporate and commercial businesses. Key successes included the launch of 'Arena', our online foreign exchange and money market deposit platform and our UK government bond market making operation in our Wholesale business. In Insurance, our focus on UK customer needs delivered a 23 per cent increase in LP&I UK protection sales (PVNBP), which now account for 22 per cent (2010: 13 per cent) of bancassurance sales.

Further details on the good progress we have made against our strategic initiatives in each business are given in each of the divisional reviews in this document.

Management team changes

On 1 February 2012, we announced changes to the Group's senior management team to ensure we have the right organisational structure to deliver on our strategy and move to the next phase of the Group's transformation. As a result, five business lines, Retail, Wholesale, Commercial, Wealth and International, and Insurance, now report directly to me and, further to the centralisation of all control functions as part of the Strategic Review, five control and support functions also report to me, namely Group Corporate Functions (into which Human Resources, Legal and Secretariat and Group Audit report), Risk, Finance, Operations, and Corporate Affairs.

Supporting our customers and the UK economy

As part of our strategy to be the best bank for customers, and as a leading financial services provider in the UK, we continue to actively support sustainable growth in the UK economy through the focused range of products and services we provide to our business and personal customers, as well as through partnerships we have built with industry and Government.

The banking industry has faced much criticism in recent years and we recognise that significant work is required to rebuild trust with customers and other stakeholders.The financial services sector does however have a fundamental role to play in society in supporting both individuals and businesses through the provision of financial and payment services, and can be instrumental in helping the economy prosper and grow. The industry can help ensure the future strength and economic well being of the UK and its people and given our strategic assets we aim to play an important part in this.

I am pleased to report that during 2011, despite the challenging economic climate, the Group exceeded its full year contribution to the 'Merlin' lending commitments which were agreed in February with the UK Government, both for SMEs and in total. In the full year we provided £45 billion of committed gross lending to UK businesses, of which £12.5 billion was to SMEs. In the same period, the Group supported the start-up of 124,000 new SME businesses. For 2012, we have relaunched our SME Charter in which we have pledged to make at least £12 billion of gross new lending available to SMEs.

SMEs are a particularly important source of job creation and growth in the UK. Our core Commercial business is focused on serving these customers, and we demonstrated our support for SME customers in 2011 with year on year net lending growth of 3 per cent in this business area. This compared favourably with the negative growth in SME lending across the industry reported in the latest available market statistics from the Bank of England. In 2012, we have pledged to make at least £12 billion of gross new lending available to SMEs, with a further pledge to deliver positive net lending growth, to help stimulate economic output and improve confidence in the sector.

GROUP CHIEF EXECUTIVE'S REVIEW

As a member of the Business Finance Taskforce, we have led work to improve SME customer relationships through mentoring and a right to appeal and have agreed to contribute £300 million to the Business Growth Fund to provide better access to equity finance.

For our Retail customers, the Group completed £28 billion of new mortgage business in 2011, achieving a market share of approximately 20 per cent of gross new residential mortgage lending. We are committed to supporting the UK housing market and first-time buyers in particular. We advanced more than £5.6 billion of new lending to first-time buyers in 2011, helping over 52,000 customers own their first homes. Our market share of new first-time buyer business was approximately 24 per cent by value in 2011. In total, we advanced more than £15.5 billion of new mortgages to over 124,000 customers buying their home in the UK in 2011. Our Halifax brand is a leading lender in the affordable housing sector, with a dedicated product range designed for borrowers seeking shared equity or shared ownership schemes.

Looking forward, as part of our commitment to customers, we will keep the same net number of branches in our network for the next three years, excluding Verde, and we will not close a branch if it is the last one in a community.

We also committed to reduce the level of FSA reportable complaints we receive, excluding PPI complaints, by 20 per cent in 2011 compared to 2010. We achieved a 24 per cent reduction, and reduced our banking complaints per 1,000 accounts to 1.5. We achieved this through initiatives such as our Phone a Friend service, training of our 40,000 front line colleagues, and the roll out in the second half of an externally accredited complaint handling qualification. This makes us the first financial services organisation to have professionally qualified complaint handlers. To enable our customers get the right outcome faster, we are extending the opening hours of our specialist complaints teams to 24 hours a day, 7 days a week. As a result of these initiatives, we are now resolving over 90 per cent of complaints at first touch. In 2012, we have committed to improving this performance further, by reducing banking complaints to just 1.3 per 1,000 current accounts, and in 2014 to 1.0 per 1,000 current accounts.

Meeting our customers' needs with successful new products and services

Our strategy recognises our customers' needs for product simplicity and transparency, access through multiple channels, and value-for-money products and services. I am therefore pleased at the success of the new products and services launched in 2011, and the widespread recognition and broad range of external awards achieved across the Group. In Retail, notable product successes included a number of innovative Halifax savings products, which while not rate-leading, delivered strong deposit growth. These included, in the first half, the ISA Promise which saw our cash ISA balances grow significantly above our historic share, and, in the second half, the Savers Prize Draw which saw over 450,000 customers registered for the first draw.

We also received a number of external awards recognising the quality and consistency of delivery to our customers. Within Wholesale, our Corporate Markets area won the Best Bank of the Year award for the seventh consecutive year at the Real FD/CBI Excellence awards, while in Retail we were named 'Best Overall Mortgage Lender' for the tenth year running in the Your Mortgage Magazine Awards and in Insurance we were named as Britain's most popular home insurance provider by the independent market researchers GFK NOP for the tenth year in a row. In responding to our customers' need for access through multiple channels, in Retail, we launched a suite of Mobile Banking apps, and have now recorded one and a half million downloads.

Our commitment to our employees

Our success depends on our employees, the service they provide for our customers, and the long-term partnerships they build with them. We are committed to attracting, retaining and developing our people, and in 2011 launched a number of initiatives to identify and develop our future leaders, to simplify the link between performance and reward, and to ensure colleagues have the capabilities to deliver excellent service through learning and development resources such as our Learning Academies, through supporting external qualifications, and by introducing development and review programmes.

While the results of the colleague engagement survey we conducted in the second half of the year reflected both the challenging external environment and the work that remains to be done in ensuring Lloyds Banking Group is a great place to work, the progress we have made during the year reflects the strong capabilities and dedication of our people which will continue to support the delivery of our strategy.

Remuneration is an important issue for our stakeholders and the Group. We are keen to ensure we recruit and retain the right employees to drive our business forward and deliver on our strategy while ensuring that there is alignment between remuneration and results. Variable pay is reflective of the performance of the business and total discretionary bonus awards are approximately 30 per cent lower than last year with bonuses above £2,000 subject to deferral and adjustment. In addition, given the continued challenging economic conditions salary awards have been limited, especially at more senior levels.

EC mandated business disposal (Project Verde)

Following our decision early in 2011 to accelerate Project Verde, we have made good progress, and, having reviewed the formal offers for the Verde business, the preferred bidder for the business is The Co-operative Group. Any final transaction will be subject to regulatory approval and certain other conditions. The Group will continue to progress an IPO as an alternative to a direct sale. We remain on track to complete the transfer of the business before the end of 2013.

Equity dividends

The European Commission's restriction on equity dividend payments was part of the conditions of the State Aid restructuring plan which expired in early 2012. We understand that the absence of dividends has created difficulties for many of our shareholders and we remain committed to recommencing progressive dividend payments as soon as we are able.

It is our intention to do so when the financial position of the Group and market conditions permit, and after regulatory capital requirements are defined and prudently met. At this time those requirements remain unclear and although we have made good progress against our strategic priorities during the year we are not yet able to forecast when we will be able to resume dividend payments, although we continue to strive to recommence them as soon as possible.

Greater clarity emerging on UK regulatory framework

The publication of the ICB's final report in September and the Government's response to the report in December are significant steps in providing greater clarity on changes to the regulatory framework for the UK banking industry to secure greater financial stability.

GROUP CHIEF EXECUTIVE'S REVIEW

On competition, we are pleased that the Verde sale is seen as creating an effective new challenger in our market, and that our proposals, developed with the Payments Council, to make it quicker and simpler for customers to switch accounts, were recommended by the ICB and backed by the Government.

We also welcome the Government's endorsement of the ICB's proposals to ring-fence retail banking operations as part of a wider regulatory framework including capital and liquidity and effective macro- and micro-prudential supervision, which should remove any implicit tax-payers' guarantee for the ring-fenced entities. Given that we are predominantly a retail and commercial bank, we would expect to be less affected by the implementation of a retail ring-fence, but believe it will be important for any transition period to be flexible in order to minimise any impact on economic growth, and for banks to implement the required structural changes.

The ICB also recommended that ring-fenced banks should hold a capital base of at least 10 per cent to absorb the impact of potential losses or financial crises. The Government's proposals on capital are consistent with the capital targets we set in our strategic review in 2011 and, although much work remains to be done on the detail of the implementation capital requirements, we are on track to achieve the capital levels the ICB recommends.

We expect the Government to provide further details of its plans in the spring of 2012 and to outline which of the proposals it intends to progress to legislation. We will continue to work with HM Treasury and our regulators in the coming months ahead of the publication of the final white paper.

Economic outlook

While the outlook for the UK economy remains uncertain, and vulnerable to developments in the Eurozone, we believe the most likely scenario is for further weakness in the first half of 2012 followed by a relatively modest recovery in the second half resulting in broadly flat real GDP for the year as a whole, with further modest recovery in 2013. As a result, we expect UK base rates to remain at current levels into 2013, and unemployment to rise from current levels to peak at around 9 per cent in 2013. However, we expect inflation (CPI) to fall from current high levels to below 3 per cent in 2012 and possibly below 2 per cent in 2013. UK property prices are likely to reflect the weak economic environment, with house prices remaining broadly flat in 2012 and 2013 and commercial property prices likely to be marginally weaker in 2012, and marginally stronger in 2013.

Outlook and financial guidance

We expect the external environment to remain challenging in 2012, with a subdued economy, continued high levels of regulatory scrutiny and political uncertainty relating to the banking sector, and the continued potential for downside effects from financial market volatility and instability in the Eurozone.

Nevertheless, we remain confident that our medium-term financial targets, as set out in our June 2011 Strategic Review are achievable over time, although, as we anticipated in our Q3 2011 Interim Management Statement, we now expect the attainment of our income related targets, including for Other Operating Income, to be delayed as a result of the weaker than expected economic outlook. As a consequence, we now also expect the attainment of our return on equity target to be delayed beyond 2014. On the other hand, we continue to expect to deliver our balance sheet, cost and impairment targets in 2014, and in some cases sooner, given the good progress made so far.

In relation to our balance sheet, this progress includes the £53 billion reduction in non-core assets achieved in the year and the 60 basis point increase in our core tier 1 ratio to 10.8 per cent. As regards our income targets, we have reduced our asset quality ratio (impairment as a percentage of average advances) by 39 basis points to 1.62 per cent, a significant step towards our target of 50 to 60 basis points. The positive strong momentum of our Simplification programme, with £242 million of run-rate cost savings already achieved at the end of 2011, means that we are now increasing our target cost savings from this programme by £200 million, to £1.9 billion (from £1.7 billion) by the end of 2014, and to £1.7 billion from £1.5 billion in 2014.

Given the economic outlook, in 2012, on a combined businesses basis, we expect income to be lower than in 2011, given further non-core asset reductions, subdued demand in the core business leading to a broadly stable core book, higher wholesale funding costs, and interest rates likely to remain at low levels for longer. We retain significant capacity to grow core assets subject to demand and to maintaining our prudent appetite for risk. Our banking net interest margin, as expected, was marginally below 2 per cent in the fourth quarter of 2011. We expect our full year banking net interest margin to be below 2 per cent in 2012, falling year-on-year by approximately the same amount in 2012 as in 2011, as a result of continued higher wholesale funding costs, the repricing of interest earning assets and higher costs from the spread between base rates and LIBOR. We expect the benefit from fair value unwind to reduce to approximately £0.5 billion in 2012. However, we expect a further reduction in costs, and a similar reduction in Group impairment in 2012 as seen in 2011, as a result of further asset quality improvements across the divisions, with the largest improvement coming from International.

We expect to continue to strengthen our balance sheet in 2012, by a further reduction in non-core assets of approximately £25 billion, through targeting further deposit growth of around 3 per cent (based on a continuation of current market conditions), by strengthening our funding position, with approximately 50 per cent of our term wholesale funding target for 2012 already completed, and by further improving our core tier 1 ratio. Growth in customer deposits remains a key part of our funding strategy, and, assuming a continuation of current trends, we would expect to reach our medium-term Group loan-to-deposit ratio target of 130 per cent or below by the end of 2012, two years ahead of plan.

While we remain mindful of the challenges of the external environment, Lloyds Banking Group is now in a significantly stronger position than it was twelve months ago, and I would like to thank all our people for their contribution to our progress in 2011. Given we are likely to have lower interest rates for longer and higher regulatory costs along with deleveraging in credit markets, it will be those banks who can create competitive advantage through a lower risk premium combined with best in class efficiency who will achieve superior returns and will capture the opportunities as economic conditions improve. Absent a material deterioration in the economic environment, we remain confident in our ability to continue to execute against our strategic plan, and therefore continue to believe we are well positioned to realise over time the full potential of our organisation, brands and capabilities, and to achieve strong, stable and sustainable returns for shareholders.

António Horta-Osório
Group Chief Executive

BUSINESS REVIEW

MARKETPLACE TRENDS

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

Regulation

- → Stringent UK capital and liquidity standards
- → More focus on consumer protection and transparency
- → Recovery and resolution mechanisms and Retail ring-fencing
- → ICB final recommendations

The quantum of regulatory change remains high and the regulatory environment remains challenging but we are starting to see greater clarity in a number of areas. There are however a number of different issues that are likely to have a fundamental impact on the business going forward including the recommendations arising from the Independent Commission on Banking, future capital and liquidity requirements, and the changes to the UK banking supervisory structure

Independent Commission on Banking

In 2010 the UK Government appointed an Independent Commission on Banking (ICB) to review possible structural measures to reform the banking system and promote stability and competition. The ICB published its final report on the 12 September 2011 putting forward proposals that require ring-fencing some of the retail and SME activities of banks from their investment banking activities and additional capital requirements beyond those required under Basel III.

On 19 December 2011 the Chancellor delivered the Government's first formal response to the ICB's Final Report of 12 September. The response endorsed many of the key recommendations contained in the ICB's Final Report, including the ring-fencing of commercial and retail operations, higher capital requirements and a 7-day current account switching service. Importantly for the Group, the Government also supported the principle of a 'flexible' ring fence, which allows banks to choose where to place some (but not all) services.

Greater clarity on the Independent Commission on Banking's recommendations was given during the year but uncertainty over key elements of the reform proposals still remain.

While the Group welcomes the increased clarity provided by the Government's initial response, significant uncertainty remains over key elements of the reforms, including what activities could be allowed inside the 'ring-fenced bank', the extent of depositor preference of other creditors and measures that could see some categories of wholesale funding 'bailed-in' in the instance of resolution.

The Government has announced that it will be producing a formal White Paper in the spring and we would anticipate that this paper will provide additional clarity, while still leaving some issues open to consultation. The Group continues to work to assess the impact that the reforms may have on its business and continues to play a constructive role in the debate with the Government and other stakeholders.

Capital Requirements Directive IV

Evolving capital and liquidity requirements continue to be a priority for the Group. Separate to the capital recommendations laid out by the ICB, the Basel Committee on Banking Supervision has put forward proposals for a reform package which changes 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 and the fourth round of changes to the European Capital Requirements Directive IV is currently in draft form and progressing through the European legal framework towards finalisation.

UK Banking Supervisory Structure

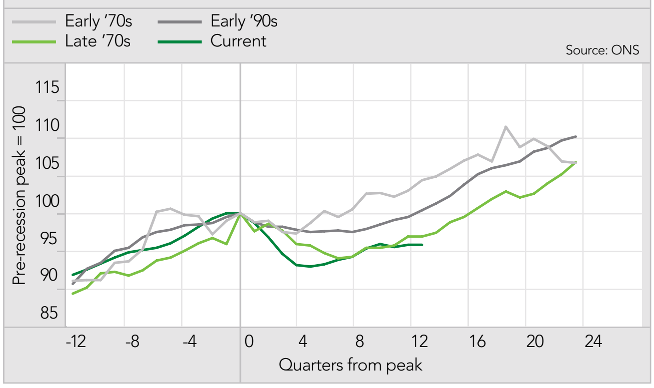
The recent ongoing difficulties in global financial markets have prompted a review and alteration to the banking supervisory structure in the UK. In April 2011, the FSA commenced an internal reorganisation as a first step in a process towards the formal transition of regulatory and supervisory powers from the FSA to the new Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA) in 2012. Until this time the responsibility for regulating and supervising the activities of the Lloyds Banking Group and its subsidiaries will remain with the FSA. However, the reorganisation could lead to changes in how the Group is regulated and supervised on a day-to-day basis. 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 approaches across the EU.

MARKETPLACE TRENDS

The economy

The global economy was split in 2011 between relatively strong growth in emerging markets, and economies struggling to recover from recession in much of the Western world. Indeed, the extent of the UK economic recovery has now fallen behind even the weak recovery after the late 1970's recession.

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



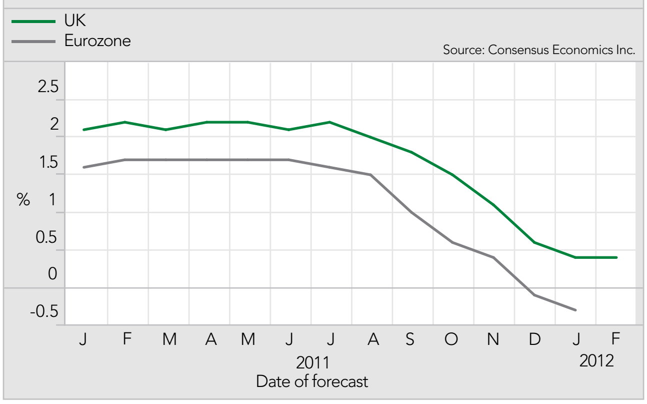
The stark difference is due to the high levels of indebtedness that many developed economies accumulated prior to 2008, which are holding back economic growth through deleveraging of initially the private sector, but now governments too. In the Eurozone, countries with particularly high government debt or deficit levels have lost market confidence as they struggled to achieve the necessary fiscal tightening to bring their public finances onto a sustainable trajectory without damaging economic growth prospects too severely. Ireland, Portugal and Greece have received further IMF and EU financial support in return for accepting even more stringent austerity programmes, and at the time of writing it looks likely that private creditors will suffer effective haircuts of significantly more than 50 per cent on their Greek debt. Italy and Spain have also tightened public budgets further, and given their much greater size this is dragging down Eurozone economic growth more significantly. In the US, public finance concerns are less immediate, but the unsustainable long term trajectory of debt on current policies has led to political stalemate, raising the risk of sudden fiscal tightening as previous loosening measures expire, and in turn hurting businesses' and consumers' confidence. Global growth was also hampered in 2011 by natural disasters, including the floods in Australia and the earthquake and tsunami in Japan, the latter causing significant disruption to global manufacturing supply chains.

First estimates suggest the UK economy grew by 0.9 per cent in 2011, well below the long term average of 2.3 per cent. The economy is currently estimated to have shrunk slightly in the final quarter of the year as consumers' and businesses' confidence fell, the result of relatively high inflation reducing consumers' spending power, a faster than expected reduction in public sector employment, and the worsening outlook for the Eurozone which caused companies to postpone investment spending and recruitment. Unemployment rose from 7.7 per cent in the first quarter of 2011 to 8.4 per cent by December. Company failures in England and Wales rose from a low point of 3,973 in the final quarter of 2010 to 4,260 by the fourth quarter of 2011, although the failure rate remained steady over that period at just 0.7 per cent of companies, close to its pre-recession trough. Property prices were broadly flat through the year, however – house prices on average fell marginally by 2 per cent in the year to December 2011, and commercial property prices rose on average by just 1 per cent.

Based on data for the first three quarters of 2011, the Irish economy appears to have grown in 2011 for the first time since 2007, and the unemployment rate appears to be stabilising. Strict austerity measures in recent years targeted at improving international competitiveness are beginning to pay off – falling domestic demand is now being more than offset by increasing net exports. Property markets remain very weak, however; house prices fell by over 16 per cent in 2011 and CRE prices by 11 per cent. Despite the large fall in prices already, an overhang of vacant property continues to weigh on market prices.

Future economic developments in the UK and Ireland are highly contingent on how successful political leaders are at stemming the Eurozone crisis, to what extent the private sector can offset shrinking of the public sector, and how the implementation of new regulation on banks impacts their ability to supply credit whilst meeting tighter capital and liquidity criteria. The recent weakening in the Eurozone economy and the balance of risks make double-dip recession there in early 2012 the most likely scenario – indeed this is now the consensus view (Chart 2).

Chart 2: **Consensus forecasts for 2012 GDP growth**



The current consensus view for 2012 UK GDP growth is not yet that weak, at 0.4 per cent. The low level of imbalances in the economy relative to the 2008 position suggest that weak growth should not deteriorate into significant recession provided the Eurozone moves quickly towards a solution to the sovereign debt crisis. Bank Rate is likely to stay at or close to current low levels for some time, and property prices are expected to be broadly stable. Unemployment is likely to rise further, however, as estimates of public sector job cuts have increased. The current consensus view for 2012 Irish GDP growth is broadly flat, and the unemployment rate there is expected to be stable. Property prices are expected to fall further, but by less than in 2011.

However, whilst a definitive solution to the Eurozone crisis remains lacking there continues to be a high risk that ongoing uncertainty around the Eurozone economic outlook, the survival of the Euro currency and the availability of credit could cause a significant recession in the UK and Ireland. Such a scenario would likely result in higher UK corporate failures, a second leg of falling property prices, albeit by less than during the 2008-9 recession, and rising commercial tenant defaults. Irish property prices would also fall by more than currently expected. In turn, this would have a negative impact on the Group's income, funding costs and impairment charges.

MARKETPLACE TRENDS

The impact on our markets

The weak economic recovery has kept growth in our markets subdued. With the economy expected to grow weakly at best in 2012, our central expectation is that growth in our markets will remain weak in 2012.

For the market as a whole, net new mortgage lending has amounted to just 0.7 per cent of outstanding balances during 2011, very similar to 2010. Consumers made net repayments of unsecured debt (excluding student loans) of around 2 per cent of outstanding balances for the third consecutive year in 2011. Household deposits rose by 2.6 per cent in 2011 similar to the rate of increase in the previous two years but well down from the 8-9 per cent growth per year pre-recession.

Similarly, companies have been focused on paying down existing debt, for the third successive year in 2011. Non-financial companies made net repayments of 3.7 per cent of sterling lending from banks and building societies in 2011, after repayments of 3.5 per cent in 2010 and 2.2 per cent in 2009. Company deposits with UK banks rose by 1.1 per cent in 2011, slower than the 1.8 per cent rise in 2010 and the 4.5 per cent increase in 2009. Although companies have held back investment spending and prioritised cashflow, much of this has fed into lower borrowing rather than higher deposits.

In Ireland, continued falls in house prices, despite the already steep reductions prior to 2011, have kept impairments high and we expect property prices to remain subdued.

We expect that another weak year for the UK economy in 2012 will be accompanied by weak customer deposit growth and a continued period of declining demand for borrowing, particularly from companies. The continuation of low interest rates, and the substantial adjustments that many companies and households have already made to their indebtedness, is likely to minimise any deterioration in arrears. Our central expectation of broadly flat property prices in the UK in 2012 is consistent with the subdued market expected.

Customer drivers, including competition

- → **Want simplicity and transparency**
- → **Demand a quality, multi-channel customer service experience**
- → **Growing demand for advice to plan/save for retirement**
- → **Increasingly demand better value for their money**

In the competitive open market in which we operate there is an increasing range of products and services available to customers, and with the current public scrutiny of banks the expectations and demands of customers continue to increase.

Access to convenient branches remains important for many customers but demand for a quality multi-channel banking proposition is now more prevalent and the provision of effective telephone, digital and mobile channels is increasingly important. Service remains one of the key drivers of customer satisfaction and customers are less accepting of poor service given the competitive nature of the market.

In the current low interest environment many customers are demanding better value for money but security and reputation remain important factors. Customers want clear and transparent products delivered with good service and access to helpful, relevant, expert advice when they need it. Customers are demanding basic banking services to be delivered well but there is also an increasing demand for advice in more complex areas such as help in planning and saving for retirement. Product innovation is also important for some whereas longstanding relationships remain important for others.

As highlighted above, there are some clear customer trends emerging but we recognize that every customer, whether they be retail or corporate, has their own personal needs and has to be treated individually. It is clear that different customer segments have different demands and the opportunity exists to differentiate service for varied segments but fundamentally the customer has a choice and will select the provider that can most effectively service their personal needs.

The financial services market remains competitive. We are seeing a number of new entrants including Virgin Money and Metro Bank looking to make inroads into the market and the disposal of the Verde branches along with the improved switching process will further enhance competition.

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

Marketplace trends

Key opportunities

- → **Economic environment:** Significant progress in reducing the Group's risk profile and strengthening the balance sheet in recent years along with strategic actions taken in 2011 means we are better positioned to benefit as the economy recovers.
- → **Customer requirements:** Our strategic assets, including a comprehensive multi-channel distribution network, strong customer relationships, well recognised brands and high quality people mean we are positioned to address the customer trends.
- → **Regulatory environment:** Greater clarity emerging on regulatory requirements.

Key challenges

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

BUSINESS MODEL AND STRATEGY

UNLOCKING THE GROUP'S POTENTIAL

Our business model

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

Our business model is designed around our distinctive capabilities in serving personal, commercial and corporate customers across the UK, with a focused range of banking, insurance, investment, debt financing and risk management products to meet customer needs.

In delivering these products to our customers we capitalise on our strong customer relationships, our iconic and distinct brands, our broad multi channel distribution and our customer focused people.

We have over 30 million customers and customer leadership driven by superior customer insight, tailored products, better service and relationship focus is the overriding priority. We want to meet all the financial needs of our customers and help them succeed financially. Only by successfully focusing on the needs of customers can we deliver sustainable value to our shareholders.

Though the UK financial services market remains one of the largest in the world our business model and strategy has been formulated in the context of a cautious outlook for the UK economy.

Fundamentally we remain a more conservative, through the cycle, relationship focused business and with a stronger balance sheet, a simpler and more efficient structure and the renewed customer focus we believe we can deliver strong, stable and sustainable returns for shareholders.

Halifax is being repositioned as a leading challenger brand in UK retail banking, with a value for money proposition and innovative products.

BUSINESS MODEL AND STRATEGY

Our strategy

A UK focused strategy to be the best bank for customers, which will deliver strong, stable and sustainable returns for our shareholders.

We are looking to create a more agile, efficient and responsive customer focused organisation with a real focus on operating sustainably and responsibly. We will reshape and simplify the business and invest a portion of the savings realised from the simplification initiatives in customer related growth initiatives. Whilst focusing on core markets which offer strong returns and attractive growth we will maintain a prudent approach to risk and further strengthen the Group's balance sheet and liquidity position.

We intend to reshape our business portfolio to fit our assets, capabilities and risk appetite. We will further reduce the balance sheet through the continued reduction of our non-core assets and reduce the risk in the business through the application of a conservative approach to, and prudent appetite for risk. We will also reduce our international presence.

We believe we can unlock the potential in the franchise and deliver value to customers and shareholders by creating a simpler, more agile and responsive organisation. Opportunities exist to increase the efficiency of operations and processes and reduce costs whilst still addressing customer needs more effectively. The creation of a simpler, more agile organisation will enable the Group to adapt more effectively to the external environment whilst addressing the changing needs of the customer base more effectively.

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

Our action plan for success

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

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

SIMPLIFY…
the Group to improve agility and efficiency.

INVEST…
to be the best bank for customers.

STRENGTHEN…
the Group's balance sheet and liquidity position.

The Bank of Scotland was founded in 1695 and over the years has developed long lasting, strong relationships with its customers.

DELIVERING OUR ACTION PLAN

RESHAPE

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

Aim

We will focus on attractive UK customer segments and their product needs, to target a sustainable statutory return on equity of between 12.5 and 14.5 per cent.

We will invest behind core areas which offer strong returns and attractive growth: these are businesses which are capital and liquidity efficient, with sustainable competitive advantage, and which are central to our core customer strategy.

In reshaping our business, we have identified the following areas of focus:

→ **Continued reduction in non-core assets**
→ **A prudent appetite for risk**
→ **Streamlining our international presence**

Key initiatives and progress in 2011

Significant progress has already been made this year in reshaping our business, particularly with regard to embedding new risk processes and reducing non-core assets.

Continued reduction in non-core assets

In 2011 we have continued to make good progress in reducing the level of non-core assets, which now stand at £141 billion, down £53 billion in the year.

Non-core assets are generally businesses which deliver below-hurdle returns, which are outside our risk appetite or are distressed, are subscale or have an unclear value proposition, or have a poor fit with our customer strategy.

We have continued to take a disciplined approach to the management and reduction of our non-core assets. Our non-core commercial real estate and corporate loans are managed on a day-to-day basis by a dedicated workout unit reporting to our Risk function, while non-strategic activities are managed by dedicated teams until run-off or sale.

We will continue to divest or run off non-core assets and are targeting a reduction in our non-core assets to less than or equal to £90 billion by the end of 2014, and for them to account for less than or equal to £65 billion of risk-weighted assets by that time. We are also targeting non-core run-off and disposals to be net capital generative over the period 2012 to 2014.

A prudent appetite for risk

We have now fully embedded across the business a conservative approach to, and prudent appetite for, risk, and have in place disciplined controls over the risk profile of all new business. We have also reviewed our existing portfolios and confirmed them as adequately provisioned.

The intended reduction of non-core assets and the prudent management of risk should result in an improvement in the Group's asset quality ratio to 50 to 60 basis points by the end of 2014, with the core business expected to be at the bottom end of this range. In 2011 we have made excellent progress, with our asset quality ratio dropping from 201 to 162.

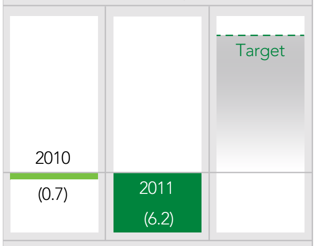
Streamlining our international presence

We will streamline our international presence from around 30 countries to less than half that number by 2014 and in 2011 we have already made good progress having announced the exit from seven countries. We will also concentrate our skills and investment in these countries which will enable us to make sure local opportunities can be identified and initiated in a cost effective value adding manner.

Performance against our targets

Return on equity

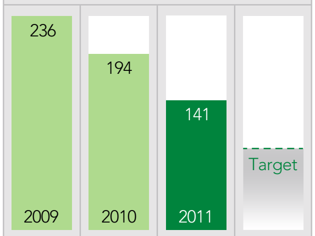
Target
12.5-14.5%



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

Non-core asset reduction

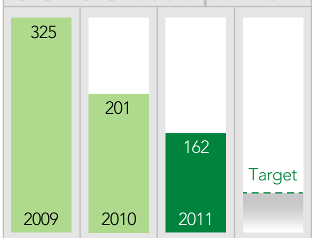
2014 target
≤£90bn



Good progress continues to be made in reducing the level of non-core assets.

Asset quality ratio

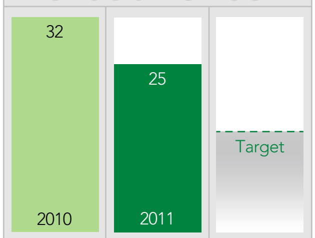
2014 target
50-60 basis points



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

International presence

2014 target
<15 countries



We will streamline our international presence from circa 30 countries to less than half that number by 2014.

Priorities for 2012

→ **Continue to carefully and effectively run down our non-core assets taking into consideration risk and value**
→ **Continued improvement to asset quality ratio**
→ **Continued reduction in our International presence**

DELIVERING OUR ACTION PLAN

SIMPLIFY

the Group to improve agility and efficiency.

Aim

We are targeting further cost saving and investment initiatives to attain a cost:income ratio of 42–44 per cent.

Our integration programme was substantially completed in 2011, delivering a single banking platform and a run-rate of £2 billion per annum in cost synergies and other operating efficiencies.

We are now targeting a further £1.7 billion of cost savings in 2014 through a series of simplification initiatives. Savings will be realised by focusing on the four areas below:

- → **Operations and processes**
- → **Channels and products**
- → **Sourcing**
- → **More agile organisation**

Key initiatives and progress in 2011

The integration programme initiated at the time of the HBOS acquisition was substantially completed during the year, with a run rate of more than £2 billion per annum of cost savings and other operational efficiencies now achieved, in line with target. This was a significant achievement, particularly the successful migration of nearly 30 million customer accounts to a single operating platform. The implementation of a single operating platform for our key product areas means the Group is now in a strong position to undertake further simplification initiatives, as outlined below.

Simplification initiatives

The Group is now targeting a further £1.7 billion of sustainable annual total cost savings in 2014, and by leveraging our prior experience from integration, this can be completed in a cost and time efficient manner. We have made strong initial progress with run-rate cost savings of £242 million at end 2011. The main initiatives now being progressed are:

Operations and processes: We are conducting an end-to-end redesign of our processes, which will include significant process automation, and will materially reduce the number of IT applications. This will improve the customer experience (for example through accelerating the fulfilment of requests and reducing errors), increase productivity and reduce risk, complexity and costs.

Sourcing: We will optimise our demand management and further strengthen our supplier relationships, reducing the number of suppliers to the Group to under 10,000, and further focusing on a core group of lead suppliers, to achieve approximately a 15 per cent saving on addressable spend. In 2011 we reduced supplier numbers by around 2,500.

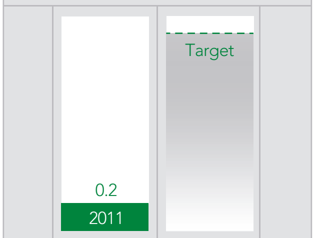
More agile organisation: We have already made good progress in creating a more agile organisation through delayering our management structure and centralising control functions, but further developments including the creation of a simpler legal structure still need to be progressed. Our focus will be on reduction in middle management, bringing our top team closer to the customers and front-line staff.

Channels and products: We intend to create a highly efficient distribution platform whilst providing customers with greater choice and convenience. We will streamline our product suite and migrate products to digital distribution channels, encompassing the internet, mobile applications and telephony.

Performance against our targets

Cost savings (simplification)

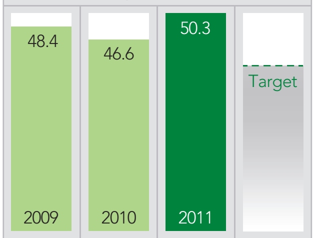
2014 target
£1.7bn



We are targeting £1.7 billion of cost savings in 2014 through a series of simplification initiatives and have delivered £0.2 billion in 2011.

Cost:income ratio

Target
42-44%



Although the cost:income ratio increased in 2011 we continue to believe the cost savings and investment initiatives will deliver a cost:income ratio of 42-44 per cent.

Priorities for 2012

- → **Creation of a more efficient and agile organisational structure**
- → **Increased focus on sourcing and further reducing the number of supplier relationships**
- → **Undertaking a fundamental review of our key processes**
- → **Increased utilisation and development of digital distribution channels**

DELIVERING OUR ACTION PLAN

INVEST

to be the best bank for customers.

Aim

We intend to invest approximately £500 million annually by 2014, equivalent to approximately one-third of the savings from our simplification initiatives, to grow our core income, with approximately £2 billion invested between 2011 and 2014.

This is in addition to our business-as-usual investment programme and is expected to result in core income growth above UK GDP growth, primarily driven by growth in other operating income.

Our investment will be subject to disciplined tests, including the financial returns, fit to our risk appetite and alignment with our strategy to be the best bank for customers. The investment will primarily be focused on:

- → **Becoming the best bank for personal customers**
- → **Becoming the best through-the-cycle partner for our business customers**
- → **Maintaining bancassurance as a core element of our proposition**

Key initiatives and progress in 2011

Much of the additional investment we intend to make in the business will be derived from the cost savings delivered from the simplification initiatives, which have yet to occur. Despite this we have already made significant investments in 2011, including the revitalisation of Halifax as a challenger brand and the implementation of a new e-solution for foreign exchange trading and money market deposits for our Corporate customers.

Investing to be the best bank for personal customers

In Retail, we have started to revitalise the Halifax brand to be a leading challenger brand in UK retail banking. We aim to deliver a simple, efficient and fair customer experience, innovative products such as the ISA Promise or Savers Prize Draw, and to be a value-for-money leader.

We will also invest in Lloyds TSB and Bank of Scotland as leading relationship brands in UK retail banking. We will be focused on recognising and rewarding our customers' loyalty, and we will invest in our branches, in new channels such as mobile banking, and services like Money Manager.

In Wealth, our goal is to be the primary Wealth advisor to our UK mass affluent, affluent and high net worth customers. We will invest in new coverage models to better meet our customers' service needs, electronic capabilities such as an improved on-line channel and an execution-only service, and a new investment platform incorporating Scottish Widows' and third-party products. We will also refocus our International business on UK expatriates and others with UK connections.

Invest to be the best through-the-cycle partner for our business customers

Our goal is to be the best through-the-cycle partner for our business customers, both through our Commercial Banking operations, which serve Small and Medium-sized Enterprises (SMEs), and our Wholesale Banking business, which addresses the needs of UK companies and institutions thereby taking a leading role in supporting the UK economy.

In both businesses, our goal will be to increase our share of capital-light services, including risk and cash management, general insurance, pensions and wealth for SMEs, and transaction banking, debt financing, and rates business for UK corporates and institutions.

Bancassurance is a core part of our proposition

Bancassurance will be a core part of our proposition, through our multi-brand retail strategy. There is a growing need for advice relating to investment and protection and we are well placed to address this through our bancassurance model.

Performance against our targets

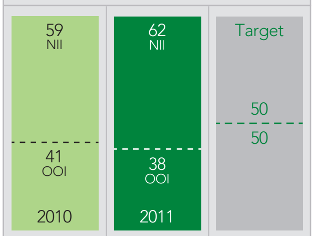
Investment

2014 target
c.£500m pa

We expect to invest approximately £500 million annually by 2014, equivalent to approximately one-third of savings from our simplification initiatives, to grow our core income in addition to our business as usual investment programme.

NII:OOI split

Target
50:50



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

Priorities for 2012

- → **Further revitalisation of Halifax as a challenger brand**
- → **Continued support of the SME sector**
- → **Increasing share of capital light business in the corporate and commercial business**
- → **Further investment in improving the bancassurance proposition**

DELIVERING OUR ACTION PLAN

STRENGTHEN

the Group's balance sheet and liquidity position.

Aim

We will continue to strengthen the Group's balance sheet and liquidity position to ensure a robust core tier 1 capital ratio and stable funding base by:

- → **Targeting a robust core tier 1 capital ratio, prudently in excess of 10 per cent**
- → **Exceeding regulatory liquidity requirements**
- → **Maintaining a stable funding base**
- → **Improving the Group loan to deposit ratio to 130 per cent or below**

Key initiatives and progress in 2011

We have made great progress in strengthening the Group's balance sheet in 2011. In addition to the continued strengthening of our capital ratios, we have continued to make excellent progress in our wholesale funding and continued to reduce the level of government and central bank funding. Though much progress has been made in the last few years in this area, it is clear, given the current economic and regulatory environment that further strengthening is required and we will continue to target improvement in four main areas: capital position, liquidity, funding and loan to deposit ratio.

Robust capital position

We are targeting a core tier 1 capital ratio prudently in excess of 10 per cent from 1 January 2013 when the transition period to Basel III commences. Although we already have a core tier 1 capital ratio of 10.8 at the end of 2011 we expect the implementation of Basel III to have a negative effect and we therefore continue to target further improvement.

Exceeding regulatory liquidity requirements

We expect to meet the requirement for our Liquidity Coverage Ratio and our Net Stable Funding Ratio to be in excess of 100 per cent by 2014, in advance of regulatory requirements. This will require us to increase our holdings of primary liquid assets to a level broadly equivalent to our wholesale funding with a maturity of less than one year, although the quantum of this will be lower than currently as we reduce the levels of wholesale funding.

A stable funding base

Given the significant progress made in the last couple of years on non-core asset reductions, deposit growth and funding our wholesale funding requirement has fallen significantly. As a result our annual wholesale term issuance requirement has also now fallen and we now expect term issuance of £20 to £25 billion per annum going forward.

We also expect a continued reduction in the level of government and central bank funding with current plans assuming that the remaining facilities will be repaid in line with contractual maturity dates, the last of which is in October 2012. The Group remains committed to being a commercial, self sufficient, dividend paying entity over time.

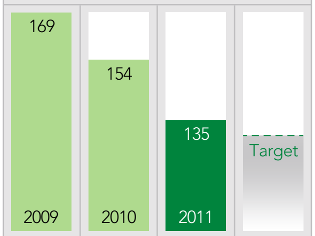
Group loan-to-deposit ratio

With a reduction in our non-core assets, and further growth in our relationship customer deposits, we were initially targeting an improvement in our Group loan-to-deposit ratio to 130 per cent or below by the end of 2014, but we now expect to attain this in 2012.

Performance against our targets

Loan to deposit ratio

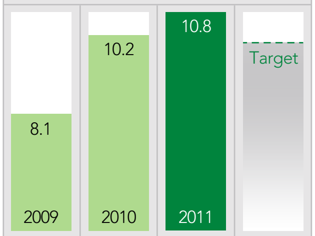
2014 target
130%



We have made good progress in reducing our loan-to-deposit ratio and though we initially targeted a loan-to-deposit ratio of <130 per cent by the end of 2014, we now expect to attain this in 2012.

Core tier 1 ratio

2013 target
>10%



We have continued to improve our core tier 1 ratio, which now stands at 10.8 per cent on a Basel II basis. We continue to target a core tier 1 ratio prudently in excess of 10 per cent from 1 January 2013 when the transition period to Basel III commences.

Priorities for 2012

- → **Further improvements to the core tier 1 capital ratio**
- → **Increased liquidity as a proportion of wholesale funding with a maturity less than a year**
- → **Continued deposit growth from core customer relationships**
- → **Attaining our £20-£25 billion wholesale term funding target**
- → **Further reductions in the loan to deposit ratio**

RELATIONSHIPS AND RESPONSIBILITY

BUILDING VALUABLE RELATIONSHIPS

The successful delivery of our strategy will be driven by the relationships we develop with our customers.

With over 30 million personal and business customers and a presence in communities across the country, we are uniquely placed to help unlock the potential of families, businesses and communities we serve, making a significant contribution to the future strength and prosperity of the UK. Our vision of being the best bank for customers along with our focus on operating sustainably and responsibly underpins our approach to business. Over the next few pages we set out our approach to:

CUSTOMERS…
COLLEAGUES…
COMMUNITIES…

The Group's continued success depends on our colleagues and their ability to build strong and deep relationships with customers.

Investing in communities

Lloyds Banking Group is the biggest corporate investor in UK communities, investing over £85 million last year in financial inclusion and financial capability, higher education and sports for young people and almost £30 million to support grassroots charities working with disadvantaged communities.

RELATIONSHIPS AND RESPONSIBILITY

CUSTOMERS

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

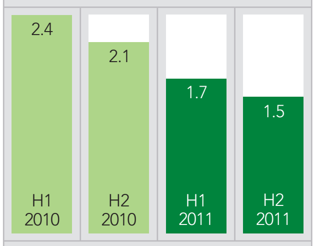
Aim

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

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

Performance in 2011

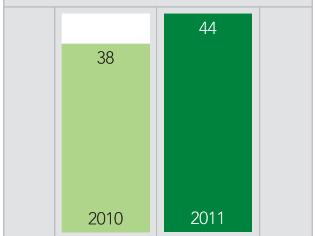
Customer complaints (FSA complaints* per 1,000 a/c)



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

*Excluding PPI

Customer satisfaction (net promoter score) %



We have developed a comprehensive customer experience program measuring customer service at key touch points and likelihood to recommend through the cross industry Net Promoter Score metric.

Priorities for 2012

- → **Further simplify our systems, processes and products, making it easier and more convenient for customers to bank with us, thereby improving the overall experience**
- → **Continue to improve our complaint handling performance reducing FSA reportable banking complaints per 1,000 accounts to 1.3 by the end of 2012**
- → **Maximize the use of our customer relationships and insight to enable us to engage more effectively with our customers and become more responsive to customers' needs**

Summary

The strategy for the Group is built on being the best bank for customers, and to create value by investing where we can make a real difference for these customers. The Customer is therefore at the heart of everything we do, whether it be our branches, our brands or our people and is a key driver for our Group values.

We have over 30 million personal, commercial and corporate customers and operate the largest retail bank in the UK. In 2011 we made great progress towards our goal of being the best bank for customers with a number of notable product launches, a significant reduction in customer complaints and numerous system and process improvements whilst continuing to support our customers and the UK economic recovery. We also received a number of external awards recognising the quality and consistency of delivery to our customers. Our Corporate and Commercial businesses won the Best Bank of the Year award for the seventh consecutive year at the Real FD/CBI Excellence awards, while in Retail we were named 'Best Overall Mortgage Lender' for the tenth year running in the Your Mortgage Magazine Awards and in Insurance we were named as Britain's most popular home insurance provider by the independent market researchers GFK NOP for the tenth year in a row.

Our customer focus is increasingly driving key business decisions and the responsible position we took on PPI and our commitment to keep our branch network at the same level for the next three years (excluding Verde) and not to close a branch if it is the last in the community demonstrates our commitment to do the right thing for customers.

Supporting our customers and the UK economic recovery

As part of our strategy to be the best bank for customers, and as a leading financial services provider in the UK, the Group continues to actively support sustainable growth in the UK economy through the focused range of products and services we provide to our business and personal customers, as well as through partnerships we have built with industry and government.

Despite the challenging environment the Group exceeded its full year contribution to the 'Merlin' lending commitments which were agreed in February with the UK government, both for SMEs and in total. In the full year we provided £45.3 billion of committed gross lending to UK businesses of which £12.5 billion was to SMEs. In the same period the Group supported the start up of nearly 124,000 new SME businesses. The Group actively looks at all opportunities to support UK businesses and we continue to innovate in the market to meet our customers' needs.

RELATIONSHIPS AND RESPONSIBILITY

Customers

SMEs are a particularly important source of job creation and growth in the UK. Our Commercial business is focused on serving these customers, and we demonstrated our support for SME customers in 2011 with year on year net lending growth of 3 per cent in this business area. This compared favourably with the negative growth in SME lending across the industry reported in the latest available market statistics from the Bank of England. As part of this growth we increased our advances to manufacturing businesses through invoice finance by 30 per cent net. In 2012, we have pledged to make at least £12 billion of gross new lending available to SMEs, with a further pledge to deliver positive net lending growth, to help stimulate growth and improve confidence in the sector. We support corporate and commercial customers throughout the economic cycle to ensure their financial health, viability and growth and our Business Support Unit (BSU) specifically helps businesses in financial difficulties. Since 2009 the BSU has restructured facility for around 10,000 businesses and has protected more than 250,000 UK jobs. We are also simplifying processes and improving transparency for the benefit of customers. We have successfully piloted a re-egineering of our lending processes, halving the time to fulfil lending to customers, and intend to roll this out by the end of 2012 and launched simpler fixed charge money transmission Monthly Price Plan tariffs.

For our Retail customers, the Group completed £28 billion of new mortgage business in 2011, achieving a market share of approximately 20 per cent of gross new residential mortgage lending. We are committed to supporting the UK housing market and first-time buyers in particular. We advanced more than £5.6 billion of new lending to first-time buyers in 2011, helping over 52,000 customers own their own homes. Our market share of new first-time buyer business was approximately 24 per cent by value in 2011. In total, we advanced more than £15.5 billion of new mortgages to over 124,000 customers buying their home in the UK in 2011.

Complaint handling

As part of our strategy to become the best bank for customers we publicly committed to reduce the level of FSA reportable banking complaints, excluding PPI, we receive by 20 per cent. We achieved a reduction from 2.1 complaints per 1,000 accounts in the second half of 2010, to 1.5 in the second half of 2011. We aim to reduce this further in 2012 to 1.3 complaints per 1,000 accounts, and to 1.0 complaint per 1,000 accounts in 2014. The progress to date has been accomplished through the success of our phone-a-friend service, a specialist team which branch staff can refer to, and the training we have provided to our 40,000 front line colleagues. As a result of these initiatives, we are now resolving over 90 per cent of complaints at first touch. We are the first financial services organisation to roll out to all our complaint handling staff an externally accredited complaint handling qualification. In addition we have extended the opening hours of the specialist teams so they can deal with complaints 24 hours a day, 7 days a week, ensuring customers get the right outcome faster.

We have also introduced a group wide team that focuses on listening to customers and making improvements to remove the cause of customers' complaints. This has reduced complaints received from customers by more than 30,000 per month in 2011. All these changes have been driven by listening to our customers.

Delivering Innovative products and services

Our strategy recognises our customers needs for product simplicity and transparency, access through multiple channels and value for money products and services. We have worked hard to ensure we are offering products and services that respond to customers evolving needs and as a result a number of new and innovative products have been launched in 2011 such as the Halifax Savers Prize Draw. In addition, customers told us they wanted better ways of managing their money, so we launched Lloyds TSB Money Manager, an easy-to-use Internet Banking service that helps customers understand how they are spending their money and using their account. We also understand that people want to be able to access their accounts and balances on the move – our new mobile banking applications have been downloaded 1.5 million times and reached the number one spot in the Apple App Store free apps.

We have enhanced our internet banking offering to enable our retail customers to do more online, and extended the innovative Lloyds TSB Lend a Hand Mortgage to help customers purchase a home with the help of their local authority. To strengthen our strategy of being the best bank for SMEs, we launched our Best for Business campaign, reaffirmed our continued support for the SME Charter to respond to 90 per cent of lending appeals within 15 days which will exceed the industry standard of 30 days, and maintained our leading part in the Business Growth Fund which is the latest initiative from the Business Finance Taskforce.

In developing innovative and quality products and services the Bank liaises closely with internal and external suppliers to access and best use their expertise. External suppliers are very important in a number of areas and enable the Group to provide the best products & services to our customers. Engaging with them, and the wider supply market, in a way that adds mutual value is a key part of our Sourcing strategy to ensure we gain the best value for our customers across price, quality & social impacts.

Customer service and simplification

By putting customers at the heart of our business, and listening to their needs we have managed to simplify and enhance our systems and processes to help serve our customers more quickly and efficiently. The Integration programme has given us a single set of integrated systems which provides a great base for further development but we have also rolled out a number of initiatives to help make banking quicker and easier for customers. In fact we have made over 100 changes to simplify our systems and processes including the introduction of Immediate Deposit Machines and slip free transactions. We have also reviewed branch roles and opening times to ensure we can meet our customers' needs and are open when they expect them to be.

Customer satisfaction is assessed through the Net Promoter Score (NPS), which measures the likelihood of customers recommending us to others and all of our high street brands made significant headway in 2011, achieving their highest ever NPS scores, with the group wide score rising from 38 in 2010 to 44 in 2011. The Group monitors NPS across a range of touch points to ensure that the customer experience improves across the board. The process gives insight for specific channels, such as a branch or telephony network, product experiences, such as opening a new account, and other key events such as handling of complaints. This insight allows us to adapt our colleague training and processes in order to give customers an increasing quality of service. Our Halifax brand also received the highly coveted 'Best Customer Service' award at the Consumer MoneyFacts awards 2012, evidencing the real progress that's being made.

RELATIONSHIPS AND RESPONSIBILITY

Customers

Treating Customers fairly

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

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

Financial Inclusion

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

As the UK's biggest provider of social bank accounts, we make a significant investment in helping to bring people into the financial system. We currently provide over 4.2 million such accounts and in 2011 opened around 250,000 new accounts. We are also the only bank to offer basic banking facilities to prisoners, in conjunction with the National Offender Management Service. Almost as importantly, we can help our customers move to a full facility current account. In 2011 over 100,000 customers who previously had a social bank account either upgraded to or opened a mainstream bank account. We have recently made a number of improvements to make it easier for social bank account customers to upgrade.

Supplier relationships

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

We are committed to making Lloyds Banking Group the Best Bank for Customers. The image shows how our customers are at the heart of everything we do in our retail business. The wheel brings together how we'll make the most of our brands, the investment we're making in our branch network, and what's needed from colleagues to bring this to life for our customers.

COLLEAGUES

Our colleagues deliver the experiences that will make us Britain's best bank for customers.

Aim

Our ambition is for a more diverse, better engaged and stimulated employee group to help us achieve our goals. At Lloyds Banking Group, we want the diversity of our employee base to more accurately reflect the diversity in our society; the better we reflect our marketplace the better we can serve it.

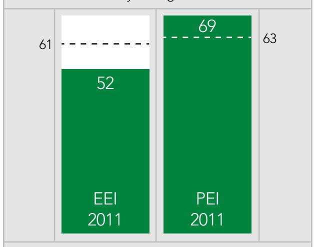
Growing talent is a key priority, we need to motivate and nurture a developing pool of talent that drives our business in a way that is sustainable and realistic in the current climate.

All of this goes hand in hand with giving people equal access to a variety of opportunities and making our business work closely with our surrounding communities to build relationships and share skills.

Performance in 2011

Staff engagement score %

- - - - UK industry average



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

Staff training days

Colleagues received an average of 6.9 days formal learning in 2011 reflecting ongoing commitment to learning and development.

Priorities for 2012

- → Making our customer-facing teams more successful, by ensuring those colleagues who come into direct contact with our customers are equipped with the necessary skills and expertise to provide a positive customer experience
- → Growing great leaders
- → Simplifying the way we work

Building long lasting relationships through people

Lloyds Banking Group's continued success depends on our colleagues. Our colleagues aim to provide excellent service everyday and spend time listening to customers to understand what is important to them. Building valued relationships with customers enables our teams to support customers in getting the most from their money.

To make this happen our organisation aims to attract, retain and develop the best talent in the industry and embraces diversity. At Lloyds Banking Group, we are committed to making a significant investment in our people. Life here is fast-moving and full of challenges; it's also incredibly rewarding. Our rewards and benefits packages, which go beyond salary and bonus, are designed to keep our employees motivated to deliver excellent customer service.

As a leader in financial services, we are committed to professional development and creating outstanding learning opportunities that enable people to reach their potential. We invest in our people, offering the best coaching and training. Learning@Lloyds Banking Group is one of the largest corporate learning facilities in Europe.

We also encourage our people to contribute to our leading corporate and social responsibility practices; a strong part of our culture. Employees raised £1.4 million for Save the Children, a partnership that will run until June 2012.

During 2011 we set out our new strategy to achieve our vision of becoming the best bank for customers. To help make that vision a reality, we consulted with colleagues from across the business to identify the things that will be important in achieving our vision. This led us to our three Lloyds Banking Group values – Putting Customers First. Keeping It Simple. Making a Difference Together.

RELATIONSHIPS AND RESPONSIBILITY

Colleagues

These values define what we stand for when we are at our best; individually and as a team. They will help shape decisions all colleagues make and the actions they take and are being woven in to the way we do business across the Group, to help make us the best bank for customers.

Integration

Inevitably in bringing the two organisations together, there has been a requirement to rationalise and this has led to a reduction in roles. Where possible we have redeployed colleagues to other areas of the Group or reduced numbers through natural attrition. Where it has been necessary for colleagues to leave the organisation, this has been achieved by offering voluntary severance and using fewer contractors and agency colleagues. Compulsory redundancies are always a last resort.

The focus has been on enabling the business to integrate, while also building foundations for the future to ensure the organisation can attract, retain and develop the best talent. People have been at the heart of the change programme, and a robust communications process has been followed to ensure that colleagues were aware of the changes before they happened. We have four recognised Unions who have been consulted on all changes.

The year has seen an ongoing harmonisation process of different heritage employment policies, and the unions have been involved in these discussions.

This year we delivered a significant milestone in our integration when we harmonised terms and conditions for most employees in the Group. In addition, over 83,000 employees selected benefits available through our Flexible Benefits plan. We implemented our new Defined Contribution pension scheme, 'Your Tomorrow', which was awarded the Pension Quality Mark Plus – the highest quality mark available from the National Association of Pension Funds.

Colleague engagement

In 2011, we launched a new Colleague Survey across the Group. The new survey supports our ambition to drive simplification across the business and will reduce the time colleagues spend giving feedback and will provide them with more time to focus on the activities which will help us to achieve our vision.

The new survey uses a proven engagement model, delivered through the means of a single focussed question set. The outputs provide two separate and measurable scores, the Employee Engagement Index (EEI), which measures the individual motivation of colleagues, and the Performance Excellence Index (PEI), measuring how strongly colleagues believe the Group is committed to improving customer service. These will be used to create national and local action plans that prioritise the things that will make the Group a better place to work.

The question set was explicitly designed to support the outcomes of our Strategic Review and to provide an early indication of the extent to which employees identify with our three new values – Putting Customers First, Keeping It Simple and Making a Difference Together.

The results highlight strong levels of engagement in areas such as performance management and learning and development. Our PEI score of 69 is above the UK industry average, showing that nearly three quarters of colleagues believe their work gives them a sense of personal accomplishment and almost 9 out of 10 colleagues say they receive recognition for a job well done. It also reflects our on-going commitment to provide all colleagues with a promising career at Lloyds Banking Group. Our EEI score show that we need to do more to engender trust in the leadership team and confidence in the future of the organisation, with a score of 52 versus a UK industry average of 61.

To demonstrate our strong commitment to listening and acting on issues that matter most to colleagues, we will:

Firstly, continue to deliver on our Group Strategy to be the best bank for customers and colleagues. We know this will improve confidence in the future of our organisation and result in growth, greater efficiencies, new business opportunities and real career prospects for colleagues across our business.

Secondly, rebuild confidence and trust in our leadership by increasing the time leaders spend listening and talking to colleagues across all areas of our business.

Thirdly, drive customer focus at all levels in our organisation to stimulate ongoing quality and improvement. To do this, we must ensure we keep telling our colleagues about the changes that will be implemented as a result of the survey and continue to do all we can to make Lloyds Banking Group a great place to work.

Integration Training

A strong focus has been to support colleagues through the changes needed to successfully complete our integration programme, the largest one in European Banking history. This has included providing training to over 16,000 colleagues in our branches, to ensure they are fully prepared to work with new customer systems.

The overriding principles of the training approach were to ensure colleagues were confident, competent and that the customer experience was consistent and smooth.

The success of the exercise was a tribute to the way in which colleagues throughout the Community Banks worked together. The Branch Experience involved colleagues from Halifax and Bank of Scotland working in Lloyds TSB branches. This practical hands-on experience saw communities working together, sharing knowledge and experience that was an essential ingredient to colleagues learning.

In all, c800,000 hours of training was invested in colleagues, ensuring that the integration programme delivered for the business, colleagues and customers.

RELATIONSHIPS AND RESPONSIBILITY

Colleagues

Talent, recruitment and retention

One of our uppermost priorities is recruiting, retaining and developing talented leaders. Identifying and developing leaders to strengthen succession planning is vital in supporting our strategic review initiatives.

We have undertaken detailed organisational reviews centred on assessing our leaders performance and potential to undertake bigger roles as well as succession planning for our most senior leaders. The approach led by Group Executive Committee, incorporates a rigorous assessment of the performance, potential and development needs of the top three layers of leadership in the organisation and was presented to the Board.

We are committed to ensuring that we offer clear career paths to retain our most able senior leaders. In 2011 we made significant progress and 60 per cent of all senior leader vacancies were filled internally.

Earlier this year we had our succession planning and execution independently assessed as strong and in many instances, industry-leading when compared with other FTSE 100 businesses. Succession to the Group Executive Committee and divisional leadership teams has materially improved year-on-year with 92 per cent of roles having at least one identified successor.

We have brought greater focus to building strong talent pipelines at middle and junior leadership levels. A number of initiatives launched in 2011 include the MBA programme, Lloyds Scholars programme and a new development programme for emerging executives and middle managers.

Retaining our talent through difficult times continues to be a priority and we have launched well-being initiatives across several teams this year which have proved popular and useful resources for colleagues at all levels.

In 2011 we recruited 167 people into the Lloyds Banking Group Graduate Leadership Programme. The strength of the Programme has been externally acknowledged and the Group has been rated by The Times as one of the Top 30 UK organisations for graduate recruitment. In addition we have attracted 47 interns to the Group along with under privileged students aged 16-19 in our new 6 week career academies programme.

Performance and reward

Managing performance plays a critical role in helping us to develop our colleagues to build long term partnerships with customers and strong relationships with each other. This year has seen clear steps taken to improve organisational performance.

Following the completion of the Group Strategic Review in June, we started to simplify and further integrate our approach by aligning performance and reward for all colleagues. Reflecting the new regulatory environment, 2011 also saw a strengthening of executive performance management with the introduction of a new moderation process to assess risk stewardship by all our senior executives.

This year has seen the design and implementation of an award winning new Defined Contribution pension scheme – Your Tomorrow which gives considerable flexibility to employees to plan for retirement.

Learning and development

Becoming the Best Bank for customers means our colleagues must have the capabilities to deliver excellent service.

We have continued to shape and deploy our Learning Academies which provide easy access to clear learning maps for colleagues providing further clarity on the technical and leadership capabilities required to be effective. Nearly 100,000 colleagues have access to the academies which cover critical topics such as risk, relationship management and financial control.

Graduate Development Programme

Following the Graduate Development Programme, graduates are choosing branch roles as their career choice.

"Last year I secured the opportunity of Bank Manager at the new Lloyds TSB Olympic branch in Europe's largest shopping centre – Westfield Stratford City. With a successful opening in September I'm delighted that we managed to deliver outstanding performance whilst providing high quality customer service."

Jeff Wilkinson, Bank Manager
Lloyds TSB Stratford Westfield

RELATIONSHIPS AND RESPONSIBILITY

Colleagues

A strong focus has been to support colleagues through the changes needed to successfully complete our integration programme; this has included providing training to over 16,000 colleagues in our branches to ensure they were fully prepared to work with the new customer systems and applications following the biggest migration of customer data in Europe.

We remain committed to supporting a range of programmes linked to professional qualifications or relevant external certification and have reviewed our policy to ensure equality and consistency for all colleagues.

Our executive and leadership development approach in 2011 was driven by our strategy to create a high-performance culture within the Group. Integral to this strategy, has been the need to develop a clear articulation internally and externally of the leadership behaviours and capabilities required to take our business from integration to transformation.

During 2011, we have delivered the high-profile executive leadership programme and a new group wide talent development programme. Embedded in both these programmes is the requirement for leaders to take ownership in progressing our work around diversity and inclusion. Our investment in developing leaders in 2011 included the launch of 360 degree feedback to the top three layers in the organisation.

In addition, our recently launched management licence programmes provide foundation line management and leadership skills to managers.

Diversity and inclusion

A key element to achieving our vision is having a diverse and inclusive workforce; an area in which we have made positive progress during 2011.

Our gender strategy is led by members of our Group Executive Committee and Sir Win Bischoff, our Chairman, and supports the recommendations of the Lord Davies Review whereby we aim to increase our female representation on the board by 25 per cent by 2015. In December we launched Breakthrough; our new women's network which has over 600 members and we have established a series of development interventions, specifically targeted at women at various stages of their career to ensure they are equipped with the necessary skills and experience to successfully compete for senior positions.

The *Stonewall 2011 Top 100 Employers* for lesbian, gay and bisexual people, ranked the Group as the top private sector employer in the UK and as Top Scottish employer by Stonewall Scotland.

We received a *technology4good* award for our workplace adjustments programme, improving the way we support colleagues with disabilities or long-term health conditions. We have launched a new online disability awareness programme to ensure colleagues and line managers have the support they need.

In our ethnic diversity strategy, we have launched a new Career Development Programme for ethnic minority managers, targeted at those colleagues who are looking to achieve their first management or senior management position. The programme discusses barriers to progression, how to overcome them and supports participants to achieve their full potential.

In 2011, we completed our second annual Diversity & Inclusion Week, themed: *Pride Through Inclusion*. This awareness raising campaign featured each member of the Group Executive Committee, our Chief Executive and our Chairman. Colleagues were able to download a range of articles and tools including a guide to action planning.

We have also begun an unconscious bias programme, starting with our most senior leaders. The workshop raises issues in a meaningful way, encouraging participants to draw links with their day-to-day work and behaviours, and equipping them with tools and techniques to help combat bias in the workplace.

We will continue to build upon our progress during 2012 to ensure we reflect the diverse needs of our customers, colleagues and communities.

Rainbow network – Marking a milestone

Rainbow – the Group's network for lesbian, gay, bisexual and transgender (LGBT) colleagues – this year reached 1000 members, making it one of the largest employee networks of its kind in the UK.

Rainbow helps to engage and support LGBT colleagues promoting a positive working environment across the organisation.

COMMUNITIES

By doing more through our responsible business strategy, we aim to help build thriving communities.

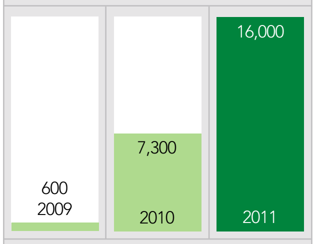
Aim

We have a presence in every community across the UK. We recognise that to be the best bank for customers, we must also be the best bank for communities.

In 2011 we developed a new responsible business strategy which aims to help build thriving communities, and, in so doing, rebuild trust and pride in the Group. Our vision is to be recognised by shareholders, customers and colleagues as making a real difference.

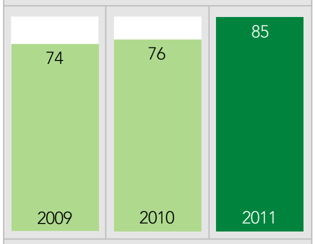
We are investing in financial inclusion and projects to improve consumers' financial capability; access to higher education for students from lower income families; sports for young people; and almost £30 million a year to the Group's Charitable Foundations to support grassroots charities working with disadvantaged communities. We are also working to reduce our environmental impact by reducing our use of resources such as energy, water and paper and by investing in new sources of renewable energy. We are encouraging the companies we bank, and invest in, to do the same, using our influence as a large financial services organisation to deliver a positive impact for communities.

Colleague volunteers



In 2011, the Group supported over 16,000 colleagues' volunteering for charities and community groups. The Foundations also provided Matched Giving to some of these organisations for colleagues' time spent volunteering outside of working hours.

Total community investment £m



We are the biggest corporate investor in UK communities. Last year, we invested over £85 million to support financial inclusion and financial capability, higher education, sports for young people and grassroots charities.

Priorities for 2012

- → **Explore opportunities to improve our management of environmental, social and governance risks and increase transparency around our management of these**
- → **Launch a Fund that will enable colleagues to help their chosen community organisation with financial support**
- → **Launch a five year partnership that will support social entrepreneurs and create hundreds of jobs across the UK**

Embedding responsible business

We established a new Responsible Business Steering Group in 2011 to drive our new responsible business strategy. It comprises the following business leaders from across the Group:

Anita Frew, Non-Executive Director
Matt Young, Director, Group Corporate Affairs
Eva Eisenschimmel, Managing Director, Customers, Brands, Digital and Telephone Banking
Stephen Pegge, Director, SME Markets in Commercial
Paul Baker, Director, Group Property
Kate Guthrie, HR Director, Insurance
Philip Grant, Managing Director, UK Wealth
Paul Turner, Director, Community & Sustainable Business

The Steering Group meets every two months and will report to the Board and Group Executive Committee twice a year. In 2012, we are also setting up an independent panel of experts and opinion formers to provide thought leadership and challenge to the Group.

Community engagement

Lloyds Banking Group is the UK's biggest corporate investor in UK communities. Last year, we invested over £85 million in communities, including support for financial capability, higher education, sports for young people and support to the Group's charitable Foundations.

Funding grassroots charities

In 2011, we donated almost £30 million to the Lloyds TSB Foundations and the Bank of Scotland Foundation. The Foundations disburse grants to local, regional and national charities that operate at the heart of communities. 2011 also marked the 25th anniversary of the Lloyds TSB Foundations. Over the last quarter of a century, the Lloyds TSB Foundations and Bank of Scotland Foundation have invested more than £510 million supporting over 50,000 community based charities.

In addition to making grants, the Foundations work in partnership with the Group to champion colleague fundraising and volunteering efforts through their Matched Giving Scheme. Colleagues in the UK can claim up to £1,000 in Matched Giving each year. In 2011, over 6,200 applications were made, totalling £2.3 million in matched giving for charity.

RELATIONSHIPS AND RESPONSIBILITY

Communities

Charity of the Year

Our Charity of the Year for 2011/2012 is Save the Children. We raised £1.4 million in 2011 for Save the Children which will fund 46 FAST programmes across the UK. FAST (Families and Schools Together) increases the life chances of children in the UK's most deprived areas by supporting parents to improve their children's learning and development at home, so they can reach their full potential at school.

Over half of children in the most disadvantaged areas fall behind at the age of five compared to just over a quarter of children from better off areas, and many never catch up. Teachers report a 10 per cent improvement in reading, writing and maths among children enrolled on FAST programmes, after just eight weeks. As well as improving children's academic performance, the programme has also been credited with improving children's behaviour and bringing children and parents closer together.

Employee volunteering

Our employees are our closest link with the communities in which we operate, and, as one of the biggest employers in the UK, our colleague volunteering initiatives can make a real difference. Our Day to Make a Difference volunteering programme enables colleagues across the UK to spend one day a year volunteering for a charity or community project of their choice. In 2011, over 16,000 colleagues volunteered, compared with 7,300 in 2010. However, we know there is more we can do to support colleagues in connecting with their communities. We are redesigning our volunteering programme to make it simpler and more rewarding for colleagues to participate and hope to engage even more colleagues in 2012.

In 2011, as in 2010, Lloyds Banking Group was the largest corporate participant in Business in the Community's Give & Gain Day – the UK's largest single day of volunteering. Over 2,000 colleagues took part, undertaking a variety of activities including renovating playgrounds, clearing conservation areas and hosting employability skills sessions for schoolchildren. In 2011 we also announced that we are sponsoring Give & Gain Day for the next three years.

Making a Difference Awards

Our annual Making a Difference Awards celebrate employees who make an exceptional contribution to charities and community groups. In 2011 we received nominations for 1,164 colleagues who had made a huge difference to their communities. The 203 award winners received a contribution from the Group for their chosen charities. The Group also donated £20 for every nomination received to our Charity of the year, totalling £23,280 for Save the Children. In total the Group donated almost £100,000 through these awards to charities and local communities.

Lloyds Scholars

Lloyds Scholars, the Group's flagship Higher Education Programme, was launched in 2011 for students attending the University of Sheffield and University of Bristol. The programme aims to encourage and support young people from families with below average income to attend some of Britain's top universities. We believe Lloyds Scholars is the only corporate social mobility programme of its kind in the UK.

Lloyds Scholars provides students with support for their academic and vocational development, offering a complete financial and support package. This includes bursaries to help with living costs and study materials; performance-related cash awards for good grades; hands-on work experience through paid summer internships with the Group; and access to advice and support from a dedicated mentor. In return for these benefits, we ask Scholars to champion the scheme to future applicants and take part in at least 100 hours volunteering in their local communities each year.

In the 2011/2012 programme we have thirty students participating from the University of Sheffield and University of Bristol. We are expanding the programme to six universities and 120 students for the next intake of students.

Lloyds Scholars, our unique social mobility programme

"The National Union of Students has always been supportive of business contributing to the cost of higher education, so it's great to see Lloyds Banking Group starting the Lloyds Scholars scheme. Of course higher education is massively beneficial to the public, as well as to the student, but business also benefits from students who have a higher level of education and an enriched world-view."

"As well as widening participation to higher education, we're particularly pleased that this scheme seeks to deepen participation through volunteering at university, ensuring that students not only receive the appropriate support through their mentoring scheme but are given opportunities to get further involved in their free-time."

Liam Burns, National President
National Union of Students

RELATIONSHIPS AND RESPONSIBILITY

Communities

Financial wellbeing

We take seriously our responsibility to do more to raise levels of general financial understanding amongst the communities we serve. In addition, we make a very significant investment in helping to bring those who are excluded into mainstream financial services. Our financial inclusion work is covered in more detail on page 33.

Money for Life

Money for Life is Lloyds Banking Group's flagship £4 million financial capability and personal money skills programme, targeted at the Further Education, Adult and Community Learning sector. We are providing tutors and support workers with the skills they need to talk confidently about money management, and to support their learners to stay out of debt and save for the future.

Last year, we launched our Teach Me, Teach Others financial education training programme. We are providing 1,400 free places on the programme for colleges and community groups, to enable them to deliver quality financial education in their communities. In addition, 100 Lloyds Banking Group employees have taken the Teach Others course and are now volunteering in a wide variety of community organisations.

We also launched the Money for Life Challenge in 2011, a national competition providing small grants for 16-24 year olds to run a money management project in their local community. The most innovative and impactful projects will be rewarded at national and UK finals in 2012.

Environmental responsibility

In 2011, we introduced a set of market leading long-term environmental targets under our Environmental Action programme to significantly reduce our environmental footprint. We aim to reduce paper, water and business travel by 20 per cent; ensure that less than 20 per cent of waste is sent to landfill; and reduce energy use by 30 per cent by 2020. We publish a standalone, data-driven Climate and Environment Report on an annual basis which details progress we have made against our targets, and this is available from the Lloyds Banking Group website. Last year, we achieved the Carbon Trust Standard for our entire UK operations, which recognises our robust approach to measuring, managing and reducing our carbon emissions. We also reduced our use of energy by 1 per cent, our use of water by 3 per cent and paper use by 7 per cent in 2011 compared with 2010. Our overall carbon footprint reduced by 1 per cent in 2011 compared with 2010.

Over the last year we have been the UK's most active provider of finance to renewable energy projects, having lent over £413 million across 13 renewable energy projects in the UK, Germany and the US. Our approach to environmental risk management is covered on pages 162 and 163.

We are also encouraging businesses that bank with us to take action to address climate change. We have trained over 650 colleagues on our Business & Environment programme, to enable them to guide and support our customers in recognising environmental risks and seizing the opportunities. We are the only major UK bank to provide this kind of support to its business customers.

We recognise that our influence extends well beyond the size of our organisation. Our asset management business, Scottish Widows Investment Partnership (SWIP), has over £140 billion invested around the world and is committed to using its influence to encourage best practice in corporate governance and management of sustainability risks. SWIP has also launched a new sustainability strategy across its entire £8.5 billion property portfolio.

CO_2 Emissions (tonnes)

	2011	2010
Total UK CO_2 emissions	**421,568**	425,996
Scope 1 emissions	**52,179**	60,302
Scope 2 emissions	**321,698**	324,007
Scope 3 emissions	**42,691**	41,687

We have improved the accuracy of energy data for the 2010 reporting years, replacing estimates with actual data. We have also changed our method for reporting car travel data in 2011 and have applied this method to historical data.

Teaching Others

Jeff McArthur, Regulatory and External Risk Manager at Lloyds TSB, is a graduate of the Money for Life Teach Others course. He has delivered financial capability workshops at Dress for Success, a charity offering employment-based services and workshops to help disadvantaged women become economically independent.

"Many of the women have recently returned to work after long-term unemployment and wanted to better manage their finances," Jeff explains.

"I provided advice on basic budgeting and explained how they could use banking products and services to help them manage their money."

RELATIONSHIPS AND RESPONSIBILITY

Communities

Tracking progress

Independent consultants verify our performance every year. We also measure our performance against our peers through external benchmarks. In 2011, we were re-selected for the Dow Jones Sustainability Index. We were also ranked top UK bank in the FTSE4Good Index and were re-selected for the Carbon Disclosure Leadership Index. We have a Platinum ranking in Business in the Community's Corporate Responsibility Index and were awarded Business in the Community's CommunityMark, the national standard that publicly recognises excellence in community investment.

Summary

The Group's strategic vision recognises that being the best bank for customers also means being the best bank for communities. We believe that, over time, our new responsible business strategy will help us rebuild public trust and colleague pride in the Group by making a difference to the UK.

We aim to set an example and demonstrate the highest standards of integrity in the way we do business. In 2012 we will explore opportunities to increase transparency of our management of social, environmental and ethical risks. We also plan to launch a new, group wide code of ethics, linked to the Group's values, setting out values, principles and commitments to stakeholders that underpin the way we do business.

We are launching a partnership with the School for Social Entrepreneurs that will over five years provide a support package to 500 entrepreneurs to create new social enterprises and hundreds of jobs in communities across the UK. Social entrepreneurs are people who use their entrepreneurial talent to address a social need or problem in their community. Their businesses are playing an increasingly important role in the UK economy with an estimated annual turnover worth £25 billion and a workforce totalling one million. The programme will enable 100 entrepreneurs every year to go through the School's unique action learning programme and receive grants ranging from £4,000 to £25,000.

We will also pilot a community fund that will enable colleagues to help their chosen community organisation with financial support. Small grants will be made available for community organisations that our colleagues and customers have elected to support.

Andrew Clark - Services to the Community

Andrew Clark, a Relationship Director in our Commercial business and a Making a Difference Award winner, volunteers as a Community First Responder and also a St. John Ambulance member. Last year Andrew secured £8,000 for his responder team and attended 156 calls ranging from falls to strokes, chest pains, fitting, difficulty breathing and cardiac arrests, being on call for a total of 600 hours.

As a volunteer for St. John Ambulance, Andrew is County Staff Officer for the Operations department who are responsible for the management of all public duties, vehicles and logistics in the county. For a number of years Andrew has also crewed an ambulance, having completed his ambulance service blue light driving assessment and ambulance training. In 2010 Andrew contributed 413 hours of voluntary service.

OUR LONDON 2012 PARTNERSHIP

LONDON 2012

In 2011 we continued to bring the London 2012 Games closer to people and communities across the UK.

Background

Lloyds Banking Group is proud to be the official banking and insurance partner for the London 2012 Olympic and Paralympic Games, the biggest sporting event ever staged in the UK.

Our vision for our partnership, delivered through Lloyds TSB, Bank of Scotland and Scottish Widows, is to bring the Games even closer to communities and millions of people across the UK. In 2011 we continued to realise this vision with a programme of inclusive, inspirational and engaging activities, resulting in us being seen as the sponsor doing the most to support the Games.

Bringing the Games closer to communities

With Lloyds TSB and Bank of Scotland branches on nearly every UK high street we are in a unique position to bring the inspiration and excitement of the Games closer to communities across the country, through programmes like National School Sport Week and our Local Heroes programme, supporting the future of Team GB and ParalympicsGB.

Giving customers the chance to get involved

We are creating as many opportunities as possible for our customers and the communities we serve across the UK to get involved in the Games:

- In 2011, more than 200,000 people signed up to Trackside, our customer exclusive programme. Trackside is just one of the ways we are giving customers the chance to win tickets to the London 2012 Olympic and Paralympic Games. Through Trackside, 1,500 personal banking customers will each win a pair of tickets to the Games. We are also giving customers chances to win exclusive experiences with Olympians and Paralympians.
- Lloyds TSB is the only Presenting Partner of both the London 2012 Olympic and Paralympic Torch Relays and in 2011 we gave our customers and the wider public the chance to become Torchbearers and carry the Flame in the Relay(s).
- As the Official Partner of the London 2012 Ticketing programme, we are helping to ensure customers and communities have access to information about tickets to the Olympic and Paralympic Games. Our Official London 2012 Ticket Guides were available in all of our branches.
- Scottish Widows is Pensions and Investment Provider of the London 2012 Olympic and Paralympic Games and in 2011 we gave customers the chance to be at the Games - more than 60,000 entered our exclusive competition.

National School Sport Week – York High School

York High School held a number of events to celebrate National School Sport Week 2011, promoting the Olympic and Paralympic Values, boosting participation in physical activity and providing young people with leadership opportunities.

The week had a positive impact on the students' attitudes towards sport and many particularly enjoyed trying new sports. They developed team-working skills and created a great atmosphere around the school.

The students became accustomed to being physically active and made a pledge about their future level of physical activity, which will be monitored by the school's Young Ambassadors. And, links forged with community sports clubs should encourage a higher uptake of sports outside of school hours.

OUR LONDON 2012 PARTNERSHIP

Helping businesses benefit from London 2012

We are focused on supporting our business customers to maximise the opportunities of the Games and ensure a lasting legacy for UK businesses. In 2011 we used the power of London 2012 to inspire businesses all over the UK:

- One in three of the £3 billion worth of London 2012 contracts have been awarded to our business customers with more contract opportunities still available along the supply chain.
- We developed a free, step-by-step guide, to help businesses understand the various ways in which they can prepare for the Games and seize the business opportunities.
- Our Pace & Power events brought together local business people with Olympians and Paralympians and Local Heroes, who shared their thoughts on sporting success and how this can be translated into the world of business.
- As the chosen bank to the Olympic Delivery Authority and LOCOG, we are proud of our role in supporting the development of the Olympic Park and other Games venues.

Activation Programmes

Olympic and Paralympic Torch Relays

In 2011 we ran public campaigns to find hundreds of people who have made a positive difference in their community to be Torchbearers and carry the Flame in the London 2012 Olympic Torch Relay or Paralympic Torch Relay. We received thousands of nominations from customers and the public across the UK, many of whom had uplifting and inspirational stories to share.

We developed the Lloyds TSB London 2012 Olympic Torch Tour, which travelled the UK during the summer of 2011. The Tour gave people the chance to get up close to the new Olympic Torch and learn more about the history and excitement of the Relay. The Tour visited 76 communities over 84 days, directly engaging 56,000 people with our London 2012 activity.

National School Sport Week

Delivered in partnership with the Youth Sport Trust, Lloyds TSB National School Sport Week (with Bank of Scotland and sportscotland in Scotland) uses the excitement of the London 2012 Games to inspire more young people to do more sport.

We provide resources to schools to help them plan activities leading up to and during the week and in 2011 over 4 million young people took part. 48 per cent of secondary school pupils and 42 per cent of primary school pupils said they have joined or would like to join a new sports team or club in school after taking part in National School Sport Week.

Local Heroes

The Local Heroes programme helps some of the most talented emerging athletes in the UK during one of the toughest stages of their career.

In partnership with SportsAid, the UK's leading charity for identifying and supporting young talented athletes, we committed to supporting more than 1,000 of these future stars of Team GB and ParalympicsGB by the time of the London 2012 Games.

2011 was the fourth year of the Local Heroes programme and we supported 324 athletes. Local Heroes also attended a variety of internal and customer-facing Group events and initiatives including sharing their experiences with young schoolchildren during National School Sport Week; attending events with Olympians and business customers on the parallels between high performance in business and sport; and visiting branches with the London 2012 Olympic Torch to engage with our colleagues, customers and their families.

London 2012 Trackside: Bringing London 2012 closer to our customers

Trackside, launched in February 2011, is a customer exclusive programme giving Lloyds TSB and Bank of Scotland personal customers chances to win tickets to the London 2012 Games and opportunities to meet Olympians and Paralympians, as well as ensuring customers are the first to hear about our latest London 2012 news and offers. Registered customers receive regular e-newsletters and in 2011 we gave away more than 1,100 pairs of tickets to the 2012 Games to these personal customers.

Golden Hopefuls

Through Scottish Widows Golden Hopefuls Programme we are helping four of Britain's new generation of world class sporting hopefuls who share the same goal of competing at London 2012.

Simon Brown – Olympic Torchbearer

Simon is 32 and from Morley, West Yorkshire. In 2006 he was shot in the face saving the lives of six of his colleagues in Iraq. Following months of rehabilitation and dozens of operations to rebuild his face Simon began to help young people come to terms with their own loss of sight at St Dunstan's charity in Sheffield.

His nominator and friend, Eleanor Noakes said, "Simon has not had an easy journey on his road to recovery and has battled with the impact of his injuries. He now uses those experiences to help others overcome their own difficulties and is a true inspiration to his community."

london london

proud partner of the Olympic and Paralympic Games

SUMMARY OF GROUP RESULTS

Performance in line with our expectations

The Group delivered a combined businesses profit of £2,685 million in 2011 broadly in line with our expectations despite the challenging external environment, with the core business delivering a resilient performance, and non-core results reflecting the substantial reductions in non-core assets achieved in the year. In line with our strategy, we continued to further reduce the risk in our balance sheet, strengthening our core tier 1 capital ratio, significantly reducing non-core assets and improving our funding position.

Group income and margin reductions partially offset by lower costs and impairments

The Group's 2011 results, which are analysed below on a combined businesses basis (except where stated), were impacted by liability management, volatile items and asset sales when compared to 2010 (see page 45). Excluding these, income declined by 10 per cent, reflecting a smaller balance sheet (average interest earning assets are down 6 per cent) primarily driven by substantial reductions of non-core assets, and a net interest margin which was 14 basis points lower than in 2010. The change in margin reflected continued high funding costs, including the costs of refinancing of a significant amount of government and central bank facilities.

Costs reduced 4 per cent, driven by Integration and Simplification related savings and lower bonus accruals, partially offset by inflationary pressures, the new UK bank levy and FSCS costs. The impairment charge reduced by 26 per cent, with lower charges seen across all divisions. These lower charges were principally supported by the continued application of our prudent risk appetite and strong risk management controls resulting in improved portfolio and new business quality, continued low interest rates, and broadly stable UK property prices, partly offset by weakening UK economic growth and rising unemployment.

Profit before tax increased by 21 per cent. Excluding the effects of liability management, volatile items and asset sales, the combined businesses profit before tax increased by 22 per cent to £2,022 million. A significant improvement in impairment was partly offset by reductions in income, principally as a result of non-core asset reductions to further strengthen the balance sheet, as well as higher funding costs.

Profit before tax included the unwind of £1,943 million of acquisition-related fair value adjustments, around £250 million lower than previously anticipated as a more cautious outlook for certain US securities resulted in the deferral of positive fair value unwind. Going forward, over the medium-term, and in line with previous guidance, declining fair value unwind benefits are expected to accrue, with the benefit expected to be approximately £0.5 billion in 2012.

The statutory loss before tax was £3,542 million in 2011 included the £3,200 million PPI provision, which is excluded from the combined businesses results, and which was taken in the first half of 2011. The statutory result also includes, amongst other things, negative insurance volatility of £838 million (2010: positive volatility of £306 million), and charges totalling £1,452 million (2010: £1,653 million), of which £1,097 million related to integration, £185 million to simplification and £170 million to the EC mandated retail business disposal costs. After a tax credit of £828 million, and after taking into account the profit attributable to non-controlling interests of £73 million, the loss attributable to equity shareholders was £2,787 million and the loss per share amounted to 4.1 pence.

Further progress in reducing the Group's risk

We continued to further reduce risk in our balance sheet, by increasing customer deposits, and by making excellent progress against our funding objectives and on the continued reduction of non-core assets, thereby achieving a substantial reduction in wholesale funding requirements. We strengthened our core tier 1 capital ratio to 10.8 per cent (31 December 2010: 10.2 per cent), largely as a result of a reduction in risk-weighted assets of £54 billion principally from the run down of higher risk non-core assets. This was partially offset by the implementation of CRD III (20 basis points) and the negative impact of the PPI provision (60 basis points).

Our loan to deposit ratio, excluding repos, improved to 135 per cent (31 December 2010: 154 per cent), and to 109 per cent in our core business (31 December 2010: 120 per cent). Customer deposits excluding repos increased by 6 per cent, reflecting good growth in relationship deposits.

Wholesale funding requirements reduced by £47 billion to £251 billion, of which £138 billion (55 per cent) including bank deposits had a maturity date of more than one year (31 December 2010: £149 billion, 50 per cent). Primary liquid assets at the year-end were £94.8 billion (31 December 2010: £97.5 billion).

We also continue to closely monitor, control and reduce our exposures to selected European countries. The Group's aggregate exposure to Greece, Ireland, Italy, Portugal and Spain totalled £25 billion, of which £16 billion relates to Ireland. Total exposure has reduced by £9 billion since 31 December 2010. Further information on our exposures to these countries, including to banking groups, asset backed securities, and corporate, retail and other exposures, is given on pages 156 to 161.

The Group made good progress against its balance sheet reduction plans in the year despite challenging market conditions. In 2011, we achieved a substantial reduction in the non-core portfolio of £53 billion, resulting in the residual portfolio at 31 December 2011 amounting to £141 billion. Notable progress was made through treasury asset reductions of £26 billion, UK commercial real estate reductions of £4.5 billion and Irish portfolio reductions of £4.9 billion. Approximately half of the reduction arose from disposals, primarily treasury assets but pleasingly we also saw gross sales of £0.9 billion in Ireland and around £1.8 billion in Australia. Asset sales overall were made broadly in line with the net book value at a Group level.

Core and non-core business performance

Detailed financial information on core and non-core business performance, including non-core asset reductions, is given on pages 86 to 93.

Our core business delivered a resilient performance given the challenging external environment. The 6 per cent decline in core income excluding liability management, volatile items and asset sales reflected subdued new lending demand and continued customer deleveraging. The effect on net interest margin of higher wholesale funding costs was mitigated by improved funding mix in the core business as a result of increased customer deposits, resulting in a small decline in net interest margin of 6 basis points.

SUMMARY OF GROUP RESULTS

Operating expenses and other costs in the core business fell by 2 per cent despite absorbing additional FSCS and bank levy costs. The core impairment charge reduced by 20 per cent, reflecting the general stabilisation of our portfolios, and our continued prudent risk appetite applied to new business. The 2011 core impairment charge as a percentage of average loans and advances to customers improved to 0.64 per cent. Core loans and advances to customers generated just 24 per cent of the Group's impaired loans, with a coverage ratio of 39 per cent at 31 December 2011.

Core business profit before tax was £6,349 million compared to £6,152 million in 2010. Excluding liability management, volatile items and asset sales, core business profit before tax decreased by 6 per cent, principally reflecting higher funding costs and a decline in average interest-earning assets as a result of subdued market conditions.

In the non-core business, the 54 per cent fall in income reflected the loss of income from the significant reductions achieved in the non-core portfolio, and losses on asset disposals of £677 million, including losses on treasury assets of £758 million which were largely offset by a related fair value unwind of £737 million included elsewhere in the income statement. Excluding the losses on disposals of assets, non-core income decreased by 36 per cent. Net interest margin fell 45 basis points to 1.01 per cent, principally reflecting higher wholesale funding costs, and higher levels of impaired assets.

Non-core operating expenses and other costs reduced by 21 per cent, reflecting the elimination of certain costs of supporting the non-core portfolios. The non-core impairment charge reduced, principally as a result of material reductions in the Wholesale and International impairment charges.

Non-core loans and advances to customers generated 76 per cent of the Group's impaired loans reflecting their higher risk profile, with a coverage ratio of 48 per cent at 31 December 2011.

Non-core loss before tax was £3,664 million (2010: loss before tax £3,940 million), with the improvement principally driven by reductions in impairment and costs, partly offset by lower income, and lower fair value unwind.

Income

Total income, net of insurance claims, decreased by 10 per cent to £21,123 million. The decrease includes the effect of non-core asset reductions, a number of volatile items including banking volatility, changes in the fair valuation of the equity conversion feature of the Group's Enhanced Capital Notes (ECNs), net derivative valuation adjustments and the effect of liability management gains in 2010 and 2011 (together 'effects of liability management, volatile items and asset sales').

Combined businesses results summary – income

	2011 £m	2010 £m	Change %
Total income	**21,466**	23,986	(11)
Insurance claims	**(343)**	(542)	37
Total income, net of insurance claims	**21,123**	23,444	(10)
Adjustments to exclude:			
Liability management gains	**(1,295)**	(423)	
Banking volatility	**(3)**	(347)	
Change in fair valuation of equity conversion feature of ECNs	**5**	620	
Net derivative valuation adjustments	**718**	42	
Gains and losses on asset sales	**649**	201	
	74	93	
Total income, net of insurance claims, excluding effects of liability management, volatile items and asset sales	**21,197**	23,537	(10)

Excluding liability management, volatile items and asset sales, total income, net of insurance claims decreased by 10 per cent, reflecting non-core asset reductions undertaken to strengthen the balance sheet, subdued lending demand, continued customer deleveraging in our core business, a lower banking net interest margin and lower treasury and trading income. The asset reductions, which resulted in losses of £649 million, were primarily non-core asset sales (including losses on treasury assets of £758 million, which were largely offset by a related fair value unwind, included elsewhere in the income statement).

	2011 £m	2010 £m	Change %
Net interest income	**12,233**	14,143	(14)
Other operating income	**9,307**	9,936	(6)
Insurance claims	**(343)**	(542)	37
Total income, net of insurance claims, excluding effects of liability management, volatile items and asset sales	**21,197**	23,537	(10)

SUMMARY OF GROUP RESULTS

Net interest income

	2011 £m	2010 £m	Change %
Net interest income	**12,233**	14,143	(14)
Net interest margin	**2.07%**	2.21%	
Average interest-earning banking assets	**£585.4bn**	£625.9bn	(6)

Group net interest income decreased by £1,910 million, or 14 per cent, to £12,233 million in 2011. This fall primarily reflects the fall of 6 per cent in average interest-earning banking assets in the year, along with the 14 basis points reduction in net interest margin.

The net interest margin in our banking businesses was 2.07 per cent, with the decline from 2.21 per cent in 2010 principally reflecting higher wholesale funding costs, higher deposit rates and the effect of refinancing a significant amount of government and central bank facilities, partially offset by an improvement in customer margins and funding mix. This fully incorporates the methodology changes outlined in our October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

Other operating income

	2011 £m	2010 £m	Change %
Other operating income	**9,307**	9,936	(6)

Other operating income decreased by 6 per cent to £9,307 million. The decrease of 6 per cent reflected the targeted reduction in non-core assets, lower core new lending volumes and lower income in Treasury and Trading as a result of market conditions.

Liability management gains

Liability management gains of £1,295 million arose in 2011 on transactions undertaken as part of the Group's management of capital, primarily on the exchange of certain debt securities for other debt instruments. The gain comprises £696 million recognised in statutory net interest income, reflecting a reduction in the carrying value of certain debt securities as a result of changes in expected cash flows, and £599 million recognised in statutory other operating income relating to the debt securities exchange. The comparable gain in 2010 was £423 million and was recognised in statutory other operating income.

Comparison of fourth quarter 2011 income with third quarter 2011 income

	Three months ended 31 December 2011 £m	Three months ended 30 September 2011 £m	Change %
Total income	**5,928**	5,162	15
Insurance claims	**(58)**	(87)	33
Total income, net of insurance claims	**5,870**	5,075	16
Adjustments to exclude:			
Banking volatility	**(35)**	(145)	
Change in fair valuation of equity conversion feature of ECNs	**259**	(490)	
Net derivative valuation adjustments	**308**	463	
Liability management gains	**(1,295)**	–	
Gains and losses on asset sales	**(5)**	24	
	(768)	(148)	
Total income, net of insurance claims, excluding effects of liability management, volatile items and asset sales	**5,102**	4,927	4
Net interest income	**2,816**	3,051	(8)
Other operating income	**2,344**	1,963	19
Insurance claims	**(58)**	(87)	33
Total income, net of insurance claims, excluding effects of liability management, volatile items and asset sales	**5,102**	4,927	4
Net interest margin	**1.97%**	2.05%	
Average interest-earning banking assets	**£567.5bn**	£581.3bn	(2)

In the fourth quarter of 2011, total income, net of insurance claims, increased by 16 per cent to £5,870 million when compared to the third quarter of 2011. Excluding effects of liability management, volatile items and asset sales, income increased by 4 per cent, with a fall in net interest income more than offset by an increase in other operating income.

SUMMARY OF GROUP RESULTS

Net interest income fell 8 per cent to £2,816 million, when compared to the third quarter of 2011. This principally reflected a 2 per cent reduction in average interest-earning banking assets in the quarter, mainly driven by non-core asset reductions, and an 8 basis point fall in net interest margin to 1.97 per cent.

Other operating income increased by 19 per cent when compared to the third quarter of 2011, reflecting a recovery from poor trading conditions seen in the third quarter, to a level of other income more comparable with that seen in the first half of the year.

Operating expenses

During 2011, operating expenses reduced by 6 per cent to £10,253 million. Total costs decreased by 4 per cent to £10,621 million, mainly as a result of further integration-related savings and a lower bonus accrual, partially offset by increased employers' National Insurance contributions, the bank levy, and Financial Services Compensation Scheme costs. The bank levy of £189 million was accrued in the final quarter and was lower than initially anticipated due to the improvement in the Group's funding profile. In the fourth quarter we recognised a charge relating to Financial Services Compensation Scheme costs of £115 million.

Combined businesses results summary – costs

	2011 £m	2010 £m	Change %
Operating expenses	**10,253**	10,882	6
UK bank levy	**189**	–	
Financial Services Compensation Scheme costs	**179**	46	
Impairment of tangible fixed assets	**–**	150	
Total costs	**10,621**	11,078	4
Integration synergies annual run-rate	**2,054**	1,379	
Simplification savings annual run-rate	**242**	–	

As at 31 December 2011, we had realised annual run-rate savings of £2,054 million from the Integration programme. A major part of the integration from an IT perspective was the migration of Halifax and Bank of Scotland customer accounts and data to the scaled Lloyds TSB platforms and this was successfully completed in the third quarter. This was an immense exercise involving the migration of approximately 30 million customer accounts and these platforms will now provide the foundation for the Group's transformation plans.

On 30 June 2011, we announced, as part of our strategy to deliver for customers and shareholders, that we would simplify the Group to improve service and are now targeting the delivery of £1.7 billion of annual savings in 2014 (£1.9 billion of run-rate savings by the end of 2014). By the end of 2011, after the first six months of this programme, we had achieved run-rate cost savings of £242 million.

Comparison of fourth quarter 2011 costs with third quarter 2011 costs

Total costs increased by 5 per cent to £2,712 million in the fourth quarter compared to the third quarter of 2011 as we recognised costs of the bank levy and Financial Services Compensation Scheme. These were partially offset by a reduction in bonus accruals in the quarter.

Further reductions in the impairment charge

The Group continued to see reductions in the impairment charge in 2011. The impairment charge of £9,787 million in 2011 was 26 per cent lower than the £13,181 million charge in 2010, with lower charges seen across all divisions. These lower charges were principally supported by the continued application of our prudent risk appetite and strong risk management controls resulting in improved portfolio and new business quality, continued low interest rates, and broadly stable UK retail and commercial property prices, partly offset by weakening UK economic growth and rising unemployment.

Impaired loans decreased by 7 per cent compared to December 2010 to £60.3 billion, representing 10.1 per cent of closing advances, driven by a decrease in Retail and Wholesale as a result of asset sales, repayments, and write-offs, partially offset by an increase in impaired loans in Ireland. The Group's overall coverage ratio was little changed at 46.0 per cent. Further detail on impaired asset trends and coverage ratios is given in the Credit Risk review commencing on page 129.

SUMMARY OF GROUP RESULTS

Combined businesses results summary – impairment charge

	2011 £m	2010 £m	Change %
Retail			
Secured	**463**	292	(59)
Unsecured	**1,507**	2,455	39
	1,970	2,747	28
Wholesale	**2,901**	4,064	29
Commercial	**303**	382	21
Wealth and International			
Ireland	**3,187**	4,264	25
Other	**1,423**	1,724	17
	4,610	5,988	23
Central items	**3**	–	
Impairment charge	**9,787**	13,181	26

Retail's impairment charge reduced by 28 per cent, with a reduction in the unsecured charge more than offsetting an increase in the secured charge. As a percentage of average loans and advances to customers, the impairment charge decreased to 0.54 per cent, from 0.74 per cent in 2010. Credit performance remained strong with fewer assets entering arrears compared to 2010, in both the secured and unsecured portfolios. Retail's coverage ratio fell from 31.8 per cent to 30.8 per cent as a result of the smaller unsecured collections portfolio.

During 2011, Retail's secured impairment charge was £463 million, in line with expectations, with the increase on 2010 largely reflecting a less certain outlook for house prices, and provisioning against existing credit risks which have longer emergence periods due to current low interest rates. These factors were partially offset by an improvement in the quality of the secured portfolio. This resulted in provisions as a percentage of impaired loans increasing from 23.5 per cent at 31 December 2010 to 25.6 per cent at 31 December 2011. Secured asset quality remained good and the number of customers entering arrears reduced through 2011 compared to 2010. The stock of properties in repossession remained stable and the sales prices of repossessed properties continued to be at expected values. The proportion of the mortgage portfolio with an indexed loan-to-value of greater than 100 per cent has decreased to 12 per cent benefitting from the regional mix of lending. The value of the portfolio with an indexed loan-to-value of greater than 100 per cent and more than three months in arrears has been stable at just over £3 billion.

Retail's unsecured impairment charge for 2011 was £1,507 million, a decrease of 39 per cent, compared to the same period in 2010. This reflected continued improving new business quality and portfolio trends as a result of our conservative risk appetite, with a focus on lending to existing customers. This focus on improving business quality has resulted in the level of early arrears for accounts acquired since 2009 being at pre-recession levels. Unsecured impaired loans decreased to £2.4 billion from £3.0 billion at 31 December 2010 as a result of tighter credit policy across the lifecycle, including stronger controls on customer affordability. Impairment provisions as a percentage of impaired loans in collections increased to 86.5 per cent at 31 December 2011 from 82.5 per cent at 31 December 2010.

The Wholesale impairment charge decreased from £4,064 million in 2010 to £2,901 million in 2011. The reduction was primarily driven by lower impairment from the corporate real estate and real estate related asset portfolios partly offset by higher impairment on leveraged acquisition finance exposures. The continued low interest rate environment helped to maintain defaults at a reduced level. In addition, newly impaired assets, being generally of better quality, are requiring a lower level of provisions once impaired than previously impaired assets. The impairment charge as a percentage of average loans and advances to customers improved significantly to 1.95 per cent in 2011 compared to 2.23 per cent in 2010. Impaired loans as a percentage of lending increased slightly to 20.5 per cent from 20.0 per cent but the coverage ratio fell to 41.6 per cent from 46.9 per cent reflecting write-offs of impaired assets with a higher impairment rate, the substantial reductions of poorer quality non-core assets and lower required impairment rates on newly impaired assets.

In Commercial, the impairment charge decreased by £79 million, or 21 per cent, to £303 million in 2011 reflecting the benefits of the low interest rate environment, which has helped maintain defaults at a lower level, and the continued application of our prudent credit risk appetite. Portfolio metrics including delinquencies and assets under close monitoring remain above benign environment levels. The impairment charge as a percentage of average loans and advances to customers improved to 1.06 per cent in 2011 compared to 1.24 per cent in 2010 and impairment provisions as a percentage of impaired loans reduced from 34.7 per cent to 30.2 per cent.

In Wealth and International, impairment charges totalled £4,610 million, a decrease of 23 per cent from £5,988 million in 2010. The reduction predominantly reflects lower impairment charges in our Irish portfolio where the rate of impaired loan migration has slowed. The impairment charge as a percentage of average loans and advances to customers improved to 7.37 per cent from 8.90 per cent. Impaired loans increased by £0.4 billion with an increase of £1.9 billion in Ireland partly offset by a reduction in the Australasian book as a result of write-offs and disposals, resulting in 42.8 per cent of the International portfolios (66.0 per cent of the Irish portfolio) being classified as impaired compared with 35.1 per cent in 2010. Provisions as a percentage of impaired loans in the International portfolios were 61.0 per cent at the end of 2011 (31 December 2010: 52.9 per cent). Impairment coverage has increased in Ireland to 62.1 per cent from 53.7 per cent, primarily reflecting further falls in the commercial real estate market during 2011, and further vulnerability exists. Impaired loans accounted for 84.3 per cent of the Irish wholesale portfolio, with a coverage ratio of 61.1 per cent. Further provisioning has been necessary in the Group's Australasian portfolio primarily reflecting geographical real estate concentrations where market conditions and asset valuations have remained weak in 2011.

SUMMARY OF GROUP RESULTS

Comparison of fourth quarter 2011 impairment charge with third quarter 2011 impairment charge

	Three months ended 31 December 2011 £m	Three months ended 30 September 2011 £m	Change %
Retail	375	422	11
Wholesale	658	686	4
Commercial	97	46	
Wealth and International			
Ireland	711	697	(2)
Other	565	105	
	1,276	802	(59)
Central items	3	–	
Impairment charge	2,409	1,956	(23)

As anticipated at the time of our Q3 Interim results Statement on 8 November 2011, the impairment charge increased in the fourth quarter, largely reflecting higher charges in Other International, primarily as a result of further provisioning in the Group's Australasian portfolio.

Balance sheet

Improving capital ratios

	2011	2010	Change %
Risk-weighted assets	£352.3bn	£406.4bn	(13)
Core tier 1 capital ratio	10.8%	10.2%	
Tier 1 capital ratio	12.5%	11.6%	
Total capital ratio	15.6%	15.2%	

Our core tier 1 capital ratio improved significantly to 10.8 per cent at 31 December 2011 (31 December 2010: 10.2 per cent). The impact of the statutory loss, and an increase in risk-weighted assets of approximately £7 billion from the implementation of CRD III which reduced core tier 1 capital ratio by approximately 20 basis points, were more than offset by a reduction in risk-weighted assets of £54.1 billion, principally from disposals of higher risk non-core assets. The total capital ratio improved to 15.6 per cent (31 December 2010: 15.2 per cent).

Risk-weighted assets reduced 13 per cent to £352.3 billion in 2011, driven by the run-down of our non-core asset portfolio, which accounted for 65 per cent of the reduction, and weak demand for new lending. Modelling changes had no material effect on risk-weighted assets.

In line with our strategy, the capital intensity of the balance sheet continues to reduce, with new lending being of better quality than existing portfolios, and thus having a lower average risk-weighting.

Further progress on balance sheet reduction

	2011 £bn	2010 £bn	Change %
Funded assets	587.7	655.0	(10)
Non-core assets	140.7	193.7	(27)
Non-core risk-weighted assets	108.8	143.9	(24)

Total Group funded assets decreased to £587.7 billion from £655.0 billion at 31 December 2010, substantially driven by reductions in non-core portfolios across the banking divisions, continued customer deleveraging and de-risking and subdued demand in lending markets. We are pleased with the progress made on our balance sheet reduction plans in the period, given challenging market conditions. In 2011, we achieved a substantial reduction in the non-core portfolio of £53 billion, resulting in the portfolio at 31 December 2011 amounting to £141 billion. This reduction includes more than €2 billion of cash generated from repayments and disposals from the Irish portfolio.

SUMMARY OF GROUP RESULTS

Further strengthening of our liquidity and funding position

	2011	2010	Change %
Customer deposits[1]	**£405.9bn**	£382.5bn	6
Wholesale funding	**£251.2bn**	£298.0bn	(16)
Loan to deposit ratio[2]	**135%**	154%	
Core business loan to deposit ratio[2]	**109%**	120%	
Government and central bank facilities	**£23.5bn**	£96.6bn	
Proportion of wholesale funding with maturity of greater than one year	**55%**	50%	
Primary liquid assets	**£94.8bn**	£97.5bn	

[1] Excluding repos of £8.0 billion (31 December 2010: £11.1 billion).

[2] Excluding repos and reverse repos.

The Group made excellent progress against its funding objectives in 2011 and further enhanced its general funding and liquidity position which is supported by a robust and stable customer deposit base. Customer deposits excluding repos increased by 6 per cent, reflecting good growth in relationship deposits, and now represent 62 per cent of our deposit and wholesale funding.

By the end of 2011, our loan to deposit ratio, excluding repos and reverse repos, had improved to 135 per cent and we expect this will continue to improve as we reduce our non-core lending balances further. Our core loan to deposit ratio also improved to 109 per cent from 120 per cent at the end of 2010.

Strong term issuance in 2011 also allowed the Group to further reduce its short-term wholesale funding and extend its maturity profile of wholesale funding with 55 per cent of wholesale funding having a maturity date greater than one year at 31 December 2011 (50 per cent as at 31 December 2010). Of the funding with maturity less than one year of £113 billion, £24 billion is secured and £24 billion relates to the UK Credit Guarantee Scheme, leaving £65 billion of other unsecured wholesale funding.

Though funding markets remain challenging, we exceeded our 2011 term funding issuance plans with £35 billion of wholesale term issuance. We announced in our Q3 2011 Interim Management Statement that we had completed our 2011 term funding programme at the end of October. The wholesale term issuance of £2 billion in November and December was therefore pre-funding for 2012.

As previously outlined we have a £20 billion to £25 billion term funding requirement during 2012 across all public and private issuance programmes. Given the pre-funding of 2012 requirements achieved in the fourth quarter of 2011, the benefits of the liability management exercise in December 2011, and issuance of £8 billion in January and February 2012, we have already achieved over 50 per cent of this target by the end of February 2012.

At 31 December 2011, the Group had £24 billion of issuance remaining under the UK Credit Guarantee Scheme. As previously outlined, we expect to repay the remaining facilities in line with their contractual maturity dates, £19 billion in the first half of 2012 and £5 billion in the second half of 2012.

The Group also continues to maintain a strong liquidity position, considerably in excess of current regulatory requirements. Our primary liquidity portfolio at the end of the year was £94.8 billion, in line with the level at December 2010. This represents approximately 133 per cent of our money market funding positions as at the end of December 2011 and is approximately 84 per cent of all wholesale funding with a maturity of less than a year, providing a substantial buffer in the event of continued market dislocation. In addition to this primary liquidity, the Group continues to hold more than £100 billion of secondary liquidity.

SUMMARY OF GROUP RESULTS

Items arising after combined businesses profit

Integration and simplification costs

Integration costs of £1,097 million and simplification costs of £185 million were incurred in 2011. These costs relate to severance, IT and business costs of implementation.

The Integration programme has now delivered run-rate recurring savings of £2,054 million per annum as at the end of 2011, at an aggregate expensed cost of £3,846 million. The Simplification programme is well underway and achieved annual run-rate savings of £242 million in 2011. Further details on the Integration and Simplification programmes are given on page 96.

Verde

The Verde business comprises a network of 632 branches, and the TSB and Intelligent Finance brands, and serves approximately 5.5 million customers. Our preferred option for the disposal of the Verde business is a direct sale and the preferred bidder for the business is The Co-operative Group. Any final transaction will be subject to regulatory approval and certain other conditions. We continue to expect to be in a position to update shareholders on progress towards the end of March 2012 at which time, and if appropriate, we will provide further details on the proposed transaction. We will continue to progress an IPO as an alternative to a direct sale.

Volatility arising in insurance businesses

A large proportion of the funds held by the Group's insurance businesses are invested in assets which are expected to be held on a long-term basis and which are inherently subject to short-term investment market fluctuations. Whilst it is expected that these investments will provide enhanced returns compared with less volatile assets over the longer term, the short-term effect of investment market volatility can be significant. The negative insurance and policyholder interests volatility of £838 million in 2011 reflects lower equity and cash returns compared to long-term expectations.

Provision in relation to German insurance business litigation

As previously disclosed, Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany. The Group has recognised a provision of £175 million in 2011 and management believes this represents the most appropriate estimate of the financial impact, based upon a series of assumptions, including the number of claims received, the proportion upheld, and resulting legal and administration costs.

Payment protection insurance

Our review of the compliance with applicable sales standards in respect of PPI continues to make good progress and we continue to believe that the provision of £3.2 billion we took in the first half of 2011 in respect of the anticipated costs of contact and/or redress, including administration expenses, is adequate and that we are appropriately provided. Costs incurred in 2011 against this provision amounted to £1,045 million.

Taxation

The tax credit for 2011 was £828 million. This reflects a lower effective tax rate than the UK statutory rate primarily due to the effect on deferred tax of the reduction in the UK corporation tax rate to 26 per cent with effect from 1 April 2011 and to 25 per cent with effect from 1 April 2012, offset by the net movement in deferred tax recognised for losses.

Summary of financial progress

During 2011, the Group has continued to make very significant progress in divesting non-core assets and refocusing customer balances (loans and deposits) to meet our prudent risk appetite and to enable reduced wholesale funding with a strong liquidity position. We have the appropriate momentum that will allow that journey to continue in the medium-term in line with our strategic objectives. Our customer propositions are now better aligned to our income generating opportunities and, while headline progress is reflective of economic conditions, we are well positioned to continue to respond to customer needs by building income through both lending and advice products. Both our derisking and customer focus are underpinned by the ongoing reshaping of our cost base, exploiting the experience of delivering the complex integration, with significant investment spend to deliver our strategic priorities.

SUMMARY OF GROUP RESULTS

Combined businesses segmental analysis

2011	Retail £m	Wholesale £m	Commercial £m	Wealth and International £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	7,497	2,139	1,251	828	(67)	585	12,233
Other income	1,649	3,335	446	1,197	2,687	(7)	9,307
Effects of liability management, volatile items and asset sales	48	(1,415)	–	–	–	1,293	(74)
Total income	9,194	4,059	1,697	2,025	2,620	1,871	21,466
Insurance claims	–	–	–	–	(343)	–	(343)
Total income, net of insurance claims	9,194	4,059	1,697	2,025	2,277	1,871	21,123
Costs:							
Operating expenses	(4,438)	(2,518)	(948)	(1,537)	(805)	(7)	(10,253)
Other costs[1]	–	–	–	(11)	(7)	(350)	(368)
	(4,438)	(2,518)	(948)	(1,548)	(812)	(357)	(10,621)
Trading surplus	4,756	1,541	749	477	1,465	1,514	10,502
Impairment	(1,970)	(2,901)	(303)	(4,610)	–	(3)	(9,787)
Share of results of joint ventures and associates	11	14	–	3	–	(1)	27
Profit (loss) before tax and fair value unwind	2,797	(1,346)	446	(4,130)	1,465	1,510	742
Fair value unwind[2]	839	2,174	53	194	(43)	(1,274)	1,943
Profit (loss) before tax	3,636	828	499	(3,936)	1,422	236	2,685
Banking net interest margin[3]	2.09%	1.56%	4.21%	1.26%			2.07%
Cost:income ratio[4]	48.3%	62.0%	55.9%	76.4%	35.7%		50.3%
Impairment as a percentage of average advances[5]	0.54%	1.95%	1.06%	7.37%			1.62%
Key balance sheet and other items 31 December 2011	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Loans and advances to customers excluding reverse repos	352.8	123.3	28.8	43.8		0.1	548.8
Customer deposits excluding repos	247.1	84.3	32.1	42.0		0.4	405.9
Risk-weighted assets	103.2	163.8	25.4	47.3		12.6	352.3

[1] Other costs include FSCS costs and UK bank levy.

[2] The net credit in 2011 of £1,943 million is mainly attributable to a reduction in the impairment charge of £1,693 million as losses reflected in the acquisition balance sheet valuations of the lending and securities portfolios have been incurred.

[3] The calculation basis for banking net interest margins is set out on page 97.

[4] Impairment on loans and advances to customers divided by average loans and advances to customers, excluding reverse repurchase transactions, gross of allowance for impairment losses.

[5] Operating expenses excluding impairment of tangible fixed assets divided by total income net of insurance claims.

SUMMARY OF GROUP RESULTS

Combined businesses segmental analysis (continued)

2010	Retail £m	Wholesale £m	Commercial £m	Wealth and International £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	8,648	2,847	1,127	1,050	(39)	510	14,143
Other income	1,607	3,974	457	1,123	2,799	(24)	9,936
Effects of liability management, volatile items and asset sales	–	(295)	–	37	15	150	(93)
Total income	10,255	6,526	1,584	2,210	2,775	636	23,986
Insurance claims	–	–	–	–	(542)	–	(542)
Total income, net of insurance claims	10,255	6,526	1,584	2,210	2,233	636	23,444
Costs:							
Operating expenses	(4,598)	(2,752)	(992)	(1,536)	(854)	(150)	(10,928)
Other costs[1]	(46)	(150)	–	–	–	–	(196)
	(4,644)	(2,902)	(992)	(1,536)	(854)	(150)	(11,124)
Trading surplus	5,611	3,624	592	674	1,379	486	12,366
Impairment	(2,747)	(4,064)	(382)	(5,988)	–	–	(13,181)
Share of results of joint ventures and associates	17	(95)	–	(8)	(10)	5	(91)
Profit (loss) before tax and fair value unwind	2,881	(535)	210	(5,322)	1,369	491	(906)
Fair value unwind	1,105	3,049	81	372	(43)	(1,446)	3,118
Profit (loss) before tax	3,986	2,514	291	(4,950)	1,326	(955)	2,212
Banking net interest margin	2.31%	1.59%	3.74%	1.46%			2.21%
Cost:income ratio	45.3%	42.2%	62.6%	69.5%	38.2%		46.6%
Impairment as a percentage of average advances	0.74%	2.23%	1.24%	8.90%			2.01%
Key balance sheet and other items 31 December 2010	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Loans and advances to customers excluding reverse repos	363.7	141.5	28.6	55.3		0.4	589.5
Customer deposits excluding repos	235.6	82.8	31.3	32.8		–	382.5
Risk-weighted assets	109.3	196.1	26.6	58.7		15.7	406.4

[1] Other costs include FSCS costs and impairment of tangible fixed assets.

DIVISIONAL RESULTS

RETAIL

Retail operates the largest retail bank in the UK and is a leading provider of current accounts, savings, personal loans, credit cards and mortgages. With its strong stable of brands including Lloyds TSB, Halifax, Bank of Scotland and Cheltenham & Gloucester, it serves over 30 million customers through one of the largest branch and fee free ATM networks in the UK.

Retail is focused on effectively meeting the needs of its customers. The division provides current accounts including packaged accounts and basic and social banking accounts. It is also the largest provider of personal loans in the UK, as well as being the UK's leading credit card issuer. Retail provides one in five new residential mortgages making it one of the leading UK mortgage lenders and provided over 52,000 mortgages to help first time buyers in 2011. Retail is the largest private sector savings provider in the UK. It is also a major general insurance and bancassurance distributor, offering a wide range of long-term savings, investment and general insurance products.

Mobile Banking

We've now had over 1 million downloads of the Lloyds TSB app launched in October 2011, and 1.5 million across Lloyds TSB, Halifax and Bank of Scotland. The app allows customers to access their online accounts, transfer funds and make payments to new and existing recipients.

Halifax shakes up savings

Each month, our registered savings customers have the ability to win one of 3x £100,000, 100x £1,000 or 1,000x £100 prizes in our Savers Prize Draw. Over 450,000 customers registered for the first prize draw, which is the first of its kind, giving customers this chance in addition to their individual product's interest rate.

2011 highlights

- → Profit before tax decreased by 9 per cent to £3,636 million
- → Total income decreased by 10 per cent
  - – Net interest income was 13 per cent lower
  - – Other income increased by 3 per cent
- → Operating expenses and other costs reduced by 4 per cent
- → The impairment charge reduced by 28 per cent
- → Fair value unwind decreased by 24 per cent
- → Loans and advances to customers decreased by 3 per cent
- → Customer deposit growth was 5 per cent
- → Retail's strategy remains focused on building deeper customer relationships

Key operating brands

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

DIVISIONAL RESULTS – RETAIL

Performance summary

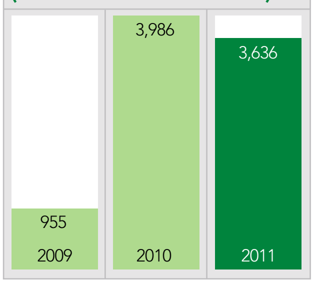
	2011 £m	2010[1] £m	Change %
Net interest income	**7,497**	8,648	(13)
Other income	**1,649**	1,607	3
Effects of liability management, volatile items and assets sales	**48**	–	
Total income	**9,194**	10,255	(10)
Costs:			
Operating expenses	**(4,438)**	(4,598)	3
Other costs[2]	**–**	(46)	
	(4,438)	(4,644)	4
Trading surplus	**4,756**	5,611	(15)
Impairment	**(1,970)**	(2,747)	28
Share of results of joint ventures and associates	**11**	17	(35)
Profit before tax and fair value unwind	**2,797**	2,881	(3)
Fair value unwind	**839**	1,105	(24)
Profit before tax	**3,636**	3,986	(9)
Banking net interest margin	**2.09%**	2.31%	
Impairment as a % of average advances	**0.54%**	0.74%	
Cost:income ratio	**48.3%**	45.3%	

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).
[2] Other costs include FSCS costs in 2010.

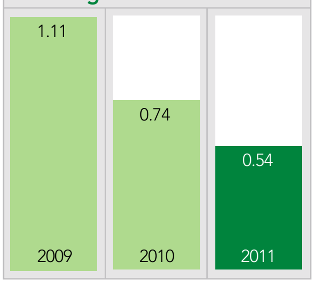
At 31 December	2011 £bn	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers (excluding repos):			
Secured	**329.1**	337.3	(2)
Unsecured	**23.7**	26.4	(10)
	352.8	363.7	(3)
Customer deposits (excluding repos):			
Savings	**206.3**	195.3	6
Current accounts	**40.8**	40.3	1
	247.1	235.6	5
Total customer balances	**599.9**	599.3	
Risk-weighted assets	**103.2**	109.3	(6)

Performance indicators

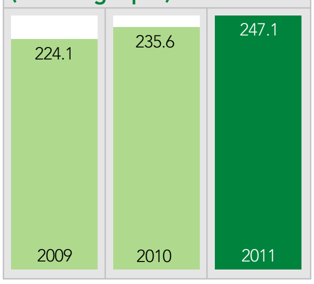
Profit before tax (combined businesses basis) £m



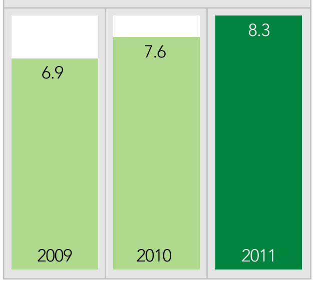
Impairment as a percentage of average advances %



Customer deposits (excluding repos) £bn



Active online customers million



DIVISIONAL RESULTS – RETAIL

2011 highlights

→ **Profit before tax decreased by 9 per cent to £3,636 million,** driven by higher funding costs and muted demand for credit.

→ **Total income decreased by 10 per cent:**

– **Net interest income was 13 per cent lower,** largely as a result of higher funding costs, muted demand for credit, the continued impact from previous de-risking of the lending portfolio with a corresponding reduction in impairments and increased competition for deposits as we continued to reduce our funding gap.

– **Other income increased by 3 per cent,** principally as a result of higher bancassurance income. Income also includes the gain on the disposal of VISA Inc. shares.

→ **Operating expenses and other costs reduced by 4 per cent,** benefiting from cost savings from both our integration and simplification programmes partially offset by inflation. We continue to invest in the Retail business to improve products and services for our customers including in both our digital platforms and our branches.

→ **The impairment charge reduced by 28 per cent,** primarily driven by a reduced unsecured charge which reflected our continued conservative approach to risk, effective portfolio management, and continued focus on existing customers.

→ **Fair value unwind decreased by 24 per cent,** driven largely by the maturing balances of the pre-acquisition portfolio.

→ **Loans and advances to customers decreased by 3 per cent** as customers continued to reduce their personal indebtedness particularly in unsecured lending, as non-core balances reduced and as we maintained a conservative risk appetite. Risk-weighted assets fell 6 per cent, principally reflecting reductions in unsecured balances.

→ **Customer deposit growth was 5 per cent,** against a market that experienced minimal growth. This strong performance reflected the compelling customer proposition Retail has developed, and was driven by strong tax-free cash ISA balance growth. This strong deposit growth, in addition to the issuance of debt securities backed by Retail assets, provided ongoing support to the Group funding position.

→ **Against its strategic objectives,** Retail's strategy remains focused on building deeper customer relationships, driven by superior customer insight, and investment in its multi-brand strategy, new products, multiple channels, and in colleagues. Retail was notably successful in developing new products to address customer needs, such as the Halifax savers prize draw and ISA promise, and developing new digital technologies, such as mobile banking, to allow customers multi-channel access. The majority of integration activity is now complete and Retail has made good progress on products, sourcing, systems and processes.

Strategic focus

Retail's goal is to be the UK's best bank for customers. This will be achieved by building deep and enduring relationships with our customers which will deliver real value to them, and, by continuing to support the UK economy. Developing our customer insight and having a deeper understanding of customers and their needs will enable us to better invest in products and services that customers will most value. In addition by simplifying the business and developing highly efficient and effective processes we will deliver an improved customer experience and increase the flexibility with which the business can respond to changes in the operating environment. Success for Retail will be reflected in an enhanced customer experience resulting in strong customer advocacy which in turn, we believe, will lead to lower customer acquisition costs, increased share of wallet and improved customer retention. Retail believes this strategy will drive sustainable long-term value for all stakeholders.

Progress against strategic initiatives

Reshaping the business

Retail is reshaping the business in a way that is driven by our customers' needs and refocusing our efforts on building deeper customer relationships. As part of this we have continued to make good progress at strengthening the balance sheet through strong customer deposit growth and by managing down balances outside our risk appetite. Retail has also progressed with plans to divest retail assets and liabilities in line with state aid obligations (Project Verde).

Retail is committed to understanding more fully what individual customers want from our products and services. Retail has a significant asset in the customer information it manages and we are investing to further develop our insight into customer needs. This will ensure we continue to do more to anticipate and meet customers' financial needs, and help us develop relationships with customers so that they trust us to meet more of their needs, and stay with us for longer, thereby creating more profitability for the Group.

Retail is committed to a multi-brand strategy operating relationship brands for Lloyds TSB and Bank of Scotland with a challenger brand for Halifax and other tactical brands in the portfolio. Through our strategy, Retail can reach more customers with more distinct and considered proposals and product offerings.

Retail has been successful at developing new challenger propositions that appeal to customers like the savers prize draw in Halifax. The prize draw offers customers the opportunity to win up to £100,000 and has achieved strong enrolment (with over 450,000 customers registered for the first draw) and improved customer advocacy. Retail also developed the Halifax ISA promise which delivers a clear service promise that resonates with customers and helped support record new ISA business performance in 2011. The mortgage offering has also been developed, including the roll-out of a new mortgage sales platform that has improved the processing of mortgage applications and significantly simplified the mortgage application process for both customers and advisors.

DIVISIONAL RESULTS – RETAIL

Simplifying the Bank

We're taking decisive steps towards becoming a simpler organisation. Retail has already made good progress with the recent integration which delivered a common banking platform across the majority of customers and accounts, additional details are provided on page 96. We are now investing in our infrastructure to ensure our systems support future simplification of the business and improve our capabilities. This includes the further development of Risk and Finance systems to make decision-making more agile and enable us to compete more effectively in our chosen markets.

Retail continues to simplify its sourcing arrangements and flatten its management structure. Retail is making good progress at reducing the number of suppliers and improving its demand management. Reducing the layers of management is delivering stronger and more effective functions and empowering managers and colleagues.

Retail is also working to introduce simpler products, systems and processes for customers. This includes developing new digital technologies to simplify our customers' interactions with the Group and make banking with us more convenient – in particular services like our award-winning internet banking, mobile banking apps (which have achieved over 1.5 million downloads) and Money Manager. Retail has seen strong improvement in customer advocacy with those customers who use these services.

Investing to be the best bank for customers

Changing our business to be simpler and more customer-centric will help us to achieve our vision, but we also need to invest in growth to be the best bank for customers. That means deepening our customer relationships, growing the capabilities and skills of our colleagues, and helping our communities to grow and prosper.

We are committed to support and build stronger relationships with all customers and as part of this are developing the products and services we provide to mass affluent and business connected customers so that we can better meet their needs and form deep and enduring relationships. This includes investing in training for our advisors and more automated systems, ensuring we help address the more complex financial needs of these customers and improve customer experience.

Retail recognises the importance of the branch for many customers and has made a commitment to maintain the same number of branches for the next three years, including pledging that it will not close a branch if it's the last in a community. Retail has also commenced a significant investment programme across the Lloyds TSB branch network. The programme targets upgrading branch interiors, increasing the opening hours in branches, simplifying the advisor role structure and improving the queuing experience. Pilots of the revised branch design and roles have delivered strong improvements in customer advocacy and new product sales.

We believe investing in our colleagues and deepening the pool of talent in the Group will ensure we continue to be an employer of choice. This includes investing in training Academies and professional qualifications to support colleagues' development.

Our support for households is vital to the strength of the UK economy. Through our community investment agenda we aim to make a lasting difference to the country, focusing on key themes such as financial capability and inclusion, and environmental responsibility.

Financial performance

Despite the difficult operating environment Retail delivered a profit before tax in 2011 of £3,636 million which was £350 million, or 9 per cent, lower than 2010.

Profit before tax and fair value unwind decreased to £2,797 million, a reduction of 3 per cent compared to 2010, driven by higher funding costs and the muted demand for credit.

Total income decreased by £1,061 million, or 10 per cent, to £9,194 million. This was driven by a reduction in net interest income of £1,151 million, while other income increased by £42 million. Core income trends were consistent with total income performance described below.

Net interest income reduced by 13 per cent compared to 2010. One of the main drivers was the increase in wholesale funding costs which were not matched by average customer rates. Net interest margin in 2011 decreased by 22 basis points to 2.09 per cent. Income growth was also constrained by muted demand for credit. Previous de-risking of the lending portfolio, with a resulting reduction in unsecured balances, also contributed to the reduction in income albeit with a proportionately greater reduction in impairment. Net interest margin, minus impairment rate, remained stable reflecting progress in de-risking the balance sheet. Finally, increased competition for deposits and strong balance growth resulted in an increase in the average rate paid on customer deposits.

Other income increased by 3 per cent in 2011 to £1,649 million from £1,607 million largely as a result of higher bancassurance income, driven by an increase in the value of protection products sold through the branch network. Income also includes the gain on the disposal of VISA Inc shares.

Operating expenses and other costs fell by 4 per cent compared to 2010 and the cost-income ratio was 48.3 per cent. Operating expenses benefited from our integration activities, the start of our simplification programme, and other day-to-day cost management activities to offset inflation. We continue to invest in the Retail business to improve products and services for our customers including our digital platforms and our branches. During 2011 Retail successfully completed a major milestone in the Integration programme, the consolidation of its main Retail product systems, which is discussed in greater detail on page 96. This now creates a solid platform to deliver the simplification programme.

DIVISIONAL RESULTS – RETAIL

Credit performance across the business continued to be supported by our conservative approach to risk, a continued focus on existing customers and low interest rates. The impairment charge on loans and advances decreased by £777 million, or 28 per cent, to £1,970 million driven by reductions in the unsecured charge. The unsecured impairment charge reduced to £1,507 million from £2,455 million in 2010, reflecting the impact of our continued conservative approach to risk (resulting in improved new business quality), effective portfolio management and a reduction in unsecured balances. The secured impairment charge increased to £463 million from £292 million in 2010 largely reflecting a less certain outlook on house prices and appropriate provisioning against existing credit risks which have longer emergence periods due to current low interest rates. These factors were partially offset by underlying improvement in the quality of the secured portfolio.

The fair value unwind net credit was £839 million compared with £1,105 million in 2010. This reduction was driven largely by the maturing balances of the pre-acquisition portfolio.

Balance sheet progress

Total customer balances remained stable at £599.9 billion as Retail continued to maintain its relationships with customers. The mix of these balances continued to move towards customer deposits as customers continued to reduce their personal indebtedness and Retail continued to make strong progress in attracting savings balances. This change in customer balance composition has additionally supported the Group's funding although it has also contributed to a reduction in income and profit.

Loans and advances to customers decreased by £10.9 billion, or 3 per cent, to £352.8 billion, compared to 31 December 2010. This was driven by reduced customer demand for new credit, existing customers continuing to reduce their personal indebtedness, non-core lending run off and Retail maintaining a conservative approach to risk. The reduction in lending to customers was in part due to the repayment of unsecured debt where balances reduced by £2.7 billion, or 10 per cent. Secured balances reduced by £8.2 billion, or 2 per cent, of which £1.9 billion was a reduction in non-core mortgage balances. The proportion of mortgages on standard variable rate, or equivalent products, now stands at 56 per cent and is expected to remain broadly stable in 2012.

Retail's gross mortgage lending was £28.0 billion in 2011 which was equivalent to a market share of 20 per cent. Retail's new mortgage lending continued to be focused on home purchase with 70 per cent of lending being for house purchase rather than re-mortgaging. Retail remains the UK's largest lender to first time buyers, helping over 52,000 customers buy their first home in 2011.

Risk-weighted assets decreased by £6.1 billion to £103.2 billion compared to 31 December 2010. This reflected the impact of lower lending balances and the reducing mix of unsecured lending.

Total customer deposits increased by £11.5 billion, or 5 per cent, to £247.1 billion in 2011. This increase was largely driven by strong growth in tax free cash ISA balances. Retail continues to perform well in the savings market despite the high levels of competition, with a strong stable of savings brands providing customers with an award winning range of products to meet their savings needs.

Retail continues to make a significant contribution to Group funding both through customer deposit growth and the supply of assets supporting over £64.0 billion of debt securities in external issue. During the year Retail contributed to £16.4 billion of new issuance. The majority of these securitisations are backed by mortgages and have a fixed repayment schedule and as such provide a stable source of funding for the Group.

DIVISIONAL RESULTS

WHOLESALE

The division comprises Wholesale Banking and Markets (WBM) and our Asset Finance business. The Wholesale Banking and Markets business serves corporates with turnover above £15 million, and financial institutions with a range of relationship focused propositions, segmented according to customer need.

Wholesale Banking and Markets businesses are grouped into three areas, coverage and product, with a support function providing centralised coordination of critical business processes and activities.

Coverage comprises Corporate Banking, Mid Markets and Sales. Corporate Banking is responsible for the overall management of relationships with major corporate and institutional customers principally in the UK. Similarly Mid Markets manages the relationships with mid market corporates, which operate on a pan-UK basis. Sales provide customers with tailor-made risk management solutions through liability, foreign exchange, commodity and interest rate management products.

Product comprises Capital Markets, Portfolio Management, Trading, Structured Corporate Finance, Transaction Banking, Structured Transactions Group and Lloyds Development Capital. These product units work alongside the coverage teams to provide specialised lending, access to capital markets and multi product financing solutions to WBM's customers. In addition, these units provide access to financial markets in order to meet the Group's balance sheet management requirements, and provide trading infrastructure to support execution of customer driven risk management transactions.

Asset Finance consists of a number of leasing and speciality lending businesses including Lex Autolease and Consumer Finance (Black Horse Motor and Personal Finance).

Following the changes to organisational structure announced in February 2012, the Asset Finance business is being transferred to Wealth and International division for 2012 reporting.

Arena

Our Wholesale business has launched 'Arena' which is now fully operational. This online portal allows quick and easy access to foreign exchange and money market deposits, allowing our customers to ensure their business is suitably financed in a way that suits their needs.

Bank of the Year – 7 years running

We won Best Bank of the Year for the 7th consecutive year at the Real FD/CBI Excellence Awards. This highlights the consistent support we provide to businesses through the full course of the economic cycle.

2011 highlights

- → **Profit before tax was £828 million compared to £2,514 million in 2010**
- → **Total income decreased 38 per cent**
  - **– Net interest income decreased by 25 per cent**
  - **– Other income decreased by 48 per cent**
- → **Operating expenses decreased by 16 per cent**
- → **The impairment charge decreased by 29 per cent**
- → **Fair value unwind decreased by 29 per cent**
- → **Assets decreased by 18 per cent**
- → **Customer deposits excluding repos were 2 per cent higher**
- → **Wholesale continued to deepen its customer relationships through a measured build out of products and capabilities**

Key operating brands

Lloyds TSB | blackhorse | LLOYDS BANK | BANK OF SCOTLAND | Lex Autolease

DIVISIONAL RESULTS – WHOLESALE

Performance summary

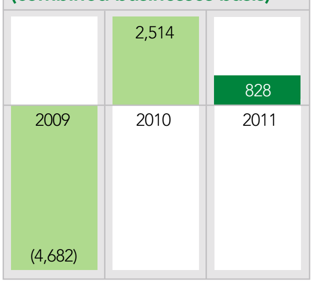
	2011 £m	2010[1] £m	Change %
Net interest income	**2,139**	2,847	(25)
Other income	**3,335**	3,974	(16)
Effects of liability management, volatile items and asset sales	**(1,415)**	(295)	
Total income	**4,059**	6,526	(38)
Costs:			
Operating expenses	**(2,518)**	(2,752)	9
Other costs[2]	**–**	(150)	
	(2,518)	(2,902)	13
Trading surplus	**1,541**	3,624	(57)
Impairment	**(2,901)**	(4,064)	29
Share of results of joint ventures and associates	**14**	(95)	
Loss before tax and fair value unwind	**(1,346)**	(535)	
Fair value unwind	**2,174**	3,049	(29)
Profit before tax	**828**	2,514	(67)
Banking net interest margin	**1.56%**	1.59%	
Impairment as a % of average advances	**1.95%**	2.23%	
Cost:income ratio (excl. impairment of tangible fixed assets)	**62.0%**	42.2%	

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).
[2] Other costs include impairment of tangible fixed assets in 2010.

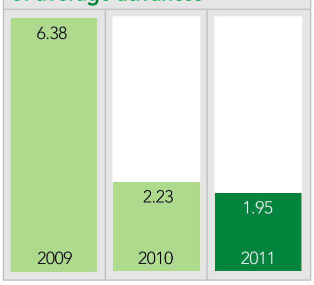
At 31 December	**2011 £bn**	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers (excluding reverse repos)	**123.3**	141.5	(13)
Reverse repos	**16.8**	3.1	
Loans and advances to customers	**140.1**	144.6	(3)
Loans and advances to banks	**8.4**	12.4	(32)
Debt securities	**12.5**	25.8	(52)
Available-for-sale financial assets	**12.6**	29.5	(57)
	173.6	212.3	(18)
Customer deposits (excluding repos)	**84.3**	82.8	2
Repos	**7.1**	10.2	(30)
Customer deposits including repos	**91.4**	93.0	(2)
Risk-weighted assets	**163.8**	196.1	(16)

Performance indicators

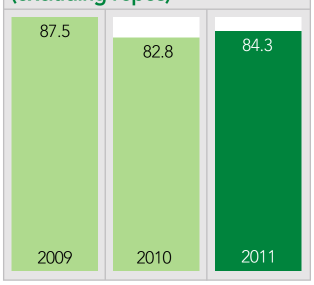
Profit (loss) before tax (combined businesses basis) £m



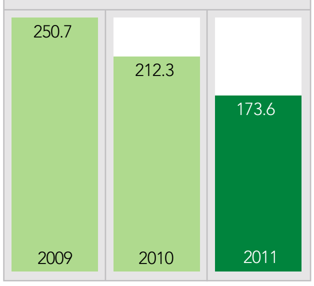
Impairment as a percentage of average advances %



Customer deposits (excluding repos) £bn



Asset reduction £bn



DIVISIONAL RESULTS – WHOLESALE

2011 highlights

- **Profit before tax was £828 million compared to £2,514 million in 2010,** with lower income as the balance sheet was materially strengthened through targeted asset reductions, partially offset by reduced impairment and lower costs. Excluding the impacts of asset sales and derivative valuation adjustments, profit before tax reduced £649 million or 30 per cent, in the context of a challenging economic and market environment.
- **Total income decreased 38 per cent** (20 per cent excluding losses on asset sales and derivative valuation adjustments)
  - **Net interest income decreased by 25 per cent,** principally reflecting the substantial reductions in non-core assets, which fell 34 per cent. Net interest margin fell by three basis points, with the impact of higher funding costs almost fully offset by re-pricing activity and increased deposit margins and volumes.
  - **Other income decreased by 16 per cent** principally reflecting reduced trading income and a lower level of operating lease asset income in Asset Finance.
- **Operating expenses decreased by 9 per cent,** with further integration cost savings, reduced operating lease depreciation and lower bonus accruals, partially offset by continued investment in core customer facing resource and systems, in line with the priorities set out in June in the Group's Strategic review.
- **The impairment charge decreased by 29 per cent,** reflecting continued strong risk management and the low interest rate environment.
- **Fair value unwind decreased by 29 per cent,** mainly driven by decreased impairments in the loan book, lower release from the reduced treasury asset portfolio and reduced general release given a more cautious outlook for the value of certain assets, partially offset by favourable exchange rate movements.
- **Assets decreased by 18 per cent,** (25 per cent excluding reverse repos), reflecting the targeted reduction in the non-core balance sheet by £35 billion. Although net lending to core customers (excluding reverse repos) reduced by £9 billion as a result of weak demand and continued customer deleveraging as credit facilities matured and were not renewed by customers, gross new committed lending to customers continues to meet our lending commitments. Risk-weighted assets reduced by 16 per cent, in line with the reduction in the balance sheet.
- **Customer deposits excluding repos were 2 per cent higher,** in line with the Group Strategy to increase customer deposits.
- **Against its strategic objectives,** Wholesale continued to deepen its customer relationships through a measured build out of products and capabilities in support of the needs of the existing customer base. With the majority of integration now completed, a new, simpler organisational structure was implemented. Alongside enhanced product capabilities in areas including debt capital markets, money markets, interest rate management and foreign exchange, a transaction banking transformation programme was initiated in the year, to build an enhanced cash management, payments and trade customer offering.

Strategic focus

Wholesale's strategic goal is to be recognised as the UK's leading, through-the-cycle, partner to UK companies and institutions, with the clear objective of supporting our customers' success. We will strengthen the franchise by retaining and deepening our recurring, multi-product customer relationships, building on deep insight into our customers' needs and by offering a broad range of lending, deposit, risk management, debt capital market and transaction banking products. This strategy will enable us to grow our capital light revenues and continue to be a significant provider of financial support to the UK economy.

Progress against strategic initiatives

Reshaping the business

Against the backdrop of a challenging operating environment, in 2011 Wholesale made significant progress in serving more fully the wider needs of the core customer franchise in a capital and funding efficient way. Whilst maintaining the through-the-cycle commitment to making lending available, Wholesale is rebalancing the business towards customers' known fee based banking and financing needs. This growth path for the core business is complemented by a clear mandate to limit or reduce the consumption of capital and funding in non-core areas.

In 2011 Wholesale reduced non-core assets by £35 billion significantly contributing towards the reduction of the Group's wholesale funding requirement. Whilst this has meant the loss of associated income, it has resulted in a material improvement in the profile of the Group's balance sheet, both in terms of risk and absolute size. Further, in total, these asset sales were in line with the net book value.

In 2012, the focus will be on strengthening the franchise in those businesses that generate sustainable, predictable returns on equity at the level targeted by the Group Strategic Review while continuing to reduce non core assets in a capital efficient way.

Simplifying the Bank

To deliver the strategy, a new, simplified, business model has been implemented to ensure more effective co-ordination of Coverage, Product and Support. Coverage and Product are now more closely integrated to create a single team offering to allow seamless access to the banking and financial markets expertise our customers demand. The Support functions have been reconfigured and delayered to provide centralised, efficient and client focused processes and activities to inform and drive better business decisions and performance. This simpler approach will enable easier co-ordination of multi-product solutions on behalf of Wholesale's customers and improve the way we meet their on-going needs.

DIVISIONAL RESULTS – WHOLESALE

Investing in customer franchise

The Strategic Review in June confirmed Wholesale's commitment to meet more fully the range of needs of Wholesale's customer base. In 2011, product capability has been enhanced through the further development of our debt capital markets business and the implementation of Bloomberg e-trading to support trading of bonds and gilts with financial institution clients. In addition Arena, a scalable online portal for foreign exchange, interest rate management and money market deposits, is now fully operational, and providing efficient, cost effective, market access for customers. Lloyds TSB also achieved Gilt-Edged Market Maker status, becoming a primary dealer in UK government bonds, creating opportunities to further service a wider group of Financial Institutions.

In 2011, Wholesale initiated a Transaction Banking Transformation Programme, to build an improved, cash management, payments and trade customer offering. This programme will deliver improved customer services in stages, with the bank's Faster Payments scheme already successfully extended and a service allowing customers to obtain more easily settlement from their European customers introduced. Lloyds Banking Group partnership with London 2012 saw the successful processing of card settlements for Olympic and Paralympic Games ticketing and Transaction Banking also launched the UK's first contactless prepaid cards for corporate use, with a special range of Visa London 2012 Olympic and Paralympic Games themed Cards.

Awards

In 2011, Wholesale's focus on deepening customer relationships and continued commitment to core businesses was once again recognised by Finance Directors of commercial and corporate companies who voted Lloyds TSB as Bank of the Year in the CBI/Real FD awards for the seventh year running.

Wholesale also achieved double success at Euroweek's Syndicated Loan and Leveraged Finance Awards 2011 winning the 'Best Arranger of UK Loans' and 'Best Arranger of Mid-Cap Loans' awards. This was the second consecutive year that the Group has won these awards, reinforcing the market's recognition of Wholesale's expertise in arranging these transactions, as well as the ongoing commitment that the Group have made to our customers. Further notable successes include the Leveraged Finance House of the Year in the Private Equity News Awards for Excellence in Private Equity, three awards at the Project Finance International Awards 2011 and in debt capital markets where the bank ranked first in 2011 for sterling corporate UK parent bond issuance (Dealogic).

Financial performance

Profit before tax was £828 million compared to a profit before tax of £2,514 million in 2010. Income reduced by £2,467 million and fair value unwind fell, partially offset by lower costs and a significant decrease in the impairment charge, and the elimination of losses in joint venture businesses.

The profit performance was significantly impacted by the impact of net derivative valuation adjustments and asset disposals net of associated fair value. Excluding these effects profit before tax was £1,506 million.

Core profit before tax decreased to £682 million compared to profit before tax of £2,052 million in 2010, largely due to reduced income from a reduced balance sheet as customers deleverage, a challenging trading environment and as a result of net derivative valuation adjustments. Impairments increased due to certain specific large cases. Excluding net derivative valuation adjustments core profit before tax was £1,400 million, down 33 per cent on 2010.

Non-core profit before tax was £146 million compared to a profit of £462 million in 2010, reflecting the effect of lower income from the continued downward management of the balance sheet, partially offset by lower costs, a continued significant decrease in impairments net of fair value unwind and elimination of losses in the joint venture businesses.

Income

Wholesale's income performance was significantly impacted by lower asset balances, losses on asset disposals in the year to strengthen the balance sheet and net derivative valuation adjustments. Net derivative valuation adjustments of £718 million were driven primarily by a large fall in long term sterling interest rates and significantly higher market credit spreads. Losses on disposal of £697 million were realised from the disposal of assets and were offset by a related fair value unwind. Net of these effects, income reduced by £1,347 million or 20 per cent, primarily as a consequence of economic and market conditions, which resulted in customer deleveraging, higher funding costs, and lower trading revenues.

	2011 £m	2010 £m	Change %
Total income	**4,059**	6,526	(38)
Adjustments to exclude:			
Net derivative valuation adjustments	**718**	42	
Gains and losses on asset sales	**697**	253	
Total income net of volatile items and asset sales	**5,474**	6,821	(20)

Net interest income decreased by £708 million, or 25 per cent, to £2,139 million. The decrease reflects lower interest-earning asset balances in line with the Group's targeted balance sheet reduction of loans and advances to customers and banks, debt securities and available-for-sale positions. Net interest income was also adversely affected by higher funding costs. This was partially offset by an increase in the liability margin resulting from the increased market value of deposits.

The net banking margin decreased by three basis points to 1.56 per cent. This principally reflects increased wholesale funding costs, partly offset by customer re-pricing and increased deposit margins and volumes. Asset margins decreased as the benefit of higher customer rates was more than offset by funding costs, whilst liability margins improved.

DIVISIONAL RESULTS – WHOLESALE

Other income decreased by £639 million, or 16 per cent, to £3,335 million, mainly reflecting lower income in Asset Finance and reduced trading revenues. The effect of losses on asset disposals from the continued focus on balance sheet reductions and net derivative valuations adjustments due to the increased market implied credit risk associated with customer derivative balances resulted in losses of £1,415 million, compared to £295 million in 2010.

Core income was £3,559 million compared to £4,793 million in 2010, reflecting the effects of net derivative valuation adjustments and as a consequence of difficult market and economic conditions, reduced lending balances to corporate customers, and higher wholesale funding costs. Excluding derivative valuation adjustments income decreased 12 per cent showing resilience in the challenging environment.

Non-core income decreased to £500 million compared to £1,733 million in 2010, due to losses on asset disposals (offset by a related fair value unwind included elsewhere in the income statement), a significantly lower balance sheet from the continuing successful asset reduction programme, lower margin due to higher wholesale funding costs and reduced income as the non-core Asset Finance businesses were run down or sold.

The core banking net interest margin saw a significant increase of 21 basis points to 1.80 per cent, driven primarily by a lower reliance on wholesale funding as asset balances reduced and deposit balances increased. The non-core banking margin, which is predominantly asset based, decreased by 32 basis points to 1.28 per cent, largely from increased wholesale funding costs.

Costs

Operating expenses decreased by £234 million, or 9 per cent, to £2,518 million from further savings from the Integration programme, lower operating lease depreciation, lower bonus accruals and other ongoing cost management actions to mitigate the impact of inflationary increases. This was partially offset by continued investment in customer facing resources and systems.

Impairment and fair value unwind

The impairment charge decreased by £1,163 million, or 29 per cent, to £2,901 million reflecting a sustained decrease since the peak in 2009. As a percentage of average loans and advances to customers, the impairment charge improved to 1.95 per cent from 2.23 per cent in 2010. This reflected robust and proactive risk management and lower defaults from continued low interest rates despite a subdued economic environment.

The core impairment charge was £741 million, compared to £576 million in 2010. The increase is attributable to a few specific large cases reflecting the nature of impairments in a Wholesale portfolio. The non-core impairment charge decreased by £1,328 million, or 38 per cent, to £2,160 million in 2011. This was primarily due to lower impairment from non-core corporate real estate and real estate related asset portfolios, reflecting a stabilisation of commercial property prices in 2011. Non-core impairments in 2010 were significant as a result of the scale and pace of deterioration in the property sector and poorer quality heritage HBOS lending.

The share of results from joint ventures and associates, which are all non-core, comprised a small profit of £14 million, an improvement of £109 million, due to the non-recurrence of losses and impairments taken in 2010.

Fair value unwind decreased £875 million to £2,174 million, reflecting the lower impairments in the loan book, reduced release on the smaller non-core treasury asset book and a risk based approach to release on certain treasury assets given market conditions, partially offset by favourable exchange rate movements. The fair value unwind predominantly relates to non-core portfolios.

Balance sheet progress

In 2011 Wholesale continued to focus on strengthening the balance sheet by reducing non-core assets. Assets (comprising loans and advances to customers and banks, debt securities and available-for-sale financial assets) reduced by £38.7 billion, or 18 per cent, to £173.6 billion, primarily reflecting deleveraging by customers and continued active de-risking of the non-core balance sheet by either selling down or reducing holdings in debt securities and available-for-sale assets, as well as disposal of £4.8 billion of non-core commercial real estate customer balances. The non-core reduction was £35.2 billion, primarily driven by a reduction in treasury assets of £26 billion. This overall balance sheet reduction was net of an increase in reverse repo balances as liquidity was invested in high quality primary liquid assets on a secured basis.

Loans and advances to customers excluding reverse repos reduced by £18.2 billion, or 13 per cent, to £123.3 billion as demand for new corporate lending and refinancing of existing facilities was more than offset by maturities, reflecting a continued trend of subdued corporate demand for lending, customer deleveraging and asset sales in non-core sectors. Non-core lending accounted for 51 per cent, of this reduction. Available-for-sale financial assets balances reduced by £16.9 billion, or 57 per cent, to £12.6 billion and debt securities by £13.3 billion, or 52 per cent, to £12.5 billion. This was driven by the reduction in the non-core balance sheet through treasury and other asset sales or not replenishing holdings after amortisations and maturities. The non-core proportion of these reductions was £12.7 billion, or 75 per cent, in the case of available-for-sale assets, and £13.1 billion, or 98 per cent, in the case of debt securities. Loans and advances to banks reduced by £4.0 billion, or 32 per cent, to £8.4 billion.

Customer deposits excluding repos increased by 2 per cent to £84.3 billion, due to an increase in deposits in line with the Group's funding strategy. Customer deposits on the core book increased by 3 per cent to £81.5 billion.

Risk-weighted assets decreased by £32.3 billion, or 16 per cent, to £163.8 billion, primarily reflecting balance sheet reductions and run down in other non-core asset portfolios, as well as the impact of changes in the risk profile, partially offset by Basel regulatory changes to market risk. Non-core risk-weighted assets represent £24.7 billion, or 76 per cent, of this reduction.

DIVISIONAL RESULTS – WHOLESALE

Wholesale (excluding Asset Finance)

	2011 £m	2010[1] £m	Change %
Net interest income	**1,783**	2,430	(27)
Other income	**2,212**	2,631	(16)
Effects of liability management, volatile items and asset sales	**(1,394)**	(295)	
Total income	**2,601**	4,766	(45)
Costs:			
Operating expenses	**(1,534)**	(1,636)	6
Impairment of tangible fixed assets	**–**	(150)	
	(1,534)	(1,786)	14
Trading surplus	**1,067**	2,980	(64)
Impairment	**(2,701)**	(3,800)	29
Share of results of joint ventures and associates	**13**	(95)	
(Loss) before tax and fair value unwind	**(1,621)**	(915)	(77)
Impairment as a % of average advances	**1.93%**	2.22%	
Cost:income ratio (excl. impairment of tangible fixed assets)	**59.0%**	34.3%	

[1]Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

At 31 December	2011 £bn	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers excl reverse repos	**116.9**	132.6	(12)
Reverse repos	**16.8**	3.1	
Loans and advances to customers[1]	**133.7**	135.7	(1)
Loans and advances to banks	**8.4**	12.4	(32)
Debt securities	**12.5**	25.8	(52)
Available-for-sale financial assets	**12.6**	29.5	(57)
	167.2	203.4	(18)
Customer deposits[2]	**91.4**	93.0	(2)
Risk-weighted assets	**155.8**	184.1	(15)

[1]Of which reverse repos represent £16.8 billion (31 December 2010: £3.1 billion).
[2]Of which repos represent £7.1 billion (31 December 2010: £10.2 billion).

Total income decreased by £2,165 million to £2,601 million, mainly driven by a decrease in other operating income. This principally reflects losses of £676 million on the disposal of assets in 2011, (offset by a related fair value unwind of £737 million, reflected elsewhere in the income statement), net derivative valuation adjustments of £718 million and the effect of a reduced balance sheet. Excluding asset sales and temporary volatility, income decreased by £1,066 million or 21 per cent, broadly in line with the balance sheet movement.

Net interest income decreased by £647 million, or 27 per cent, to £1,783 million. The decrease reflects lower interest-earning asset balances in line with the continued focus on balance sheet reduction and strengthening, mainly in loans and advances to customers, debt securities and available-for-sale positions. Net interest income was also adversely affected by higher wholesale funding costs, which was partially offset by an increase in the liability margin resulting from the increased market value of deposits.

Other income decreased by £419 million, or 16 per cent, to £2,212 million, primarily reflecting the lower trading revenue and reduced fees and commissions.

Operating expenses decreased by £102 million, or 6 per cent, to £1,534 million. The reduction in operating expenses from integration savings, lower bonus accruals and the continued focus on cost management have been offset by reinvestment into customer facing resources and systems

The impairment charge decreased by £1,099 million to £2,701 million in 2011, reflecting a sustained decrease since the peak in 2009. As a percentage of average loans and advances to customers, the impairment charge improved to 1.93 per cent in 2011 compared to 2.22 per cent in 2010. This reflected robust and proactive risk management and lower defaults from continued low interest rates despite a subdued economic environment

The share of results from joint ventures and associates comprised a small profit of £13 million, an improvement of £108 million, due to the non-recurrence of losses and impairments taken in 2010.

DIVISIONAL RESULTS – WHOLESALE

Asset Finance

	2011 £m	2010[1] £m	Change %
Net interest income	**356**	417	(15)
Other income	**1,123**	1,343	(16)
Effects of liability management, volatile items and asset sales	**(21)**	–	
Total income	**1,458**	1,760	(17)
Operating expenses	**(984)**	(1,116)	12
Trading surplus	**474**	644	(26)
Impairment	**(200)**	(264)	24
Share of results of joint ventures and associates	**1**	–	
Profit before tax and fair value unwind	**275**	380	(28)
Impairment as a % of average advances (annualised)	**2.33%**	2.34%	
Cost:income ratio	**67.5%**	63.4%	

[1]Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

At 31 December	2011 £bn	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers	**6.4**	8.9	(28)
Operating lease assets	**2.7**	3.0	(10)
Risk-weighted assets	**8.0**	12.0	(33)

Profit before tax and fair value unwind was £275 million, compared to £380 million in 2010. The £105 million reduction was largely due to a decrease in income.

Total income decreased by £302 million, or 17 per cent, to £1,458 million as a result of lower business volumes, including assets held under operating leases, the non-recurrence of VAT claims settled in the prior year and a £21 million loss on disposal of Hill Hire plc. The lower business volumes are in-line with the targeted reduction in this asset class and were partly offset by improved margins.

Operating expenses decreased by £132 million, or 12 per cent, to £984 million. This reflected an £88 million, or 11 per cent, decrease in depreciation charges on assets held under operating leases largely from a lower fleet size. Other costs decreased by £44 million, or 13 per cent, reflecting strong cost management and savings achieved from integration.

The impairment charge decreased by £64 million to £200 million, reflecting an improvement in market conditions for both the retail and non-retail consumer finance businesses. The lower impairment charge has been driven by a reduction in new cases entering arrears, the reduced book size and the improved credit quality of new business.

DIVISIONAL RESULTS

COMMERCIAL

Commercial serves in excess of 1.1 million small and medium-sized enterprises and community organisations from start-up to those with a turnover of up to £15 million, as well as providing asset based finance to business of all sizes.

Commercial comprises Commercial Banking, Commercial Finance, providing invoice discounting and factoring, hire purchase and leasing and AMC the long term lender to the agricultural sector. The business has a 'through the cycle' customer relationship approach, drawing on a wide range of Group service in order to meet their needs through their business lifecycle – from start-up, through growth, to maturity and succession. Through the SME Charter, Commercial have committed to lend £12 billion gross and continue to deliver positive net lending in 2012 and to help 300,000 start ups in the three years to end 2012.

Flexible monthly price plan

Lloyds TSB was the first UK bank to offer a range of flexible Monthly PricePlans, which simplify charges and improve transparency for business banking customers. This innovative approach offers customers choice, flexibility and gives them greater control of their banking.

Supporting start-ups

Through our Relationship Manager network an innovative company has been able to research and launch their range of umbrellas, where the material changes colour when wet. SquidLondon umbrellas are stocked in places such as the Conran Store and the TATE.

2011 highlights

- Profit before tax increased by 71 per cent
- Total income increased by 7 per cent
  - Net interest income grew by 11 per cent
  - Other operating income decreased by 2 per cent
- Operating expenses reduced by 4 per cent
- The impairment charge reduced by 21 per cent
- Loans and advances to core customers increased by 3 per cent against a contracting market
- Customer deposits grew 3 per cent
- Risk-weighted assets decreased by 5 per cent
- Commercial has focused on strengthening its customer relationships and supporting SMEs through the cycle demonstrated by:
  - Sustainable franchise growth
  - Supporting customers through responsible lending
  - Improving cross-sales

Key operating brands

Lloyds TSB BANK OF SCOTLAND AMC

DIVISIONAL RESULTS – COMMERCIAL

Performance summary

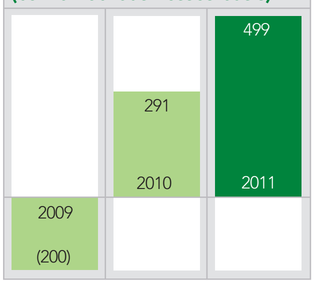
	2011 £m	2010[1] £m	Change %
Net interest income	**1,251**	1,127	11
Other income	**446**	457	(2)
Effects of liability management, volatile items and asset sales	**–**	–	
Total income	**1,697**	1,584	7
Costs:			
Operating expenses	**(948)**	(992)	4
Other costs	**–**	–	
	(948)	(992)	4
Trading surplus	**749**	592	27
Impairment	**(303)**	(382)	21
Profit before tax and fair value unwind	**446**	210	
Fair value unwind	**53**	81	(34)
Profit before tax	**499**	291	71
Banking net interest margin	**4.21%**	3.74%	
Impairment as a % of average advances	**1.06%**	1.24%	
Cost:income ratio	**55.9%**	62.6%	

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

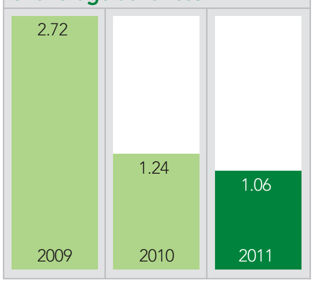
At 31 December	2011 £bn	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers (excluding repos)	**28.8**	28.6	1
Customer deposits (excluding repos)	**32.1**	31.3	3
Total customer balances	**60.9**	59.9	2
Risk-weighted assets	**25.4**	26.6	(5)

Performance indicators

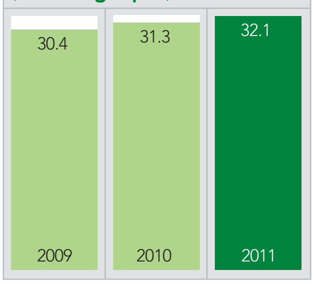
Profit (loss) before tax (combined businesses basis) £m



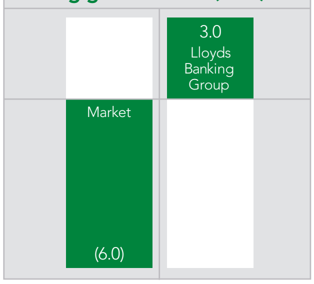
Impairment as a percentage of average advances %



Customer deposits (excluding repos) £bn



Commercial net lending growth 2011 (core) %



DIVISIONAL RESULTS – COMMERCIAL

2011 highlights

- **Profit before tax increased by 71 per cent,** due to higher income, combined with a reduction in impairments and costs.
- **Total Income increased by 7 per cent:**
  - **Net interest income grew by 11 per cent,** due largely to the increase in deposit balances, and a higher net interest margin. This deposit balance growth, the beneficial effect of the consequently larger funding surplus, and a more favourable deposit mix were the key drivers behind the 47 basis point increase in banking net interest margin
  - **Other operating income decreased by 2 per cent,** reflecting subdued levels of business activity in the early part of the year and reduced levels of money transmission income reflecting the greater use of electronic banking facilities by customers.
- **Operating expenses reduced by 4 per cent,** primarily as a result of integration cost savings including lower back office staffing requirements.
- **The impairment charge reduced by 21 per cent,** due to an overall improvement in the credit quality of the portfolio reflected in a reduction in observed default and delinquency rates. This is supported by the specialist relationship support, which helps customers facing difficult business conditions.
- **Loans and advances to core customers increased by 3 per cent against a contracting market.** This reflects the continuing support given to small and medium sized businesses, fully offsetting the reduction in non-core assets.
- **Customer deposits grew 3 per cent,** reflecting our ongoing success in attracting deposits from new customers, combined with targeted support in key customer segments such as the education and legal sectors.
- **Risk-weighted assets decreased by 5 per cent,** reflecting the improved mix and risk profile of the portfolio.
- **Against its strategic objectives,** Commercial has focused on strengthening its customer relationships and supporting SMEs through the cycle by further developing its understanding and support of individual business requirements. This is demonstrated by:
  - **Sustainable franchise growth** in supporting 124,000 start up businesses, and achieving positive net switchers from other banks.
  - **Supporting customers through responsible lending,** combined with improving credit quality, balance sheet funding and RWA use.
  - **Improving cross-sales** of Wealth Management, Insurance, and Treasury products leading to additional revenue for other businesses in the Group.

Strategic focus

Commercial's goal is to be the best bank for smaller and medium sized businesses. The main strategic focus is to improve the depth of relationship with SMEs through specialist customer propositions in key markets, by improving relationship management skills and capacity to cross-sell and optimising customer service through efficiencies that also contribute to cost effectiveness targets.

Progress against strategic initiatives

Reshaping the business

The business is being reshaped by investing to improve the customer proposition, leveraging wider Group capabilities, and supporting SMEs through the cycle to help them prosper and develop. This will be achieved through investment in our Relationship Managers and will be supported by product and system development aligning to customers' wider financial needs. The number of customer facing industry specialists has increased improving support in key markets.

In support of the SME sector, the Group has exceeded its agreed full year contribution to the aggregate Merlin capacity lending target in respect of SMEs. The core net lending balance growth of 3 per cent compares favourably with the contraction of SME lending across the industry reported by the Bank of England.

Supporting the full range of customer needs has resulted in balanced growth of deposits and lending, which has strengthened the balance sheet maintaining the funding surplus. The benefit of close relationship support through the cycle is evidenced in the improvement in credit quality.

Risk-weighted assets have reduced in the context of increased lending, reflecting the improvement in risk profiles as well as the higher mix of secured lending in the book.

Simplifying the Bank

Commercial has made good progress with simplification, with the majority of customers now on a single banking platform. Simpler organisational structures and processes have been delivered with the benefit of lower back office staffing requirements.

The customer benefits arising from simplification are important with significant progress being made on the re-engineering of the lending process. A successful pilot of the new process has halved the time taken to fulfil lending to customers. This will be fully rolled out by the end of 2012. The product range has also been simplified for customers with the launch of the UK's first range of Monthly Price Plans providing certainty and control over bank charges to SME customers; over 30,000 customers have already signed up to this new product.

DIVISIONAL RESULTS – COMMERCIAL

Investing in growth

SMEs are a strategic priority reflecting the Group's commitment to the sector, the competitive advantage entailed in the Group's distribution strengths and relationship expertise, and the potential offered by better co-ordination of the wider range of services across the Group.

The Commercial Finance business, which provides asset backed lending to SMEs, has increased its client base and provided further support to industry sectors including increasing advances to the manufacturing sector by 30 per cent against the prior year.

The Business Support Unit (BSU) is helping businesses in financial difficulties, in line with the commitment to support customers through the economic cycle. Since 2009 the BSU has restructured facilities for around 10,000 businesses and has protected more than 250,000 UK jobs.

Commercial's commitments to customers are made in the SME Charter which has been refreshed and extended to encourage enterprise, provide clear and fair pricing, access to finance and support for communities. As part of this, Commercial has committed to lend £12 billion to customers in 2012. This will be supported by at least 200 customer networking events which have proved to be a key platform for recruitment and customer support.

Commercial supports businesses across the SME sector and has supported 124,000 start up businesses in 2011 as part of the three year commitment to help 300,000 businesses. Support to SME customers will be improved through deepening customer relationships, with internal investment resources agreed along with detailed plans to achieve this.

Awards

- Awarded Bank of the Year (joint award with Wholesale) for the 7th consecutive year on the basis of votes of Finance Directors in the *Real FD Excellence Awards supported by the CBI and the Institute of Chartered Accountants.*
- Awarded best charity account provider in the Business Moneyfacts Awards.
- Awarded Asset Financer of the Year (January 2011) – Credit Today Awards.

Financial performance

Profit before tax and fair value unwind in 2011 was £446 million compared to a profit of £210 million in 2010. The improvement of £236 million was largely driven by deposit balance growth and the increased value to the Group's cost of funding from deposits as well as a benefit from a change in the mix of Commercial's deposit balances. The increase in income is partially offset by other operating income which has decreased £11 million, 2 per cent, due to subdued levels of trading activity in the early part of the year and reduced levels of money transmission income reflecting the greater use of electronic banking facilities by customers.

Operating expenses have decreased £44 million, 4 per cent, primarily as a result of integration cost saving programmes delivering positive results, including lower back office staffing requirements.

Impairment has decreased £79 million, 21 per cent, due to an overall improvement in the credit quality of the portfolio leading to a reduction in observed default and delinquency rates. Impairment charges as an annualised percentage of average loans and advances to customers has reduced to 1.06 per cent from 1.24 per cent in 2010, an improvement of 18 basis points year-on-year.

The fair value unwind decreased by 34 per cent, reflecting the decrease in impairment charge.

Balance sheet progress

Loans and advances to customers at £28.8 billion, were broadly unchanged from the prior year. However, core lending increased 3 per cent, where Commercial has been successful in encouraging SME customers to invest and attract switchers requiring term lending and invoice finance facilities. Significant effort in promoting support has included running nearly 700 customer events in 2011.

Customer deposits increased 3 per cent to £32.1 billion reflecting our ongoing success in attracting new customers, combined with targeted support in key customer segments such as the education and legal sectors.

DIVISIONAL RESULTS

WEALTH AND INTERNATIONAL

Wealth and International combines the private banking and asset management businesses and the Group's international businesses.

The Wealth business comprises private banking and asset management. Wealth's private banking operations cater to the full range of wealth clients from affluent to Ultra High Net Worth within the UK, Channel Islands and Isle of Man, and internationally. Our private banking business operates under the Lloyds TSB and Bank of Scotland brands.

Our asset management business, Scottish Widows Investment Partnership, has a broad client base, managing assets for Lloyds Banking Group customers as well as a wide range of clients including pension funds, charities, local authorities, Discretionary Managers and Financial Advisers. In addition, the Group holds a 60 per cent stake in St James's Place, the UK's largest independent listed wealth manager.

The International business comprises the Group's international banking businesses outside the UK, with the exception of corporate business in North America which is managed through the Group's Wholesale division. These largely comprise corporate, commercial and asset finance business in Australia and Continental Europe and retail businesses in Germany and the Netherlands.

Best UK Private Bank

At the Financial Times and Investors Chronicle Wealth Management Awards, Bank of Scotland Private Banking won Best UK Private Bank. Voted for by industry experts and readers of the FT, the award evidences the high quality service our private banking clients receive.

Developing employee capabilities

In 2011 we launched the Wealth Academy, a new learning and development initiative for our Wealth employees. The academy offers access to thousands of industry-leading learning solutions as well as a route to attaining professional qualifications.

So far the academy has helped over 1,400 of our employees develop their skills and deliver more for customers as a result.

2011 highlights

- → **Loss before tax decreased by 20 per cent**
- → **Within the core business, profit before tax and fair value unwind increased by 20 per cent**
- → **Total income decreased by 8 per cent**
  - **Net interest income was 21 per cent lower**
  - **Banking net interest margin reduced by 20 basis points**
  - **Other income increased by 7 per cent**
- → **Operating expenses increased by 1 per cent**
- → **The impairment charge reduced by 23 per cent**
- → **Fair value unwind decreased by 48 per cent**
- → **Net loans and advances to customers decreased by 21 per cent**
- → **Customer deposits grew by 28 per cent**
- → **Wealth demonstrated continued strength in client acquisition through the UK franchise with an 8 per cent increase in customer numbers**

Key operating brands

Private Banking Lloyds TSB | LOOK AT THINGS DIFFERENTLY BANK OF SCOTLAND | SCOTTISH WIDOWS INVESTMENT PARTNERSHIP PERFORM | Lloyds TSB | International

DIVISIONAL RESULTS – WEALTH AND INTERNATIONAL

Performance summary

	2011 £m	2010[1] £m	Change %
Net interest income	**828**	1,050	(21)
Other income	**1,197**	1,123	7
Effects of liability management, volatile items and asset sales	**–**	37	
Total income	**2,025**	2,210	(8)
Costs:			
Operating expenses	**(1,537)**	(1,536)	
Other costs[2]	**(11)**	–	
	(1,548)	(1,536)	
Trading surplus	**477**	674	(29)
Impairment	**(4,610)**	(5,988)	23
Share of results of joint ventures and associates	**3**	(8)	
Loss before tax and fair value unwind	**(4,130)**	(5,322)	22
Fair value unwind	**194**	372	(48)
Loss before tax	**(3,936)**	(4,950)	20
Wealth	**189**	220	(14)
International	**(4,319)**	(5,542)	22
Loss before tax and fair value unwind	**(4,130)**	(5,322)	22
Banking net interest margin	**1.26%**	1.46%	
Impairment as a % of average advances	**7.37%**	8.90%	
Cost:income ratio	**76.4%**	69.5%	

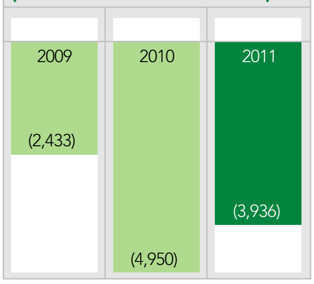
[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

[2] Other costs include FSCS costs in 2011.

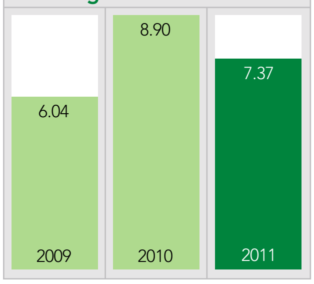
At 31 December	2011 £bn	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers (excluding repos)	**43.8**	55.3	(21)
Customer deposits (excluding repos)	**42.0**	32.8	28
Total customer balances	**85.8**	88.1	(3)
Risk-weighted assets	**47.3**	58.7	(19)

Performance indicators

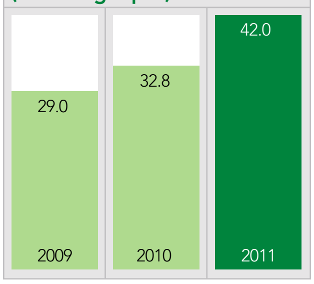
Loss before tax (combined businesses basis) £m



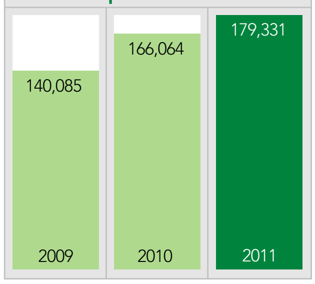
Impairment as a percentage of average advances %



Customer deposits (excluding repos) £bn



UK wealth relationships clients



DIVISIONAL RESULTS – WEALTH AND INTERNATIONAL

2011 highlights

- **Loss before tax decreased by 20 per cent,** with a fall in impairments partly offset by lower income, fair value unwind and higher operating expenses.
- **Within the core business, profit before tax and fair value unwind increased by 20 per cent,** primarily due to a 22 per cent growth in customer core balances and improvement in customer net interest margins partially offset by increased operating expenses reflecting the continued investment in deposit activity in line with our strategy of strengthening the balance sheet and growing our share of the Wealth market.
- **Total income decreased by 8 per cent:**
  - **Net interest income was 21 per cent lower,** reflecting lower lending volumes and increased impaired assets, partly offset by the favourable impact of foreign currency movements, particularly the Australian Dollar. We saw higher deposit balances and margins in our core business where net interest income has increased by 20 per cent.
  - **Banking net interest margin reduced by 20 basis points** reflecting the increased strains of lost earnings on higher impaired asset balances and higher funding costs. This was offset by stronger deposit margins in the Wealth businesses and higher deposit balances and margins in our International on-line deposit business, which drove the banking net interest margin in our core business up by 85 basis points to 4.16 per cent.
  - **Other income increased by 7 per cent,** with foreign exchange benefits in International, partly offset by the impact of lower funds under management in the Wealth businesses driven by market conditions together with a shift in customer investments from funds under management to deposits.
- **Operating expenses increased by 1 per cent,** due to higher regulatory costs, investment in growth initiatives and the effect of stronger foreign currency rates, partly offset by benefits from cost saving initiatives across all businesses.
- **The impairment charge reduced by 23 per cent.** Following higher charges in 2010, especially in the fourth quarter as the economic environment in Ireland deteriorated, the rate of impaired loan migration has slowed. The coverage ratio increased from 53 per cent to 61 per cent reflecting further provisions in the year, particularly in Ireland.
- **Fair value unwind decreased by 48 per cent,** reflecting accelerated unwind of fair value adjustments in 2010 in line with actual levels of impairment losses experienced, particularly in Ireland and Australia.
- **Net loans and advances to customers decreased by 21 per cent,** largely driven by de-risking of the balance sheet through reducing non-core assets across both Wealth & International. Risk-weighted assets decreased by 19 per cent, reflecting lower asset balances and additional impairment provisions, particularly in International.
- **Customer deposits grew by 28 per cent,** primarily due to continued strong inflows in the on-line deposit business. The funding gap has reduced by £20.7 billion to £1.8 billion reflecting continued focus within International on de-risking and right-sizing the balance sheet together with continued strong deposit inflows.
- **Against its strategic objectives,** Wealth demonstrated continued strength in client acquisition through the UK franchise with an 8 per cent increase in customer numbers. To date the division has announced the exit from seven countries, and corporate lending has been refocused around selected customers aligned to UK product and sector plans and the Group's international risk appetite. International is contributing to a strengthening of the Group's balance sheet through a significant and managed run-down of non-core assets together with diversification of sources of funding through international deposits.

Strategic focus

Wealth provides strong growth opportunities for the Group and, through deepening the relationships with existing Group clients alongside targeted customer acquisition, the goal is to be recognised as the primary Wealth advisor to the UK mass affluent, affluent and high net worth customers together with UK expatriates and others with UK connections.

In the International businesses, the priority is to maximise value in the medium term. The immediate focus is on close management of the lending portfolios, particularly in Ireland, and reducing assets where appropriate. At the same time, International is delivering operational efficiencies and rightsizing the cost base to fit the reshaped business models.

Progress against strategic initiatives

As with the wider Group, Wealth and International's strategic focus has been on:

Reshaping the business to better fit the Group's risk appetite

Focus remains on maximising value and aligning with the Group's risk appetite through close management of the lending portfolio, continuing disciplined reduction of non-core assets, diversifying sources of funding and rationalisation of our international presence.

Wealth and International have reduced non-core loans and advances to customers by £11.3 billion in 2011 through a mixture of repayments and selected asset disposals (in addition to foreign exchange and impairments as outlined below), including the sale of £1 billion (gross) of commercial real estate assets in Australia and New Zealand. Our International on-line deposit business continued to grow strongly with customer balances as at December 2011 of £13.8 billion. The division has also made good progress towards reducing its International presence.

DIVISIONAL RESULTS – WEALTH AND INTERNATIONAL

Simplifying the division to right-size cost base and deliver operational efficiencies

The group wide Simplification initiative is well underway, the focus of which is on simplifying operations and processes, delayering management structures, consolidating supplier relationships and increasing the efficiency of distribution channels. Wealth & International is in the process of realising additional efficiencies and cost savings through its initiatives to develop a single customer platform across all International Wealth businesses, streamlining of operating models and creation of a shared support infrastructure.

In 2011, the UK Private Banking and High Net Worth businesses have been successfully integrated to form 'One Private Bank', with a simplified management structure and aligned business models across the heritage brands. During the second half of the year, around 60,000 UK Wealth accounts have been migrated onto a single operating platform.

Developing a more focused business and investing in growth

The division will focus on serving customers both within the UK and also those with UK connections. In International, corporate lending has been refocused around selected customers aligned to UK product and sector plans and the Group's international risk appetite. In Wealth, the focus of propositions will be within the existing UK customer franchise in addition to customers with UK connections in Commonwealth countries, Europe, Middle East, and on the Indian Subcontinent.

Significant investment is being made towards growing market share in what is viewed as a key growth opportunity for the Group – UK and International Wealth. The investment is geared towards developing compelling propositions for mass affluent, affluent and high net worth customers; this will address a key gap for the Group in the mass affluent market and will enhance our investment management offering in the affluent and high net worth segments. Underpinning this, we are consolidating our platforms and simplifying the operating model to deliver a better customer experience in a more efficient manner, thereby improving customer onboarding, retention and value capture through cross sales.

Financial performance

Loss before tax and fair value unwind reduced by 22 per cent to £4,130 million due to a lower impairment charge, predominantly in Ireland, more than offset by lower income and higher costs.

Total income decreased by 8 per cent to £2,025 million.

Net interest income decreased by 21 per cent, or 25 per cent in constant currency terms. Higher funding costs and the increased strain of impaired assets, reflected in a 33 per cent reduction in net lending margins together with lower lending volumes impacting net interest income are partially offset by the impact of the stronger Australian dollar in International. Deposit margins increased by 14 per cent reflecting changing product mix predominantly as a result of continued deposit inflows in the on-line deposit business at higher margins together with improving margins across the Wealth businesses.

Other income increased by 7 per cent, mainly due to foreign exchange benefits in International. Excluding the impact of foreign exchange, other income decreased by 1 per cent.

Operating expenses and other costs increased by 1 per cent, due to increased investment in the International deposit business, the impact of the stronger Australian dollar and Swiss franc and additional regulatory costs in Wealth. On a constant currency basis, operating expenses reduced by 1 per cent. Despite increased investment in International deposit gathering, the cost: income ratio overall improved by 3 per cent in our core business.

The impairment charge reduced by 23 per cent to £4,610 million. Following increased charges in the last quarter of 2010, driven by the significant deterioration in the economic environment in Ireland, the rate of impaired loan migration has slowed in 2011.

Balance sheet progress

Net loans and advances to customers decreased by £11.5 billion to £43.8 billion, as we continued to focus management action on de-risking the balance sheet. The reduction of £11.5 billion reflects net repayments (including asset sales) of £6.0 billion, additional impairment provisions of £4.6 billion mainly within the International businesses and foreign exchange movements of £0.9 billion.

Risk-weighted assets decreased by £11.4 billion to £47.3 billion, reflecting lower asset balances and increased impairment provisions, particularly in the non-core portfolios.

Customer deposits increased by £9.2 billion to £42.0 billion mainly due to continued strong deposit inflows in the on-line deposit businesses.

DIVISIONAL RESULTS – WEALTH AND INTERNATIONAL

Wealth

	2011 £m	2010[1] £m	Change %
Net interest income	**354**	296	20
Other income	**990**	981	1
Effects of liability management, volatile items and asset sales	**–**	37	
Total income	**1,344**	1,314	2
Costs:			
Operating expenses	**(1,044)**	(1,047)	
Other costs[2]	**(11)**	–	
	(1,055)	(1,047)	(1)
Trading surplus	**289**	267	8
Impairment	**(100)**	(46)	(117)
Share of results of joint ventures and associates	**–**	(1)	
Profit before tax and fair value unwind	**189**	220	(14)
Impairment as a % of average advances	**1.10%**	0.48%	
Cost:income ratio	**78.5%**	79.7%	

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

[2] Other costs include FSCS costs in 2011.

At 31 December	2011 £bn	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers	**8.5**	9.1	(7)
Customer deposits	**27.2**	26.8	1
Total customer balances	**35.7**	35.9	(1)
Risk-weighted assets	**7.8**	10.4	(25)

In Wealth, our key focus has been to grow our market share in UK and International Wealth primarily through growing the total amount of deposits and funds under management that we manage on behalf of franchise customers, whilst improving margins and operating efficiency. Although funds under management within Private and International Banking decreased by 5 per cent to £12.8 billion, this primarily reflected market movements and a consequent shift of customer appetite away from investment products.

Profit before tax and fair value unwind decreased by 14 per cent to £189 million mainly due to increased impairment losses partly offset by higher income. Excluding non-recurring gains on sale of non-core businesses of £36 million which were recognised in the first half of 2010, profit before tax and fair value unwind increased by 3 per cent.

Total income increased by 2 per cent to £1,344 million. Excluding non-recurring gains on sale, which were recognised in the first half of 2010, income increased by 5 per cent.

Net interest income increased by 20 per cent, reflecting improving deposit margins across the Wealth business.

Operating expenses and other costs increased by 1 per cent to £1,055 million. Benefits from cost saving initiatives across the Wealth businesses have been offset by increased regulatory and one-off costs and the impact of the stronger Swiss Franc in the International Wealth business. Excluding the impact of foreign exchange and one-off costs, operating expenses reduced by 3 per cent.

The impairment charge increased to £100 million primarily due to increased charges in the Group's Spanish mortgage book reflecting deterioration in the local property markets and economic outlook in Spain.

Balance sheet progress

Net loans and advances to customers decreased by £0.6 billion or 7 per cent, to £8.5 billion due to net repayments of £0.7 billion and increased impairment provisions across the non-core portfolios and foreign exchange movements of £0.1 billion.

Risk-weighted assets decreased by £2.6 billion or 25 per cent, to £7.8 billion reflecting lower lending volumes and improved use of collateral.

Customer deposits increased by £0.4 billion, or 1 per cent, to £27.2 billion.

DIVISIONAL RESULTS – WEALTH AND INTERNATIONAL

Funds under management

	As at 31 December 2011 £bn	As at 31 December 2010 £bn
Scottish Widows Investment Partnership (SWIP)		
Internal	**116.8**	118.2
External	**23.1**	28.0
	139.9	146.2
Other Wealth:		
St James's Place	**28.5**	27.0
Invista Real Estate	**0.8**	5.3
Private and International Banking	**12.8**	13.5
Closing funds under management	**182.0**	192.0

	2011 £bn	2010 £bn
Opening funds under management	**192.0**	184.1
Inflows:		
SWIP – internal	**2.7**	2.0
– external	**1.5**	8.9
Other	**8.5**	6.7
	12.7	17.6
Outflows:		
SWIP – internal	**(4.5)**	(5.6)
– external	**(5.3)**	(13.3)
Other	**(10.1)**	(5.1)
	(19.9)	(24.0)
Investment return, expenses and commission	**(2.8)**	15.1
Net operating increase (decrease) in funds	**(10.0)**	8.7
Sale of Bank of Scotland Portfolio Management Service	**–**	(0.8)
Closing funds under management	**182.0**	192.0

Funds under management reduced by £10.0 billion to £182.0 billion. Net outflows of £19.9 billion reflect expected attrition on insurance funds within SWIP, the market backdrop in the second half of 2011 and fund outflows within Invista Real Estate reflecting both transfers to SWIP during the year and the wind down of Invista Real Estate business. SWIP's inflows include £2.4 billion of funds previously managed by Invista Real Estate. Reductions in global equity values contributed towards investment return, expenses and commission of funds under management by £2.8 billion. This together with the general market backdrop contributed to a shift in customer investments in our Wealth businesses away from funds towards Wealth and Retail deposits.

DIVISIONAL RESULTS – WEALTH AND INTERNATIONAL

International

	2011 £m	2010[1] £m	Change %
Net interest income	474	754	(37)
Other income	207	142	46
Effects of liability management, volatile items and asset sales	–	–	
Total income	681	896	(24)
Costs:			
Operating expenses	(493)	(489)	(1)
Other costs	–	–	
	(493)	(489)	(1)
Trading surplus	188	407	(54)
Impairment	(4,510)	(5,942)	24
Share of results of joint ventures and associates	3	(7)	
Loss before tax and fair value unwind	(4,319)	(5,542)	22
Impairment as a % of average advances	8.43%	10.30%	
Cost:income ratio	72.4%	54.6%	

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

At 31 December	2011 £bn	2010 £bn	Change %
Key balance sheet and other items			
Loans and advances to customers	35.3	46.2	(24)
Customer deposits	14.8	6.0	
Total customer balances	50.1	52.2	(4)
Risk-weighted assets	39.5	48.3	(18)

Within International, our key focus has been to strengthen the balance sheet through material and targeted reductions in non-core assets and diversifying sources of funding through international deposit raising. Loans and advances to customers reduced by 24 per cent (including £5.2 billion of net repayments and asset sales) and customer deposits increased by 147 per cent to £14.8 billion.

Loss before tax and fair value unwind reduced by £1,223 million to £4,319 million mainly as a result of a lower impairment charge, reflecting a reduction of £1,077 million in Ireland and £328 million in Australia.

Total income decreased by 24 per cent, but was 38 per cent lower in constant currency, reflecting lower interest-earning assets and the increased strain of lost earnings on higher impaired assets.

Operating expenses increased by 1 per cent. On constant currency terms, operating expenses reduced by 4 per cent reflecting cost saving initiatives across the International business, partly offset by the continued investment in International's on-line deposit business.

The impairment charge and loans and advances to customers are summarised by key geography in the following table.

	Impairment charges		Loans and advances to customers	
	2011 £m	2010 £m	2011 £bn	2010 £bn
Ireland	3,187	4,264	14.7	19.6
Australia	1,034	1,362	8.1	12.3
Wholesale Europe	204	210	5.9	6.9
Latin America/Middle East	64	97	0.4	0.6
Netherlands	21	9	6.2	6.8
	4,510	5,942	35.3	46.2

The impairment charge reduced by £1,432 million, or 24 per cent, to £4,510 million due to reduced impairment charges in Ireland and Australia.

Balance sheet progress

Net loans and advances to customers decreased by £10.9 billion or 24 per cent, to £35.3 billion due to net repayments of £5.2 billion across all businesses (including the sale of £1 billion of commercial real estate assets in Australia and New Zealand), further impairment provisions and foreign exchange movements of £0.8 billion. The division is focused on de-risking and right-sizing the balance sheet, focusing on key Group relationships, as well as reducing concentrations in Commercial Real Estate.

Risk weighted assets decreased by £8.8 billion or 18 per cent, to £39.5 billion reflecting lower asset balances and further impairment provisions and foreign exchange rate movements. This is partly offset by an increase in risk weighted assets to cover further deterioration in the Irish housing market and other credit risk model changes which impact risk weighted assets.

Customer deposits increased by £8.8 billion to £14.8 billion driven by continued strong performance within our International on-line deposit business.

DIVISIONAL RESULTS

INSURANCE

The Insurance division provides long term savings, protection and investment products and general insurance products to customers in the UK and Europe and consists of three business units:

Life, Pensions and Investments UK (LP&I UK): The UK Life, Pensions and Investments business is the leading bancassurance provider in the UK and has one of the largest intermediary channels in the industry. The business provides long-term savings, protection and investment products distributed through the bancassurance, intermediary and direct channels through the Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows brands.

Life, Pensions and Investments Europe: The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands.

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

Rapid Response

The Group's new Rapid Response Vehicle enables quicker service and greater support for General Insurance customers impacted by events affecting multiple households.

For example, more than 150 homes were flooded in Sutton Coldfield in Birmingham last November when a water main at nearby Barr Beacon reservoir burst.

The Rapid Response Vehicle was called to the scene and colleagues from Insurance used the van to co-ordinate customer visits, settle claims and assess the scope of repairs. Fortunately, we were able to reach a number of customers before they contacted us.

defaqto 2011 ★★★★★

5-star rated

Three of LP&I's flagship intermediary products, the retirement account, the investment bond and the global investor have received a Defaqto 5-star rating for the second year running.

2011 highlights

- → Profit before tax increased by 7 per cent
- → Total income, net of insurance claims, increased by 2 per cent
- → Operating expenses and other costs decreased by 5 per cent
- → LP&I UK EEV new business margin increased to 4.2 per cent from 3.7 per cent in 2010
- → LP&I UK sales of £10,219 million (PVNBP) reduced by 1 per cent
- → General Insurance profits increased by 21 per cent to £497 million
- → Capital management initiatives in 2011 have resulted in £2.3 billion mitigation of the potential impact of CRD IV
- → Scottish Widows was awarded Defined Contribution (Bundled Services) Provider of the Year in the Pension and Investment Provider Awards 2011
- → Insurance has focused on removing duplication to simplify the business and is improving customer insight to support responsiveness to changing customer needs

Key operating brands

SCOTTISH WIDOWS Lloyds TSB HALIFAX BANK OF SCOTLAND

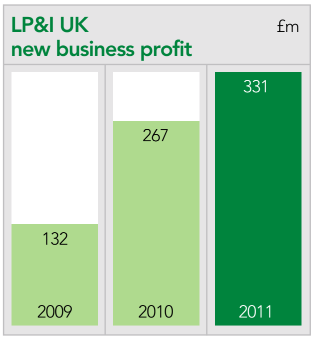
DIVISIONAL RESULTS – INSURANCE

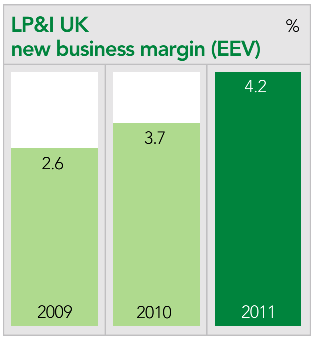
Performance summary

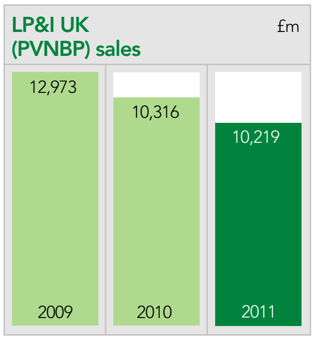
	2011 £m	2010[1] £m	Change %
Net interest income	**(67)**	(39)	(72)
Other income	**2,687**	2,799	(4)
Effects of liability management, volatile items and asset sales	**–**	15	
Total income	**2,620**	2,775	(6)
Insurance claims	**(343)**	(542)	37
Total income, net of insurance claims	**2,277**	2,233	2
Costs:			
Operating expenses	**(805)**	(854)	6
Other costs[2]	**(7)**	–	
	(812)	(854)	5
Share of results of joint ventures and associates	**–**	(10)	
Profit before tax and fair value unwind	**1,465**	1,369	7
Fair value unwind	**(43)**	(43)	
Profit before tax	**1,422**	1,326	7
Profit before tax and fair value unwind by business unit			
Life, Pensions and Investments:			
UK business	**886**	830	7
European business	**82**	127	(35)
General Insurance	**497**	412	21
Profit before tax and fair value unwind	**1,465**	1,369	7
EEV new business margin	**4.0%**	3.5%	
Life, Pensions and Investments sales (PVNBP)	**10,662**	10,828	(2)

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).
[2] Other costs include FSCS costs in 2011.

Performance indicators







DIVISIONAL RESULTS – INSURANCE

2011 highlights

- **Profit before tax increased by 7 per cent.** In 2010 income was reduced by a non-recurring charge of £70 million in respect of the Group's decision to cease writing new payment protection insurance (PPI) business. Excluding this charge profit before tax and fair value unwind increased by 2 per cent in 2011.
- **Total income, net of insurance claims, increased by 2 per cent,** (reduction of 1 per cent excluding the £70 million charge in 2010). This is attributable to strong sales of corporate pensions through the intermediary channel and the continued change in new business mix within Life, Pensions and Investments UK (LP&I UK) towards more profitable protection business reflecting a focus on meeting customer needs in an area where there is a general level of under provision in the UK. Improved claims experience within General Insurance which has been offset by lower PPI related income is also a significant contributor to this.
- **Operating expenses and other costs decreased by 5 per cent** due mainly to a continued focus on cost management and delivery of integration cost savings, partly offset by an additional charge in relation to an industry wide Financial Services Compensation Scheme (FSCS) levy in 2011.
- **LP&I UK EEV new business margin increased to 4.2 per cent from 3.7 per cent in 2010.** The improvement reflects the growth in protection sales and the business ceasing to write certain low margin products in 2010. The Internal Rate of Return (IRR) on new business remains in excess of 16 per cent.
- **LP&I UK sales of £10,219 million (PVNBP) reduced by 1 per cent,** partly reflecting the continuing change in mix towards protection products to meet customer protection needs, which generate a lower PVNBP compared to investments but generate a higher new business profit. Sales through our Intermediary channel have increased by 20 per cent to £6,415 million reflecting strong sales of Corporate Pensions.
- **General Insurance profits increased by 21 per cent to £497 million** primarily due to lower freeze and unemployment claims year on year offset by lower income resulting from the Group ceasing to write new PPI business in 2010.
- **Capital management initiatives in 2011 have resulted in £2.3 billion** mitigation of the potential impact of Capital Requirements Directive IV (CRD IV). The capital position of the UK life insurance group under the Insurance Groups Directive (IGD) remains strong with an estimated capital surplus of £3.7 billion.
- **Scottish Widows** was awarded Defined Contribution (Bundled Services) Provider of the Year in the Pension and Investment Provider Awards 2011 and Best Group Pension Provider in the Corporate Adviser Awards 2012.
- **Against its strategic objectives,** Insurance has focused on removing duplication to simplify the business and is improving customer insight to support responsiveness to changing customer needs. LP&I (UK) has built upon successful sales force integration and single bancassurance proposition launch to deliver a number of further improvements to its operations and capability. General Insurance has improved customer experience by the introduction of a single telephony and e-commerce platform across all brands.

Strategic focus

Insurance is a relationship business focused on helping our customers to protect themselves today whilst preparing for a secure financial future. Having renewed its strategic vision Insurance confirmed its objective to be the best Insurance business for customers.

Progress against strategic initiatives

Reshaping the business

In 2012, Insurance is being reshaped to run as one insurance business with a customer focused corporate and management structure. By operating as one business and actively managing the combined capital, Insurance expects to leverage significant benefits from risk diversification which will give further competitive advantage. Insurance continues to progress well with the implementation of Solvency II requirements.

The business continues to make good progress in improving the profitability of the customer focused product set. In 2011, the Life, Pensions and Investments EEV new business margin improved to 4.0 per cent (from 3.5 per cent in 2010) and the focus on value over volume will continue as Insurance grows a business that is focused on developing long term relationships with customers. The General Insurance business also focuses on generating value with a targeted participation and underwriting strategy in attractive market segments and efficient and effective management of claims. This value is demonstrated by a combined ratio of 69 per cent in 2011.

Capital management initiatives in 2011 have resulted in £2.3 billion mitigation of the potential impact of CRD IV. This includes capital restructuring within the business that occurred in July 2011 which reduced the Group's estimated total core tier 1 impact of CRD IV by over £2 billion. Since 1 January 2010, the mitigation of the potential impact of CRD IV is estimated to be £4.6 billion in total.

In 2011 LP&I (UK) built upon the successful sales force integration and proposition launch to deliver a number of further improvements to its operational capability and cost effectiveness. These include in-sourcing life and pensions policies from a third party, the further consolidation of locations, delivery of new eCommerce capability for intermediaries and enhanced investment accounting capabilities through a single outsourced arrangement.

Within General Insurance significant improvements have been delivered in improving the customer experience through the delivery of combined claims and administration platforms.

DIVISIONAL RESULTS – INSURANCE

Simplification

Insurance continues to focus on cost reduction with costs decreasing by 5 per cent in 2011. Efficiencies have been achieved without compromising the quality of customer service and customer satisfaction ratings have remained robust across the division.

The Simplification programme will deliver further improvements through the provision of simpler systems and processes.

Investing in growth

There is a focus on growth across the Insurance business to support our multi-brand strategy and to deliver sustainable growth in key markets.

A Group Strategic Initiative is investing in building lasting relationships with our bancassurance customers through the introduction of new advice models, enhanced products and access to new direct channels.

Selective participation in the important Intermediary and Direct channels will be supported by investment in new and enhanced product propositions and improved channels to market.

In General Insurance, the strategy is focused around protecting and growing home insurance business whilst seeking to expand its role in other markets.

Strong and enduring relationships with distributors are essential to the success of the business. The business is working collaboratively with our colleagues across the Group to design and deliver value adding propositions aligned to channel customers' insurance needs. In the intermediary channel, it continues to support Independent Financial Advisers (IFAs) in their preparation for the Retail Distribution Review (RDR). Inevitably, as a result of RDR, some IFAs will choose to exit markets and therefore some customers will no longer receive advice from their IFAs. The business is committed to providing a direct proposition to maintain a high quality of service to these customers.

Life, Pensions and Investments

UK Business

	2011 £m	2010[1] £m	Change %
Net interest income	(62)	(48)	(29)
Other income	1,458	1,408	4
Total income	1,396	1,360	3
Operating expenses	(510)	(530)	4
Profit before tax and fair value unwind	886	830	7
Profit before tax and fair value unwind by business unit			
New business profit – insurance business[2]	382	332	15
– investment business[2]	(51)	(65)	22
Total new business profit	331	267	24
Existing business profit	539	611	(12)
Experience and assumption changes	16	(48)	
Profit before tax and fair value unwind	886	830	7
EEV new business margin (UK)	4.2%	3.7%	
Life, Pensions and Investments sales (PVNBP)	10,219	10,316	(1)

[1]Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

[2]As required under IFRS, products are split between insurance and investment contracts depending on the level of insurance risk contained. For insurance contracts, the new business profit includes the net present value of profits expected to emerge over the lifetime of the contract, including profits anticipated in periods after the year of sale; for investment contracts the figure reflects the profit in the year of sale only, after allowing for the deferral of income and expenses. Consequently the recognition of profit from investment contracts is deferred relative to insurance contracts.

Life, Pensions and Investments (LP&I UK) delivered profit growth, before tax and fair value unwind, of £56 million, or 7 per cent. In 2010 income was reduced by a non-recurring charge of £70 million in respect of the Group's decision to cease writing new payment protection insurance (PPI) business which, although a General Insurance product, impacted LP&I as a result of the life cover contained within PPI contracts. Excluding this charge profit before tax and fair value unwind decreased by 2 per cent in 2011.

Total new business profit increased by £64 million, or 24 per cent, to £331 million. The increase is primarily attributable to strong sales of corporate pensions through the intermediary channel, the continued growth of our protection business in the bancassurance channel as we help more customers and address the sizeable protection gap that exists in the UK and reduction in lower margin business following the launch of the integrated bancassurance proposition in June 2010.

LP&I UK margin on an EEV basis increased to 4.2 per cent in 2011 from 3.7 per cent in 2010. The improved margin reflects the strategic choices made in respect of product and channel propositions. The Internal Rate of Return (IRR) on new business remains in excess of 16 per cent.

Existing business profit has decreased by £72 million, or 12 per cent, to £539 million. The decrease predominantly reflects higher interest payments following capital restructuring initiatives, a reduction in the assumed rate of return, and lower levels of shareholder net assets following capital repatriation initiatives in 2010.

DIVISIONAL RESULTS – INSURANCE

The net impact of experience variances and assumption changes has increased to a credit of £16 million in 2011 from a charge of £48 million in 2010. The benefit mainly reflects the absence of the £70 million charge taken in 2010 from the Group's decision to cease writing new PPI business.

The capital position of the UK life insurance companies remains robust. Following the legal entity reorganisation of the Insurance division in July 2011, there is now one insurance group reporting under the Insurance Groups Directive (IGD) with an estimated capital surplus of £3.7 billion. This compares with £1.3 billion and £1.6 billion for the Scottish Widows and HBOS Insurance groups, respectively, at the end of 2010.

European business

Profit before tax decreased by £45 million, 35 per cent, to £82 million. The reduction is driven largely by a non-recurring charge following clarification by the German regulator (BaFin) surrounding the deduction of tax and policy-holder distributions and experience and assumption charges.

The strategy is to secure value in the existing business, building on the relationship with its key distributor.

New business

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

Present value of new business premiums (PVNBP)

	2011			2010			
	UK £m	Europe £m	Total £m	UK £m	Europe £m	Total £m	Change %
Analysis by product							
Protection	**708**	**53**	**761**	574	56	630	21
Payment protection	**21**	**–**	**21**	70	–	70	(70)
Savings and investments	**1,133**	**246**	**1,379**	1,617	315	1,932	(29)
Individual pensions	**1,480**	**144**	**1,624**	1,606	141	1,747	(7)
Corporate and other pensions	**4,423**	**–**	**4,423**	2,750	–	2,750	61
Retirement income	**747**	**–**	**747**	889	–	889	(16)
Managed fund business	**116**	**–**	**116**	177	–	177	(34)
Life and pensions	**8,628**	**443**	**9,071**	7,683	512	8,195	11
OEICs	**1,591**	**–**	**1,591**	2,633	–	2,633	(40)
Total	**10,219**	**443**	**10,662**	10,316	512	10,828	(2)
Analysis by channel							
Intermediary	**6,415**	**443**	**6,858**	5,365	512	5,877	17
Bancassurance	**3,216**	**–**	**3,216**	4,432	–	4,432	(27)
Direct	**588**	**–**	**588**	519	–	519	13
Total	**10,219**	**443**	**10,662**	10,316	512	10,828	(2)

Total sales (PVNBP) have reduced by 2 per cent to £10,662 million. New business margins have improved to 4.0 per cent in 2011 from 3.5 per cent in 2010. This partly reflects the launch of the integrated bancassurance proposition in June 2010 which has resulted in a change in mix away from higher single premium savings products towards lower premium, higher margin, protection business.

Despite the reduction in sales total new business profit within LP&I UK increased by £64 million, or 24 per cent, to £331 million.

Sales (PVNBP), excluding OEICs have increased by 11 per cent, and although OEIC sales have decreased by 40 per cent the new business margin on these sales has increased, reflecting the focus on value over volume.

Within the intermediary channel the increase in sales of £981 million, or 17 per cent, mainly reflects strong sales of corporate pensions in LP&I UK. The increase in sales has been achieved whilst maintaining the new business margin on corporate pension business.

In the bancassurance channel the reduction in sales reflects a change in mix away from savings products which generate a higher PVNBP towards protection business, which although more profitable, generates lower PVNBP. Sales of savings products have been particularly affected by recent stock market turbulence and lower consumer confidence, particularly in the second half of the year. Despite the reduction in PVNBP there was an increase in new business profit largely as a result of the increase in protection sales reflecting success in helping customers address their protection needs. As previously communicated in the Group Strategic review the business will continue to focus on meeting the insurance and investment needs of the Group's existing customers.

The direct channel, although relatively small at this time, is performing well and is being developed for future growth. This channel will become even more important following the introduction of RDR.

DIVISIONAL RESULTS – INSURANCE

Funds under management

The table below shows the funds of the Life, Pensions and Investment companies within the Insurance division. These funds are predominantly managed within the Group by the Wealth and International division.

	2011 £bn	2010 £bn
Opening funds under management	**133.1**	122.1
UK business		
Premiums	**10.1**	11.2
Claims and surrenders	**(14.6)**	(14.9)
Net outflow of business	**(4.5)**	(3.7)
Investment return, expenses and commission	**(0.2)**	10.5
Other movements[1]	**–**	4.3
Net movement	**(4.7)**	11.1
European business		
Net movement	**(0.5)**	0.4
Dividends and capital repatriation	**(0.3)**	(0.5)
Closing funds under management	**127.6**	133.1
Managed by the Group	**103.4**	109.3
Managed by third parties	**24.2**	23.8
Closing funds under management	**127.6**	133.1

[1]Other movements in funds under management incorporates alignment changes and the inclusion of managed pension funds.

The net outflow of business is primarily a result of the move in sales away from savings products which generate large single premiums, caused in part by more difficult economic conditions for long-term savings and the run-off of the in-force book.

The key drivers of investment return are equity and gilt movements. In the year UK equity markets fell 3 per cent and European markets fell 15 per cent while gilt markets increased by 16 per cent. In 2010 both equities and gilts performed strongly, creating large investment gains.

Maturity profile of in-force business

The table below shows the profile of the Value of In-Force (VIF) asset recognised on the IFRS balance sheet based on the date when the profit is expected to emerge.

	VIF	VIF emergence in years (%)				
	Total £m	0-5	6-10	11-15	16-20	> 20
2011	**5,247**	**37**	**24**	**16**	**10**	**13**
2010	5,898	36	23	16	10	15

The total VIF has decreased from 2010 to 2011. The increase in VIF from new business has been more than offset by a combination of the expected run-off in VIF on in-force business, the reduction in VIF from market volatility (particularly on equities) and the change in assumptions used in the calculation of the VIF over the year.

The profile of the emergence of VIF in future years show that almost 40 per cent of the VIF is expected to be released within 5 years, with nearly 80 per cent expected to be released within 15 years.

DIVISIONAL RESULTS – INSURANCE

General Insurance

	2011 £m	2010[1] £m	Change %
Home insurance	**857**	862	(1)
Payment protection insurance	**125**	253	(51)
Other	**53**	70	(24)
Net operating income	**1,035**	1,185	(13)
Claims paid on insurance contracts (net of reinsurance)	**(343)**	(542)	37
Operating income, net of claims	**692**	643	8
Operating expenses	**(195)**	(221)	12
Share of results of joint ventures and associates	**–**	(10)	
Profit before tax and fair value unwind	**497**	412	21
Combined ratio	**69%**	79%	

[1]Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

Profit before tax and fair value unwind from General Insurance increased by 21 per cent to £497 million. The increase was primarily due to improved PPI claims experience from the run off of this business line, the absence of severe weather related claims as experienced in 2010 and lower expenses. As a result of these factors the combined ratio has improved to 69 per cent.

Total income for home insurance was broadly unchanged from 2010 at £857 million and reflects the maturity and competitiveness of the market.

Claims of £343 million were 37 per cent lower than in 2010, mainly due to improved claims experience as a result of the run off of the PPI business and lower unemployment claims and lower property claims following the freeze events that impacted January and December 2010.

Operating expenses decreased by £26 million, or 12 per cent, to £195 million primarily as a result of further delivery of integration savings and a continued focus on cost management.

DIVISIONAL RESULTS – GROUP OPERATIONS

	2011 £m	2010[1,2] £m	Change %
Total income	**42**	(12)	
Direct costs:			
Information technology	**(1,031)**	(1,204)	14
Operations	**(596)**	(656)	9
Property	**(909)**	(966)	6
Sourcing	**(56)**	(58)	3
Support functions	**(73)**	(89)	18
	(2,665)	(2,973)	10
Result before recharges to divisions	**(2,623)**	(2,985)	12
Total net recharges to divisions	**2,567**	2,930	(12)
Share of results of joint ventures and associates	**–**	3	
Loss before tax	**(56)**	(52)	(8)

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

[2] 2010 comparative figures have also been amended to reflect the centralisation of operations across the Group as part of the integration programme. To ensure a fair comparison of 2011 performance, 2010 direct costs have been changed with an equivalent offsetting adjustment in recharges to divisions.

Strategy

Group Operations aim is to be a world class operations business whilst ensuring value through cost and process efficiency. This will be achieved by providing excellent technology and effective process to support the businesses; driving simplification, automation and continuous improvement; developing world class operations, leadership and capability; and maintaining strong controls to protect the Group.

The success of the Integration programme in delivering a platform and single set of processes now enables the Group to commence its Simplification programme as part of the Group Strategic transformational journey. The Simplification programme is well underway and is now targeting cost savings of £1.7 billion in 2014 as well as improving service and the customer experience. Group Operations will play a major part in the whole programme but particularly through sourcing, end to end processes, and property initiatives.

Sourcing: we will optimise our demand management, simplify specifications and further strengthen our supplier relationships, reducing the number of suppliers to the Group from around 18,000 to under 10,000, and further focus on a core group of lead suppliers to achieve approximately a 15 per cent saving on addressable spend.

End to end processes: we will conduct an end-to-end redesign of our processes, which will include significant process automation, simplifying processes for our staff, increasing accuracy, and reducing complaints. This will result in more time to serve customers, generate sales, and create an improved customer experience.

Property: we will further consolidate the Group's property portfolio, enabled by the delivery of process and efficiency savings from the Simplification programme.

Group Operations will also play a key role in delivering the technical expertise and support for the other Group Strategic initiatives.

Financial performance

2011 direct costs decreased by £308 million, or 10 per cent, to £2,665 million reflecting the continued focus on cost management and the delivery of integration synergy savings and Simplification benefits.

Information Technology costs decreased by 14 per cent, with integration savings offsetting inflationary rises.

Operations costs decreased by 9 per cent, through the continuing rationalisation of our major Operations functions. Operations includes Banking Operations, Collections and Recoveries, and Payments and Business Services

Group Property costs decreased by 6 per cent, with the continuing consolidation of the heritage property portfolios delivering further integration benefits.

Sourcing includes the cost of running the department and certain centrally managed contracts. Costs have decreased by 3 per cent and Sourcing has also played a major part in helping to deliver group wide sourcing synergies.

Support functions (includes Group Security & Fraud and Group Change Management) costs decreased by 18 per cent through the delivery of integration synergy savings and Simplification benefits.

CENTRAL ITEMS

	2011 £m	2010[1] £m
Net interest income	**585**	571
Other income	**(49)**	(73)
Effects of liability management, volatile items and asset sales	**1,293**	150
Total income	**1,829**	648
Operating expenses and other costs[2]	**(259)**	(107)
Trading surplus	**1,570**	541
Impairment	**(3)**	–
Share of results of joint ventures and associates	**(1)**	2
Profit before tax and fair value unwind	**1,566**	543
Fair value unwind	**(1,274)**	(1,446)
Profit (loss) before tax	**292**	(903)

[1] Incorporates the methodology changes outlined in the October 2011 announcement (New Allocation Methodologies for Funding Costs and Capital).

[2] Other costs include FSCS costs and UK bank levy in 2011.

Central items include income and expenditure not recharged to the divisions, including the costs of certain central and head office functions and the financial impact of banking volatility taken centrally.

Total income increased by £1,181 million to £1,829 million primarily due to a £1,143 million increase in volatility and liability management effects. These included a £872 million increase in liability management gains. In addition, there was a £615 million reduction in the mark-to-market losses arising from the equity conversion feature of the Group's Enhanced Capital Notes, partly offset by a £344 million adverse movement on banking volatility, which is attributed to ineffectiveness in hedge accounting relationships and banking book derivatives not mitigated through hedge accounting.

Liability management gains arose on transactions undertaken as part of the Group's management of capital, largely the exchange of certain debt securities for other debt instruments or, for 2010 only, ordinary shares. These transactions resulted in a gain of £1,295 million in 2011, which comprises £696 million recognised in statutory net interest income, reflecting a reduction in the carrying value of certain debt securities as a result of changes in expected cash flows, and £599 million recognised in statutory other income relating to the exchange of existing securities into new securities. The gain in 2010 (£423 million) was recognised in statutory other income.

In 2011, volatile items comprised changes in fair valuation of the equity conversion feature of the Group's Enhanced Capital Notes of £(5) million (2010: £(620) million) and banking volatility of £3 million (2010: £347 million). There were no asset sales in either 2011 or 2010 taken in Central items.

Operating expenses and other costs increased by £152 million to £259 million primarily due to Financial Services Compensation Scheme costs of £161 million (Group total: £179 million) and bank levy costs of £189 million, £55 million of which has been attributed to non-core, partly offset by lower pension costs held centrally.

Fair value unwind decreased by £172 million to a charge of £1,274 million primarily due to deal maturities leading to reduced amortisation.

OTHER FINANCIAL INFORMATION

Core and non-core business analysis

Core and non-core income statement

Core	2011 £ million	2010 £ million
Net interest income	10,916	11,745
Other income	8,360	8,769
Effects of liability management, volatile items and asset sales	603	51
Total income	19,879	20,565
Insurance claims	(343)	(542)
Total income, net of insurance claims	19,536	20,023
Operating expenses	(9,369)	(9,838)
Other costs[1]	(313)	(46)
Trading surplus	9,854	10,139
Impairment	(2,887)	(3,612)
Share of results of joint ventures and associates	10	14
Profit before tax and fair value unwind	6,977	6,541
Fair value unwind	(628)	(389)
Profit before tax – core	6,349	6,152
Banking net interest margin	2.42%	2.48%
Impairment as a % of average advances	0.64%	0.75%
Non-core		
Net interest income	1,317	2,398
Other income	947	1,167
Effects of liability management, volatile items and asset sales	(677)	(144)
Total income	1,587	3,421
Insurance claims	–	–
Total income, net of insurance claims	1,587	3,421
Operating expenses	(884)	(1,044)
Other costs[1]	(55)	(150)
Trading surplus	648	2,227
Impairment	(6,900)	(9,569)
Share of results of joint ventures and associates	17	(105)
Loss before tax and fair value unwind	(6,235)	(7,447)
Fair value unwind	2,571	3,507
Loss before tax – non-core	(3,664)	(3,940)
Banking net interest margin	1.01%	1.46%
Impairment as a % of average advances	4.60%	5.56%
Profit before tax – combined businesses	2,685	2,212

[1] Other costs include FSCS costs and UK bank levy in 2011, and FSCS costs and impairment of tangible fixed assets in 2010.

The basis of preparation of the core and non-core income statement is set out on page 5.

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

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Core and non-core business analysis (continued)

Core and non-core business

2011	**Income, net of insurance claims £m**	**Impairment charge £m**	**Loans and advances to customers[1] £bn**	**Risk-weighted assets £bn**	**Customer deposits[1] £bn**
Core portfolios					
Retail	**8,922**	**1,796**	**325.1**	**92.6**	**247.1**
Wholesale	**3,559**	**741**	**93.3**	**104.7**	**88.6**
Commercial	**1,674**	**296**	**27.4**	**23.8**	**31.8**
Wealth and International	**1,369**	**51**	**7.9**	**9.8**	**40.7**
Insurance	**2,141**	**–**	**–**	**–**	**–**
Group Operations & Central items	**1,871**	**3**	**0.1**	**12.6**	**1.3**
	19,536	**2,887**	**453.8**	**243.5**	**409.5**
Non-core portfolios					
Retail	**272**	**174**	**27.7**	**10.6**	**–**
Wholesale	**500**	**2,160**	**46.8**	**59.1**	**2.8**
Commercial	**23**	**7**	**1.4**	**1.6**	**0.3**
Wealth and International	**656**	**4,559**	**35.9**	**37.5**	**1.3**
Insurance	**136**	**–**	**–**	**–**	**–**
	1,587	**6,900**	**111.8**	**108.8**	**4.4**
Total Group	**21,123**	**9,787**	**565.6**	**352.3**	**413.9**
	%	**%**	**%**	**%**	**%**
Core portfolios	**92**	**30**	**80**	**69**	**99**
Non-core portfolios	**8**	**70**	**20**	**31**	**1**

2010	Income, net of insurance claims £m	Impairment charge £m	Loans and advances to customers[1] £bn	Risk-weighted assets £bn	Customer deposits[1] £bn
Core portfolios					
Retail	9,695	2,629	333.7	98.0	235.6
Wholesale	4,793	576	88.5	112.3	89.0
Commercial	1,543	381	26.6	24.5	31.0
Wealth and International	1,295	26	8.1	12.0	31.6
Insurance	2,061	–	–	–	–
Group Operations & Central items	636	–	0.4	15.7	0.9
	20,023	3,612	457.3	262.5	388.1
Non-core portfolios					
Retail	560	118	30.0	11.3	–
Wholesale	1,733	3,488	56.1	83.8	4.0
Commercial	41	1	2.0	2.1	0.3
Wealth and International	915	5,962	47.2	46.7	1.2
Insurance	172	–	–	–	–
	3,421	9,569	135.3	143.9	5.5
Total Group	23,444	13,181	592.6	406.4	393.6
	%	%	%	%	%
Core portfolios	85	27	77	65	99
Non-core portfolios	15	73	23	35	1

[1] Includes reverse repos and repos.

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Core and non-core business analysis (continued)

Core business

	2011 £ million	2010 £ million	Change %
Net interest income	10,916	11,745	(7)
Other income	8,360	8,769	(5)
Effects of liability management, volatile items and asset sales	603	51	
Total income	19,879	20,565	(3)
Insurance claims	(343)	(542)	37
Total income, net of insurance claims	19,536	20,023	(2)
Costs:			
Operating expenses	(9,369)	(9,838)	5
Other costs	(313)	(46)	
	(9,682)	(9,884)	2
Trading surplus	9,854	10,139	(3)
Impairment	(2,887)	(3,612)	20
Share of results of joint ventures and associates	10	14	(29)
Profit before tax and fair value unwind	6,977	6,541	7
Fair value unwind	(628)	(389)	(61)
Profit before tax – core	6,349	6,152	3
Banking net interest margin	2.42%	2.48%	
Impairment as a % of average advances	0.64%	0.75%	

Key balance sheet items	As at 31 December 2011 £bn	As at 31 December 2010 £bn	Change %
Loans and advances to customers (excluding reverse repos)	437.0	454.2	(4)
Reverse repos	16.8	3.1	
Loans and advances to banks	32.0	29.9	7
Debt securities held as loans and receivables	0.2	0.3	(33)
Available-for-sale financial assets	27.9	20.9	33
Other assets:			
Derivative financial instruments	66.0	50.7	30
Trading and other financial assets at fair value through profit and loss	138.8	154.6	(10)
Other	111.1	84.2	32
	315.9	289.5	9
Total core assets	829.8	797.9	4
Risk-weighted assets	243.3	262.5	(7)
Customer deposits (excluding repos)	401.5	377.0	6
Repos	8.0	11.1	(28)

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Core and non-core business analysis (continued)

Combined businesses consolidated income statement – core

2011	Retail £m	Wholesale £m	Commercial £m	Wealth and Int'l £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	7,246	1,566	1,229	367	(77)	585	10,916
Other income	1,628	2,731	445	1,002	2,561	(7)	8,360
Effects of liability management, volatile items and asset sales	48	(738)	–	–	–	1,293	603
Total income	8,922	3,559	1,674	1,369	2,484	1,871	19,879
Insurance claims	–	–	–	–	(343)	–	(343)
Total income, net of insurance claims	8,922	3,559	1,674	1,369	2,141	1,871	19,536
Operating expenses	(4,432)	(2,107)	(942)	(1,116)	(765)	(7)	(9,369)
Other costs	–	–	–	(11)	(7)	(295)	(313)
Trading surplus	4,490	1,452	732	242	1,369	1,569	9,854
Impairment	(1,796)	(741)	(296)	(51)	–	(3)	(2,887)
Share of results of joint ventures and associates	10	–	–	1	–	(1)	10
Profit before tax and fair value unwind	2,704	711	436	192	1,369	1,565	6,977
Fair value unwind	657	(29)	53	8	(43)	(1,274)	(628)
Profit before tax – core	3,361	682	489	200	1,326	291	6,349
Banking net interest margin	2.20%	1.80%	4.37%	4.16%			2.42%
Impairment as a % of average advances	0.54%	0.89%	1.09%	0.63%			0.64%
Key balance sheet and other items	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Assets							
Loans and advances to customers excl reverse repos	325.1	76.5	27.4	7.9		0.1	437.0
Customer deposits excluding repos	247.1	81.5	31.8	40.7		0.4	401.5
Risk-weighted assets	92.6	104.7	23.8	9.8		12.6	243.5

OTHER FINANCIAL INFORMATION

Core and non-core business analysis (continued)

Combined businesses consolidated income statement – core (continued)

2010	Retail £m	Wholesale £m	Commercial £m	Wealth and Int'l £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	8,112	1,777	1,088	305	(47)	510	11,745
Other income	1,583	3,130	455	990	2,635	(24)	8,769
Effects of liability management, volatile items and asset sales	–	(114)	–	–	15	150	51
Total income	9,695	4,793	1,543	1,295	2,603	636	20,565
Insurance claims	–	–	–	–	(542)	–	(542)
Total income, net of insurance claims	9,695	4,793	1,543	1,295	2,061	636	20,023
Operating expenses	(4,591)	(2,191)	(984)	(1,109)	(813)	(150)	(9,838)
Other costs	(46)	–	–	–	–	–	(46)
Trading surplus	5,058	2,602	559	186	1,248	486	10,139
Impairment	(2,629)	(576)	(381)	(26)	–	–	(3,612)
Share of results of joint ventures and associates	17	2	–	–	(10)	5	14
Profit before tax and fair value unwind	2,446	2,028	178	160	1,238	491	6,541
Fair value unwind	965	24	81	30	(43)	(1,446)	(389)
Profit before tax – core	3,411	2,052	259	190	1,195	(955)	6,152
Banking net interest margin	2.37%	1.59%	3.86%	3.31%			2.48%
Impairment as a % of average advances	0.77%	0.57%	1.34%	0.31%			0.75%
Key balance sheet and other items	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Assets							
Loans and advances to customers excl reverse repos	333.7	85.4	26.6	8.1		0.4	454.2
Customer deposits excluding repos	235.6	78.8	31.0	31.6		–	377.0
Risk-weighted assets	98.0	112.3	24.5	12.0		15.7	262.5

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Core and non-core business analysis (continued)

Non-core business

	2011 £ million	2010 £ million	Change %
Net interest income	**1,317**	2,398	(45)
Other income	**947**	1,167	(19)
Effects of liability management, volatile items and asset sales	**(677)**	(144)	
Total income	**1,587**	3,421	(54)
Insurance claims	**–**	–	
Total income, net of insurance claims	**1,587**	3,421	(54)
Costs:			
Operating expenses	**(884)**	(1,044)	15
Other costs	**(55)**	(150)	
	(939)	(1,194)	21
Trading surplus	**648**	2,227	(71)
Impairment	**(6,900)**	(9,569)	28
Share of results of joint ventures and associates	**17**	(105)	
(Loss) before tax and fair value unwind	**(6,235)**	(7,447)	16
Fair value unwind	**2,571**	3,507	(27)
(Loss) before tax – non-core	**(3,664)**	(3,940)	7
Banking net interest margin	**1.01%**	1.46%	
Impairment as a % of average advances	**4.60%**	5.56%	

Key balance sheet items	As at 31 December 2011 £bn	As at 31 December 2010 £bn	Change %
Loans and advances to customers	**111.8**	135.3	(17)
Loans and advances to banks	**0.6**	0.4	50
Debt securities held as loans and receivables	**12.3**	25.4	(52)
Available-for-sale financial assets	**9.5**	22.1	(57)
Other	**6.5**	10.5	(38)
Total non-core assets	**140.7**	193.7	(27)
Risk-weighted assets	**108.8**	143.9	(24)
Customer deposits (excluding repos)	**4.4**	5.5	(20)

OTHER FINANCIAL INFORMATION

Core and non-core business analysis (continued)

Combined businesses consolidated income statement – non-core

2011	Retail £m	Wholesale £m	Commercial £m	Wealth and Int'l £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	251	573	22	461	10	–	1,317
Other income	21	604	1	195	126	–	947
Effects of liability management, volatile items and asset sales	–	(677)	–	–	–	–	(677)
Total income	272	500	23	656	136	–	1,587
Insurance claims	–	–	–	–	–	–	–
Total income, net of insurance claims	272	500	23	656	136	–	1,587
Costs:							
Operating expenses	(6)	(411)	(6)	(421)	(40)	–	(884)
Other costs	–	–	–	–	–	(55)	(55)
	(6)	(411)	(6)	(421)	(40)	(55)	(939)
Trading surplus	266	89	17	235	96	(55)	648
Impairment	(174)	(2,160)	(7)	(4,559)	–	–	(6,900)
Share of results of joint ventures and associates	1	14	–	2	–	–	17
Profit before tax and fair value unwind	93	(2,057)	10	(4,322)	96	(55)	(6,235)
Fair value unwind	182	2,203	–	186	–	–	2,571
Profit before tax – non-core	275	146	10	(4,136)	96	(55)	(3,664)
Banking net interest margin	0.83%	1.28%	1.40%	0.80%			1.01%
Impairment as a % of average advances	0.59%	3.35%	0.41%	8.39%			4.60%
Key balance sheet and other items	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Assets							
Loans and advances to customers excl reverse repos	27.7	46.8	1.4	35.9			111.8
Customer deposits excluding repos	–	2.8	0.3	1.3			4.4
Total non-core assets	27.7	73.3	1.4	37.7	0.6	–	140.7
Risk-weighted assets	10.6	59.1	1.6	37.5			108.8

OTHER FINANCIAL INFORMATION

Core and non-core business analysis (continued)

Combined businesses consolidated income statement – non-core (continued)

2010	Retail £m	Wholesale £m	Commercial £m	Wealth and Int'l £m	Insurance £m	Group Operations and Central items £m	Group £m
Net interest income	536	1,070	39	745	8	–	2,398
Other income	24	884	2	133	164	–	1,167
Effects of liability management, volatile items and asset sales	–	(181)	–	37	–	–	(144)
Total income	560	1,733	41	915	172	–	3,421
Insurance claims	–	–	–	–	–	–	–
Total income, net of insurance claims	560	1,733	41	915	172	–	3,421
Costs:							
Operating expenses	(7)	(561)	(8)	(427)	(41)	–	(1,044)
Other costs	–	(150)	–	–	–	–	(150)
	(7)	(711)	(8)	(427)	(41)	–	(1,194)
Trading surplus	553	1,022	33	488	131	–	2,227
Impairment	(118)	(3,488)	(1)	(5,962)	–	–	(9,569)
Share of results of joint ventures and associates	–	(97)	–	(8)	–	–	(105)
Profit before tax and fair value unwind	435	(2,563)	32	(5,482)	131	–	(7,447)
Fair value unwind	140	3,025	–	342	–	–	3,507
Profit before tax – non-core	575	462	32	(5,140)	131	–	(3,940)
Banking net interest margin	1.64%	1.60%	1.97%	1.18%			1.46%
Impairment as a % of average advances	0.37%	4.37%	0.05%	10.15%			5.56%
Key balance sheet and other items	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Assets							
Loans and advances to customers excl reverse repos	30.0	56.1	2.0	47.2			135.3
Customer deposits excluding repos	–	4.0	0.3	1.2			5.5
Total non-core assets	30.0	109.7	2.0	49.1	0.7	2.2	193.7
Risk-weighted assets	11.3	83.8	2.1	46.7			143.9

OTHER FINANCIAL INFORMATION

Volatility arising in insurance businesses

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

In 2011 the Group's statutory result before tax included negative insurance and policyholder interests volatility totalling £838 million compared to positive volatility of £306 million in 2010.

Volatility comprises the following:

	2011 £m	2010 £m
Insurance volatility	(557)	100
Policyholder interests volatility[1]	(283)	216
Total volatility	(840)	316
Insurance hedging arrangements	2	(10)
Total	(838)	306

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

Insurance volatility

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

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

United Kingdom (Sterling)	2012 %	2011 %	2010 %
Gilt yields (gross)	2.48	3.99	4.45
Equity returns (gross)	5.48	6.99	7.45
Dividend yield	3.00	3.00	3.00
Property return (gross)	5.48	6.99	7.45
Corporate bonds in unit-linked and With Profit Funds (gross)	3.08	4.59	5.05
Fixed interest investments backing annuity liabilities (gross)	3.89	4.78	5.30

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

The negative insurance volatility during the period ended 31 December 2011 in the Insurance division was £557 million, primarily reflecting the underperformance of equity markets in the second half of 2011 and lower cash returns compared to long-term expectations.

Group hedging arrangements

To protect against further deterioration in equity market conditions, and the consequent negative impact on the value of in-force business on the Group balance sheet, the Group purchased put option contracts in 2010, financed by selling some upside potential from equity market movements. These expired in 2011 and the charge booked in 2011 on these options was £3 million. New protection against significant market falls was acquired in 2011 to replace the expired contracts. There was no initial cost associated with these hedging arrangements. On a mark-to-market valuation basis a gain of £5 million was recognised in relation to the new contracts in 2011.

OTHER FINANCIAL INFORMATION

Volatility arising in insurance businesses (continued)

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life, pensions and investments business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders over the long term.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group's tax charge rather than being offset against the related income. The impact is, therefore, to either increase or decrease profit before tax with a corresponding change in the tax charge. Over the longer term the charges levied to policyholders to cover policyholder tax on investment returns and the related tax provisions are expected to offset. In practice timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the normalised approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility. Other sources of volatility include the minorities' share of the profits earned by investment vehicles which are not wholly owned by the long-term assurance funds.

In the year to 31 December 2011, the statutory results before tax in both the Insurance and Wealth and International divisions included a charge to other income which relates to policyholder interests volatility totalling £283 million (2010: £216 million credit). This charge included the impact of deferred tax asset impairments due to less optimistic economic forecasts and changes in expected policyholder tax provisions. Policyholder tax liabilities increased during 2011 and led to a tax charge during the period.

Liability management gains

Liability management gains arose on transactions undertaken in both 2010 and 2011. As a result of transactions in 2011 the Group has recognised gains of £1,295 million (2010: gain of £423 million). In December 2011, the Group carried out an exercise allowing the holders of certain Lloyds TSB Bank and HBOS securities to exchange their securities (Exchange Securities) for other securities issued by Lloyds TSB Bank.

The gain relating to the 2011 transaction consists of £599 million recognised in other operating income relating to the extinguishment of the existing liability in respect of the Exchange Securities for which new securities were issued and £570 million recognised in net interest income, principally relating to the change in carrying value, arising as a result of a change in the estimated maturities of the remaining Exchange Securities. The gain recognised in net interest income will reverse as the securities accrete to par over the remaining life.

In December 2011, the Group decided to defer payment of non-mandatory coupons on certain securities and, instead, settle them using an Alternative Coupon Satisfaction Mechanism on their contractual terms. This change in expected cashflows resulted in a gain of £126 million in net interest income from the recalculation of the carrying value of these securities.

OTHER FINANCIAL INFORMATION

Integration costs and benefits

The Group has successfully achieved the integration programme target of delivering run-rate cost synergies and other operating efficiencies of £2 billion per annum from the programme by the end of 2011.

The sustainable run-rate synergies achieved as at 31 December 2011 totalled £2,054 million, excluding a number of one-off savings. The table below analyses the run-rate synergies as at 31 December 2011 by division.

	2011		
	Synergy run-rate as at 31 December 2011 £m	Allocation of Group Operations run-rate to divisions £m	Run-rate by market facing division £m
Retail	346	454	800
Wholesale and Commercial	324	270	594
Wealth and International	273	31	304
Insurance	204	59	263
Group Operations	857	(857)	–
Central items	50	43	93
Total	2,054	–	2,054

Cost synergies have been delivered through the integration of HBOS operations, processes and IT systems. These synergies have arisen through procurement; property with 83 head office sites vacated; IT cost savings and job reductions.

Integration costs of £1,097 million were incurred in the year and have been excluded from the combined businesses results. This brings the total integration costs since the HBOS acquisition to £3,846 million.

Migrating our business systems to a single platform

2011 saw the single biggest event of the Integration programme with the successful migration of our core business systems to a single IT platform. The Group has moved 30 million customer accounts and transferred 35 billion pieces of data between systems successfully. This has been the largest ever financial services IT Integration, and at its peak it involved many thousands of colleagues across the organisation.

There were three major components to the system migrations:

- The Lloyds TSB Branch Counter System (ICS) was introduced to all Halifax and Bank of Scotland branches and 3,800 HBOS Automated Teller Machines (ATMs) and 667 Intelligent Deposit Machines (IDMs) were moved across to the Lloyds Banking Group IT network
- The market leading Mortgage Sales Platform, already in use in Halifax and Bank of Scotland branches, was successfully rolled out to 800 Lloyds TSB mortgage advisors in England and Wales
- In September 2011 30 million HBOS current accounts and savings accounts and Commercial and UK Private Banking accounts, were migrated onto the Lloyds Banking Group IT system. This customer data migration was successfully achieved after five proving cycles, 11 dress rehearsals including two full trial account migrations, over 250,000 business tests and 27,000 colleagues trained totalling 1.5 million hours

The vast majority of integration activity is now complete, with a handful of peripheral migrations to be completed in 2012.

Simplification costs and benefits

The successful delivery of the Integration programme has provided a platform and single set of processes that now enables the Group to commence its next transformational journey. A core element of this transformational agenda is the Simplification programme. The programme is structured around four key initiatives:

Operations & Processes – getting our processes right end-to-end, with the right IT in the right places.

Sourcing – better understanding what we need across the Group and getting the right deals from our suppliers.

Organisation – focusing on how the Group is structured and the way we work.

Channels and Products – simplifying our products whilst continuing to improve and innovate our channels.

The programme is well underway having achieved £178 million of Simplification and other cost savings in 2011, equivalent to an annual run-rate saving of £242 million. The programme is now targeting £1.7 billion of savings in 2014, an increase of £0.2 billion over previous guidance.

Simplification costs of £185 million were incurred in the year and have been excluded from the combined businesses results.

OTHER FINANCIAL INFORMATION

Banking net interest margin

	2011	2010
Banking net interest income	£12,094m	£13,839m
Average interest-earning banking assets	£585,386m	£625,854m
Average interest-bearing banking liabilities	£363,967m	£341,169m
Banking net interest margin	2.07%	2.21%
Banking asset margin	1.46%	1.71%
Banking liability margin	0.98%	0.92%
Core		
Banking net interest margin	2.42%	2.48%
Banking net interest income	£10,612m	£11,428m
Non-core		
Banking net interest margin	1.01%	1.46%
Banking net interest income	£1,482m	£2,411m

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

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

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

	2011 £m	2010 £m
Banking net interest income – combined businesses	12,094	13,839
Insurance division	(67)	(39)
Other net interest income (including trading activity)	206	343
Group net interest income – combined businesses	**12,233**	14,143
Fair value unwind	(710)	(301)
Banking volatility and liability management gains	820	(321)
Insurance gross up	336	(949)
Volatility arising in insurance businesses	19	(26)
Group net interest income – statutory	**12,698**	12,546

FIVE YEAR FINANCIAL SUMMARY

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

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

	2011	2010	2009	2008[6]	2007[6]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	**20,771**	24,956	23,278	9,868	10,696
Operating expenses	**(16,250)**	(13,270)	(15,984)	(6,100)	(5,568)
Trading surplus	**4,521**	11,686	7,294	3,768	5,128
Impairment	**(8,094)**	(10,952)	(16,673)	(3,012)	(1,796)
Gain on acquisition	**–**	–	11,173	–	–
(Loss) profit before tax	**(3,542)**	281	1,042	760	3,999
(Loss) profit for the year	**(2,714)**	(258)	2,953	798	3,320
(Loss) profit for the year attributable to equity shareholders	**(2,787)**	(320)	2,827	772	3,288
Total dividend for the year[1]	**–**	–	–	648	2,026
	31 December 2011	31 December 2010	31 December 2009	31 December 2008	31 December 2007
Balance sheet data (£m)					
Share capital	**6,881**	6,815	10,472	1,513	1,432
Shareholders' equity	**45,920**	46,061	43,278	9,393	12,141
Net asset value per ordinary share	**67p**	68p	68p	155p	212p
Customer deposits	**413,906**	393,633	406,741	170,938	156,555
Subordinated liabilities	**35,089**	36,232	34,727	17,256	11,958
Loans and advances to customers	**565,638**	592,597	626,969	240,344	209,814
Total assets	**970,546**	991,574	1,027,255	436,033	353,346
	2011	2010	2009	2008	2007
Share information					
Basic earnings per ordinary share	**(4.1)p**	(0.5)p	7.5p	6.7p	28.9p
Diluted earnings per ordinary share	**(4.1)p**	(0.5)p	7.5p	6.6p	28.7p
Total dividend per ordinary share[1]	**–**	–	–	11.4p	35.9p
Market price (year end)	**25.9p**	65.7p	50.7p	126.0p	472.0p
Number of shareholders (thousands)	**2,770**	2,798	2,834	824	814
Number of ordinary shares in issue (millions)[2]	**68,727**	68,074	63,775	5,973	5,648
	2011	2010	2009	2008	2007
Financial ratios (%)[3]					
Dividend payout ratio	**–**	–	–	83.9	61.6
Post-tax return on average shareholders' equity	**(6.2)**	(0.7)	8.8	7.0	28.1
Cost:income ratio[4]	**78.2**	53.2	68.7	61.8	52.1
	31 December 2011	31 December 2010	31 December 2009[7]	31 December 2008[7]	31 December 2007
Capital ratios (%)[5]					
Total capital	**15.6**	15.2	12.4	11.1	11.0
Tier 1 capital	**12.5**	11.6	9.6	7.9	8.1
Core tier 1 capital	**10.8**	10.2	8.1	5.5	7.4

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

[2] This figure excludes 81 million (2007 to 2008: 79 million) limited voting ordinary shares.

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

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

[5] Capital ratios are in accordance with Basel II requirements; other than the ratios for 2007 which reflect Basel I.

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

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

RISK MANAGEMENT

All narrative is unaudited unless otherwise stated. Tables are both audited and unaudited as stated. The audited information is required to comply with the requirements of relevant International Financial Reporting Standards.

RISK MANAGEMENT

The Group's approach to risk is founded on a robust control framework and a strong risk management culture which guides the way all employees approach their work, the way they behave and the decisions they make.

Progress in 2011

- The Group has a fully embedded conservative approach to, and prudent appetite for, risk and has in place disciplined controls over the risk profile for all new business, aligned to the strategic review.
- The Group has made good progress in reducing non-core assets and improving the asset quality ratio.
- Excellent progress in de-risking the Retail books. Solid progress in Wholesale and good progress to tackle the issues in the international books.
- Our continued focus on our conduct risk agenda to ensure we are achieving the best outcomes for our customers is completely aligned with being the best bank for customers.

Priorities for 2012

Risk Division's mission in 2012 is to support sustainable growth through:

- Strategy: Supporting the delivery of the Group's strategic plan, within risk appetite
- Risk Infrastructure: Continue to invest in and develop our risk systems
- Risk Culture: Build and leverage on our strong risk culture of business ownership
- Regulatory Change: Be a role model
- People Agenda: Continue to attract, retain and develop high quality people

The Group's approach to risk

Governance

- The Group's approach to risk is founded on a robust control framework and a strong risk management culture which guides the way all employees approach their work, behave and make decisions promptly.
- Board-level engagement, coupled with the direct involvement of senior management in group wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated.
- The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.

Risk Appetite

- The Board takes the lead by establishing the 'tone at the top' and approving group risk appetite which is then cascaded throughout the Group in terms of policies, authorities and limits. The Board ensures that senior management implements policies and procedures designed to promote professional behaviour and integrity.

Culture

- The Board ensures that senior management implements risk policies and risk appetites that either limit or, where appropriate, prohibit activities, relationships, and situations that could be detrimental to the Group's risk profile.
- The Group has a conservative business model embodied by a risk culture founded on prudence and individual accountability, where the needs of customers are paramount.
- The focus has been and remains on building and sustaining long-term relationships with customers, through good and bad economic times.

Enterprise-Wide Risk Management

- The Group uses an Enterprise-Wide Risk Management framework for the identification, assessment, measurement and management of risk.
- It seeks to maximise value for shareholders over time by aligning risk appetite with corporate strategy, assessing the impact of emerging risks and developing risk tolerances and mitigating strategies.
- The framework seeks to strengthen the Group's ability to identify and assess risks, aggregate and report group wide risks and refine risk appetite.

RISK MANAGEMENT

Decision Making

– The Risk Committee, chaired by a Non-Executive Director, comprises other Non-Executive Directors and oversees the Group's risk exposures. The Chief Risk Officer regularly informs the Risk Committee of the aggregate risk profile and has direct access to the Chairman and members of the Risk Committee.

– The Group Risk Committee and the Group Asset and Liability Committee are chaired by the Group Chief Executive. The aggregate group wide risk profile and risk appetite are discussed at these monthly meetings.

Risk as a strategic differentiator

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

Strong Control Framework

– A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management.

– The Group optimises performance by allowing business units to operate within approved parameters.

– The Group's approach to risk management ensures that business units remain accountable for risk.

Conservative Approach

– The Group has a fully embedded conservative approach to, and prudent appetite for risk.

Board Level Reporting

– The Group continues to enhance its capabilities by providing to the Board both qualitative and quantitative data including stress testing analysis on risks associated with strategic objectives.

– Taking risks which are well understood, consistent with strategy and appropriately remunerated, is a key driver of shareholder return.

– Risk analysis and reporting supports the identification of opportunities as well as risks and provide an aggregate view of the overall risk portfolio.

– The Group's key risks, management actions and performance against risk appetite are monitored and reported at Group level.

Accountability

– Risk is included as one of the five principal criteria within the Group's balanced scorecard on which business area and individual's performance is judged.

– Business executives have specified risk management objectives, and incentive schemes take account of performance against these.

– The Risk function oversees the performance assessment of business areas and senior staff to ensure adherence to the Group's risk and control frameworks and oversees that performance has been achieved within risk appetite.

Risk Division

– During 2011 good progress has been made in creating a more agile Risk function through further delayering the management structure and simplifying the operating model.

– This reinforces the model of a strong and independent Risk function that keeps the Group safe, supports sustainable business growth and minimises losses within risk appetite.

Risk Transformation

– The Group's continued investment agenda, ensures Risk systems, processes and management information continue to meet the needs of the Group and external stakeholders.

Reflecting the importance the Group places on risk management, risk is included as one of the five principle criteria within the Group's balanced scorecard on which business areas and individual staff performance and remuneration is judged.

Conservative risk appetite across the shape of our existing and new business – taking into account customer outcomes, operational risks, impact on our people, as well as credit, funding and stressed earnings metrics. Approved by the Board and now fully embedded through the whole control framework – policies, procedures and limits.

The Group achieved a significant reduction in it's impairment charge in 2011, due primarily to lower corporate real estate charges in Wholesale and strong Retail performance. All divisions experienced a reduction in impairment charges of above 20 per cent from 2010.

In 2011, there has been a significant improvement in our Balance Sheet, capital and funding position.

As part of the allocation of investment under the Group Strategic Review, the continued development of risk systems was a key priority to maintain our robust control framework over the long-term.

RISK MANAGEMENT

State funding and state aid

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

The 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 the Group) and the Government in relation to gross business lending capacity in the 2011 calendar year was subject to a similar set of criteria. The Group delivered in full its share of the commitments by the five banks, both in respect of lending to SMEs in respect of overall gross business lending. The Group has made a unilateral lending pledge for 2012 as part of its publicly announced SME charter.

In addition, the 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 the Group. This has placed a number of requirements on the Group including an asset reduction target from a defined pool of assets by the end of 2014 and the disposal of certain portions of its retail business by the end of November 2013. In June 2011 the 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 the 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. The Group is also continuing to progress an Initial Public Offering (IPO) in parallel. The 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.

Risk governance

The embedding of integrated governance, risk and control frameworks throughout the Group has continued, through a consistent approach to risk appetite, policies, delegated authorities and governance committee structures.

The risk governance structure is intended to strengthen risk evaluation and management, whilst also positioning the Group to manage the changing regulatory environment in an efficient and effective manner. The risk governance structure for Lloyds Banking Group is shown in table 1.1.

Board and Board Committees

The Board, assisted by Risk Committee and Audit Committee, approves the Group's overall governance, risk and control frameworks and risk appetite. The Board also reviews the Group's aggregate risk exposures and concentrations of risk to ensure that these are consistent with the Board's agreed appetite for risk. The roles of the Board, Audit Committee and Risk Committee are shown in the corporate governance section on pages 177 to 186 and further key risk oversight roles are described below.

The **Risk Committee**, which comprises Non-Executive Directors, oversees and challenges the development, implementation and maintenance of the Group's risk management framework, ensuring that its strategy, principles, policies and resources are aligned internally to its risk appetite as well as externally to regulation, corporate governance and industry best practice. The Risk Committee regularly reviews the Group's risk exposures across the primary risk drivers and the detailed risk types.

The **Group Executive Committee** supports the Group Chief Executive in ensuring the effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, whilst also reviewing the Group's aggregate risk exposures and concentrations of risk. Throughout 2011 businesses provided the Group Executive Committee with regular updates on business performance, always including a review of their key risks. The Group Executive Committee is supported by other Group committees as shown in table 1.1, and in particular by:

– The **Group Asset and Liability Committee** is responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.

– The **Group Incident Executive** sets the strategic direction for the Group's response to significant incidents which could affect its ability to continue to operate, and instigates any tactical initiatives required.

– The **Group Stress Testing Committee** is responsible for reviewing, challenging and recommending to Group Executive Committee the annual stress testing of the Group's operating plan based on internal and FSA recommended scenarios, annual European Banking Authority stress tests, and other group wide macroeconomic stress tests.

– The **Group Product Governance Committee** provides strategic and senior oversight over design, launch and management of products, including new product approval, annual product reviews and management of risk in the back book.

– The **Group Risk Committee** reviews and recommends the Group's risk appetite and governance, risk and control frameworks, high-level group policies and the allocation of risk appetite. The Group Risk Committee regularly reviews risk exposures and risk/reward returns.

During 2011, the Group's risk committee framework has been reviewed in order to ensure more effective risk management, clearer accountabilities, and more efficient and simplified processes. A new risk committee framework has been implemented, whereby the Group Risk Committee is supported by the following Committees:

RISK MANAGEMENT

– **Credit Risk Committees**, which are responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of high-level Group credit policy, and compliance with regulatory credit requirements. Risk Committees monitor and review the Group's aggregate credit risk exposures and concentrations of risk on behalf of the Group Risk Committee.

– The **Group Market Risk Committee**, which on behalf of the Group Asset and Liability Committee, monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.

– The **Insurance Risk Committee** monitors, reviews and makes recommendations on the risk management framework, risk strategy and appetite for the Insurance business, ensuring that the policy and oversight framework for insurance risk management is appropriate. The committee reviews and challenges relevant insurance reporting and issues arising, including: the Group's aggregate portfolio of insurance risk against approved plans and risk appetite and the need and opportunity for effecting insurance risk mitigation.

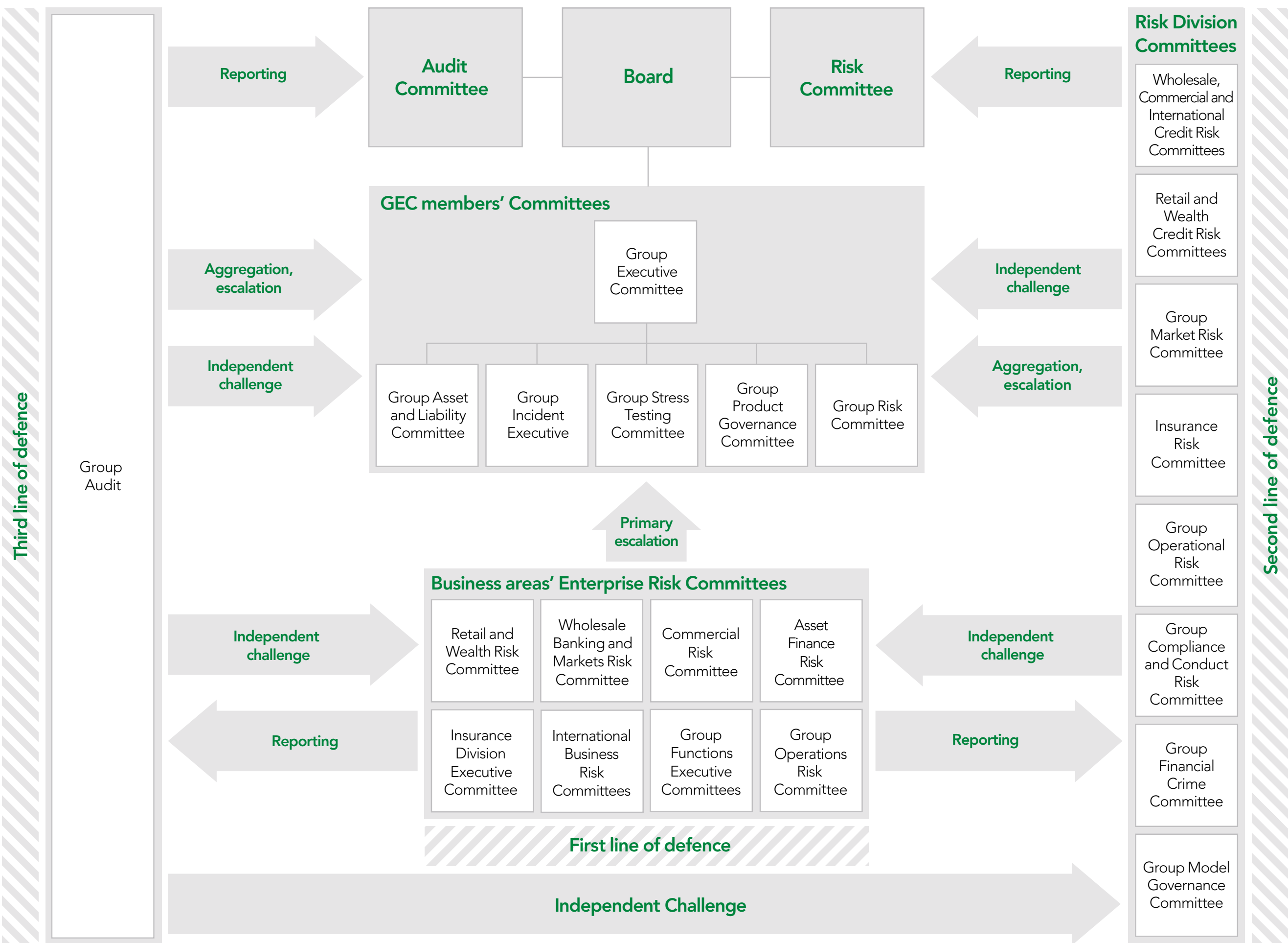
– The **Group Operational Risk Committee**, which is responsible for identifying significant current and emerging operational risks or accumulation of risks and control deficiencies across the Group and reviewing associated oversight plans to ensure pre-emptive risk management action. The Committee also seeks to ensure that adequate business area engagement occurs to develop, implement and maintain the Group's operational risk management framework.

– The **Group Compliance and Conduct Risk Committee** is responsible for forming a group wide view of the Group's compliance and conduct risk profile, reviewing the effectiveness of compliance and conduct risk frameworks and reviewing relevant polices and engagement with regulators.

– The **Group Financial Crime Committee** serves as the principal Group forum for reviewing and challenging the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The Committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.

– The **Group Model Governance Committee** is responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group's risk modelling framework, specifically regarding consistency of approach across business units and risk types. It approves risk models other than a small number defined as highly material to the Group, which are approved by the Group Risk Committee. This also meets FSA BIPRU requirements regarding the governance and approval for Internal Ratings Based models, including Internal Assessment models, Market Risk VaR and Advanced Measurement approach models.

Table 1.1: **Risk governance structures**



RISK MANAGEMENT

Risk Division, headed by the Chief Risk Officer, consists of eleven Risk Directors and their specialist teams. These teams provide oversight and independent challenge to business management and support the senior executive and the Board with independent reporting on risks and opportunities. Risk Directors, responsible for each risk type, meet on a regular basis under the Chairmanship of the Chief Risk Officer to review and challenge the risk profile of the Group and to ensure that mitigating actions are appropriate.

Business Unit Managing Directors/Executives have primary responsibility for measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group's policies and are within the parameters set by the Board, Group Executive Committee and Risk Division. Compliance with policies and parameters is overseen by the Risk Committee, the Group Risk Committee, the Group Asset and Liability Committee, and Risk Division, and independently challenged by Group Audit.

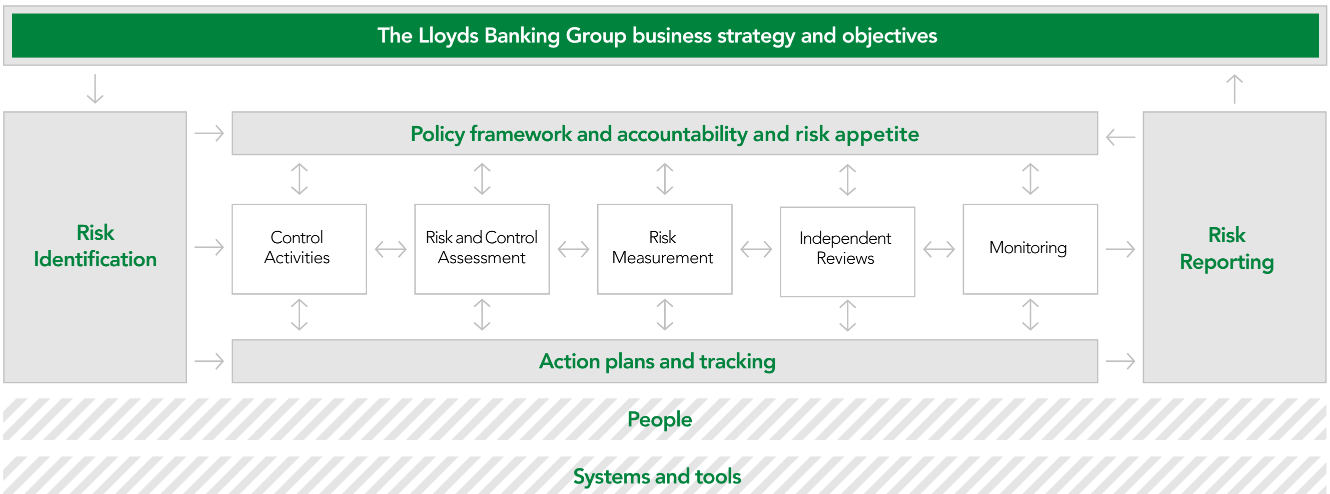
Risk management oversight

The Chief Risk Officer oversees and promotes the development and implementation of consistent group wide governance risk and control frameworks. The Chief Risk Officer, supported by the Risk Directors, provides objective challenge to the Group's senior management. The Group Executive Committee and the Board receive regular briefings and guidance from the Chief Risk Officer to ensure awareness of the overarching risk management framework and a clear understanding of their accountabilities for risk and internal control.

Risk Directors, who report directly to the Chief Risk Officer, are allocated responsibility for specific risk types and are responsible for ensuring the adequacy of the framework for their risk types as well as the oversight of the risk profile across the Group. Risk Directors also support specific business areas to provide an enterprise-wide risk management perspective.

The Director of Group Audit provides independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group Audit is fully independent of Risk, seeking to ensure objective challenge to the effectiveness of the risk governance framework.

Table 1.2: **Risk management framework**



Risk management in the business

Line management is directly accountable for the management of risks arising in their individual businesses. A key objective is to ensure that business decisions strike an appropriate balance between risk and reward, consistent with the Group's risk appetite.

All business areas complete a control effectiveness review annually (see page 186), reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Executives of each business area and each Group Executive Committee member certify the accuracy of their assessment.

Risk management in the business forms part of a tiered risk management model, as shown above, with Risk Division providing oversight and challenge, and the Chief Risk Officer and Group committees establishing the group wide perspective.

This approach provides the Group with an effective mechanism for developing and embedding risk policies and risk management strategies which are aligned with the risks faced by its businesses. It also seeks to facilitate effective communication on these matters across the Group.

RISK MANAGEMENT

Risk management framework

The Group's risk management principles and framework cover all the types of risk which could impact on its banking and insurance businesses.

The Group uses an enterprise-wide risk management framework to maximise shareholder value over time by aligning risk management with the corporate strategy, assessing the impact of emerging risks, and developing tolerances and mitigating strategies. The framework ensures that policies and controls can be adapted to reflect adjustments to business strategy and risk appetite in response to changing market conditions.

The principal elements of the framework are shown in table 1.2. These map to the components of the internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

The **Lloyds Banking Group business strategy and objectives** are used to determine the Group's high level risk appetite and measures and metrics for the primary risk drivers (see table 1.3).

The risk appetite is proposed by the Group Chief Executive following review by the Group Risk Committee and Group Asset and Liability Committee, and is approved by the Board. The approved high level appetite and limits are delegated to the Group Chief Executive and then cascaded in consultation with the Group Risk Committee and Group Asset and Liability Committee to members of the Group Executive Committee and the business.

The risk appetite is executed through **Policy Framework and Accountabilities**, comprising the following levels of policy:

– Principles: Board-level statements of principle for the six primary risk drivers
– High-level Group policy: policy statements for the main risk types which align to each risk driver
– Detailed Group policy: more specific and detailed policy statements of Group policy
– Business Area policy: local policy which is produced by exception where a greater level of detail is needed by a business area than is appropriate for Group-level policy.

All policies are reviewed annually to ensure they remain fit for purpose.

During 2011, the Group's Policy Framework has been reviewed with a view to simplification, which will be implemented over the coming year.

Colleagues are expected to be aware of and to comply with the policies and procedures which apply to them and their work. Line management in each business area has primary responsibility for ensuring that they do so.

Risk Division oversees the effective implementation of policy, and Group Audit provides independent assurance to the Board about the effectiveness of the Group's internal control framework and adherence to policy.

Clear and consistent **risk identification** is undertaken using a common risk language to define and categorise risks (see table 1.3), also supporting risk aggregation and standardised reporting.

Proportionate **control activities** are in place mitigating or transferring risk where appropriate. **Risk and control assessments** including the annual control effectiveness review are undertaken assessing the effectiveness of mitigating actions and whether risk exposures are consistent with the Group's risk appetite.

The impact of risks and issues is determined through effective **risk measurement**, including modelling, stress testing and scenario analysis to assess financial, reputational and regulatory capital implications.

The outcomes of **independent reviews** (including internal and external audit and regulatory reviews) are reflected in risk management activities and action plans.

Monitoring processes are in place supporting the reporting and escalation of significant issues or losses to appropriate levels of management. Business areas monitor and report on their risk levels against risk appetite and their performance against relevant limits or policies.

Risk reporting is reviewed by the business executive sitting as a risk committee, to ensure that senior management is satisfied with the overall risk profile, risk accountabilities and progress on any necessary action plans and tracking. Information is provided to Risk Division for review and aggregation to feed into regular reporting on risk exposures and material issues.

At Group level a consolidated risk report and risk appetite dashboard are produced which are reviewed and debated by the Group Risk Committee, Risk Committee and the Board to ensure that they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The report and dashboard provide a monthly assessment of the aggregate residual risk for the primary risk drivers, comparing the assessment with the previous periods and providing a forecast for the next twelve months and also provides an assessment of emerging risks, which could impact the Group over the next five years.

The overall effectiveness of the risk management framework depends on the **people** undertaking these activities and the quality of the supporting **systems and tools**. The risk transformation programme has initiated a significant investment in risk infrastructure to strengthen the Group's risk management capability.

RISK MANAGEMENT

Principal risks and uncertainties

At present the most significant risks faced by the Group, which are derived from the primary risk drivers and detailed risk types in table 1.3 (page 112), are shown below. These risks could impact on the success of delivering against the Group's long-term strategic objectives. For further information on the economy see pages 21 and 22.

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

During the first half of 2011 the 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. The 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 the 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 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 Group carries out 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 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 the 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, the 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 the Group will achieve the proposed Basel III liquidity and funding requirements in advance of expected implementation dates.

The 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, the Group experienced downgrades in its long-term rating of between one and two notches from three of the major rating agencies. The impact that the Group experienced following the downgrades was consistent with the Group's modelled outcomes based on the stress testing framework. The 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.

The Group's borrowing costs and issuance in the capital markets are dependent on a number of factors, and increased cost or reduction of capacity could materially adversely affect the Group's results of operations, financial condition and prospects. In particular, reduction in the credit rating of the Group or deterioration in the capital markets' perception of the Group's financial resilience, could significantly increase its borrowing costs and limit its issuance capacity in the capital markets. As an indicator over the last 12 months the spread between an index of A rated long term senior unsecured bank debt and an index of similar BBB rated bank debt, both of which are publicly available, has ranged between 60 and 115 basis points. The applicability to and implications for the Group's funding cost would depend on the type of issuance, and prevailing market conditions. The impact on the Group's funding cost is subject to a number of assumptions and uncertainties and is therefore impossible to quantify precisely.

Downgrades of the Group's long term debt rating could lead to additional collateral posting and cash outflow. A hypothetical simultaneous two notch downgrade of the Group's long-term debt rating from all major rating agencies, after initial actions within management's control, could result in an outflow of £11 billion of cash, £4 billion of collateral posting related to customer financial contracts and £24 billion of collateral posting associated with secured funding. These effects do not take into account additional management and restructuring actions that the Group has identified that could materially reduce the amount of required collateral postings under derivative contracts related to its own secured funding programmes.

The downgrades that the Group experienced in the fourth quarter of 2011 did not significantly change its borrowing costs, reduce its issuance capacity or require significant collateral posting. The Group notes the February 2012 announcement 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 2011, the 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.

RISK MANAGEMENT

Liquidity and funding (continued)

Mitigating Actions

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

The 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 the 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 (CRD IV) 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 Group's balance sheet include the continued functioning of the money and capital markets; successful right-sizing of the 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 the Group's credit rating; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets. Additionally, the Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. These are assumed within the Group's funding plan. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

Term wholesale funding issuance for the year totalled £35 billion, in excess of plan, representing £2 billion pre-funding of the requirement for 2012.

The Group term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) improved to 55 per cent (50 per cent at 31 December 2010) due to good progress in new term issuance and a reduction in short term money market funding the wholesale funding position includes debt issued under the legacy government Credit Guarantee Scheme, for which the last maturity will occur in 2012.

Total wholesale funding reduced by £47 billion to £251 billion, with the volume with a residual maturity less than one year falling £36 billion to £113 billion.

The ratio of customer loans to deposits improved to 135 per cent compared with 154 per cent at 31 December 2010. Loans and advances reduced by £41 billion and customer deposits increased by £23 billion, representing growth of 6 per cent in 2011.

For further information on Liquidity and funding risk, see page 112.

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 divisions, reflecting the risks inherent in the Group's lending activities and, to a much lesser extent in the Insurance division 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 UK economy remains fragile. Consumer and business confidence is low, consumer spending has been falling over the past year, 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 (including those in Wealth and International): have seen UK bad debts reduce further in 2011 as a result of risk management activity and more stable, low interest rate UK economic conditions. These portfolios will remain strongly linked to the economic environment, with inter alia house price falls, unemployment increases, consumer over-indebtedness and rising interest rates being possible impacts to the secured and unsecured retail exposures.

Mitigating Actions

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

The Group follows a relationship based business model with risk management processes, appetites and experienced staff in place. Further details on mitigating actions are detailed on pages 130 to 132.

For further information on Credit risk, see page 129.

RISK MANAGEMENT

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 12 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 the Group's EC mandated branch disposal (Project Verde), that, to create a strong challenger in the UK banking market, the entity which results from the divestment 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 the Company's divestment by 2015. The ICB did not recommend explicitly that the Company 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' divestment by the 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 the 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 the 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 Group and its 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 (ie 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 the 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.

RISK MANAGEMENT

Regulatory (continued)

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 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

We continue 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

The 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

The 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

The 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. The Group is also continuing to progress its plans to achieve Solvency II compliance.

For further information on Regulatory risk, see page 167.

RISK MANAGEMENT

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 Board approved framework using a range of metrics to monitor the Group's profile against its 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. The average 95 per cent 1-day trading Value at Risk (VaR) was £6 million for the year to 31 December 2011.

For further information on Market risk, see page 164.

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 the Group's strategic vision to be the best bank for customers. As a provider of a wide range of financial services products across different brands and numerous distribution channels to an extremely broad and varied customer base, 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 treatment in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

Mitigating Actions

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

The Group's Conduct 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. We have developed and implemented a framework to enable us to deliver the right outcomes 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.

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

For further information on Customer treatment, see page 167.

RISK MANAGEMENT

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 the Group's people are fundamental to its success. Consequently, the Group's management of material people risks is critical to its capacity 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:

– The 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 our 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 legal and 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.

For further information on People risk, see page 167.

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

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.

For further information on Insurance risk, see page 169.

RISK MANAGEMENT

Full analysis of risk drivers

Table 1.3: **Risk drivers**

Primary risk drivers	Financial Soundness	Credit Risk	Market Risk	Operational Risk	Insurance Risk	Business Risk
Detailed risk types	Liquidity and funding Capital Financial and prudential regulatory reporting Disclosure Tax	Retail Wholesale Commercial Wealth and International	Basis risk Interest rate Foreign exchange Equity Credit spread	Regulatory Customer treatment People Supplier management Customer processes Financial crime Money laundering and sanctions Security IT systems Change Organisational Infrastructure	Mortality Longevity Morbidity Persistency Property Expenses Unemployment	Execution of strategy
	Page 112	Page 129	Page 164	Page 167	Page 169	Page 170

Risk drivers

The Group's risk language is designed to capture the Group's 'primary risk drivers'. A description of each 'primary risk driver', including definition, appetite, control and exposures, is included below. These are further sub-divided into 33 more granular risk types to enable more detailed review and facilitate appropriate reporting and monitoring, as set out in table 1.3.

Through the Group's risk management processes, these risks are assessed on an ongoing basis and seek to ensure optimisation of risk and reward and that, where required, appropriate mitigation is in place. Both quantitative and qualitative factors are considered in assessing the Group's current and potential future risks.

Financial soundness

Financial soundness risk has three key risk components covering liquidity and funding risk; capital risk; and financial and prudential regulatory reporting, disclosure and tax risk.

Liquidity and funding risk

Definition

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost. Funding risk is further defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

Risk appetite

Liquidity and funding risk appetite for the banking businesses is set by the Board and reviewed on an annual basis. This statement of the Group's overall appetite for liquidity risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee, the Group Chief Executive allocates this risk appetite across the Group. It is reported through various metrics that enable the Group to manage liquidity and funding constraints. The Group Chief Executive, assisted by the Group Asset and Liability Committee regularly reviews performance against risk appetite.

Exposure

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

Measurement

A series of measures are used across the Group to monitor both short and long-term liquidity including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. The Board approved liquidity risk appetite links a number of these measures to balance sheet progression set out in the Group funding plan, with regular reporting to the Group Asset and Liability Committee and the Board. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Details of contractual maturities for assets and liabilities form an important source of information for the management of liquidity risk. Note 56 to the financial statements on page 337 sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. This forms the foundation of the Group's liquidity controls.

Mitigation

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives;

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business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term funding. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise interbank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's short-term money market funding is based on a qualitative analysis of the market's capacity for the Group's credit. The Group has developed strong relationships with certain wholesale market segments, and also has access to corporate customers to supplement its retail deposit base.

The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group's banking businesses. The Group holds sizeable balances of high grade marketable debt securities as set out in Table 1.4 which can be sold to provide, or used to secure, additional short term funding should the need arise from either market counterparties or central bank facilities (European Central Bank, Federal Reserve, Bank of England and Reserve Bank of Australia).

Monitoring

Liquidity is actively monitored at business unit and Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular the Group Asset and Liability Committee which meets monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent oversight.

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

- Firstly, the Group stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed, evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both Lloyds Banking Group name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.
- Secondly, the Group has a contingency funding plan embedded within the Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing.

The Group has invested considerable resource to ensure that it satisfies the governance, reporting and stress testing requirements of the FSA's new ILAS liquidity regime. The Group has noted the industry move towards strategic balance sheet measures of the funding profile and has started to monitor and forecast the Group's Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR). The Group is aware that the regulatory liquidity landscape is subject to potential change. Specifically, in relation to the papers issued by the Basel Committee on Banking Supervision ('Strengthening the resilience of the banking sector' and 'International framework for liquidity risk measurement, standards and monitoring') the Group has actively participated in the industry-wide consultation and calibration exercises which took place through 2010.

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

Liquidity and funding management in 2011

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 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, the Group continued to fund adequately, maintaining a broadly stable stock of primary liquid assets during the year and meeting its regulatory liquidity ratios at all times.

The key dependencies on successfully funding the Group's balance sheet include the continued functioning of the money and capital markets; successful right-sizing of the Group's balance sheet; the repayment of the Government Credit Guarantee Scheme facilities in accordance with the agreed terms; no further deterioration in the Group's credit rating; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets. Additionally, the Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. These are assumed within the Group's funding plan. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

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

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Table 1.4: **Group funding by type (audited)**

	2011 £bn	2011 %	2010 £bn	2010 %
Deposits from banks[1]	**25.4**	**3.9**	26.4	3.9
Debt securities in issue:[1]				
Certificates of deposit	**28.0**	**4.3**	42.4	6.2
Commercial paper	**18.0**	**2.7**	32.5	4.8
Medium-term notes[2]	**69.8**	**10.6**	87.7	12.9
Covered bonds	**36.6**	**5.6**	32.1	4.7
Securitisation	**37.5**	**5.7**	39.0	5.7
	189.9	**28.9**	233.7	34.3
Subordinated liabilities[1]	**35.9**	**5.4**	37.9	5.6
Total wholesale funding[3]	**251.2**	**38.2**	298.0	43.8
Customer deposits	**405.9**	**61.8**	382.5	56.2
Total Group funding[4]	**657.1**	**100.0**	680.5	100.0

[1] A reconciliation to the Group's balance sheet is provided on page 116.
[2] Medium-term notes include £23.5 billion of funding from the Credit Guarantee Scheme.
[3] The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.
[4] Excluding repos and total equity.

Total wholesale funding reduced by £47 billion to £251 billion, with the volume with a residual maturity less than one year falling £35 billion to £113 billion. Term wholesale funding for the year totalled £35 billion, in excess of plan, representing £2 billion pre-funding of the requirement for 2012. The Group term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) improved to 55 per cent (50 per cent at 31 December 2010) due to good progress in new term issuance and a reduction in short term money market funding.

Total wholesale funding is analysed by residual maturity as follows:

Table 1.5: **Wholesale funding by residual maturity (audited)**

	2011 £bn	2011 %	2010 £bn	2010 %
Less than one year	**113.3**	**45.1**	148.6	49.9
One to two years	**26.0**	**10.4**	46.8	15.7
Two to five years	**60.2**	**23.9**	52.3	17.6
More than five years	**51.7**	**20.6**	50.3	16.8
Total wholesale funding	**251.2**	**100.0**	298.0	100.0
Less than one year:				
Of which secured	**24.4**	**21.5**	38.4	25.8
Of which unsecured	**88.9**	**78.5**	110.2	74.2
	113.3	**45.1**	148.6	49.9
Greater than one year:				
Of which secured	**63.0**	**45.7**	55.4	37.1
Of which unsecured	**74.9**	**54.3**	94.0	62.9
	137.9	**54.9**	149.4	50.1

The table below summarises the Group's term issuance during 2011. The challenge of meeting the Group's 2011 issuance plan in a very volatile market was successfully accomplished by the ability of the Group to access a diverse range of markets and currencies, both in unsecured and secured form.

Table 1.6: **Analysis of 2011 term issuance (audited)**

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	**2.5**	**6.1**	**1.9**	**0.8**	**11.3**
Medium-term notes	**0.2**	**4.2**	**2.6**	**2.8**	**9.8**
Covered bonds	**1.2**	**–**	**2.4**	**–**	**3.6**
Private placements[1]	**3.7**	**1.6**	**4.8**	**0.5**	**10.6**
Total issuance	**7.6**	**11.9**	**11.7**	**4.1**	**35.3**

[1] Private placements include structured bonds and term repurchase agreements (repos).

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The wholesale funding position includes debt issued under the legacy Government Credit Guarantee Scheme, for which the last maturity will occur in October 2012.

Table 1.7: **Analysis of government and central bank facilities (audited)**

	2011 £bn	2010 £bn
Credit Guarantee scheme	23.5	45.4
Other	–	51.2
Total government and central bank facilities	23.5	96.6

The ratio of customer loans to deposits improved to 135 per cent compared with 154 per cent at 31 December 2010. Loans and advances reduced by £41 billion and customer deposits increased by £23 billion, representing growth of 6 per cent in 2011.

Table 1.8: **Group funding position (audited)**

	2011 £bn	2010 £bn	Change %
As at 31 December			
Funding requirement			
Loans and advances to customers[1]	548.8	589.5	(7)
Loans and advances to banks[2]	10.3	10.5	(2)
Debt securities	12.5	25.7	(51)
Available-for-sale financial assets – secondary[3]	12.0	25.7	(53)
Cash balances[4]	4.1	3.6	14
Funded assets	587.7	655.0	(10)
Other assets[5]	286.1	269.6	6
	873.8	924.6	(5)
On balance sheet primary liquidity assets:[6]			
Reverse repurchase agreements	17.3	7.3	
Balances at central banks – primary[4]	56.6	34.5	64
Available-for-sale financial assets – primary	25.4	17.3	47
Held to maturity	8.1	7.9	3
Trading and fair value through profit or loss[7]	(3.5)	–	
Repurchase agreements	(7.2)	–	
	96.7	67.0	44
Total Group assets	970.5	991.6	(2)
Less: other liabilities[5]	(251.6)	(229.1)	10
Funding requirement	718.9	762.5	(6)
Funded by			
Customer deposits[7]	405.9	382.5	6
Wholesale funding	251.2	298.0	(16)
Repurchase agreements	15.2	35.1	(57)
Total equity	46.6	46.9	(1)
Total funding	718.9	762.5	(6)

[1] Excludes £16.8 billion (31 December 2010: £3.1 billion) of reverse repurchase agreements.
[2] Excludes £21.8 billion (31 December 2010: £15.6 billion) of loans and advances to banks within the insurance businesses and £0.5 billion (31 December 2010: £4.2 billion) of reverse repurchase agreements.
[3] Secondary liquidity assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).
[4] Cash balances and balances at central banks – primary are combined in the Group's balance sheet.
[5] Other assets and other liabilities primarily include balances in the Group's insurance businesses and the fair value of derivative assets and liabilities.
[6] Primary liquidity assets are FSA eligible liquid assets including UK Gilts, US Treasuries, Euro AAA government debt and unencumbered cash balances held at central banks.
[7] Excluding repurchase agreements of £8.0 billion (31 December 2010: £11.1 billion).

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Encumbered assets

The Group remains a consistent issuer in a number of secured funding markets, in particular RMBS and covered bonds (see Table 1.6).

The Group's level of encumbrance arising from external issuance of securitisation and covered bonds has remained broadly constant, reflecting the maturity and stability of the Group's utilisation of this form of term funding, and the established cycle of redemptions and new issuance. Total notes issued externally from secured programmes (ABS and covered bonds) have increased from £71.1 billion at 31 December 2010 to £74.1 billion, reflecting gross issuance of £14.9 billion in 2011. A total of £118.5 billion (2010: £143.6 billion) of notes issued under securitisation and covered bond programmes have also been retained internally, the bulk of which are held to provide a pool of collateral eligible for use at central bank liquidity facilities. A small proportion of the retained collateral has been pledged in bilateral financing transactions.

Other assets pledged as collateral in special purpose entities (for example ABCP conduits) decreased from £17.1 billion at 31 December 2010 to £8.8 billion, largely as a result of a reduction in the size of the Group's holdings of debt securities. Within the asset-backed conduits, assets are encumbered as security for short term asset-backed CP investors in the vehicles; such funding forms part of debt securities in issue disclosed in note 37 on page 266.

Table 1.9: **Reconciliation of Group funding figure from table 1.4 to the balance sheet (audited)**

	Included in funding analysis (table 1.4) £bn	Repos £bn	Fair value and other accounting methods £bn	Balance Sheet £bn
At 31 December 2011				
Deposits from banks	**25.4**	**14.4**	**–**	**39.8**
Debt securities in issue	**189.9**	**–**	**(4.8)**	**185.1**
Subordinated liabilities	**35.9**	**–**	**(0.8)**	**35.1**
Total wholesale funding	**251.2**	**14.4**		
Customer deposits	**405.9**	**8.0**	**–**	**413.9**
Total	**657.1**	**22.4**		
At 31 December 2010				
Deposits from banks	26.4	24.0	–	50.4
Debt securities in issue	233.7	–	(4.8)	228.9
Subordinated liabilities	37.9	–	(1.7)	36.2
Total wholesale funding	298.0	24.0		
Customer deposits	382.5	11.1	–	393.6
Total	680.5	35.1		

Liquidity management

Liquidity is managed at the aggregate 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 Group carries out 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 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 the 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, the 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 the Group will achieve the proposed Basel III liquidity and funding requirements in advance of expected implementation dates.

The 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, the Group experienced downgrades in its long-term rating of between one and two notches from three of the major rating agencies. The impact that the Group experienced following the downgrades was consistent with the Group's modelled outcomes based on the stress testing framework. The 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.

The Group's borrowing costs and issuance in the capital markets are dependent on a number of factors, and increased cost or reduction of capacity could materially adversely affect the Group's results of operations, financial condition and prospects. In particular, reduction in the credit rating of the Group or deterioration in the capital markets' perception of the Group's financial resilience, could significantly increase its borrowing costs and limit its issuance capacity in the capital markets. As an indicator over the last 12 months the spread between an index of A rated long term senior unsecured bank debt and an index of similar BBB rated bank debt, both of which are publicly available, has ranged between 60 and 115 basis points. The applicability to and implications for the Group's funding cost would depend on the type of issuance, and prevailing market conditions. The impact on the Group's funding cost is subject to a number of assumptions and uncertainties and is therefore impossible to quantify precisely.

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Downgrades of the Group's long term debt rating could lead to additional collateral posting and cash outflow. A hypothetical simultaneous two notch downgrade of the Group's long-term debt rating from all major rating agencies, after initial actions within management's control, could result in an outflow of £11 billion of cash, £4 billion of collateral posting related to customer financial contracts and £24 billion of collateral posting associated with secured funding. These effects do not take into account additional management and restructuring actions that the Group has identified that could materially reduce the amount of required collateral postings under derivative contracts related to its own secured funding programmes.

The downgrades that the Group experienced in the fourth quarter of 2011, did not significantly change its borrowing costs, reduce its issuance capacity or require significant collateral posting. The Group notes the February 2012 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 2011, the Group had £202 billion of highly liquid unencumbered assets in its liquidity portfolio which are available to meet cash and collateral outflows, as illustrated in the table below. 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.

Table 1.10: **Liquidity portfolio (unaudited)**

			2011 £bn	2010 £bn
Primary liquidity			**94.8**	97.5
Secondary liquidity			**107.4**	62.4
Total			**202.2**	159.9
Primary liquidity	**2011 £bn**	2010 £bn	**Average 2011 £bn**	Average 2010 £bn
Central bank cash deposits	**56.6**	34.5	**51.4**	46.7
Government bonds	**38.2**	63.0	**48.4**	41.3
Total	**94.8**	97.5	**99.8**	88.0
Secondary liquidity	**2011 £bn**	2010 £bn	**Average 2011 £bn**	Average 2010 £bn
High-quality ABS/covered bonds	**1.4**	15.3	**8.0**	16.3
Credit institution bonds	**2.1**	5.4	**3.7**	7.2
Corporate bonds	**0.3**	0.4	**0.6**	0.3
Own securities (retained issuance)	**81.6**	34.1	**76.8**	27.4
Other securities	**8.6**	7.2	**9.2**	5.9
Other[1]	**13.4**	–	**6.4**	–
Total	**107.4**	62.4	**104.7**	57.1

[1] Includes other central bank eligible assets.

Following the introduction of the FSA's Individual Liquidity Guidance under ILAS, the Group now manages its liquidity position as a coverage ratio (proportion of stressed outflows covered by primary liquid assets) rather than by reference to a quantum of liquid assets; the liquidity position reflects a buffer over the regulatory minimum. The Group receives no recognition under ILAS for assets held for secondary liquidity purposes.

Primary liquid assets of £94.8 billion represent approximately 133 per cent (95 per cent at 31 December 2010) of our money market funding positions and are approximately 84 per cent (66 per cent at 31 December 2010) of all wholesale funding with a maturity of less than a year, and thus provides substantial buffer in the event of continued market dislocation.

In addition to primary liquidity holdings the Group has significant secondary liquidity holdings providing access to open market operations at a number of central banks which the Group routinely makes use of as part of its normal liquidity management practices. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions.

The Group notes the Basel Committee's Principles of Sound Liquidity Risk Management and Supervision (Sound Principles). The planned introduction of the Liquidity Coverage Ratio (LCR - January 2015) and Net Stable Funding Ratio (NSFR - January 2018) contained within CRD IV are intended to raise the resilience of banks to potential liquidity shocks and provide the basis for a harmonised approach to liquidity risk management. The LCR measure promotes short term resilience of the liquidity profile by ensuring that banks have sufficient high quality liquid assets to meet potential funding outflows in a stressed environment within a one month period. The NSFR promotes resilience over a longer time horizon by requiring banks to fund their activities with a more stable source of funding on a going concern basis. This has a time horizon of one year and has been developed to ensure a sustainable maturity structure of assets and liabilities.

The guidance issued by the Basel Committee is still subject to final ratification by the EU and the methodology is likely to be refined on the basis of feedback from banks and regulators during the observation period. The actions already announced to right size the balance sheet are expected to ensure compliance with the future minimum standards. These standards are expected to be 100 per cent for both ratios by their respective effective dates.

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Hybrid capital securities coupon payments

Since 31 January 2010, the Group has been prohibited under the terms of an agreement with the European Commission, from paying discretionary coupons and dividends on certain of its hybrid capital securities. This prohibition ended on 31 January 2012. We recommenced payments on certain hybrid capital securities from 31 January 2012. Future coupons and dividends on these hybrid capital securities will only be paid subject to, and in accordance with, the terms of the relevant securities.

The payments on those of the hybrid capital securities that are not cash-cumulative and which are expected, subject to their terms and conditions, to be paid in 2012 are estimated to amount to approximately £170 million. In the context of recent macro prudential policy discussions, the Board of Lloyds Banking Group has decided to issue new Lloyds Banking Group ordinary shares to raise this amount. The Group has entered into an agreement with a third-party financial institution in connection with the issue of these new ordinary shares. Such ordinary shares are expected to be issued, subject to market conditions, by the end of April 2012 at a price determined by reference to the volume weighted average price of our ordinary shares in a period prior to their date of issue.

Capital risk

Definition

Capital risk is defined as the risk of the Group having a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Risk appetite

Capital risk appetite is set by the Board and reported through various metrics that enable the Group to manage capital constraints and market expectations. The Group Chief Executive, assisted by the Group Asset and Liability Committee, regularly reviews performance against risk appetite. A key metric is the Group's core tier 1 capital ratio which the Group currently aims to maintain prudently in excess of 10 per cent. This and other aspects of appetite will be kept under review in the light of further clarity of regulatory and accounting reforms.

Exposure

A capital exposure arises where the Group has insufficient regulatory capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures whilst optimising value for shareholders.

Measurement

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 Lloyds Banking 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.

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. Additionally an extensive series of stress analyses is undertaken during the year to determine the adequacy of the Group's capital resources against the FSA minimum requirements in severe economic conditions.

During the course of 2011 the EBA undertook two European wide exercises to assess the capital strength of the larger banks within the sector.

The first of these, in July 2011, sought to assess the resilience of European banks to severe shocks and their specific solvency in hypothetical stress events under certain restrictive conditions. The stress test was carried out based on common methodology and key common assumptions. The assumptions and methodology were established to assess banks' capital adequacy against a 5 per cent core tier 1 capital benchmark. As a result of the assumed shock the estimated consolidated core tier 1 ratio of the Group was 7.7 per cent at the worst point of the stress in 2012.

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The second exercise, in December 2011, required banks to strengthen their capital position by building up temporary capital buffers against sovereign debt exposures to reflect market prices. In addition, it required banks to establish a buffer such that the core tier 1 ratio reaches a minimum level of 9 per cent by the end of June 2012. The Group's consolidated core tier 1 ratio from this exercise was 10.1 per cent.

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 and credit risk.
- The European Commission published a draft of the new Capital Requirements Directive and Regulation (CRD IV) 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.
- Lloyds Banking Group was one of 29 banks identified by the Financial Stability Board as being of global systemic importance (G-SIFIs) and which will be subject to stronger capital adequacy requirements than Basel III. The list of G-SIFIs will be reviewed annually from a pool of around initially 70 institutions.
- 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 Internal Ratings Based (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.

Mitigation

The Group has developed procedures to ensure that compliance with both current and potential future requirements are understood and that policies are aligned to its risk appetite.

The Group is able to accumulate additional capital through profit retention, by raising equity via, for example, a rights issue or debt exchange and by raising tier 1 and tier 2 capital by issuing subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time.

The Group has in issue, as part of tier 2 capital resources, Enhanced Capital Notes which will convert to core tier 1 capital in the event that Group's published core tier 1 ratio (as defined by the FSA in May 2009) falls below 5 per cent.

Additional measures which have been used to manage the Group's capital position include seeking to strike an appropriate balance of capital held within its insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises. Regulatory requirements are primarily controlled through the quality and volume of lending but are also affected through the modelling approaches used to determine risk weighted assets and expected losses.

In order to pay dividends, the Group's UK subsidiaries need to have distributable reserves. Whilst the group's direct subsidiary, Lloyds TSB Bank plc has distributable reserves, one of the Group's indirect principal subsidiaries, Bank of Scotland plc, does not and is currently unable to pay dividends. There is a risk that any profits earned by Bank of Scotland plc and its subsidiaries may be unable to be remitted to the Group holding company as dividends. This risk is mitigated by management who can elect to restructure the capital resources of a subsidiary entity.

Monitoring

Capital is actively managed and regulatory ratios are a key factor in the Group's budgeting and planning processes. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios, including those that would occur under stressed scenarios, is made to the Senior Asset and Liability Committee, the Group Asset and Liability Committee, the Group Risk Committee and the Board.

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Table 1.11: **Capital resources (audited)**

	2011 £m	2010 £m
Core tier 1		
Shareholders' equity per balance sheet	45,920	46,061
Non-controlling interests per balance sheet	674	841
Regulatory adjustments to non-controlling interests	(577)	(524)
Regulatory adjustments:		
Adjustment for own credit	(136)	(8)
Defined benefit pension adjustment	(1,004)	(1,052)
Unrealised reserve on AFS debt securities	(940)	747
Unrealised reserve on AFS equity	(386)	(462)
Cash flow hedging reserve	(325)	391
Prudent valuation adjustments	(32)	–
Other items	(4)	(3)
	43,190	45,991
Less: deductions from core tier 1		
Goodwill	(2,016)	(2,016)
Intangible assets	(2,310)	(2,390)
50% excess of expected losses over impairment	(720)	–
50% of securitisation positions	(153)	(214)
Core tier 1 capital	37,991	41,371
Non-controlling preference shares[1]	1,613	1,507
Preferred securities[1]	4,487	4,338
Less: deductions from tier 1		
50% of material holdings	(94)	(69)
Total tier 1 capital	43,997	47,147
Tier 2		
Undated subordinated debt	1,859	1,968
Dated subordinated debt	21,229	23,167
Less: restriction in amount eligible	–	–
Unrealised gains on available for sale equity	386	462
Eligible provisions	1,259	2,468
Less: deductions from tier 2		
50% excess of expected losses over impairment	(720)	–
50% of securitisation positions	(153)	(214)
50% of material holdings	(94)	(69)
Total tier 2 capital	23,766	27,782
Supervisory deductions		
Unconsolidated investments – life	(10,107)	(10,042)
Unconsolidated investments – general insurance and other	(2,660)	(3,070)
Total supervisory deductions	(12,767)	(13,112)
Total capital resources	54,996	61,817

[1] Covered by grandfathering provisions issued by FSA.

Table 1.12: **Risk Weighted Assets and Capital Ratio's (unaudited)**

	2011 £m	2010 £m
Risk-weighted assets	352,341	406,372
Ratios		
Core tier 1 ratio	10.8%	10.2%
Tier 1 capital ratio	12.5%	11.6%
Total capital ratio	15.6%	15.2%

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Table 1.13: **Analysis of risk-weighted assets (unaudited)**

	2011 £m	2010 £m
Divisional analysis of risk-weighted assets		
Retail	103,237	109,254
Wholesale	163,766	196,164
Commercial	25,434	26,552
Wealth and International	47,278	58,714
Group Operations and Central items	12,626	15,688
	352,341	406,372
Risk type analysis of risk-weighted assets		
Foundation IRB	90,450	114,490
Retail IRB	98,823	105,475
Other IRB	9,433	14,483
Advanced Approach	198,706	234,448
Standardised Approach	103,525	124,492
Credit risk	302,231	358,940
Operational risk	30,589	31,650
Market and counterparty risk	19,521	15,782
Total risk-weighted assets	352,341	406,372

Risk-weighted assets reduced by £54,031 million to £352,341 million, a decrease of 13 per cent. This reflects risk weighted asset reductions across all banking divisions driven by balance sheet reductions of non-core assets, lower core lending balances and stronger management of risk.

Retail risk weighted assets reduced by £6,017 million mainly due to lower lending balances and the reducing mix of unsecured lending.

The reduction of Wholesale risk weighted assets of £32,398 million primarily reflects the balance sheet reductions including treasury asset sales and the run down in other non-core asset portfolios. This has been partly offset by an increase in market risk weighted assets, as a result of the implementation of CRD III.

Risk weighted assets within Wealth and International have reduced by £11,436 million as a result of asset run-off and write off and foreign exchange movements.

Integration of model activity previously undertaken on a separate heritage basis was largely completed in 2010 and there have been no significant migrations to IRB methodologies during 2011. In common with other banking groups operating on an IRB basis we anticipate moving some activity that is currently measured on the standardised approach over to an IRB methodology. These changes will take place primarily during 2012 and 2013.

Tier 1 capital

Core tier 1 capital has decreased by £3,380 million largely reflecting losses in the period. In addition there has been an increase in excess of expected losses over impairment losses, reflecting the reduction of legacy lending that is subject to very high provision levels and replacement with new lending.

Tier 2 capital

Tier 2 capital has decreased in the period by £4,016 million reflecting the increase in excess of expected losses over impairment, as noted above, and a reduction in eligible provisions. In addition, dated subordinated debt has also reduced in the period, partly due to amortisation and partly due to a capital restructuring exercise in December 2011, which resulted in a net overall redemption of dated subordinated debt.

Supervisory deductions

Supervisory deductions mainly consist of investments in subsidiary undertakings that are not within the banking group for regulatory purposes. These investments are primarily the Scottish Widows and Clerical Medical life and pensions businesses together with general insurance business. Also included within deductions for other unconsolidated investments are investments in non-financial entities that are held by the Group's private equity (including venture capital) businesses. During the period there has been a decrease in supervisory deductions primarily due to reduced holdings in private equity businesses, and in some cases changes to the level and/or nature of investments resulting in a reclassification as material holdings.

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The movements in core tier 1 and total capital in the period are shown below:

Table 1.14: **Movements in core tier 1 and total capital during the year (audited)**

	Core tier 1 £m	Total £m
At 1 January 2011	41,371	61,817
Loss attributable to ordinary shareholders	(2,787)	(2,787)
Decrease in regulatory post-retirement benefit adjustments	48	48
Decrease in goodwill and intangible assets deductions	80	80
Increase in excess of expected losses over impairment allowances	(720)	(1,440)
Increase in material holdings deduction	–	(50)
Decrease in eligible provisions	–	(1,209)
Decrease in supervisory deductions from total capital	–	345
Decrease in dated subordinated debt	–	(1,938)
Other movements	(1)	130
At 31 December 2011	**37,991**	**54,996**

Table 1.15: **Analysis of capital ratios (unaudited)**

	Lloyds TSB Bank Group		Bank of Scotland Group	
	2011 £m	2010 £m	2011 £m	2010 £m
Tier 1	50,220	49,375	17,432	21,470
Tier 2	25,214	21,073	13,148	15,002
Supervisory deductions	(23,159)	(13,112)	(983)	(1,672)
Total capital	**52,275**	**57,336**	**29,597**	**34,800**
RWAs	352,341	406,372	199,249	250,598
Ratios				
Core tier 1	12.2%	10.5%	8.4%	8.3%
Tier 1	14.3%	12.2%	8.7%	8.6%
Total capital	14.8%	14.1%	14.9%	13.9%

Capital ratios for Lloyds TSB Bank Group reflect a restructuring of internal capital undertaken in the period, which has significantly strengthened the core tier 1 and tier 1 positions. Capital ratios in both entities have benefited from a reduction in risk-weighted assets in the period.

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Life insurance businesses

The business transacted by the life insurance companies within the Group comprises unit-linked business, non profit business and with-profits business. Several companies transact either unit-linked and/or non-profit business, but Scottish Widows plc (Scottish Widows) and Clerical Medical Investment Group Limited (Clerical Medical) hold the only large With Profit Funds managed by the Group.

Basis of determining regulatory capital of the life insurance businesses

Available capital resources

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the FSA.

Statutory basis. Assets are generally valued on a basis consistent with that used for accounting purposes (with the exception that, in certain cases, the value attributed to assets is limited) and which follows a market value approach where possible. If the market is not active, the Group establishes a fair value by using valuation techniques. Liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets in accordance with the FSA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

Regulatory capital requirements

Each life insurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the FSA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows and Clerical Medical, the regulatory capital requirement is a combination of amounts held in respect of actuarial reserves, sums at risk and maintenance expenses (the Long-Term Insurance Capital Requirement) and amounts required to cover various stress tests (the Resilience Capital Requirement). The regulatory capital requirement is deducted from the available capital resources to give 'statutory excess capital'.

For Scottish Widows and Clerical Medical, no Resilience Capital Requirement is required. However, a further test is required in respect of the With Profit Funds. This involves comparing the statutory basis of assessment with a realistic basis of assessment as described below.

'Realistic' basis. The FSA requires each life insurance company which contains a With Profit Fund in excess of £500 million to also carry out a 'realistic' valuation of that fund. The Group has two such funds; one within Scottish Widows and one within Clerical Medical. The word 'realistic' in this context reflects the fact that assumptions are best-estimate as opposed to prudent. This realistic valuation is an assessment of the financial position of a With Profit Fund calculated under a methodology prescribed by the FSA.

The valuation of with-profits assets in a With Profit Fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profits business written in a With Profit Fund, it includes the present value of the anticipated future release of the prudent margins for adverse deviation. In addition, the realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above.

The realistic valuation of liabilities includes an allowance for future bonuses. Options and guarantees are valued using a stochastic simulation model which values these liabilities on a basis consistent with tradable market option contracts (a 'market-consistent' basis). The model takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given in the section entitled 'Options and guarantees' on page 127.

The 'realistic excess capital' is calculated as the difference between realistic assets and realistic liabilities of the With Profit Fund with a further deduction to cover various stress tests (the Risk Capital Margin). In circumstances where the 'realistic excess capital' position is less than the 'statutory excess capital', the company is required to hold additional capital to cover the shortfall. Any additional capital requirement under this test is referred to as the With Profit Insurance Capital Component.

The determination of realistic liabilities of the With Profit Funds includes the value of internal transfers expected to be made from each With Profit Fund to the Non Profit Fund held within the same life insurance entity. These internal transfers may include charges on policies where the associated costs are borne by the Non Profit Fund. The With Profit Insurance Capital Component may be reduced by the value, calculated in the stress test scenario, of these internal transfers, but only to the extent that credit has not been taken for the value of these charges in deriving actuarial reserves for the relevant Non Profit Fund.

Capital statement

The following table provides more detail regarding the capital resources available to meet regulatory capital requirements in the life insurance businesses. The figures quoted are based on management's current expectations pending completion of the annual financial returns to the FSA. The figures allow for an anticipated transfer of £85 million from the Non Profit Fund of Scottish Widows Annuities Ltd to its Shareholder fund. During 2011, as part of a project to rationalise the Group structure Clerical Medical was purchased by Scottish Widows for £1,846 million. Scottish Widows recovered £1,485 million of this amount as a result of capital transactions with its holding company.

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Table 1.16: **Capital resources (unaudited)**

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Fund £m	UK Life Shareholder Fund £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2011 (statutory basis)						
Shareholders' funds:						
Held outside the long-term funds	**–**	**–**	**–**	**1,843**	**632**	**2,475**
Held within the long-term funds	**–**	**–**	**6,592**	**–**	**312**	**6,904**
Total shareholders' funds	**–**	**–**	**6,592**	**1,843**	**944**	**9,379**
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	**242**	**58**	**–**	**–**	**–**	**300**
Value of in-force business	**–**	**–**	**(5,491)**	**–**	**(818)**	**(6,309)**
Other differences between IFRS and regulatory valuation of assets and liabilities	**–**	**–**	**107**	**(163)**	**124**	**68**
Estimated share of 'realistic' liabilities consistent with the FSA reporting treatment	**(341)**	**(58)**	**–**	**–**	**–**	**(399)**
Qualifying loan capital	**–**	**–**	**–**	**1,997**	**–**	**1,997**
Support arrangement assets	**184**	**–**	**(184)**	**–**	**–**	**–**
Available capital resources	**85**	**–**	**1,024**	**3,677**	**250**	**5,036**
At 31 December 2010 (statutory basis)						
Shareholders' funds:						
Held outside the long-term funds	–	–	–	1,414	721	2,135
Held within the long-term funds	–	–	8,029	–	401	8,430
Total shareholders' funds	–	–	8,029	1,414	1,122	10,565
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	322	321	–	–	–	643
Value of in-force business	–	–	(6,172)	–	(843)	(7,015)
Other differences between IFRS and regulatory valuation of assets and liabilities	–	–	625	(919)	111	(183)
Estimated share of 'realistic' liabilities consistent with the FSA reporting treatment	(409)	(58)	–	–	–	(467)
Qualifying loan capital	–	–	–	1,991	–	1,991
Support arrangement assets	344	–	(344)	–	–	–
Available capital resources	257	263	2,138	2,486	390	5,534

Available capital resources for With Profit Funds are presented in the table on a 'realistic' basis as this is more onerous than on a regulatory basis.

Formal intra-group capital arrangements

Scottish Widows has a formal arrangement with one of its subsidiary undertakings, Scottish Widows Unit Funds Limited, whereby the subsidiary company can draw down capital from Scottish Widows to finance new business which is reinsured from the parent to its subsidiary. Scottish Widows has also provided subordinated loans to its fellow group undertaking Scottish Widows Bank plc. No such arrangement exists for Clerical Medical.

Constraints over available capital resources

Scottish Widows

Scottish Widows was created following the demutualisation of Scottish Widows Fund and Life Assurance Society in 2000. The terms of the demutualisation are governed by a Court-approved Scheme of Transfer (the 'Scheme') which, inter alia, created a With Profit Fund and a Non-Participating Fund and established protected capital support for the with-profits policyholders in existence at the date of demutualisation. Much of that capital support is held in the Non-Participating Fund and, as such, the capital held in that fund is subject to the constraints noted below.

Requirement to maintain a Support Account: The Scheme requires the maintenance of a 'Support Account' within the Non-Participating Fund. The quantum of the Support Account is calculated with reference to the value of assets backing current with-profits policies which also existed at the date of demutualisation. Under the Scheme assets can only be transferred from the Non-Participating Fund if the value of the remaining assets in the fund exceeds the value of the Support Account. Scottish Widows has obtained from the FSA permission to include the value of the Support Account or, if greater, the excess of realistic liabilities for business written before demutualisation over the relevant assets (subject to the Non-Participating Fund being able to cover this amount by its surplus admissible assets) in assessing the realistic value of assets

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available to the With Profit Fund. At 31 December 2011, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,198 million (31 December 2010: £1,693 million) and the estimated value of the Support Account was zero (31 December 2010: £197 million). However, at 31 December 2011, the excess of realistic liabilities with-profits business written down before demutualisation over the relevant assets was £67 million (31 December 2010: £55 million) which, in accordance with the FSA's permission, has been used to assess the estimated value of realistic assets available to the With Profit Fund (and has therefore reduced the value of the Non-Participating Fund's surplus admissible assets by that amount).

Further Support Account: The Further Support Account is an extra tier of capital support for the with-profits policies in existence at the date of demutualisation. The Scheme requires that assets can only be transferred from the Non-Participating Fund if the economic value of the remaining assets in the fund exceeds the aggregate of the Support Account and Further Support Account. Unlike the Support Account test, the economic value used for this test includes both admissible assets and the present value of future profits of business written in the Non-Participating Fund or by any subsidiaries of that fund. The balance of the Further Support Account is expected to reduce to nil by the year 2030. At 31 December 2011, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £5,494 million (31 December 2010: £4,322 million) and the estimated combined value of the Support Account and Further Support Account was £2,291 million (31 December 2010: £2,446 million).

Other restrictions in the Non-Participating Fund: In addition to the policies which existed at the date of demutualisation, the With Profit Fund includes policies which have been written since that date. As a result of statements made to policyholders that investment policy will usually be the same for both types of business, there is an implicit requirement to hold additional regulatory assets in respect of the business written after demutualisation. The estimated amount required to provide such support at 31 December 2011 is £117 million (31 December 2010: £147 million). Scottish Widows has obtained from the FSA permission to include the value of this support in assessing the realistic value of assets available to the With Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long-Term Fund to meet both policyholders' reasonable expectations in light of liabilities in force at a year end and the new business expected to be written over the following year.

Clerical Medical

The surplus held in the Clerical Medical With Profit Fund can only be applied to meet the requirements of the fund itself or distributed according to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses on traditional with-profits business. The use of capital within the fund is also subject to the terms of the scheme of demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. Capital within the Clerical Medical Non Profit Fund is available to meet the With Profit Fund requirements.

Other life insurance businesses

Except as described above capital held in UK Non Profit Funds is potentially transferable to other parts of the Group, subject to meeting the regulatory requirements of these businesses. There are no prior arrangements in place to allow capital to move freely between life insurance entities or other parts of the Group.

Overseas life business includes several life companies outside the UK, including Germany and Ireland. In all cases the available capital resources are subject to local regulatory requirements, and transfer to other parts of the Group is subject to additional complexity surrounding the transfer of capital from one country to another.

Movements in regulatory capital

The movements in the Group's available capital resources in the life business can be analysed as follows:

Table 1.17: **Movements in available capital resources (unaudited)**

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Fund £m	UK Life Shareholder Fund £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2010	257	263	2,138	2,486	390	5,534
Changes in estimations and in demographic assumptions used to measure life assurance liabilities	(24)	41	289	91	(6)	391
Dividends and capital transactions	–	–	(1,483)	1,057	(156)	(582)
Change in support arrangements	(160)	–	160	–	–	–
New business and other factors	12	(304)	(80)	43	22	(307)
At 31 December 2011	**85**	**–**	**1,024**	**3,677**	**250**	**5,036**

With Profits Funds

Available capital in the Scottish Widows With Profit Fund has decreased from £257 million at 31 December 2010 to an estimated £85 million at 31 December 2011. This is largely as a result of a reduction in the support arrangements from the Non Profit Fund. Available capital in the Clerical medical With Profit Fund has decreased from £263 million at 31 December 2010 to an estimated zero at 31 December 2011. The fund is in the process of distributing the free estate. Ultimately all surplus will be distributed to policyholders hence the available capital at 31 December 2011 is zero.

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UK Non Profit Funds

Available capital in the UK Non Profit Funds has decreased from £2,138 million at 31 December 2010 to an estimated £1,024 million at 31 December 2011. The main cause of the decrease was the impact of capital transactions supporting the purchase of Clerical Medical by Scottish Widows in July 2011. This was partially offset by increases in available capital from changes in assumptions. It should be noted that the decrease in the Non Profit Fund from the purchase of Clerical Medical is largely compensated for by an increase in the available capital in the Shareholder Funds.

UK Life Shareholder Funds

Available capital in the UK Life Shareholder Funds has increased from £2,486 million at 31 December 2010 to an estimated £3,677 million at 31 December 2011. The main cause of the increase was the impact of capital transactions supporting the purchase of Clerical Medical by Scottish Widows.

Overseas life business

Available capital has decreased during 2011 due to a significant dividend payment which was only partially offset by profits emerging on new and in force business.

Analysis of policyholder liabilities reported in the balance sheet in respect of the Group's life insurance business is as follows. With Profit Fund liabilities are valued in accordance with FRS 27.

Table 1.18: **Analysis of policyholder liabilities (unaudited)**

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK Non Profit Funds £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2011					
With Profit Fund liabilities	**13,651**	**9,300**	**4**	**–**	**22,955**
Unit-linked business (excluding that accounted for as non-participating investment contracts)	**–**	**–**	**38,474**	**7,801**	**46,275**
Other life insurance business	**–**	**–**	**8,745**	**55**	**8,800**
Insurance and participating investment contract liabilities	**13,651**	**9,300**	**47,223**	**7,856**	**78,030**
Non-participating investment contract liabilities	**–**	**–**	**45,469**	**4,167**	**49,636**
Total policyholder liabilities	**13,651**	**9,300**	**92,692**	**12,023**	**127,666**
At 31 December 2010					
With Profit Fund liabilities	13,845	10,394	5	–	24,244
Unit-linked business (excluding that accounted for as non-participating investment contracts)	–	–	38,641	8,011	46,652
Other life insurance business	–	–	8,527	90	8,617
Insurance and participating investment contract liabilities	13,845	10,394	47,173	8,101	79,513
Non-participating investment contract liabilities	–	–	47,058	4,304	51,362
Total policyholder liabilities	13,845	10,394	94,231	12,405	130,875

Capital sensitivities

Shareholders' funds

Shareholders' funds outside the long-term business fund, other than those used to match regulatory requirements, are mainly invested in assets that are less sensitive to market conditions.

With Profit Funds

The with-profit realistic liabilities and the available capital for the With Profit Funds are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund. The available capital resources (and capital requirements) are sensitive to the level of the stock market, with the position worsening at low stock market levels as a result of the guarantees to policyholders increasing in value. However, the exposure to guaranteed annuity options increases under rising stock market levels. An increase in the level of equity volatility implied by the market cost of equity put options also increases the market consistent value of the options given to policyholders and worsens the capital position. Various hedging strategies are used to manage these exposures.

The most critical non-economic assumptions are the level of take-up of options inherent in the contracts (higher take-up rates are more onerous), mortality rates (lower mortality rates are generally more onerous) and lapses prior to dates at which a guarantee would apply (lower lapse rates are generally more onerous where guarantees are in the money). The sensitivity of the capital position and capital requirements of the With Profit Funds is partly mitigated by the actions that can be taken by management.

Other long-term funds

Outside the With Profit Funds, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower

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mortality rates are more onerous). Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of life insurance contracts. In addition, poor cost control would gradually reduce the available capital and lead to an increase in the valuation of the liabilities (through an increased allowance for future costs).

Assets held in excess of those backing reserves are invested predominantly in cash and cash like instruments. The investment strategy is determined in line with the policy of Lloyds Banking Group to minimise both the profit volatility and the working capital (defined as available capital less minimum required capital) required to ensure all capital requirements continue to be met under a range of stress tests.

Options and guarantees

The Group has sold insurance products that contain options and guarantees, both within the With Profit Funds and in other funds.

Options and guarantees within the With Profit Funds

The most significant options and guarantees provided from within the With Profit Funds are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies.

For those policies written in Scottish Widows pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up within the With Profit Fund of Scottish Widows called the Additional Account which is available, inter alia, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2011 of £2.0 billion (2010: £1.8 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the FSA, the liabilities of both the Clerical Medical and Scottish Widows With Profit Funds are valued using a market-consistent stochastic simulation model. This model is used in order to place a value on the options and guarantees which captures both their intrinsic value and their time value.

The most significant economic assumptions included in the model are:

- Risk-free yield. The risk-free yield is defined as spot yields derived from the UK gilt yield curve.
- Investment volatility. The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2011, the 10 year equity-implied at-the-money assumption was set at 27.2 per cent (31 December 2010: 26.1 per cent). The assumption for property volatility was 15 per cent (31 December 2010: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 19 per cent (31 December 2010: 15 per cent).

The model includes a matrix of the correlations between each of the underlying modelled asset types. The correlations used are consistent with long-term historical returns. The most significant non-economic assumptions included in the model are management actions (in respect of investment policy and bonus rates), guaranteed annuity option take-up rates and assumptions regarding persistency (both of which are based on recent actual experience and include an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities), and assumptions regarding mortality (which are based on recent actual experience and industry tables).

Options and guarantees outside the With Profit Funds

A number of typical guarantees are provided outside the With Profit Funds such as guaranteed payments on death (e.g. Term assurance) or guaranteed income for life (e.g. annuities). In addition, certain personal pension policyholders in Scottish Widows, for whom reinstatement to their occupational pension scheme was not an option, have been given a guarantee that their pension and other benefits will correspond in value to the benefits of the relevant occupational pension scheme. The key assumptions affecting the ultimate value of the guarantee are future salary growth, gilt yields at retirement, annuitant mortality at retirement, marital status at retirement and future investment returns. There is currently a provision, calculated on a deterministic basis, of £61 million (31 December 2010: £57 million) in respect of those guarantees. If future salary growth were 0.5 per cent per annum greater than assumed, the liability would increase by some £2 million. If yields were 0.5 per cent lower than assumed, the liability would increase by some £9 million.

Financial and prudential regulatory reporting, disclosure and tax risk

Definition

The risk of reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial, prudential regulatory and tax reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate information about the Group on a timely basis.

Risk appetite

The risk appetite is set by the Board and reviewed on an annual basis or more frequently. It includes complying with statutory and regulatory reporting requirements and avoiding the need for restatement of publicly disclosed information.

Exposure

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate systems, processes and controls to support statutory, prudential regulatory and tax reporting, to prevent and detect financial reporting fraud, to manage the Group's tax position and to support market disclosures.

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Mitigation

The Group maintains a system of internal controls, which is designed to:

- ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded;
- enable the calculation, preparation and reporting of financial, prudential regulatory and tax outcomes in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements;
- ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements and as far as possible are consistent with best practice and in compliance with the British Bankers' Association Code for Financial Reporting Disclosure.

Monitoring

Financial reporting risk, prudential regulatory reporting risk, tax risk and disclosure risk are all actively monitored at business unit and Group levels. There are specific programmes of work undertaken across the Group to support:

- annual assessments of (1) the effectiveness of internal controls over financial reporting and (2) the effectiveness of the Group's disclosure controls and procedures, both in accordance with the requirements of the US Sarbanes Oxley Act;
- annual certifications by the Senior Accounting Officer with respect to the maintenance of appropriate tax accounting arrangements, in accordance with the requirements of the 2009 Finance Act.

The Group also has in place an assurance process to support its prudential regulatory reporting and monitoring activities designed to identify and review tax exposures on a regular basis. There is ongoing monitoring to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

The Group has a disclosure committee which assists the Group Chief Executive and Group Finance Director in fulfilling their disclosure responsibilities under relevant listing requirements.

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Credit risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

Risk appetite

Credit risk appetite is set at Board level and is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems as inputs. These metrics are supported by more detailed appetite metrics at Divisional and business level and by a comprehensive suite of policies, sector caps, product and country limits to manage concentration risk and exposures within the Group's approved risk appetite.

This statement of the Group's overall appetite for credit risk is reviewed and approved annually. With the support of the Group Risk Committee, the Group Chief Executive allocates this risk appetite across the Group.

Exposures

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions, sovereigns and corporate clients. The credit risk exposures of the Group are set out in note 56 to the financial statements on page 322. Credit risk exposures are categorised as 'retail', arising primarily in the Retail and Wealth and International Divisions, 'commercial' and 'corporate', 'financial institutions' or 'Sovereigns' arising in the Wholesale, Commercial and Wealth and International Divisions.

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially also exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail term commitments to extend credit can be cancelled without notice and the creditworthiness of customers is monitored frequently. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards, which are monitored regularly.

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 19 to the financial statements on page 251 shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2011. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 56 to the financial statements on page 322.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers. A significant proportion of the investments are held in unit-linked and with-profits funds where the shareholder risk is limited, subject to any guarantees given.

Note 2(H) to the financial statements on page 221 provides details of the Group's approach to the impairment of financial assets.

Measurement

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components: (i) the 'probability of default' by the counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

For regulatory capital purposes the Group's rating systems assess probability of default and if permitted, exposure at default and loss given default, in order to derive an expected loss. If not permitted, regulatory prescribed exposure at default and loss given default values are used in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes.

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and subject matter expert judgement. Each rating model is subject to a validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. The most material rating models are approved by the Group Risk Committee. Responsibility for the approval of the remaining material rating models, and the governance framework in place around all Lloyds Banking Group models, is delegated to the Group Model Governance Committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities (details of these rating scales are published in Lloyds Banking Group's Pillar III disclosure). Exposures migrate between rating grades if the assessment of the counterparty probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale (Note 56 to the financial statements on page 323 provides an analysis of the portfolio and page 134 provides details of our Credit risk portfolio).

The quality definition of both retail and non-retail counterparties/exposures is largely based on the outcomes of credit risk (probability of default – PD) models. The Group operates a significant number of different rating models, typically developed internally using statistical analysis and may use management judgement – retail models rely more on the former; non-retail models include more of the latter, especially in the larger corporate and more specialised lending portfolios. Internal data is supplemented with external data in model development, where appropriate.

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The models vary, inter alia, in the extent to which they are point in time versus through the cycle. The models are subject to rigorous validation and oversight/governance, including where appropriate, benchmarking to external information.

In non-retail portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties/exposures migrate between rating grades if the assessment of the PD changes. The modelled PDs 'map' to a (non-retail) master scale which enables the consolidation of credit risk information, and it is this that forms the basis for the IFRS credit quality characterisation.

In retail, for reporting purposes, counterparties are also segmented into a number of rating grades, each representing a defined range of default probabilities and exposures migrate between rating grades if the assessment of the counterparty probability of default changes.

The nature, construction and calibration of retail and non-retail models are very different and so too are their respective master scales (not least in their graduality). The distribution of probabilities of default is also different, which precludes reportage on a single consolidated basis.

Mitigation

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

Internal control

Credit principles and policy: Risk Division sets out the credit principles and policy according to which credit risk is managed. Principles and policies are reviewed at least annually, and any changes are subject to a review and approval process. Policies, where appropriate, include lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. These policies and procedures define chosen target market and risk acceptance criteria. These have been and will continue to be fine-tuned as appropriate and include the use of early warning indicators to help anticipate future areas of concern and allow us to take early and proactive mitigating actions.

The Group uses a variety of lending criteria within Retail when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant's previous credit history using information held by credit reference agencies (CRA). The Group also assesses the affordability of the borrowings to the borrower under stressed scenarios including increased interest rates. In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are hard limits above which the Group will reject the application. The Group also has certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

The Group's lending practices within Retail have changed since 2009 in several ways: the Group has lowered its maximum loan-to-value thresholds, which have been reduced across all mortgage product types; the Group has withdrawn from 'specialist' secured lending since early 2009 (self-certificated and sub-prime lending) and increased credit scorecard cut-offs for both secured and unsecured lending; the Group has tightened its assessments and the maximum limit for affordability of borrowings for both secured and unsecured lending. In addition, the number of properties permitted in buy-to-let portfolios has been reduced.

For UK mortgages, the Group's policy is to reject all standard applications with a loan-to-value (LTV) greater than 90 per cent. For mainstream mortgages the Group has maximum per cent LTV limits which depend upon the loan size. These limits are currently:

(Unaudited)

Loan size From	To	Maximum LTV
£1	£750,000	90% LTV
£750,001	£1,000,000	85% LTV
£1,000,001	£2,000,000	80% LTV
£2,000,001	£5,000,000	70% LTV

For mainstream mortgages greater than £5,000,000 the maximum LTV is 50 per cent. Buy-to-let mortgages are limited to a maximum of £1,000,000 and 75 per cent LTV. All mortgage applications above £500,000 are subject to manual underwriting.

The Group's approach to underwriting applications for unsecured products in Retail takes into account the total unsecured debt held by a customer and their affordability. The Group rejects any application for an unsecured product where a customer is registered as bankrupt or insolvent, or has a County Court Judgment registered at a CRA used by the Group. In addition, for credit cards the Group rejects any applicant with total unsecured debt greater than £50,000 registered at the CRA; or revolving debt-to-income ratio greater than 75 per cent; or total unsecured debt-to-income ratio greater than 100 per cent. For unsecured personal loan applications, we reject any applicant with total unsecured debt greater than £50,000 registered at the CRA. Rules around refinancing of debt have also been made more stringent since 2009 as a result of the application of rules relating to the total unsecured debt held by a customer and the Group's approach in assessing affordability. This has resulted in fewer customers being eligible to refinance unsecured debt.

Counterparty limits: Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.

Credit scoring: In its principal retail portfolios, the Group uses statistically based decisioning techniques (primarily credit scoring models). The Risk Division reviews model effectiveness, while new models and model changes are referred by them to the appropriate Model Governance Committees for approval. The most material changes are approved in accordance with the governance framework set by the Group Model Governance Committee.

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Individual credit assessment and sanction: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting is generally the same as that for assets intended to be held over the period to maturity.

Controls over rating systems: The Group has established an independent team in the Risk Division that sets common minimum standards, designed to ensure risk models and associated rating systems are developed consistently, and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating systems are developed and owned by the Risk Division. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by independent specialist functions in their respective division.

Cross-border and cross-currency exposures: The Board sets country risk appetite. Within these, country limits are authorised by the country limits panel, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support the approved business and strategic plans of the Group.

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to the Group's risk appetite and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 21 to the financial statements on page 255, provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending, but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.

Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group wide level, at divisional and business unit level and by rating model and portfolio, for example, within a specific industry sector.

Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control (see Intensive Care section); security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.

Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.

Credit risk assurance and review: Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Group Credit Risk Assurance, a Group level function comprising experienced credit professionals, is also in place. In conjunction with Risk senior management, this team carries out independent risk based credit reviews, providing individual business unit assessment of the effectiveness of risk management practices and adherence to risk controls across the diverse range of the Group's wholesale businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical ('standard') credit reviews, non-standard reviews, project reviews, credit risk rating model reviews and bespoke assignments, including impairment reviews as required. The work of Group Credit Risk Assurance continues to provide executive and senior management with assurance and guidance on credit quality, effectiveness of credit risk controls and accuracy of impairments.

The determination of cash flows for cases in the Business Support Units (BSU) is undertaken by a specialist risk team who gather a range of information from various sources including the customer, professional advisers and the Group's own credit teams to fully understand and appraise the customer's business and circumstances. A more detailed assessment is undertaken to assist in reducing risk exposure and highlighting potential strategic options. This often involves the Group, in addition to using its own internal experts, engaging professional advisers to perform Independent Business Reviews (IBRs) and, where relevant, independently value collateral held. In more complex cases, such as those involving work-out strategies, the review may also involve:

– critically assessing customer's ability to successfully manage the business effectively in a distressed situation where turnaround is required;
– analysis of market sector factors, i.e. products, customers, suppliers, pricing and margin issues;
– performance review of operational areas that should be considered in terms of current effectiveness and efficiency and scope for improvements;
– financial analysis to model plans and factor in potential sensitivities, vulnerabilities and upsides; and
– determining the most appropriate corporate and capital structure suitable for the work-out strategy concerned.

The above assessment, monitoring and control processes continue throughout the period the case is managed within the BSU.

Collateral

The principal collateral types for loans and advances are:

– mortgages over residential and commercial real estate;
– charges over business assets such as premises, inventory and accounts receivables;
– charges over financial instruments such as debt securities and equities; and
– guarantees received from third parties.

The Group maintains guidelines on the acceptability of specific classes of collateral.

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Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement.

It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. Collateral is reviewed on a regular basis in accordance with business unit credit policy, which will vary according to the type of lending and collateral involved. For residential mortgages, the Group adjusts open market property values to take account of the costs of realisation and any discount associated with the realisation of the collateral. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are identified for the relevant individual loans and advances.

The Group considers risk concentrations by collateral providers and collateral type, as appropriate, with a view to ensuring that any potential undue concentrations of risk are identified and suitably managed by changes to strategy, policy and/or business plans.

Master netting agreements

Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), the Group enters into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since it is affected by each transaction subject to the agreement.

Other credit risk transfers

The Group also undertakes asset sales, securitisations and credit derivative based transactions as a means of mitigating or reducing credit risk, taking into account the nature of assets and the prevailing market conditions.

Monitoring

In conjunction with Risk, businesses identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Risk Division in turn produces an aggregated review of credit risk throughout the Group, including reports on significant credit exposures, which are presented to the Group Risk Committee and the Board Risk Committee.

The performance of all rating models is monitored on a regular basis, in order to seek to ensure that models provide appropriate risk differentiation capability, the generated ratings remain as accurate and robust as practical, and the models assign appropriate risk estimates to grades/pools. All models are monitored against a series of agreed key performance indicators. In the event that the monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated in accordance with the governance framework set by the Group Model Governance Committee.

Intensive care of customers in difficulty

Retail Assets

The Group's aim in offering forbearance and other assistance to retail customers in financial distress is to benefit both the customer and the Group by: discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests; and bringing customer facilities back into a sustainable position which, for residential mortgages, also means keeping customers in their homes.

The Group offers a range of tools and assistance to support retail customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework; controls around the execution of policy; regular review of the different treatments to confirm that they remain appropriate; monitoring of customers' performance and the level of payments received; and management visibility of the nature and extent of assistance provided and the associated risk.

Assistance is provided through trained colleagues in branches and dedicated telephony units, and via online guidance material. For those customers requiring more intensive help, assistance is provided through dedicated support units where tailored repayment programmes can be agreed. Customers are actively supported and referred to free money advice agencies when they have multiple credit facilities, including those at other lenders, that require restructuring. Within the Collections and Recoveries functions, the sharing of best practice and alignment of policies across the Group has helped to drive more effective customer outcomes and achieve operational efficiencies.

One component of our relationship management approach is to contact customers showing signs of financial difficulty, discussing with them their circumstances and offering solutions to prevent their accounts falling into arrears.

The specific tools available to assist customers vary by territory and product and the customer's status. In defining the treatments offered to customers who have experienced financial distress, the Group distinguishes between the following three categories:

– Forbearance – a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments such as a temporary capital payment break.
– Financial distress assistance – an account change for customers in financial distress where arrears accrue at the contractual payment such as a short-term arrangement to pay.

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– Repair – an account change used to repair a customer's position when they have emerged from financial difficulty, such as capitalisation of arrears when a payment track record has been re-established.

To assist customers in financial distress, the Group also participates in, or benefits from, the following UK Government (Government) sponsored programmes for households:

– Income Support for Mortgage Interest: This is a Government medium-term initiative that provides certain defined categories of customers, principally those who are unemployed, access to a benefit scheme, paid for by the Government, which covers all or part of the interest on the mortgage. Qualifying customers are able to claim for mortgage interest on up to £200,000 of the mortgage. All decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the Government. Payments are made directly to the Group by the appropriate Government department.

– Homeowner Mortgage Support Scheme: This is a Government medium-term initiative that enables borrowers affected by temporary reductions in income to access reduced payments for a period of up to two years. The Government provides a partial guarantee to the Group whilst a customer participates in the plan. Decisions on eligibility, principally whether the Group expects the borrower's earnings to recover fully, initially rest with the Group and must be made on the basis of detailed information received from an independent fee-free advisor. After a year, the customer must undergo a further full assessment made by the advice agency. The customer must pay at least 30 per cent of the interest due. Any shortfall in payments made during the period covered by the scheme is collected through increased payments over the remaining term. The scheme was closed to new customer applications in April 2011 by the Department of Communities and Local Government.

– Mortgage Rescue Scheme: This is a Government short-term initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full.

Wholesale Assets (including Commercial)

In order to support wholesale customers that encounter difficulties during the current economic downturn, the Group increased the size of its dedicated Business Support Unit (BSU) to cover all its UK and International portfolios.

Wholesale credit facilities are reviewed on a regular basis and more frequently where required. When financial stress is exhibited, the customer would be transferred at an early stage to our specialist BSU and Customer Support teams.

The over-arching aim of BSU is to work with each customer to try and resolve the issues, to restore the business to a financially viable position and facilitate a business turnaround. This could be through a number of channels, including providing advice on how to develop and implement turnaround strategies, and considering potential restructuring of debt and forbearance. This may involve using turnaround professionals, for example accountants and valuers.

BSU Relationship Managers are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and ongoing close scrutiny by senior management. Exposure is minimised through a combination of appropriate forbearance, asset sales, restructuring and work-out strategies.

Customer Support provides intensive care and support to Commercial SME customers in difficulty. Whilst the customer relationship remains with the Relationship Manager, they are supported by a Customer Support Manager to oversee and manage identified risk.

The main types of forbearance for wholesale customers in financial distress could include:

– Covenant resets and breach of covenant waivers

– Extension of facilities outside of agreed terms

– Capital repayment holidays

– Debt for Equity swaps

– Partial debt write off

Forbearance alone is not necessarily an indicator of impairment but will always be a trigger point for the Bank to review the customer's credit and assess whether the risk has changed.

Multiple types of forbearance concessions often occur on the more distressed cases managed in BSU or Customer Support. Each case is treated depending on its own specific circumstances and our strategy and offer of forbearance is largely dependent on the individual situation. Early identification, control and monitoring are key.

One of the components of the approach to forbearance and early identification of issues used for wholesale assets is our Credit Risk Classification Policy, which is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. This policy includes our good book/mainstream early warning process identifying "Special Mention" and "Sub Standard" cases. This process seeks to ensure that Relationship Managers act promptly to identify, and highlight to senior management, customers that have the possibility to become higher risk in the future. Customers classified as Special Mention/Sub Standard are subject to additional controls and regular monitoring routines, including oversight by BSU and the independent Credit Sanctioning function.

Concessions granted under forbearance would be classified in our Credit Risk Classification system according to the severity of the customer's financial distress. Management information is produced which gives a high level view of asset quality, with clearly defined parameters and features. Trends and warning signs are reported and advised to senior management promptly, which include issues not yet identified by rating models. A robust review and challenge process is applied to each credit if asset quality declines, initiating an appropriate and measured response. As the financial stress of a credit deteriorates the Credit Risk Classification helps to determine the route and management of the customer. Repeat

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transgressions of forbearance would be reflected in the strategy to manage the customer and an objective reassessment of any impairment will be undertaken on a regular basis. This is subject to independent review and sanctioning.

In addition, the Group, through its banking businesses, participates in a number of initiatives designed to assist small and medium-sized enterprises. These include:

- The Lending Code: Introduced by the British Bankers' Association in November 2009, the Lending Code is a voluntary set of commitments and standards of good practice to ensure that lenders act fairly and reasonably in all dealings with customers. This has been reviewed and updated in March 2011, not only to incorporate the key elements of the Statement of Principles, a previously issued brochure which outlined an agreed approach to working with micro-enterprise customers (entities with fewer than 10 employees and having a turnover of less than €2 million), but also to introduce key elements of the work of the Business Finance Taskforce (see below). A leaflet 'A Guide to the Lending Code for Micro-enterprises' provides an introduction to the standards customers should expect from the banks, building societies and credit-card providers who follow the Lending Code.
- Business Finance Taskforce: The Group through its banking businesses has taken a leading role in the Business Finance Taskforce, which committed to a number of key actions in three broad areas: (i) improving customer relationships; (ii) ensuring better access to finance and (iii) providing better information and promoting customer understanding. Key elements of this include:
  - The lending appeals process: If a lending application is declined, customers have the right to appeal that decision. We have committed to respond to 90 per cent of appeals with a decision within 15 working days.
  - The finance application checklist: Details of the type of information we may ask customers to provide in order to support their lending application.
  - Business mentoring: Businesses may benefit from the support of a business mentor. www.mentorsme.co.uk is a free online service that enables businesses to locate local independent mentoring organisations that suit their specific business needs.
- 2012 SME Charter: Our 2012 SME Charter details our commitment to supporting UK business and incorporates our pledge to support any viable business through temporary difficulties and into recovery. As part of our commitment to this, we issue a Letter of Concern to customers when we have concerns about their business or the Group's relationship with them. This aims to generate early dialogue between the customer and the Group, so that a joint approach to the situation can be agreed with them.

The Group's accounting policy for loan renegotiations and forbearance is set out in note 2(H) to the financial statements.

Our credit risk portfolio in 2011

Overview

- The Group achieved a significant reduction in its impairment charge in 2011 to £9,787 million (from £13,181 million in 2010), due primarily to lower corporate real estate and real estate related charges in Wholesale, lower charges in the Irish portfolio together with strong Retail performance. All divisions experienced impairment charge reductions by over 20 per cent from 2010.
- These lower charges were principally supported by the continued application of our prudent risk appetite and strong risk management controls resulting in improved portfolio and new business quality, continued low interest rates, and broadly stable UK property prices, partly offset by weakening UK economic growth and rising unemployment.
- The Group's overall core impairment charge during 2011 was materially lower compared to 2010, due primarily to strong Retail performance offset by higher core impairments in Wholesale due to a few specific cases.
- The Group's non-core impairment charge in 2011 was also materially lower compared to 2010. This is primarily driven by lower impairment from the non-core corporate real estate and real estate related lending portfolios in Wholesale, together with the non-core Irish portfolio.
- Prudent credit policies and procedures are in place throughout the Group, focusing on development of enduring client relationships. As a result of this approach, the credit quality of new lending remains strong.
- The Group's more difficult exposures are being managed successfully in the current challenging economic environment by the Wholesale Business Support Units and Retail Collection and Recovery Units. The Group's exposure to Ireland has been closely managed, with a dedicated UK-based business support team in place to manage the winding down of the Irish book.
- The Group continues to proactively manage down sovereign as well as banking and trading book exposure to selected Eurozone countries.
- Divestment strategy is focused on balance sheet reduction and disposal of higher risk positions.

Table 1.19: **Impairments on Group loans and advances (audited)**

	2011 £m	2010 £m	Change %
Retail	**1,970**	2,747	28
Wholesale	**2,901**	4,064	29
Commercial	**303**	382	21
Wealth and International	**4,610**	5,988	23
Central items	**3**	–	
Total impairment charge	**9,787**	13,181	26

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Table 1.20: **Impairment charge by division (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Retail	**356,907**	**8,822**	**2.5**	**2,718**	**30.8**
Wholesale	**135,395**	**27,756**	**20.5**	**11,537**	**41.6**
Commercial	**29,681**	**2,915**	**9.8**	**880**	**30.2**
Wealth and International	**56,394**	**20,776**	**36.8**	**12,583**	**60.6**
Reverse repos and other items	**17,066**	**–**	**–**	**–**	**–**
	595,443	**60,269**	**10.1**	**27,718**	**46.0**
Impairment provisions[1]	**(27,718)**				
Fair value adjustments[2]	**(2,087)**				
Total Group	**565,638**				
At 31 December 2010					
Retail	368,981	9,750	2.6	3,096	31.8
Wholesale	158,002	31,658	20.0	14,863	46.9
Commercial	29,649	2,856	9.6	992	34.7
Wealth and International	66,368	20,342	30.7	10,684	52.5
Reverse repos and other items	3,378	–	–	–	–
	626,378	64,606	10.3	29,635	45.9
Impairment provisions[1]	(29,635)				
Fair value adjustments[2]	(4,146)				
Total Group	592,597				

[1] Impairment provisions include collective unimpaired provisions.

[2] The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Company's consolidated financial records at their fair value and took into account both the expected future impairment losses and market liquidity at the date of acquisition. The unwind relating to future impairment losses requires significant management judgement to determine its timing which includes an assessment of whether the losses incurred in the current period were expected at the date of the acquisition and assessing whether the remaining losses expected at the date of the acquisition will still be incurred. The element relating to market liquidity unwinds to the income statement over the estimated useful lives of the related assets (until 2014 for wholesale loans and 2018 for retail loans) although if an asset is written off or suffers previously unexpected impairment then this element of the fair value will no longer be considered a timing difference (liquidity) but permanent (impairment). In 2011, a net credit of £1,943 million (2010: £3,118 million) relates to the unwind of HBOS acquisition fair value adjustments. Of that amount, £1,693 million (2010: £2,229 million) relates to impairment losses incurred which were expected at the date of acquisition. The fair value unwind in respect of loans and advances is expected to continue to decrease in future years as fixed-rate periods on mortgages expire, loans are repaid or written off, and will reduce to zero over time.

Table 1.21: **Total impairment charge (audited)**

	2011 £m	2010 £m	Change %
Total impairment losses on loans and advances to customers	**9,712**	12,958	25
Loans and advances to banks	**–**	(13)	
Debt securities classified as loans and receivables	**49**	57	14
Available-for-sale financial assets	**81**	115	30
Other credit risk provisions	**(55)**	64	
Total impairment charge	**9,787**	13,181	26

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Table 1.22: **Impairment charge by division – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Retail	**328,524**	**7,151**	**2.2**	**2,310**	**32.3**
Wholesale	**78,772**	**3,904**	**5.0**	**2,320**	**59.4**
Commercial	**28,289**	**2,885**	**10.2**	**858**	**29.7**
Wealth and International	**7,991**	**265**	**3.3**	**100**	**37.7**
Reverse repos and other items	**17,066**	**–**	**–**	**–**	**–**
	460,642	**14,205**	**3.1**	**5,588**	**39.3**
Impairment provisions	**(5,588)**				
Fair value adjustments	**(1,171)**				
Total Group	**453,883**				
At 31 December 2010					
Retail	338,174	8,067	2.4	2,715	33.7
Wholesale	87,892	4,430	5.0	2,323	52.4
Commercial	27,618	2,835	10.3	976	34.4
Wealth and International	8,435	202	2.4	74	36.6
Reverse repos and other items	3,378	–	–	–	–
	465,497	15,534	3.3	6,088	39.2
Impairment provisions	(6,088)				
Fair value adjustments	(2,138)				
Total Group	457,271				

[1] Impairment provisions include collective unimpaired provisions.

Table 1.23: **Total impairment charge – core (unaudited)**

	2011 £m	2010 £m	Change %
Retail	**1,796**	2,629	32
Wholesale	**741**	576	(29)
Commercial	**296**	381	22
Wealth and International	**51**	26	(96)
Central items	**3**	–	
Total impairment charge	**2,887**	3,612	20

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Table 1.24: **Impairment charge by division – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Retail	**28,383**	**1,671**	**5.9**	**408**	**24.4**
Wholesale	**56,623**	**23,852**	**42.1**	**9,217**	**38.6**
Commercial	**1,392**	**30**	**2.2**	**22**	**73.3**
Wealth and International	**48,403**	**20,511**	**42.4**	**12,483**	**60.9**
Reverse repos and other items	**–**	**–**	**–**	**–**	**–**
	134,801	**46,064**	**34.2**	**22,130**	**48.0**
Impairment provisions	**(22,130)**				
Fair value adjustments	**(916)**				
Total Group	**111,755**				
At 31 December 2010					
Retail	30,807	1,683	5.5	381	22.6
Wholesale	70,110	27,228	38.8	12,540	46.1
Commercial	2,031	21	1.0	16	76.2
Wealth and International	57,933	20,140	34.8	10,610	52.7
Reverse repos and other items	–	–	–	–	–
	160,881	49,072	30.5	23,547	48.0
Impairment provisions	(23,547)				
Fair value adjustments	(2,008)				
Total Group	135,326				

[1] Impairment provisions include collective unimpaired provisions.

Table 1.25: **Total impairment charge – non-core (unaudited)**

	2011 £m	2010 £m	Change %
Retail	**174**	118	(47)
Wholesale	**2,160**	3,488	38
Commercial	**7**	1	
Wealth and International	**4,559**	5,962	24
Total impairment charge	**6,900**	9,569	28

Pages 138 to 155 provide the Credit risk divisional split.

Outlook – Group

The UK economy is fragile with a weak short-term economic outlook generally expected. Consumer and business confidence remains low, relatively high inflation has reduced consumer spending power and exports are falling.

In addition to the possibility of further economic deterioration, financial market instability represents an additional downside risk. Uncertainty over the best way forward for the highly indebted Eurozone persists and poses a serious threat to the global economic recovery, with political instability and contagion to other Eurozone countries increasing in the last quarter of 2011. Financial markets are expected to remain dislocated and volatile, with the risk of contagion unlikely to dissipate in the near term, and this continues to place strains on funding markets at a time when many financial institutions (in particular) have material ongoing funding needs.

The Group's Wholesale leveraged finance portfolios and its commercial real estate and real estate related property lending portfolios remain particularly vulnerable, especially in the significant secondary and tertiary asset lending book. The impact of further economic weakness will also be felt in the traditional lending portfolios in Corporate and Commercial. In addition, the Irish economic outlook remains challenging and the property market depressed, and both these factors could further adversely impact the wholesale and retail Irish portfolios.

However, despite the downside risks, against its base case economic assumptions, the Group expects the total impairment charge in 2012 to reduce by a similar percentage amount to the reduction in 2011, reflecting the stabilisation of its portfolios and proactive risk management activities.

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Credit Risk – Retail

Overview

– The Retail impairment charge was £1,970 million in 2011, a decrease of £777 million, or 28 per cent, from 2010.

– The decrease in the Retail impairment charge was driven by the unsecured portfolio as a result of the improved quality of new business and effective portfolio management. The Retail impairment charge for loans and advances to customers, as an annualised percentage of average loans and advances to customers, decreased to 0.54 per cent in 2011 from 0.74 per cent in 2010.

– The overall value of assets entering arrears in 2011 were lower in both unsecured and secured lending compared to 2010.

– Non-core represents 8 per cent of total Retail assets as at 31 December 2011 and is primarily Specialist mortgages which is closed to new business and has been in run-off since 2009.

Table 1.26: **Retail impairment charge**

(audited)	**2011 £m**	2010 £m	Change %
Secured	**463**	292	(59)
Unsecured	**1,507**	2,455	39
Total impairment charge	**1,970**	2,747	28
(unaudited)	**2011 £m**	2010 £m	Change %
Core:			
Secured	**330**	250	
Unsecured	**1,466**	2,379	
	1,796	2,629	32
Non-core:			
Secured	**133**	42	
Unsecured	**41**	76	
	174	118	(47)
Total impairment charge	**1,970**	2,747	28

Impaired loans and provisions

Retail impaired loans decreased by £0.9 billion to £8.8 billion compared with 31 December 2010 and, as a percentage of closing loans and advances to customers, decreased to 2.5 per cent from 2.6 per cent at 31 December 2010. Impairment provisions, as a percentage of impaired loans, reduced to 30.8 per cent from 31.8 per cent at 31 December 2010.

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The Retail division's loans and advances to customers are analysed in the following table:

Table 1.27: **Impairments on Retail loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
As at 31 December 2011					
Secured	**332,143**	**6,452**	**1.9**	**1,651**	**25.6**
Unsecured:					
Collections		**1,233**	**5.0**	**1,067**	**86.5**
Recoveries[2]		**1,137**	**4.6**	**–**	
	24,764	**2,370**	**9.6**	**1,067**	
Total gross lending	**356,907**	**8,822**	**2.5**	**2,718**	**30.8**
Impairment provisions[1]	**(2,718)**				
Fair value adjustments	**(1,377)**				
Total	**352,812**				
As at 31 December 2010					
Secured	341,069	6,769	2.0	1,589	23.5
Unsecured:					
Collections		1,826	6.6	1,507	82.5
Recoveries[2]		1,155	4.1	–	
	27,912	2,981	10.7	1,507	
Total gross lending	368,981	9,750	2.6	3,096	31.8
Impairment provisions[1]	(3,096)				
Fair value adjustments	(2,154)				
Total	363,731				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

The Retail division's loans and advances to customers are analysed in the following table:

Table 1.28: **Retail loans and advances to customers (audited)**

	2011 £m	2010 £m
Secured:		
Mainstream	**256,518**	265,368
Buy to let	**48,276**	46,356
Specialist	**27,349**	29,345
	332,143	341,069
Unsecured:		
Credit cards	**10,192**	11,207
Personal loans	**11,970**	13,881
Bank accounts	**2,602**	2,624
Others	**–**	200
	24,764	27,912
Total Retail gross lending	**356,907**	368,981

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Table 1.29: **Impairments on Retail loans and advances – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Secured	**304,589**	**4,895**	**1.6**	**1,265**	**25.8**
Unsecured:					
Collections		**1,202**	**5.0**	**1,045**	**86.9**
Recoveries[2]		**1,054**	**4.4**	**–**	
	23,935	**2,256**	**9.4**	**1,045**	
Total gross lending	**328,524**	**7,151**	**2.2**	**2,310**	**32.3**
Impairment provisions	**(2,310)**				
Fair value adjustments	**(1,111)**				
Total Retail	**325,103**				
As at 31 December 2010					
Secured	311,500	5,231	1.7	1,247	23.8
Unsecured:					
Collections		1,777	6.6	1,468	82.6
Recoveries[2]		1,059	4.0	–	
	26,674	2,836	10.6	1,468	
Total gross lending	338,174	8,067	2.4	2,715	33.7
Impairment provisions	(2,715)				
Fair value adjustments	(1,755)				
Total Retail	333,704				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

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Table 1.30: **Impairments on Retail loans and advances – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Secured	**27,554**	**1,557**	**5.7**	**386**	**24.8**
Unsecured:					
Collections		**31**	**3.8**	**22**	**71.0**
Recoveries[2]		**83**	**10.0**	**–**	
	829	**114**	**13.8**	**22**	
Total gross lending	**28,383**	**1,671**	**5.9**	**408**	**24.4**
Impairment provisions	**(408)**				
Fair value adjustments	**(266)**				
Total Retail	**27,709**				
As at 31 December 2010					
Secured	29,569	1,538	5.2	342	22.2
Unsecured:					
Collections		49	4.0	39	79.6
Recoveries[2]		96	7.7	–	
	1,238	145	11.7	39	
Total gross lending	30,807	1,683	5.5	381	22.6
Impairment provisions	(381)				
Fair value adjustments	(399)				
Total Retail	30,027				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

Secured

Secured impairment charge

The impairment charge increased by £171 million, to £463 million in 2011 compared to the previous year. The impairment charge as a percentage of average loans and advances to customers, increased to 0.14 per cent from 0.09 per cent in 2010. The provision coverage increased reflecting a less certain outlook on house prices and appropriate provisioning against existing credit risks which have longer emergence periods due to current low interest rate environment, partially offset by underlying improvements in the quality of the portfolio.

Impairment provisions held against secured assets reflect the Group's view of appropriate allowance for incurred losses. The Group holds appropriate impairment provisions for customers who are experiencing financial difficulty, either on a forbearance arrangement or who may be able to maintain their repayments whilst interest rates remain low. At December 2011, 1.2 per cent of loan balances were on a forbearance arrangement, compared to 1.3 per cent at 31 December 2010.

Secured impaired loans

Impaired loans decreased by £0.3 billion to £6.5 billion at 31 December 2011 and, as a percentage of closing loans and advances to customers, reduced to 1.9 per cent from 2.0 per cent at 31 December 2010.

The number of customers going into arrears reduced throughout 2011 in comparison with 2010. Specialist lending remains closed to new business and this book has been in run-off since 2009.

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Secured arrears

The percentage of mortgage cases greater than three months in arrears (excluding repossessions) remained stable at 2.3 per cent at 31 December 2011 compared to 31 December 2010 and 30 June 2011. The percentage of Specialist mortgage cases greater than three months in arrears (excluding repossessions) increased to 7.5 per cent at 31 December 2011 from 6.4 per cent at 31 December 2010 with the majority of this growth occurring in the first half of 2011.

Table 1.31: **Mortgages greater than three months in arrears (excluding repossessions) (unaudited)**

	Number of cases		Total mortgage accounts %	
	31 Dec 2011 Cases	31 Dec 2010 Cases	**31 Dec 2011 %**	31 Dec 2010 %
Greater than three months in arrears (excluding repossessions)				
Mainstream	**53,734**	55,675	**2.0**	2.1
Buy to let	**7,805**	7,577	**1.8**	1.8
Specialist	**13,677**	12,582	**7.5**	6.4
Total	**75,216**	75,834	**2.3**	2.3

	Value of debt[1]		Total mortgage balances %	
	31 Dec 2011 £m	31 Dec 2010 £m	**31 Dec 2011 %**	31 Dec 2010 %
Greater than three months in arrears (excluding repossessions)				
Mainstream	**5,988**	6,247	**2.3**	2.4
Buy to let	**1,145**	1,157	**2.4**	2.5
Specialist	**2,427**	2,262	**8.9**	7.7
Total	**9,560**	9,666	**2.9**	2.8

[1] Value of debt represents total book value of mortgages in arrears.

The stock of repossession was stable with 3,043 cases at 31 December 2010 and 3,054 at 31 December 2011, and is broadly consistent with prior years and below the Council of Mortgage Lender's average.

Secured loan to value analysis

The average indexed loan-to-value (LTV) on the mortgage portfolio at 31 December 2011 was 55.9 per cent compared with 55.6 per cent at 31 December 2010. The average LTV for new mortgages and further advances written in 2011 was 62.1 per cent compared with 60.9 per cent for 2010. The tables below show LTVs across the principal mortgage portfolios.

The indexed LTV in excess of 100 per cent as a percentage of closing loans and advances ending 31 December 2011 reduced to 12.0 per cent (£39.7 billion), compared with 13.2 per cent (£44.9 billion) at 31 December 2010. This decrease in negative equity was driven by the regional mix of business being biased towards areas experiencing house price growth despite national house prices falling.

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Table 1.32: **Actual and average LTVs across the Retail mortgage portfolios (audited)**

	Mainstream %	Buy to let %	Specialist[1] %	Total %
At 31 December 2011				
Less than 60%	**32.5**	**12.7**	**14.6**	**28.1**
60% to 70%	**12.7**	**13.0**	**10.1**	**12.5**
70% to 80%	**17.2**	**24.1**	**17.2**	**18.2**
80% to 90%	**16.0**	**17.3**	**19.3**	**16.5**
90% to 100%	**11.2**	**17.1**	**19.0**	**12.7**
Greater than 100%	**10.4**	**15.8**	**19.8**	**12.0**
Total	**100.0**	**100.0**	**100.0**	**100.0**
Average loan-to-value:[2]				
Stock of residential mortgages	**52.2**	**74.0**	**72.6**	**55.9**
New residential lending	**61.4**	**65.8**	**n/a**	**62.1**
Impaired mortgages	**72.0**	**99.8**	**88.0**	**78.4**
At 31 December 2010				
Less than 60%	33.0	11.4	14.0	28.5
60% to 70%	12.1	11.1	9.4	11.7
70% to 80%	16.1	21.9	15.9	16.8
80% to 90%	15.3	18.0	21.3	16.2
90% to 100%	11.9	19.1	20.0	13.6
Greater than 100%	11.6	18.5	19.4	13.2
Total	100.0	100.0	100.0	100.0
Average loan-to-value:[2]				
Stock of residential mortgages	51.9	75.6	72.9	55.6
New residential lending	60.0	66.5	n/a	60.9
Impaired mortgages	72.3	97.8	87.3	78.0

[1] Specialist lending is closed to new business and is in run-off.

[2] Average loan-to-value is calculated as total loans and advances as a percentage of the total collateral assigned to these loans and advances.

Unsecured

In 2011 the impairment charge on loans and advances to customers reduced by £948 million to £1,507 million compared with 2010. This reflected continued improving business quality and portfolio trends resulting from the Group's conservative risk appetite, with a focus on lending to existing customers.

A combination of the Group's risk appetite, reduced demand from customers for new unsecured borrowing and existing customers continuing to reduce their personal indebtedness contributed to loans and advances to customers reducing by £3.1 billion to £24.8 billion at 31 December 2011.

The impairment charge as a percentage of average loans and advances to customers decreased to 5.66 per cent in 2011 from 8.11 per cent in 2010, with the impairment charge reducing at a greater rate than the reduction in average loans and advances in 2011.

Impaired loans decreased by £0.6 billion to £2.4 billion which represented 9.6 per cent of closing loans and advances to customers at 31 December 2011, compared with 10.7 per cent at 31 December 2010. The reduction in impaired loans is a result of tightening credit policy across the credit lifecycle, including stronger controls on customer affordability. Retail's exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers' changing financial circumstances. The portfolios show a level of early arrears for accounts acquired since 2009 which are at pre-recession levels, highlighting an underlying improvement in the risk profile of the business.

Impairment provisions decreased by £0.4 billion, compared with 31 December 2010, to £1.1 billion. This reduction was primarily a result of the movement of assets from Collections to Recoveries, at which point they are written down to the present value of future expected cash flows. The proportion of impaired loans that have been written down to the present value of future expected cash flows on these assets has increased to 48.0 per cent at 31 December 2011 from 38.7 per cent at 31 December 2010. Impairment provisions as a percentage of impaired loans in collections increased to 86.5 per cent at 31 December 2011 from 82.5 per cent at 31 December 2010.

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Credit Risk – Wholesale

Overview

– Impairment losses for 2011 decreased significantly to £2,901 million, from £4,064 million for 2010.

– The decrease in the underlying impairment charge during 2011 is primarily driven by lower impairment from the corporate real estate and real estate-related lending portfolios, partly offset mainly by higher impairment on leveraged acquisition finance exposures during 2011 where the dampened effect of UK economic conditions had the most impact.

– Whilst subdued UK economic conditions and weaker consumer confidence is evident in a number of sectors, the reduction in the impairment charge also reflects continued strong risk management and the low interest rate environment, helping to maintain defaults at a lower level.

– The Group has proactively managed down sovereign as well as banking and trading book exposures to selected European countries. Divestment strategy was focused on balance sheet reduction and disposing of higher risk positions.

– A robust credit risk management and control framework is in place across the combined portfolios and a prudent risk appetite approach continues to be embedded across the division. Significant resources continue to be deployed into the Business Support Units, which focuses on key and vulnerable obligors and asset classes.

Table 1.33: **Wholesale impairment charge (unaudited)**

	2011 £m	2010 £m	Change %
Wholesale excluding Asset Finance	**2,701**	3,800	29
Asset Finance	**200**	264	24
Total impairment charge	**2,901**	4,064	29
Core	**741**	576	(29)
Non-core	**2,160**	3,488	38
Total impairment charge	**2,901**	4,064	29

Wholesale's impairment charge decreased £1,163 million, or 29 per cent, compared to £4,064 million during 2010. Despite a subdued UK economic environment in 2011, impairment charges have decreased substantially compared with 2010 due to robust proactive risk management, an appropriately impaired portfolio (against our current economic assumptions) and a low interest rate environment helping to maintain defaults at a lower level. Impairment charges as an annualised percentage of average loans and advances to customers reduced to 1.95 per cent from 2.23 per cent in 2010.

Impairment charge – core

Core impairments during 2011 were higher compared to 2010, which is primarily attributable to a few specific cases reflecting the nature of impairments in a wholesale portfolio.

Impairment charge – non-core

Non-core impairments in 2011 were lower than 2010, primarily reflecting lower impairment from non-core corporate real estate and real estate related asset portfolios. This reflected a stabilisation of commercial property prices in 2011. Non-core impairments in 2010 (particularly the first half) were significant as a result of the scale and pace of deterioration in the property sector and poorer quality heritage HBOS lending.

Impaired loans and provisions

Wholesale's impaired loans reduced by £3,902 million to £27,756 million compared with 31 December 2010. The reduction is due to new impaired assets mainly in the Corporate Real Estate Business Support Unit being more than offset by write-offs on irrecoverable assets, the sale of previously impaired assets, net repayments and transfers back to good book. Furthermore, the flow of assets into impaired status reduced during the year compared to 2010. Impairment provisions also reduced as a result of write-offs and a lower impairment rate on newly impaired assets especially in the corporate real estate and real estate related portfolios. As a result of this, impairment provisions as a percentage of impaired loans reduced to 41.6 per cent from 46.9 per cent at 31 December 2010.

As a percentage of closing loans and advances to customers, impaired loans increased to 20.5 per cent from 20.0 per cent at 31 December 2010. This increase is a result of the reducing level of total loans and advances to customers as at 31 December 2011 compared with 31 December 2010. We continue to monitor our vulnerable portfolios within Wholesale and, where appropriate, remedial risk mitigating actions are being undertaken.

Impaired loans and provisions – core

Core impaired loans reduced by £526 million to £3,904 million compared with 31 December 2010. The reduction is primarily due to the restructuring of assets. These restructured assets had a lower impairment coverage resulting in core impairment provisions as a percentage of core impaired loans increasing to 59.4 per cent from 52.4 per cent at 31 December 2010. As a percentage of closing core advances, core impaired loans remained unchanged compared 31 December 2010 at 5.0 per cent.

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Impaired loans and provisions – non-core

Non-core impaired loans reduced by £3,376 million to £23,852 million compared with 31 December 2010. The reduction reflects the strategy to de-risk the Group through deleverage of the non-core portfolio, with significant disposals achieved mostly in the real estate and leveraged finance portfolios. These portfolios continue to be the main contributor of newly impaired assets, but lower coverage ratios are required now than seen in previous years. This is driving the reduced coverage ratio. Non-core impairment provisions as a percentage of non-core impaired loans reduced to 38.6 per cent from 46.1 per cent at 31 December 2010. As a percentage of closing non-core advances, impaired loans increased to 42.1 per cent from 38.8 per cent at 31 December 2010. This increase is a result of impaired loans reducing more slowly than total non-core advances.

Non-core impairment provisions as a percentage of non-core impaired assets are lower at 38.6 per cent compared to 59.4 per cent for core, mainly a factor of the asset mix, where the non-core portfolios are heavily weighted toward real estate and real estate related portfolios where security is often a larger influence on the impairment outcome.

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Table 1.34: **Impairments on Wholesale loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
As at 31 December 2011					
Corporate	**68,772**	**5,631**	**8.2**	**3,051**	**54.2**
Corporate Real Estate BSU	**21,326**	**15,211**	**71.3**	**5,631**	**37.0**
Wholesale Equity	**113**	**113**	**100.0**	**100**	**88.5**
Wholesale Markets	**35,802**	**5,584**	**15.6**	**2,009**	**36.0**
Treasury and Trading	**2,220**	**–**	**–**	**–**	**–**
Asset Finance	**7,162**	**1,217**	**17.0**	**746**	**61.3**
Total Wholesale	**135,395**	**27,756**	**20.5**	**11,537**	**41.6**
Reverse repos	**16,836**				
Impairment provisions	**(11,537)**				
Fair value adjustments	**(617)**				
Loans and advances to customers	**140,077**				
Loans and advances to banks	**8,443**				
Debt securities[2]	**12,489**				
Available-for-sale financial assets[3]	**12,554**				

[1] Impairment provisions include collective unimpaired provisions.
[2] Of which Wholesale Markets is £12,135 million, Wholesale Equity £195 million, Treasury and Trading £150 million, Asset Finance £7 million, and Corporate £2 million.
[3] Of which Wholesale Markets is £7,798 million, Wholesale Equity £1,797 million, Treasury and Trading £2,922 million and Corporate £37 million.

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2010					
Corporate	80,670	6,635	8.2	3,629	54.7
Corporate Real Estate BSU	26,151	17,518	67.0	8,092	46.2
Wholesale Equity	140	108	77.1	107	99.1
Wholesale Markets	40,042	5,718	14.3	1,992	34.8
Treasury and Trading	1,050	–	–	–	–
Asset Finance	9,949	1,679	16.9	1,043	62.1
Total Wholesale	158,002	31,658	20.0	14,863	46.9
Reverse repos	3,096				
Impairment provisions	(14,863)				
Fair value adjustments	(1,562)				
Loans and advances to customers	144,673				
Loans and advances to banks	12,401				
Debt securities[2]	25,779				
Available-for-sale financial assets[3]	29,458				

[1] Impairment provisions include collective unimpaired provisions.
[2] Of which Wholesale Markets is £25,120 million, Wholesale Equity £487 million, Treasury and Trading £163 million, Asset Finance £7 million, Corporate £2 million and Commercial £2 million.
[3] Of which Wholesale Markets is £21,279 million, Wholesale Equity £2,109 million, Treasury and Trading £6,011 million and Corporate £59 million.

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Table 1.35: **Impairments on Wholesale loans and advances – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Total Wholesale	**78,772**	**3,904**	**5.0**	**2,320**	**59.4**
Reverse repos	**16,836**				
Impairment provisions	**(2,320)**				
Fair value adjustments	**(9)**				
Loans and advances to customers	**93,279**				
Loans and advances to banks	**8,153**				
Debt securities	**155**				
Available-for-sale financial assets	**3,110**				
At 31 December 2010					
Total Wholesale	87,892	4,430	5.0	2,323	52.4
Reverse repos	3,096				
Impairment provisions	(2,323)				
Fair value adjustments	(136)				
Loans and advances to customers	88,529				
Loans and advances to banks	11,994				
Debt securities	402				
Available-for-sale financial assets	7,377				

[1] Impairment provisions include collective unimpaired provisions.

Table 1.36: **Impairments on Wholesale loans and advances – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Total Wholesale	**56,623**	**23,852**	**42.1**	**9,217**	**38.6**
Reverse repos	**–**				
Impairment provisions	**(9,217)**				
Fair value adjustments	**(608)**				
Loans and advances to customers	**46,798**				
Loans and advances to banks	**290**				
Debt securities	**12,334**				
Available-for-sale financial assets	**9,444**				
At 31 December 2010					
Total Wholesale	70,110	27,228	38.8	12,540	46.1
Reverse repos	–				
Impairment provisions	(12,540)				
Fair value adjustments	(1,426)				
Loans and advances to customers	56,144				
Loans and advances to banks	407				
Debt securities	25,377				
Available-for-sale financial assets	22,081				

[1] Impairment provisions include collective unimpaired provisions

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RISK MANAGEMENT

Corporate

The £68,772 million of loans and advances to customers in the Corporate portfolio is structured across a number of different portfolios and sectors as detailed below:

UK Corporate – Major Corporate balance sheets remained relatively stable during the first half of 2011 with corporates continuing to reduce debt and build up liquidity reserves. Mergers and acquisition activity has been minimal and focus has been on refinancing existing facilities. In line with economic commentary, some consumer related sectors in the UK are now feeling the impact of a slowdown in spending. Commodity price volatility is a potential concern in terms of required funding and customer profitability.

Financial Institutions – Continuing concerns over sovereign fiscal deficits and public sector debt levels have necessitated increased scrutiny and risk reduction to the European banking sector, in particular banks domiciled in the weaker Eurozone countries. Trading exposures are in large part either short term and/or collateralised and inter bank lending activity is mainly very short term with strong investment grade counterparties.

Mid-Markets Corporate – Customers in this sector are predominantly UK-focused and mainly dependent on the performance of the domestic economy. Some of our clients' trading has, unsurprisingly, proved challenging in a number of sectors in 2011, particularly those reliant on consumer discretionary expenditure. Retail, hotels, leisure and construction have all been vulnerable to the wider economic environment during the year, with the majority of impairments in the year arising in these sectors. The impact of public sector austerity measures has also been evident in some sectors, with these also contributing to the impairment charge in the year. The mid-markets segment of the UK Corporate market appears to have limited direct vulnerability to events in the weaker Eurozone countries, however the segment is more directly exposed to any flow-through effect on the UK economy resulting from weaker export demand.

US Corporate – The business continues to be predominately investment grade focused and the balance sheets of US Major Corporates remain relatively strong, with good levels of liquidity. The reduction in the non-core corporate portfolio has continued through a combination of secondary sales, refinancings, and realisation of property assets. The year-end impairment position is one of modest net write backs with new impairments on existing cases more than offset by recoveries. Overall, portfolio asset quality remains strong.

Corporate Real Estate – Outside of London and the South East, activity in the Corporate Real Estate market remains weak, in part due to declining values and the focus on only prime properties and prime tenants. Rental growth, where achievable by our clients in the regions, is slow. Market demand for debt is low, especially for new facilities from our core customers, despite messaging that we are open for business which meets our lending criteria. Customers are adopting a 'wait and see' approach, de-gearing where they can, and conserving cash. In addition, with a significant proportion of our assets supporting property investments, tenant default is an area of continuing vulnerability especially where the lending is underpinned by secondary or tertiary assets. With a continuing high level of loan maturities due over the next few years, refinancing risk remains a market-wide issue. However, our core portfolios are characterised by strong management teams with proven asset management skills and/or acceptable lease maturity profiles with borrowers meeting their interest cover and debt service obligations. New propositions are structured and priced in line with our prudent risk appetite.

Corporate Real Estate Business Support Unit

The Corporate Real Estate Business Support Unit has continued to make strong progress executing on its active asset management programme for the complex portfolio of over 1800 cases it manages. This has resulted in a further fall in the impairment total to £1,273 million (2010: £2,427 million), after the peak experienced in 2009.

Despite capital values improving 17.8 per cent from their trough in 2009, we have seen the improving trend in the real estate market in 2011 weaken for all but prime or central London based real estate.

The management of the portfolio has focussed on continuing to support its long-term customers and at the same time reduce the exposure to real estate through managed sales, which has resulted in a realisation of over £4.8 billion of cash receipts in 2011 despite the worsening transactional market. In addition there has been over £5 billion of restructurings undertaken with longer term facilities put in place to support our customer base.

Over the past two years, a total of over £8.5 billion of asset sales through managed disposals has occurred which has resulted in an overall £14.6 billion reduction of gross loan exposure in the UK. We have also concluded one of the largest loan portfolio sales in the market in December which provided a significant £923 million deleveraging of our real estate exposure.

During the year a number of new initiatives have been introduced including the sale of assets specifically grouped under receivership, which is the first time such a sale has been achieved; and an arrangement with a publicly quoted asset manager to facilitate certain residential portfolios through the receivers. Such arrangements demonstrate our desire to find solutions to ensure we maximise the recovery from these loan positions or portfolios through managing for value the underlying real estate and we continue to seek innovative ways to achieve this aim.

Wholesale Equity

The Wholesale Equity portfolio (assets representing 'Equity Risk' including ordinary equity, preference shares and debt securities) totals £4.9 billion (split £3.8 billion on balance sheet commitments and £1.1 billion as yet undrawn, the majority of which relates to Lloyds Development Capital and the Funds Investment business).

The overall size of the portfolio has shown a downward trend in the second half of 2011, in the main due to significant disposals of a number of assets from the Project Finance business. Continuing concerns around sovereign debt in the Eurozone and disappointing economic data from the major economies has resulted in ongoing volatility in equity markets.

RISK MANAGEMENT

Wholesale Markets

Loans and advances to customers of £35.8 billion largely comprise balances in the Structured Corporate Finance portfolio, which includes Acquisition Finance (leveraged lending), Project Finance and Asset Based Finance (Ship Finance, Aircraft Finance, Rail Capital and Corporate Asset finance). The dampened effect of UK economic conditions has been felt in the Acquisition Finance portfolio resulting in a higher impairment charge on leveraged exposures during 2011 compared to 2010. However, a number of sectors remain vulnerable, especially retail, leisure and healthcare, and refinancing risk is also an issue, with significant loan maturities due in the next few years. In Ship Finance, the outlook for the container, tanker and dry bulk sectors is challenging.

Wholesale Markets is also responsible for the Treasury Assets portfolio which mainly encompasses a portfolio of Asset-Backed Securities and financial institution Floating Rate Note positions. Portfolio credit quality remained relatively stable over the year and the portfolio size continues to be actively reduced through asset sales and from bond maturities. Further details of Wholesale Division's Asset-Backed Securities portfolio is provided in note 56 to the financial statements on pages 335 and 336.

Treasury and Trading

Treasury and Trading acts as the link between the wholesale markets and the Group's balance sheet management activities and provides pricing and risk management solutions to both internal and external clients.

The portfolio comprises £6.0 billion of loans and advances to banks, £2.9 billion of Available-for-Sale debt securities and £2.2 billion of loans and advances to customers (excluding reverse repos).

The majority of Treasury and Trading's funding and risk management activity is transacted with investment grade counterparties including Sovereign central banks and much of it is on a secured basis, such as repos facing a Central Counterparty ("CCP"). Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement. During the year Lloyds Banking Group became a member of LCH SwapClear as part of a move to reduce counterparty risk by clearing standardised derivative contracts through a CCP. Treasury and Trading has reduced the government bond portfolio in response to growing concern over market conditions in the Eurozone resulting in minimal exposure to weaker Eurozone sovereigns. The credit quality of the government bond portfolio is almost solely AAA/AA rated sovereign debt.

Asset Finance

There has been a marginal improvement in credit quality in relation to the retail portfolios during the year. Impairments remain lower than anticipated, particularly in the Personal Financial Services portfolios and the retail motor loans portfolio. Asset quality also continues to improve in response to the continuing strategy to enhance the quality of new business written (especially Motor Finance) and following the closure of Personal Financial Services to new business. The credit quality profile across the non-retail portfolios also remains relatively stable, and underlying impairment levels have reduced against 2010 levels, reflecting a material slow down in new default cases.

RISK MANAGEMENT

Credit Risk – Commercial

Overview

- Impairment losses for 2011 decreased significantly to £303 million, from £382 million for 2010.
- The decrease reflects the continued application of our prudent credit risk appetite approach and the benefits of the low interest rate environment which has helped maintain defaults at a lower level.
- Portfolio metrics including delinquencies and assets under close monitoring have generally remained steady or improved.
- Due to the continuing uncertainty regarding the economic outlook, we remain cautious. Downward pressures on consumer spending from a weakening labour market, still-high household indebtedness and rising Government budgetary pressures continue to imply vulnerability for a number of sectors, most notably retail, motor traders and restaurants.
- Commercial continues to operate rigorous processes to enhance control and monitoring activities which play a crucial role in identifying customers showing early signs of financial distress and bringing them into our support model.

Table 1.37: **Impairment charge (unaudited)**

	2011 £m	2010 £m	Change %
Core	296	381	22
Non-core	7	2	
Total impairment charge	**303**	382	21

Commercial's impairment charge decreased £79 million, or 21 per cent, compared to £382 million during 2010. This reflects the continued application of a prudent credit risk appetite for new business and a low interest rate environment helping to maintain defaults at a lower level. Impairment charges as an annualised percentage of average loans and advances to customers reduced to 1.06 per cent from 1.24 per cent in 2010. The majority of the business is based around full banking relationships. The relatively small non-core portfolio has continued to reduce throughout 2011.

Impaired loans and provisions

Commercial's impaired loans increased by £59 million to £2,915 million compared with 31 December 2010. Despite this small increase, impairment provisions reduced. This is as a result of lower default rates at the smaller end of the portfolio and write-offs. As a result, impairment provisions as a percentage of impaired loans reduced to 30.2 per cent from 34.7 per cent at 31 December 2010. As a percentage of closing loans and advances to customers, impaired loans increased to 9.8 per cent from 9.6 per cent at 31 December 2010.

Table 1.38: **Impaired loans and provisions (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Commercial	29,681	2,915	9.8	880	30.2
Impairment provisions	(880)				
Fair value adjustments	(51)				
Loans and advances to customers	**28,750**				
At 31 December 2010					
Commercial[2]	29,649	2,856	9.6	992	34.7
Impairment provisions	(992)				
Fair value adjustments	(103)				
Loans and advances to customers	28,554				

[1] Impairment provisions include collective unimpaired provisions.

[2] 2010 figures have been restated for transfers from Corporate.

RISK MANAGEMENT

Table 1.39: **Impaired loans and provisions – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Commercial	**28,289**	**2,885**	**10.2**	**858**	**29.7**
Impairment provisions	**(858)**				
Fair value adjustments	**(51)**				
Loans and advances to customers	**27,380**				
At 31 December 2010					
Commercial	27,618	2,835	10.3	976	34.4
Impairment provisions	(976)				
Fair value adjustments	(103)				
Loans and advances to customers	26,539				

[1] Impairment provisions include collective unimpaired provisions.

Table 1.40: **Impaired loans and provisions – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Commercial	**1,392**	**30**	**2.2**	**22**	**73.3**
Impairment provisions	**(22)**				
Fair value adjustments	**–**				
Loans and advances to customers	**1,370**				
At 31 December 2010					
Commercial	2,031	21	1.0	16	76.2
Impairment provisions	(16)				
Fair value adjustments	–				
Loans and advances to customers	2,015				

[1] Impairment provisions include collective unimpaired provisions.

RISK MANAGEMENT

Credit Risk – Wealth and International

Overview

- In Wealth and International, impairment charges totalled £4,610 million, a decrease of 23 per cent from £5,988 million in 2010. The reduction predominantly reflects lower impairment charges in our Irish portfolio where the rate of impaired loan migration has slowed.
- Impairment coverage has increased in Ireland to 62 per cent from 54 per cent, primarily reflecting further falls in the commercial real estate market during 2011, and further vulnerability exists.
- On the Irish Wholesale portfolio, 84 per cent of the portfolio is now impaired at a coverage ratio of 61 per cent.
- On the Irish Retail portfolio, impairment provisions as a percentage of impaired loans has increased to 73 per cent against a backdrop of falling house prices and an increase in borrowers falling into arrears.
- Further provisioning has been necessary in the Group's Australasian portfolio primarily reflecting geographical real estate concentrations where market conditions and asset valuations have remained weak in 2011.
- The Group has successfully started to reduce its non-core exposure to Ireland with a reduction in gross advances in excess of £2.6 billion during 2011 with disposals in the period being broadly in line with current provisioning levels.
- The Group has also significantly reduced its exposure in its Australasian business by Aus $2.1 billion including the successful disposal of a £1 billion portfolio of impaired Australasian real estate loans in the last quarter of 2011. The levels of disposals during the year represent 40 per cent of the gross impaired portfolio.
- The majority of Wealth and International's assets are non-core and in run-off.

Table 1.41: **Wealth and International impairment charge (audited)**

	2011 £m	2010 £m	Change %
Wealth	100	46	(117)
International:			
Ireland	3,187	4,264	25
Australia	1,034	1,362	24
Wholesale Europe	204	210	3
Other International	85	106	20
	4,510	5,942	24
Total impairment charge	4,610	5,988	23

Table 1.42: **Wealth and International impairment charge – core (unaudited)**

	2011 £m	2010 £m	Change %
Wealth	33	26	(27)
International	18	–	
Total impairment charge	51	26	(96)

Table 1.43: **Wealth and International impairment charge – non-core (unaudited)**

	2011 £m	2010 £m	Change %
Wealth	67	20	(235)
International	4,492	5,942	24
Total impairment charge	4,559	5,962	24

Wealth and International's impairment charge in 2011 almost entirely related to non-core portfolios. The impairment charge decreased by £1,378 million to £4,610 million compared with 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 7.37 per cent from 8.9 per cent in 2010.

RISK MANAGEMENT

Impaired loans and provisions

Total impaired loans increased by £434 million to £20,776 million compared with £20,342 million at 31 December 2010 and as a percentage of closing loans and advances to customers increased to 36.8 per cent from 30.7 per cent at 31 December 2010. The increase in impaired loans predominantly relates to the Group's non-core book in Ireland where impaired loans increased by £1.9 billion during 2011 reflecting ongoing difficulties in the economy. This results in 66 per cent of the total Irish portfolio now being classified as impaired (84 per cent wholesale). Impaired loans in the Australasian book reduced by £1.4 billion driven by write offs and impaired asset disposals.

Impairment provisions as a percentage of impaired loans increased to 60.6 per cent from 52.5 per cent at 31 December 2010. The coverage ratio in the Group's Irish Portfolio has increased further reflecting continuing weakness in real estate markets where further vulnerability exists.

Table 1.44: **Impairments on Wealth and International loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2011					
Wealth	**8,781**	**399**	**4.5**	**162**	**40.6**
International:					
Ireland Retail	**7,036**	**1,415**	**20.1**	**1,034**	**73.1**
Ireland Wholesale	**17,737**	**14,945**	**84.3**	**9,133**	**61.1**
Australia	**9,745**	**2,780**	**28.5**	**1,609**	**57.9**
Wholesale Europe	**6,356**	**978**	**15.4**	**475**	**48.6**
Other	**6,739**	**259**	**3.8**	**170**	**65.6**
	47,613	**20,377**	**42.8**	**12,421**	**61.0**
Wealth and International	**56,394**	**20,776**	**36.8**	**12,583**	**60.6**
Impairment provisions	**(12,583)**				
Fair value adjustments	**(42)**				
Total Wealth and International	**43,769**				
At 31 December 2010					
Wealth	9,472	353	3.7	116	32.9
International:					
Ireland Retail	7,673	870	11.3	616	70.8
Ireland Wholesale	19,755	13,575	68.7	7,147	52.6
Australia	14,587	4,187	28.7	2,208	52.7
Wholesale Europe	7,322	1,007	13.8	420	41.7
Other	7,559	350	4.6	177	50.6
	56,896	19,989	35.1	10,568	52.9
Wealth and International	66,368	20,342	30.7	10,684	52.5
Impairment provisions	(10,684)				
Fair value adjustments	(327)				
Total Wealth and International	55,357				

[1] Impairment provisions include collective unimpaired provisions.

RISK MANAGEMENT

Table 1.45: **Impairments on Wealth and International loans and advances – core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
As at 31 December 2011					
Wealth	**4,998**	**245**	**4.9**	**82**	**33.5**
International	**2,993**	**20**	**0.7**	**18**	**90.0**
Wealth and International	**7,991**	**265**	**3.3**	**100**	**37.7**
Impairment provisions	**(100)**				
Fair value adjustments	**–**				
Total	**7,891**				
As at 31 December 2010					
Wealth	5,513	202	3.7	74	36.6
International	2,922	–	–	–	–
Wealth and International	8,435	202	2.4	74	36.6
Impairment provisions	(74)				
Fair value adjustments	(144)				
Total	8,217				

[1] Impairment provisions include collective unimpaired provisions.

Table 1.46: **Impairments on Wealth and International loans and advances – non-core (unaudited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
As at 31 December 2011					
Wealth	**3,783**	**154**	**4.1**	**80**	**51.9**
International	**44,620**	**20,357**	**45.6**	**12,403**	**60.9**
Wealth and International	**48,403**	**20,511**	**42.4**	**12,483**	**60.9**
Impairment provisions	**(12,483)**				
Fair value adjustments	**(42)**				
Total	**35,878**				
As at 31 December 2010					
Wealth	3,959	151	3.8	42	27.8
International	53,974	19,989	37.0	10,568	52.9
Wealth and International	57,933	20,140	34.8	10,610	52.7
Impairment provisions	(10,610)				
Fair value adjustments	(183)				
Total	47,140				

[1] Impairment provisions include collective unimpaired provisions.

RISK MANAGEMENT

Wealth

Total impaired loans increased by £46 million, or 13 per cent to £399 million compared with £353 million at 31 December 2010 and as a percentage of closing loans and advances increased to 4.6 per cent from 3.7 per cent at 31 December 2010. Impairment charges increased by £54 million to £100 million compared with 2010 primarily due to increased charges in the Group's Spanish mortgage book reflecting a deteriorating housing market and economy in Spain. Impairment charges as a percentage of average loans and advances to customers increased to 1.1 per cent from 0.5 per cent in 2010.

Ireland

Total impaired loans increased by £1,915 million, or 13 per cent to £16,360 million compared with £14,445 million at 31 December 2010 and as a percentage of closing loans and advances increased to 66.0 per cent from 52.7 per cent at 31 December 2010. Impairment charges decreased by £1,077 million to £3,187 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 11.9 per cent from 15.4 per cent in 2010.

Continuing weakness in the Irish real estate markets resulted in a further increase in impaired wholesale loans and coverage in 2011. The majority of Irish retail provisions relate to a residential mortgage portfolio where impairment charges have increased in relation to 2010 due to a continued decline in residential property prices and higher arrears levels, including customers on a forbearance arrangement.

Table 1.47: **Impairments on Ireland loans and advances (audited)**

	2011			2010		
	Gross loans £m	**Impaired loans £m**	**Provisions £m**	Gross loans £m	Impaired loans £m	Provisions £m
Commercial Real Estate	**10,872**	**9,807**	**6,194**	11,685	9,232	4,791
Corporate	**6,865**	**5,138**	**2,939**	8,070	4,343	2,356
Retail	**7,036**	**1,415**	**1,034**	7,673	870	616
Total	**24,773**	**16,360**	**10,167**	27,428	14,445	7,763

The most significant contribution to impairment in Ireland is the Commercial Real Estate portfolio. Impairment provisions provide 63 per cent coverage on impaired commercial real estate loans. Mortgage lending at the year end comprised 99 per cent of the retail portfolio with impaired loans of £1.4 billion and impairment coverage of 70 per cent.

£2.6 billion of wholesale lending within the Commercial Real Estate and corporate portfolios relates to sterling loans secured on UK property.

Within the Commercial Real Estate portfolio, over 90 per cent of the portfolio is now impaired. The average impairment coverage ratio has increased in the year to 63 per cent (52 per cent 31 December 2010) reflecting the continued deteriorating Irish economic conditions and Irish commercial property market.

The Group has successfully started to reduce its non-core exposure to Ireland with disposals in excess of €1 billion in the period broadly in line with current provisioning levels.

Australasia

Total impaired loans decreased by £1,407 million, or 34 per cent to £2,780 million compared with £4,187 million at 31 December 2010. The decrease in impaired loans in the period is as a result of impaired asset disposals and write offs partially offset by further migration of cases to impaired status. Total impaired loans as a percentage of closing loans and advances decreased to 28.5 per cent from 28.7 per cent at 31 December 2010.

Impairment charges decreased by £328 million to £1,034 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 8.2 per cent from 9.3 per cent in 2010.

Impairment on the Group's Commercial Real Estate portfolio in Australasia was the main contributor to the full year charge. This portfolio is exposed to Australian non-metropolitan real estate markets where market conditions and asset valuations in 2011 have remained weak. The Group has significantly reduced its remaining exposure to these markets following the successful disposal of a £1 billion portfolio of loans during the last quarter of 2011 in our two most challenging markets (Gold Coast and New Zealand). A specific charge of £70 million was also incurred in the period as a result of losses arising from the earthquake in New Zealand.

Wholesale Europe

Total impaired loans decreased by £29 million, or 3 per cent to £978 million compared with £1,007 million at 31 December 2010 and as a percentage of closing loans and advances increased to 15.4 per cent from 13.8 per cent at 31 December 2010. Impairment charges decreased by £5 million to £204 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers increased to 2.9 per cent compared to 2.8 per cent in 2010. Commercial real estate was the primary driver of the impairment charge in Wholesale Europe reflecting provisions on a small number of specific transactions.

Other International

Impairments mainly relate to the corporate business in Dubai and the Dutch mortgage business. Total impaired loans decreased by £91 million, or 26 per cent to £259 million compared with £350 million at 31 December 2010 and as a percentage of closing loans and advances decreased to 3.8 per cent from 4.6 per cent at 31 December 2010. Impaired loans predominantly relate to a limited number of corporate exposures and the reduction in impaired balances primarily reflects write offs in respect of two loans that have been exited in the period. Impairment charges decreased by £21 million to £85 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 1.2 per cent from 1.3 per cent in 2010.

RISK MANAGEMENT

Exposures to selected Eurozone countries

The following section summarises the Group's direct exposure to certain European countries which have been identified on the basis of a Standard & Poor's rating of A or less, as at 31 December 2011. The exposures are shown at their balance sheet carrying values and are based on the country of domicile of the counterparty, unless otherwise indicated.

The Group manages its exposures to individual countries through authorised country limits which take into account economic, financial, political and social factors. In addition, the Group manages its direct risks to the selected countries by establishing and monitoring risk limits for individual banks, financial institutions and corporates. Indirect risk is taken into account, where it is determined that counterparties have material direct exposures to the selected countries.

The Group has established a Eurozone Instability Steering Group in order to monitor developments within the Eurozone on a daily basis, carry out stress testing through detailed scenario analysis and complete appropriate due diligence on the Group's exposures.

The following tables summarise exposures to the selected Eurozone countries by type of counterparty:

Table 1.48: **Eurozone exposure – by counterparty (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Direct sovereign exposure	**–**	**–**	**16**	**–**	**17**	**33**
Central Bank balances	**–**	**–**	**–**	**–**	**35**	**35**
Banks	**–**	**207**	**433**	**142**	**1,692**	**2,474**
Asset backed securities	**55**	**376**	**39**	**341**	**375**	**1,186**
Other financial institutions	**–**	**272**	**88**	**19**	**27**	**406**
Other corporate	**431**	**8,894**	**81**	**298**	**2,935**	**12,639**
Retail	**–**	**6,027**	**–**	**11**	**1,649**	**7,687**
Insurance assets	**–**	**68**	**47**	**–**	**39**	**154**
Total	**486**	**15,844**	**704**	**811**	**6,769**	**24,614**
At 31 December 2010						
Direct sovereign exposure	–	–	31	–	54	85
Central Bank balances	–	–	–	–	44	44
Banks	–	1,818	596	362	2,437	5,213
Asset backed securities	75	867	594	447	987	2,970
Other financial institutions	–	74	151	65	146	436
Other corporate	473	11,632	228	267	2,769	15,369
Retail	–	7,202	–	10	1,769	8,981
Insurance assets	–	107	294	–	110	511
Total	548	21,700	1,894	1,151	8,316	33,609

In addition to the above countries, the Group has total exposures with six other European countries which are rated A or below. No balance with one individual country exceeds £350 million. These balances primarily relate to corporate exposures.

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Direct sovereign exposures – Our sovereign exposures are primarily to the UK and the Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries. Total exposures to the selected countries are £33 million (31 December 2010: £85 million) and are primarily in respect of loans and advances held at amortised cost, with no impairments recognised. Direct sovereign exposures include those to the Export Credit Agencies for Italy and Spain. Since 2009, the Group has proactively managed and reduced limits and exposures to these countries. Derivatives with sovereigns and sovereign referenced credit default swaps are insignificant.

In addition to direct sovereign exposures, the Group maintains deposit balances with a number of European Central banks for regulatory and liquidity management purposes. For the selected countries, the Group has a central bank balance with Spain of £35 million (2010: £44 million).

Table 1.49: **Exposures to Banks (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost	**–**	**46**	**41**	**17**	**33**	**137**
Available for sale:						
Cost	**–**	**193**	**194**	**198**	**1,848**	**2,433**
AFS reserve	**–**	**(57)**	**(14)**	**(74)**	**(300)**	**(445)**
	–	**136**	**180**	**124**	**1,548**	**1,988**
Net trading assets	**–**	**–**	**188**	**–**	**59**	**247**
Derivatives – net CDS assets and liabilities	**–**	**–**	**–**	**–**	**–**	**–**
Derivatives – other	**–**	**25**	**24**	**1**	**52**	**102**
Total exposure	**–**	**207**	**433**	**142**	**1,692**	**2,474**
At 31 December 2010						
Amortised cost	–	42	59	62	52	215
Available for sale:						
Cost	–	923	512	362	2,586	4,383
AFS reserve	–	(82)	(9)	(62)	(265)	(418)
	–	841	503	300	2,321	3,965
Net trading assets	–	919	25	–	38	982
Derivatives – net CDS assets and liabilities	–	–	9	–	–	9
Derivatives – other	–	16	–	–	26	42
Total exposure	–	1,818	596	362	2,437	5,213

Included within exposures to banks and other financial institutions, and treated as available for sale assets, are Covered Bonds of £1.7 billion (2010: £2.0 billion). The covered bonds are ultimately secured on a pool of mortgage assets in the countries concerned and benefit from over-collaterisation, with an overall weighted maturity of approximately five years.

Remaining exposures to banks held at amortised cost are predominantly short-term and relate to general banking facilities, money market and repo facilities and fixed and floating rate notes. No impairments are held against these exposures. In addition there are unitilised and uncommitted money market lines and repo facilities of approximately £1.7 billion predominantly in respect of Spanish and Italian banks. Bank limits have been closely monitored with amounts and tenors reduced where appropriate.

Net trading assets relate to exposures within the credit trading market-making business. There has been a large reduction in trading assets in the year in line with the overall Group balance sheet.

Derivative balances are shown at fair value adjusted where master netting agreements exist and net of cash collateral of £155 million. There are credit default swap positions referenced to banking groups domiciled in Italy (net long of £1 million and net short of £4 million) and Spain (net short of £10 million).

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Table 1.50: **Asset Backed Securities (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost	**32**	**221**	**26**	**208**	**211**	**698**
Available for sale:						
Cost	**44**	**268**	**14**	**219**	**213**	**758**
AFS reserve	**(21)**	**(113)**	**(1)**	**(86)**	**(49)**	**(270)**
	23	**155**	**13**	**133**	**164**	**488**
Total exposure	**55**	**376**	**39**	**341**	**375**	**1,186**
At 31 December 2010						
Amortised cost	37	558	467	241	600	1,903
Available for sale:						
Cost	51	417	149	261	471	1,349
AFS reserve	(13)	(108)	(22)	(55)	(84)	(282)
	38	309	127	206	387	1,067
Total exposure	75	867	594	447	987	2,970

Country of exposure for asset backed securities are based on the location of the underlying assets.

Within the asset backed securities exposures, the underlying assets are primarily residential mortgages. No impairments are held against these exposures. Significant exposure reductions were achieved during 2011, primarily through asset sales.

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Table 1.51: **Other financial institutions (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost	**–**	**255**	**18**	**–**	**–**	**273**
Available for sale:						
Cost	**–**	**–**	**–**	**–**	**–**	**–**
AFS reserve	**–**	**–**	**–**	**–**	**–**	**–**
	–	**–**	**–**	**–**	**–**	**–**
Net trading assets	**–**	**5**	**34**	**8**	**27**	**74**
Derivatives – other	**–**	**12**	**36**	**11**	**–**	**59**
Total exposure	**–**	**272**	**88**	**19**	**27**	**406**
At 31 December 2010						
Amortised cost	–	33	43	58	77	211
Available for sale:						
Cost	–	23	4	–	–	27
AFS reserve	–	–	–	–	–	–
	–	23	4	–	–	27
Net trading assets	–	17	99	5	68	189
Derivatives – other	–	1	5	2	1	9
Total exposure	–	74	151	65	146	436

Exposures to other financial institutions primarily relate to balances held within insurance companies and funds. No impairments are held against these exposures.

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Table 1.52: **Other Corporate Exposures (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost:						
Gross exposure	**407**	**15,910**	**69**	**125**	**2,192**	**18,703**
Impairment allowances	**(43)**	**(7,961)**	**(1)**	**(25)**	**(149)**	**(8,179)**
	364	**7,949**	**68**	**100**	**2,043**	**10,524**
Net trading assets	**–**	**–**	**–**	**–**	**–**	**–**
Derivatives – other	**19**	**31**	**–**	**2**	**167**	**219**
On balance sheet exposures	**383**	**7,980**	**68**	**102**	**2,210**	**10,743**
Off balance sheet exposures	**48**	**914**	**13**	**196**	**725**	**1,896**
Total exposure	**431**	**8,894**	**81**	**298**	**2,935**	**12,639**
At 31 December 2010						
Amortised cost:						
Gross exposure	384	17,512	135	130	1,849	20,010
Impairment allowances	(19)	(6,561)	(7)	(2)	(111)	(6,700)
	365	10,951	128	128	1,738	13,310
Net trading assets	–	47	–	–	–	47
Derivatives – other	6	36	2	–	38	82
On balance sheet exposures	371	11,034	130	128	1,776	13,439
Off balance sheet exposures	102	598	98	139	993	1,930
Total exposure	473	11,632	228	267	2,769	15,369

Other Corporate balances within individual countries comprise:

Greece – The exposures in Greece principally relate to shipping loans to Greek shipping companies where the assets are generally secured and the vessels operate in international waters; repayment is mainly dependent on international trade and the industry is less sensitive to the Greek economy.

Ireland – see page 155 for further details on Irish exposures.

Italy and Portugal – exposures comprise lending to corporates, including a small amount of commercial real estate exposure.

Spain – The corporate exposure in Spain is mainly local lending (90 per cent of the total Spanish exposures) comprising corporate loans and project finance facilities (81 per cent) and commercial real estate portfolio (19 per cent).

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Table 1.53: **Retail Exposures (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost:						
Gross exposure	**–**	**7,061**	**–**	**11**	**1,685**	**8,757**
Impairment allowances	**–**	**(1,034)**	**–**	**–**	**(70)**	**(1,104)**
On balance sheet exposures	**–**	**6,027**	**–**	**11**	**1,615**	**7,653**
Off balance sheet exposures	**–**	**–**	**–**	**–**	**34**	**34**
Total exposure	**–**	**6,027**	**–**	**11**	**1,649**	**7,687**
At 31 December 2010						
Amortised cost:						
Gross exposure	–	7,818	–	10	1,712	9,540
Impairment allowances	–	(616)	–	–	(35)	(651)
On balance sheet exposures	–	7,202	–	10	1,677	8,889
Off balance sheet exposures	–	–	–	–	92	92
Total exposure	–	7,202	–	10	1,769	8,981

Retail exposures within Spain are predominantly secured residential mortgages, where about half of the borrowers are expatriates. Impaired lending represents 6 per cent (31 December 2010: 6 per cent) of the portfolio, with a coverage ratio of 49 per cent (31 December 2010: 31 per cent). See page 155 for further details on Irish exposures.

Table 1.54: **Insurance Assets (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011	**–**	**68**	**47**	**–**	**39**	**154**
At 31 December 2010	–	107	294	–	110	511

Assets held by the Insurance Business are held outside the with profits and unit linked funds. Approximately £127 million of these exposures relate to direct investments where the issuer is resident in Spain, Italy or Ireland and the credit rating is consistent with the tight credit criteria defined under the appropriate investment mandate. The remaining exposures relate to interests in two funds administered by SWIP (the Global Liquidity Fund and the Short Term Fund) where in line with the investment mandates, cash is invested in the money markets. For these funds, which are domiciled in Ireland, the exposure is analysed on a look through basis to the underlying assets held and the Insurance business's pro rata share of these assets rather than treating all the holding in the fund as exposure to Ireland. Within the above exposures there are no sovereign exposures.

Table 1.55: **Other European Exposures (unaudited)**
The Group has the following exposures to sovereigns, banks, asset backed securities and other financial institutions in the following European countries:

	Austria £m	Belgium £m	France £m	Germany £m	Luxembourg £m	Netherlands £m	Switzerland £m
At 31 December 2011							
Direct sovereign exposure	**2**	**74**	**217**	**656**	**2**	**–**	**–**
Central Bank balances	**–**	**4**	**–**	**203**	**3**	**9,594**	**125**
Banks	**202**	**404**	**1,517**	**1,291**	**4**	**712**	**937**
Asset backed securities	**–**	**–**	**525**	**703**	**–**	**176**	**–**
Other financial institutions	**5**	**11**	**143**	**100**	**14**	**173**	**77**
At 31 December 2010							
Direct sovereign exposure	–	78	842	1,837	153	2	–
Central Bank balances	–	3	4	70	4	10,846	297
Banks	762	1,009	1,675	3,007	35	1,342	1,072
Asset backed securities	––	75	806	1,678	7	1,319	–
Other financial institutions	289	21	308	313	34	788	74

Banks and Financial Institutions in the above countries may have exposures to other European countries that have Standard and Poor's rating of A or lower.

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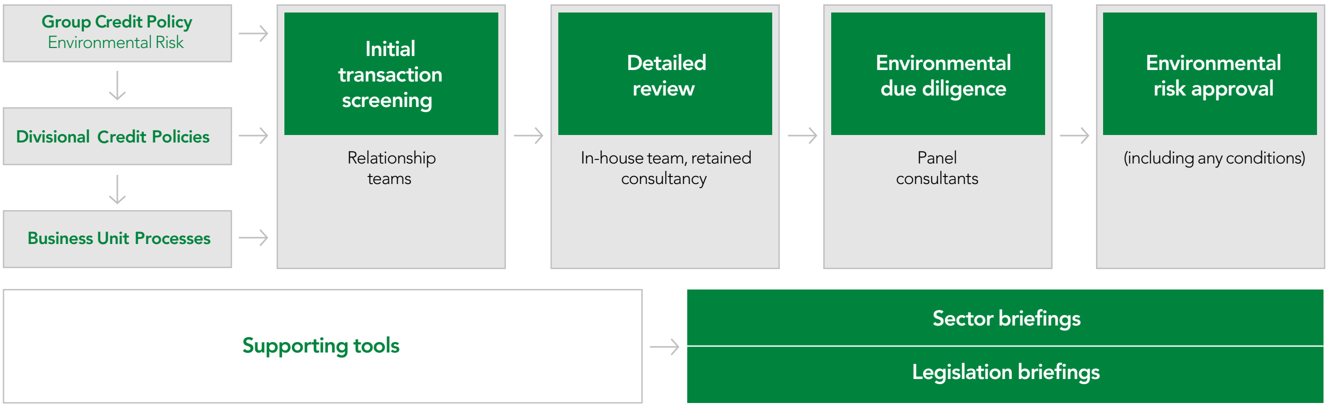
Environmental risk management

We work in line with Group policies and procedures to manage the environmental impact of our lending activities. Our group wide Credit Risk Policy requires all business loans to be assessed for material environmental risks as part of the credit sanctioning process.

In 2011, we launched an electronic environmental risk screening system, which is the primary mechanism for assessing environmental risk in Wholesale. This provides real time screening of location specific and sector based risks that may be present in a transaction. Where a risk is identified, the transaction is referred to our expert in-house Environmental Risk team for further review and assessment, as outlined below. Additional support is provided by the Group's panel of environmental consultants as required.

Table 1.56: **Our environmental risk management approach**



Colleagues are trained in environmental risk management as part of our standard credit risk training course, and the team provides bespoke training to teams upon request. Supporting this training, a range of documents are provided to all colleagues online including environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

Project Finance: Equator Principles

Lloyds Banking Group is a signatory to the Equator Principles. These support our approach to assessing and managing environmental and social issues in project finance. Project finance is often used to fund the development and construction of major infrastructure and industrial projects. The Equator Principles are applicable to project finance transactions above US$10 million and provide a framework to support responsible decision-making.

We have a robust, group wide approach to assess, monitor and report Equator Principle transactions. We also provide ongoing training for lending officers; information on the Equator Principles is included in all our training and we offer more in-depth training for staff working in project finance.

Projects are categorised depending on the level of perceived risk and magnitude of impact they pose, in relation to a set of criteria issued by the International Finance Corporation (IFC).

The categories are as follows:

Category A – Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented;

Category B – Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; and

Category C – Projects with minimal or no social or environmental impacts.

Lending officers are responsible for undertaking initial classification of transactions that qualify under the Equator Principles. Their assessments are subject to further review by our in-house Environmental Risk team, and for higher risk transactions by our Equator Principles Review Group, comprising experts from both our Risk and Project Finance teams. This ensures that each transaction is compliant and is consistent with our environmental risk policy. We provide a range of training and support materials to our risk and transactional staff to ensure that they are familiar with the requirements of the Principles.

In 2011, we participated in the Equator Principles Strategic Review process which examined the scope of application, transparency, implementation and governance of the Principles. It is the first step of a longer term process to determine the future direction of the Principles and ensure they are fit for purpose. We believe that the collective effort of financial institutions will ensure that the Equator Principles continue to play an industry leading role and will continue to engage in the update process.

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Table 1.57: **Status of Categorised Projects (unaudited)**

	A	B	C	Total
Completed	–	15	10	25
In Progress	1	4	4	9
Not Completed	–	2	4	6
	1	21	18	40

Table 1.58: **Status of Projects by Industry (unaudited)**

	Renewables	Infrastructure	Energy and Utilities	Total
Completed	16	4	5	25
In Progress	5	3	1	9
Not Completed	2	4	–	6
	23	11	6	40

Throughout 2011, the Group continued to provide finance for a wide range of projects within the renewables, energy & utilities and infrastructure sectors that have the capability to deliver positive social and environmental outcomes. This year saw a 56 per cent increase in the value of renewables projects that the Group provided finance for compared to 2010. When completed, renewable projects within the UK funded during 2011 will provide over 540,000 homes with renewable energy, avoiding tens of thousands of tonnes of CO_2 emissions each year.

Table 1.59: **Industry of Completed Transactions (unaudited)**

	No.	£m
Renewables	16	611
Infrastructure	5	316
Energy & Utilities	4	123
	25	1,050

Table 1.60: **Geography of Completed Transactions (unaudited)**

	A	B	C	Total
UK	–	5	4	9
Americas	–	7	5	12
Europe	–	1	–	1
Australasia	–	2	1	3
	–	15	10	25

RISK MANAGEMENT

Market risk

Definition

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

Risk appetite

Market risk appetite is defined with regard to the quantum and composition of market risk that currently exists in the Group and the Group's risk preferences.

This statement of the Group's overall appetite for market risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee, the Group Chief Executive allocates this risk appetite across the Group. Individual members of the Group Executive Committee ensure that market risk appetite is further delegated to an appropriate level within their areas of responsibility.

Exposures

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset.

Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products. However, some interest rate, exchange rate and credit spread positions are taken using derivatives and other on-balance sheet instruments with the objective of earning a profit from favourable movements in market rates.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets and liabilities. Interest rate risk arises predominantly from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets.

Risk also arises from the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restricts the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Foreign currency risk also arises from the Group's investment in its overseas operations.

The Group's insurance activities also expose it to market risk, encompassing interest rate, exchange rate, property, credit spreads and equity risk:

- With Profit Funds are managed with the aim of generating rates of return consistent with policyholders' expectations and this involves the mismatch of assets and liabilities.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in-force business, see note 30 to the financial statements on page 260).
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.
- Surplus assets are held primarily in four portfolios: (a) in the long-term funds of Scottish Widows plc and its subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group's defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 43 to the financial statements on page 275.

Measurement

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

- Value at Risk (VaR): for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used
- Standard Stresses: Interest Rates 25bp; Equities 10 per cent; Credit Spreads relative 30 per cent widening
- Bespoke Extreme Stress Scenarios: e.g. stock market crash

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

Although an important market standard measure of risk, VaR has limitations. These arise from the use of limited historical data, an assumed distribution, defined holding periods, set confidence intervals and frequency of calculation. The exposure level at the confidence interval does not convey any information about potential losses which may arise if this level is exceeded. A 95 per cent confidence interval with a 1 day holding period is equivalent to an expected 1 in 20 day loss. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures. Trading book VaR (1-day 99 per cent) is compared daily against both forecast and actual profit and loss.

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Trading assets and other treasury positions

Based on the 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2011 and 2010 based on the Group's global trading positions as detailed in table 1.61.

The risk of loss measured by the VaR model is the potential loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR does not assume any diversification benefit across the five risk types, which now includes inflation. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The Group internally uses VaR as the primary measure for all trading book positions arising from short term market facing activity.

Table 1.61: **VaR trading assets and other treasury positions (see 'Measurement' page 164) (audited)**

	2011				2010
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m
Interest rate risk	**2.6**	**3.0**	**5.9**	**1.8**	3.9
Foreign exchange risk	**0.4**	**0.5**	**1.6**	**0.2**	0.4
Equity risk	**–**	**–**	**–**	**–**	–
Credit spread risk	**3.1**	**2.3**	**4.5**	**1.0**	1.6
Inflation risk	**0.2**	**0.2**	**0.5**	**0.1**	0.3
Total VaR	**6.3**	**6.0**	**9.7**	**4.1**	6.2

Non-trading

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates including the margin between interbank and central bank rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets; or when, if rates rise, assets cannot be re-priced as quickly or by as much as liabilities.

Risk exposure is monitored monthly using, primarily, market value sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks. Where re-pricing maturity is based on assumptions about customer behaviour these assumptions are also reviewed monthly.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

The following table shows, split by material currency, Lloyds Banking Group sensitivities as at 31 December 2011 to an immediate up and down 25 basis points change to all interest rates.

Table 1.62: **Non-trading (audited)**

	2011		2010	
	Up 25bps £m	Down 25bps £m	Up 25bps £m	Down 25bps £m
Sterling	**(53.1)**	**54.7**	(86.9)	88.4
US Dollar	**(0.4)**	**0.3**	11.1	(11.4)
Euro	**(15.7)**	**15.9**	8.9	(9.0)
Australian Dollar	**(1.8)**	**1.8**	(1.2)	1.2
Other	**(1.4)**	**1.3**	(3.0)	3.1
Total	**(72.4)**	**74.0**	(71.1)	72.3

Base case market value is calculated on the basis of the Lloyds Banking Group current balance sheet with re-pricing dates adjusted according to behavioural assumptions. The above sensitivities show how this projected market value would change in response to an immediate parallel shift to all relevant interest rates – market and administered.

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

Pension schemes

Management of the assets of the Group's defined benefit pension schemes is the responsibility of the Scheme Trustees, who also appoint the Scheme Actuaries to perform the triennial valuations. The Group monitors its pensions exposure holistically using a variety of metrics including accounting and economic deficits and contribution rates. These and other measures are regularly reviewed by the Group Asset and Liability Committee and the Group Market Risk Committee and used in discussions with the Trustees, through whom any risk management and mitigation activity must be conducted.

The schemes' main exposures are to equity risk, real rate risk and credit spread risk. Accounting for the pension schemes under International Accounting Standard (IAS)19 spreads any adverse impacts of these risks over time.

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Insurance portfolios

The Group's market risk exposure in respect of insurance activities described above is measured using EEV as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2011 and 2010. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently is not tracked on a daily basis.

Table 1.63: **Insurance portfolios (audited)**

	2011 £m	2010 £m
Equity risk (impact of 10% fall pre-tax)	**(339.4)**	(367.4)
Interest rate risk (impact of 25 basis point reduction pre-tax)	**59.2**	82.1
Credit spread risk (impact of relative 30% widening)	**(237.3)**	(163.0)

Mitigation

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

Banking – non-trading activities

Interest rate risk arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive assets and interest rate sensitive liabilities, is managed centrally. Matching assets and liabilities are offset against each other and interest rate swaps are also used to manage the residual exposure to within the Non-Traded Market Risk Appetite.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled within the Trading Risk Appetite and any residual risk is hedged in the market.

Insurance activities

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

Monitoring

The Group Asset and Liability Committee and the Group Market Risk Committee regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored by Risk Division and where appropriate, escalation procedures are in place.

Banking activities

Trading is restricted to a number of specialist centres, the most important centre being the treasury and trading business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed centrally within limits defined in the detailed Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

Insurance activities

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the Group's overall risk appetite and regularly reviewed by the Group Market Risk Committee:

- The With Profit Funds are managed in accordance with the relevant fund's principles and practices of financial management and legal requirements.
- The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.
- Investment strategy for surplus assets held in excess of liabilities takes account of the legal, regulatory and internal business requirements for capital to be held to support the business now and in the future.

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

RISK MANAGEMENT

Operational risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people related or external events.

There are a number of categories of operational risk:

Regulatory
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.

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

People
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.

Supplier management
The risk of reductions in earnings and/or value through financial or reputational loss from services with outsourced partners or third-party suppliers.

Customer processes
The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor externally facing business processes. Customer process risk includes customer transaction and processing errors due to incorrect capturing of customer information and/or system failure.

Financial crime
The risk of reductions in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related regulatory obligations, these losses may include censure, fines or the cost of litigation. This includes risks associated with fraud and bribery.

Money laundering and sanctions
The risk of reductions in earnings and/or value, through financial or reputational loss, associated with failure to comply with prevailing regulatory obligations on activities related to money laundering, sanctions and counter terrorism, these losses may include censure, fines or the cost of litigation.

Security
The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Group's assets, the loss, corruption, misuse or theft of the Group's information assets or threats or actual harm to the Group's people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

IT systems
The risk of reductions in earnings and/or value through financial or reputational loss resulting from the failure to develop, deliver or maintain effective IT solutions.

Change
The risk of reductions in earnings and/or value, through financial or reputational loss, from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

Organisational infrastructure
The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor internally facing business processes at group, divisional or business unit level. Organisational infrastructure in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

Risk appetite

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty.

In setting operational risk appetite, the Group looks at both impact on solvency and the Group's reputation.

The Group has zero risk appetite for regulatory breaches or systemic unfair outcomes for customers. To achieve this, the Group encourages and maintains an appropriately balanced regulatory compliance culture and promotes policies and procedures to enable businesses and their staff to operate in accordance with the laws, regulations and voluntary codes which impact on the Group and its activities.

RISK MANAGEMENT

Exposures

By its very nature, operational risks can arise from a wide range of the Group's activities that involve people, processes and systems. The Group's principal operational risks relate to the Group's ability to attract, retain and motivate its people, the rate and scale of change arising from the Group's strategic review programme, the way in which the Group treats its customers and the regulatory environment in which it operates.

The Group continues to face risks relating to its ability to attract, retain, and develop high calibre talent, as a result of challenges arising from ongoing regulatory and public interest in remuneration practices. In addition there is uncertainty from EU state aid requirements and Independent Commission on Banking proposals on banking reform.

The breadth of the strategic review programme is such that all parts of the Group are impacted to a degree. The risks associated with the programme, including implementation and delivery, are the subject of rigorous oversight by business areas and Risk Division, with challenges by Internal Audit, commensurate to the scale of the change.

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 the Group's strategic aim – to be the best bank for customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies (see note 54 to the financial statements).

Regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector.

Measurement

Operational risks are measured against a set of risk appetite metrics, with appropriate limits and triggers, which have been approved by the Board.

Mitigation

The Group's operational risk management framework consists of the following key components:

- Identification and categorisation of the key operational risks facing a business area, including defining risk appetite.
- Risk assessment, including impact assessment of financial and non-financial impacts (e.g. reputational risk) for each of the key risks to which the business area is exposed.
- Control assessment, evaluating the effectiveness of the control framework covering each of the key risks to which the business area is exposed.
- Loss and incident management, capturing actions to manage any losses facing a business area.
- The development of Key Risk Indicators for management reporting, including the monitoring of risk appetite.
- Oversight and assurance of the risk management framework in businesses.
- Scenarios for estimation of potential loss exposures for material risks.

The Group purchases insurance to mitigate certain operational risk events.

Monitoring

Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. The report is discussed at the monthly Group Operational Risk Committee and Compliance & Conduct Committee. These committees can escalate matters to the Chief Risk Officer, or higher committees, if appropriate.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.

RISK MANAGEMENT

Insurance risk

Definition

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.

Risk appetite

Insurance risk appetite is defined with regard to the quantum and composition of insurance risk that exists currently in the Group and the Group's risk preferences. It takes account of the need for each entity in the Group to maintain solvency in excess of the minimum level required by the entity's jurisdictional legal or regulatory requirements.

The Group's appetite for solvency and earnings in insurance entities is reviewed and approved annually by the Board.

Exposures

The major sources of insurance risk within the Group are the insurance businesses and the Group's defined benefit staff pension schemes. The nature of insurance business involves the accepting of insurance risks which relate primarily to mortality, longevity, morbidity, persistency, expenses, property damage and unemployment. The prime insurance risk of the Group's staff pension schemes is related to longevity.

Measurement

Insurance risks are measured using a variety of techniques including stress and scenario testing; and, where appropriate, stochastic modelling.

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-200[1] year stresses and other supporting measures where appropriate, including those set out in notes 38 and 39 to the financial statements.

Mitigation

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

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

Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)
- Pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products)
- Claims management
- Product design
- Policy wording
- Product management
- The use of reinsurance or other risk mitigation techniques.

In addition, exposure limits by risk type are derived from the business planning process and used as a control mechanism to ensure risks are taken within solvency risk appetite.

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

The most significant insurance risks in the life assurance companies are longevity risk and persistency risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed.

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present.

In respect of insurance risks in the staff pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees to assist with the management of risk in line with the Group's risk appetite.

Monitoring

Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk. Reasons for any significant divergence from experience are investigated and remedial action is taken.

[1] Group pension schemes utilise 1-in-20 year stresses

RISK MANAGEMENT

Business risk

Definition
Business risk is defined as the risk that the Group's earnings are adversely impacted by a sub optimal business strategy or the sub optimal implementation of the strategy. In assessing business risk, consideration is given to internal and external factors.

Risk appetite
Business risk appetite is encapsulated in the Group's budget and medium-term plan, which are sanctioned by the Board on an annual basis. Divisions' and business units' plans are aligned to the Group's overall business risk appetite.

Exposures
The Group's portfolio of businesses exposes it to a number of internal and external factors:

- internal factors: resource capability and availability, customer treatment, service level agreements, products and funding and the risk appetite of other risk categories; and
- external factors: economic, technological, political, social and ethical, environmental, regulatory, market expectations, reputation and competitive behaviour.

Measurement
An annual business planning process is conducted at Group, divisional and business unit level which includes a quantitative and qualitative assessment of the risks that could impact the Group's plans. Within the planning round, the Group conducts both scenario analysis and stress tests to assess risks to future earning streams. Stress testing and scenario analysis are fully embedded in the Group's risk management practice. The Group assesses a wide array of scenarios including economic recessions, regulatory action scenarios, scenarios specific to the operations of each part of the business, as well as reverse stress tests.

Mitigation
As part of the annual business planning process, the Group develops a set of management actions to prevent or mitigate the impact on earnings in the event that business risks materialise. Additionally, business risk monitoring, through regular reports and oversight, results in corrective actions to plans and reductions in exposures where necessary.

Revenue and capital investment decisions require additional formal assessment and approval. Formal risk assessment is conducted as part of the financial approval process. Significant mergers and acquisitions by business units require specific approval by the Board. In addition to the standard due diligence conducted during a merger or acquisition, Risk Division conducts, where appropriate, an independent risk assessment of the target company.

Monitoring
The Group's strategy is reviewed and approved by the Board, which includes the Group Executive Committee and the Group Risk Committee. Regular reports are provided to the Group Executive Committee and the Board on the progress of the Group's key strategies and plans, including assessment of performance against Risk Appetite.

GOVERNANCE

BOARD OF DIRECTORS

Non-Executive Directors

Sir Winfried Bischoff
Chairman

NG Re Ri

Joined the Board and was appointed Chairman in September 2009. Previously Chairman of Citigroup Inc. from December 2007 to February 2009. He joined J Henry Schroder & Co in January 1966 and became Managing Director of Schroders Asia in 1971. Group Chief Executive of Schroders in 1984 and Chairman in 1995. Following the acquisition of Schroders' investment banking business by Citigroup in 2000, became Chairman of Citigroup Europe before being appointed acting Chief Executive Officer of Citigroup in 2007 and subsequently as Chairman in the same year. A Non-Executive Director of Eli Lilly and Company, and The McGraw Hill Companies Inc. in the United States. He is a member of Akbank International Advisory Board and Chairman of the Advisory Council of TheCityUK. Aged 70.

Lord Leitch
Deputy Chairman
Independent Director
(Until 29 February 2012)

A NG Re

Joined the Board in October 2005 and was appointed Deputy Chairman in May 2009. Appointed Chairman of Scottish Widows in 2007. Held a number of senior and general management appointments in Allied Dunbar, Eagle Star and Threadneedle Asset Management before the merger of Zurich Group and British American Tobacco's financial services businesses in 1998. Subsequently served as Chairman and Chief Executive Officer of Zurich Financial Services United Kingdom, Ireland, Southern Africa and Asia Pacific, until his retirement in 2004. Chairman of the Government's Review of Skills (published in December 2006). Chairman of BUPA and Intrinsic Financial Services. Chairman of Medical Aid Films and Chancellor of Carnegie College. Former Chairman of the National Employment Panel and of the ABI. Aged 64.

Anita M Frew
Independent Director

A Ri

Joined the Board in December 2010. Chairman of Victrex, the FTSE 250 global manufacturer of high performance polymers, having previously been the Senior Independent Director. Since 2000, she has held a portfolio of Non-Executive Directorships, currently holding positions as Senior Non-Executive Director of Aberdeen Asset Management and as Non-Executive Director of IMI. Prior to this she was Executive Director of Abbott Mead Vickers, Director of Corporate Development at WPP Group and a Non-Executive Director of Northumbrian Water and has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland. Aged 54.

Sir Julian Horn-Smith
Independent Director
(Until 17 May 2012)

NG Re Ri

Joined the Board in January 2005. Held a number of senior and general management appointments in Vodafone from 1984 to 2006 including a directorship of that company from 1996, Group Chief Operating Officer from 2001 and Deputy Chief Executive Officer from 2005. Previously held positions in Philips from 1978 to 1982 and Mars GB from 1982 to 1984. A Non-Executive Director of Acer Incorporated (Taiwan), De La Rue, Digicel Group and Emobile (Japan), a Director of Sky Malta, a member of the Altimo International Advisory Board and a senior adviser to UBS and CVC Capital Partners in relation to the global telecommunications sector. Deputy Chairman of BUMI. Pro Chancellor of University of Bath. A former Chairman of The Sage Group. Aged 63.

Glen R Moreno
Senior Independent Director
(Until 17 May 2012)
(Deputy Chairman from
1 March 2012 to 17 May 2012)

NG

Joined the Board in March 2010. Chairman of Pearson, the media group, since October 2005. Director of Fidelity International, one of the world's largest fund management companies, and Chairman of its Audit Committee. Deputy Chairman of The Financial Reporting Council. From 1987 to 1991 was Chief Executive of Fidelity International. Until mid 2009, was a Non-Executive Director and Senior Independent Director of Man Group, a FTSE 100 financial services group, and acting Chairman of UKFI. Former Group Executive of Citigroup; from 1969 to 1987 he held a number of senior positions at the bank in Europe and Asia. Aged 68.

David L Roberts
Independent Director
(Deputy Chairman from 17 May 2012)

A NG Re Ri

Joined the Board in March 2010. Executive Director, member of the Group Executive Committee and Chief Executive, International Retail and Commercial Banking at Barclays until December 2006. Joined Barclays in 1983 and held various senior management positions, including Chief Executive, Personal Financial Services, and Chief Executive, Business Banking. Was also a Non-Executive Director of BAA until June 2006 and a Non-Executive Director of Absa Group Limited, one of South Africa's largest financial services groups, until October 2006. From 2007 to 2009 he was also the Chairman and Chief Executive of BAWAG P.S.K. AG, the second largest retail bank in Austria. Non-Executive Chairman of The Mind Gym. Aged 49.

T Timothy Ryan, Jr
Independent Director

A Re Ri

Joined the Board in March 2009. President and Chief Executive of the Securities Industry and Financial Markets Association. Held a number of senior appointments in JP Morgan Chase from 1993 to 2008 including Vice Chairman, financial institutions and governments, from 2005. A Director of the US-Japan Foundation, Great-West Life Insurance Co., Power Corporation of Canada and Power Financial Corporation and a member of the Global Markets Advisory Committee for the National Intelligence Council. A former Director in the Office of Thrift Supervision, US Department of the Treasury and Koram Bank and the International Foundation of Election Systems. Aged 66.

Martin A Scicluna
Independent Director

A NG Ri

Joined the Board in September 2008. Chairman of Deloitte UK from 1995 to 2007 and a member of the Board from 1991 to 2007. Joined the firm in 1973 and was a partner from 1982 until he retired in 2008. A member of the Board of directors of Deloitte Touche Tohmatsu from 1999 to 2007. Chairman of Great Portland Estates. A Governor of Berkhamsted School. Aged 61.

BOARD OF DIRECTORS

Anthony Watson CBE
Independent Director
(Senior Independent Director from 17 May 2012)

A NG Re

Joined the Board in April 2009. Previously Chief Executive of Hermes Pensions Management. Held a number of senior appointments in AMP Asset Management from 1991 to 1998. A Non-Executive Director of Hammerson, Vodafone and Witan Investment Trust, a member of the Norges Bank Investment Management Advisory Board and Chairman of Lincoln's Inn Investment Committee. A former Chairman of MEPC, the Asian Infrastructure Fund and of the Strategic Investment Board (Northern Ireland) and a former member of the Financial Reporting Council. Aged 66.

Sara V Weller
Independent Director

Re Ri

Joined the Board on 1 February 2012. Between 2004 and 2011, Managing Director of Argos, the second biggest internet retailer in the UK. From January 2000 to April 2004, Marketing Director for Sainsbury's Supermarkets, before being promoted to the position of Deputy Managing Director and serving on the Board of J Sainsbury from January 2003 to the end of March 2004. Retail Marketing Director for Abbey National from December 1996 to December 1999 and worked for Mars Confectionery from September 1983 to December 1996, rising to European Franchise Manager. Non-Executive Director of Mitchells & Butlers from April 2003 to January 2010. Non-Executive Director of United Utilities Group from 1 March 2012. Aged 50.

Committee roles and responsibilities

A Audit Committee
To monitor and review the formal arrangements established by the Board in respect of the financial statements and reporting of the Group; internal controls and the risk management framework; internal audit; and the Group's relationship with its external auditors.

NG Nomination & Governance Committee
To keep the Board's governance arrangements under review and make appropriate recommendations to the Board to ensure that the Company's arrangements are consistent with best practice corporate governance standards.

Re Remuneration Committee
To set the principles and parameters of remuneration policy for the Group, and to oversee remuneration policy and outcomes for those colleagues covered by the scope of the Committee.

Ri Risk Committee
To review and report its conclusions to the Board on the Group's risk appetite and risk management framework. The Committee has a forward looking perspective, anticipating changes in business conditions.

● Chairman of committee

Executive Directors

António Horta-Osório
Group Chief Executive

Joined the Board in January 2011 as an Executive Director and became Group Chief Executive in March 2011. Started his career at Citibank Portugal where he was head of capital markets. At the same time, was an assistant professor at Universidade Catolica Portuguesa. Then worked for Goldman Sachs in New York and London. In 1993, joined Grupo Santander as Chief Executive of Banco Santander de Negocios Portugal and then became Chief Executive Officer of Banco Santander Brazil. In 2000, became Chief Executive Officer of Santander Totta, and Chairman from 2006 until 2011, as well as Executive Vice President of Grupo Santander and a member of its Management Committee. Joined Santander UK, as a Non-Executive Director in November 2004 and from August 2006 until November 2010, was its Chief Executive. Formerly a Non-Executive Director of the Court of the Bank of England. A Non-Executive Director of Fundação Champalimaud in Portugal. Aged 48.

Harry F Baines
Company Secretary

DIRECTORS' REPORT

Results

The consolidated income statement shows a loss attributable to equity shareholders for the year ended 31 December 2011 of £2,714 million.

Principal activities

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

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

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

	Pages
Business review and future developments	10 to 170
Key performance indicators	6 and 7
Financial risk management objectives and internal control policies	99 to 170 and page 186
Principal risks and uncertainties	106 to 111
Financial risk management objectives and internal control policies in relation to the use of financial instruments	99 to 170 (and in note 56 on pages 320 to 339)

Post balance sheet events

There have been no material post balance sheet events.

Going concern

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies which are set out in the risk management section under principal risks and uncertainties: liquidity and funding on pages 106 and 107 and financial soundness on pages 112 to 128 and additionally have considered projections for the Group's capital and funding position. Having considered these, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Directors

Biographical details of directors are shown on pages 172 and 173. Particulars of their emoluments and interests in shares in the Company are given on pages 187 to 203. 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		24 February 2012

Lord Leitch will retire from the Board on 29 February 2012. Sir Julian Horn-Smith and Mr Moreno will retire from the Board on 17 May 2012.

Ms S V Weller has been appointed to the Board since the annual general meeting held in 2011 and will therefore stand for election at the forthcoming annual general meeting.

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

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' REPORT

Directors' indemnities

The directors of the Company, including the former directors who retired during the year and since the year end, have entered into individual deeds of indemnity with the Company which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. In addition, the Company has granted a deed of indemnity through deed poll which constituted 'third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' to the directors of the Group's subsidiary companies, including to former directors who retired during the year and since the year end. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the directors who joined the boards in 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.

Corporate governance report

The corporate governance report can be found on pages 177 to 186 and, together with this directors' report of which it forms part, fulfils the requirements of the Corporate Governance Statement for the purpose of the FSA's Disclosure and Transparency Rules.

Share capital

Information about share capital and dividends is shown in notes 47 and 51 on pages 290 to 292 and page 295 and is incorporated into this report by reference. The Company did not repurchase any ordinary shares of 10p each during the year.

As at the date of this report a notification had been received that The Solicitor for the Affairs of Her Majesty's Treasury had a direct interest of 40.56 per cent in the issued share capital with rights to vote in all circumstances at general meetings. No other notification has been received that anyone has an interest of 3 per cent or more in the issued ordinary share capital.

Change of control

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

The Company is party to a deed of covenant with each of the four Lloyds TSB Foundations (the Foundations) which hold limited voting shares in the Company (the limited voting shares are further described in note 47 on page 292). Under the terms of the deeds of covenant, the Company makes an annual payment to each of the Foundations. In the event of a successful offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting share would convert to an ordinary share under the terms of the Company's articles of association. The payment obligation under the deeds of covenant would come to an end one year following the conversion of the limited voting shares.

Employees

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.

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

Donations

The income statement includes a charge for charitable donations totalling £32,972,000 in 2011 (2010: £30,750,000), including £28,228,000 (2010: £28,228,000) which will be paid under the deeds of covenant to the four Lloyds TSB Foundations during 2012 and £2,000,000 paid to the Bank of Scotland Foundation during 2011.

Research and development activities

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

DIRECTORS' REPORT

Policy and practice on payment of creditors

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

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

The number of days required to be shown in this report, to comply with the provisions of the Companies Act 2006, is 23. 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 Group has contractual or other arrangements that are considered essential to the business of the Group.

Significant contracts

Details of related party transactions are set out in note 53 on pages 302 to 305.

Statement of directors' responsibilities

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

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

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

Each of the directors, whose names and functions are listed on pages 172 and 173 of this annual report, confirm that, to the best of his or her knowledge:

– the Group financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and Group; and

– the management report contained in the business review includes a fair review of the development and performance of the business and the position of the Company and Group, together with a description of the principal risks and uncertainties that they face.

Auditors and audit information

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

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

On behalf of the Board

Harry F Baines
Company Secretary
27 February 2012

Company number 95000

CORPORATE GOVERNANCE REPORT

The Board is committed to achieving long term success for the Company by being the best bank for customers and generating strong, stable and sustainable returns for shareholders. The Board's strategy is underpinned by high standards of corporate governance designed to ensure consistency and rigour in its decision making. This report explains how those standards, in particular, those laid down in the Financial Reporting Council's UK Corporate Governance Code (the Code), apply in practice to ensure that the Board and management work together for the long term benefit of the Company and its shareholders. The Code can be accessed at www.frc.org.uk

Leadership and accountability

The Chairman has overall responsibility for the leadership of the Board. His role is separate from that of the Group Chief Executive who manages and leads the business. A sound relationship between the Chairman and Group Chief Executive, based on a mutual understanding of their respective roles, is essential to maintaining an open culture with the Board. Establishing an effective working relationship with António Horta-Osório, the new Group Chief Executive, has therefore been a key area of focus for the Chairman this year.

The Board is collectively responsible for the long term success of the Company including setting the strategy and establishing the values and standards of the Group. The Group Strategic Review, initiated by António Horta-Osório in March 2011, has been a key area of focus for the Board during 2011 and all Directors participated fully in its formulation. An internal project team supported by McKinsey & Co, was established under the direction of the Group Chief Executive. Detailed plans and proposals were developed by the executive between March and June 2011. During that period, the Board met a number of times to consider, evaluate and challenge the proposals. Additional meetings took place with the Non-Executive Directors individually. The final challenge process took place during a two day Board Strategy session in June 2011. This meeting was held offsite to allow Directors to fully consider and evaluate the strategic options before they were put to the Board for approval. The offsite meeting also provided an opportunity to foster closer working relationships between Board members and the new senior team.

The Chairman has overall responsibility for leadership of the Board and for ensuring that the Board devotes its attention to the right matters. He oversees the content of the agendas which are finalised at Board Agenda Review meetings involving the Chairman, Group Chief Executive and Company Secretary. The Deputy Chairman and Senior Independent Director also attend. Details of the matters reserved to the Board are set out in the Board Governance Framework which is explained further below.

The Chairman, with the support of the Company Secretary, ensures that Directors receive timely and relevant information and are kept advised of key developments, both during and between formal meetings. During 2011, the timeliness of Board communications has been enhanced by the introduction of a secure board portal which enables Directors to access papers electronically as they become available. A weekly Board dashboard ensures that Directors are kept informed of key developments and emerging issues.

It is expected that all directors, but particularly the Non-Executive Directors, constructively challenge proposals that come to the Board for decision. Facilitating an open culture is key to achieving this. During 2011, the Board, led by the Deputy Chairman, developed a charter of values aimed at encouraging strong individual and independent views to broaden the Board's outlook and strengthen its collective judgement.

Open dialogue is encouraged between Directors. To this end, the Chairman meets regularly with the Non-Executive Directors in the absence of Executive Directors either in private sessions held following regular Board or Committee meetings or in separately arranged meetings. The Executive Directors are aware of such meetings through the Board calendar. Non-Executive Directors meet at least once a year without the Chairman being present to discuss his performance. Such meetings are led by the Senior Independent Director. All Non-Executive Directors have ready access to the Group Chief Executive and other senior executives.

All Directors, including Non-Executive Directors, have access to the services of the Company Secretary in relation to discharging their duties as a director, or as a member of any Board Committee. The appointment, and removal, of the Company Secretary is a matter reserved for the Board as a whole. In addition, the Group provides access, at its expense, to the services of external advisers in order to assist directors in their role, wherever this is deemed necessary.

In 2011, a total of sixteen Board meetings were held of which nine were scheduled at the start of the year. The number of meetings held reflects the continuing challenging environment in which the Group operates and the emphasis placed on keeping the Board informed of developments on a timely basis. Details of attendance at meetings are set out on page 182.

To assist the Board in carrying out its functions and to provide independent oversight of internal control and risk management, certain responsibilities are delegated to the Board's Committees. The Board is kept up to date on the activities of the Committees through reports from each of the Committee Chairmen. Terms of reference for each of the Committees are available on the website at www.lloydsbankinggroup.com. Information on the membership, role and activities of each of the Committees can be found on pages 183 to 185.

CORPORATE GOVERNANCE REPORT

Governance framework

The Board operates through a Governance Framework which is reviewed at least annually to ensure that it remains fit for purpose. During 2011, the Governance Framework was reviewed and updated to reflect the Group Strategic Review and organisational changes. The revised Governance Framework was approved by the Board in December 2011 and comprises:

- The **Board Governance Framework**. This is, in effect, the Board's operating manual and sets out:
  - the matters that the Board has reserved to itself including the development and setting of strategy and long term objectives; approval of the medium term plan and financial budgets; capital and structure of capital; significant contracts; and various statutory and regulatory approvals;
  - terms of reference of, and delegations to, the Board Committees to ensure an appropriate level of independent oversight by the Non-Executive Directors;
  - delegation of the responsibility for day to day management of the business to the Group Chief Executive; and
  - the respective roles and responsibilities of each of the Chairman, Group Chief Executive, Senior Independent Director and Non-Executive Directors.
- The **Executive Governance Framework**. This is the means by which the Group Chief Executive delegates responsibilities at executive level to assist him in carrying out his duties. The Group Chief Executive reserves certain matters to himself and, subject to financial limits, delegates responsibilities to the Executive Directors, his direct reports and other senior executives who collectively make up the Group Executive Committee.
- The **Group Subsidiaries Manual**. Lloyds Banking Group conducts its business through a large number of subsidiary entities. To help manage the legal, regulatory and reputational risks associated with these entities, the Group requires its subsidiaries to adopt consistent, proportionate and appropriate standards. The Group Subsidiaries Manual provides guidance on the required governance structures and controls having regard to the nature and risk profile of the entity. The Group Subsidiaries Manual was introduced in April 2011 and was updated in the second half of the year to reflect changes made to the overall Governance Framework in response to the Group Strategic Review.

Board effectiveness

As Chairman, Sir Winfried Bischoff leads the ongoing review of the Board's effectiveness. The Nomination & Governance Committee, which he also chairs, oversees the process and makes recommendations to the Board as appropriate. To ensure a broad representation of independent views including perspectives from each of the Committees, membership of the Nomination & Governance Committee comprises the Deputy Chairman, the Senior Independent Director, the Chairmen of the Audit, Remuneration and Risk Committees and one other independent Non-Executive Director. The Group Chief Executive also attends meetings as appropriate.

Key activities of the Nomination & Governance Committee are summarised in the Committees' section on page 184. Given the importance of its role in ensuring effective governance of the Board, a more detailed review of the work of the Nomination & Governance Committee is provided here.

Board composition

The Nomination & Governance Committee is responsible for reviewing the composition of the Board, including size and structure. During 2011, it oversaw the search and selection process for new directors, including Sara Weller, who was appointed as a Non-Executive Director on 1 February 2012, and the new Group Finance Director. In reviewing Board composition, the Committee has regard to a range of factors, including:

Skills and experience

In reviewing composition, the Board aims to ensure that its membership represents a mix of backgrounds and experience that will enhance the quality of its deliberations and decisions. As part of the ongoing review of composition, specific skills required by the Board are identified with reference to the overall skills of the Board at the time, the need to address longer term succession and current business priorities. All Directors are required to have good – and in most cases have deep – experience and understanding of the banking and financial services sector. The complexity of the Group means that broader skills are also required. Maintaining the right balance is an ongoing priority.

The annual Board evaluation is instrumental in identifying any new skills requirements, as well as possible shortcomings, gaps and inefficiencies. As part of its longer term succession plans, the Board has identified a need for at least two new Non-Executive Directors: one with substantial insurance experience and another with in-depth accounting and financial expertise to continue to meet the FRC and SEC's 'financial expert' criteria.

Diversity

The Board continues to place emphasis on ensuring that its membership reflects diversity in the broadest sense including diversity of gender, ethnicity and background. The Group welcomes and publicly supports the Davies Review. The Board has committed to show demonstrable progress towards the goal of achieving at least 25 per cent (and ultimately 30 per cent) female representation on the Board by 2013 and expects to meet this by 2015. As a founder member of the 30% Club, which encourages UK companies to aim for at least 30 per cent female representation on their boards by 2015, Sir Winfried Bischoff takes an active interest in promoting diversity within the Group and in business more generally. The Nomination & Governance Committee currently utilises the services of an Executive search firm which has signed up to the 30% Club's voluntary Code of Conduct for Executive Search firms.

The Group aims over time to be a leader in its approach to gender diversity. It will continue to focus on diversity and inclusion in order to build a diverse talent pipeline so that there is an appropriate number of talented women ready to make the next move in their careers.

CORPORATE GOVERNANCE REPORT

Board size

Our aim is to ensure that the size of the Board is sufficient to reflect a broad range of views and perspectives whilst allowing all Directors to participate effectively in meetings. At year end, the Board comprised twelve directors which is within the range agreed by the Nomination & Governance Committee.

Independence

The Board's preference is to ensure a strong majority of independent directors. At year end, our Board comprised three Executive Directors, eight independent Non-Executive Directors and the Chairman. The Code requirement that at least half the Board should be independent Non-Executive Directors has been met throughout the year.

The Nomination & Governance Committee is responsible for assessing the independence of Non-Executive Directors on appointment and annually thereafter. Based on its 2011 assessment, it is satisfied that throughout the year, all Non-Executive Directors were independent as to both character and judgement.

In assessing independence, the Committee does not rely solely on the Code criteria but considers whether, in fact, the Non-Executive Director is demonstrably independent and free of relationships and other circumstances that could affect their judgement. It does this with reference to the individual performance and conduct in reaching decisions. It also takes account of any relationships that have been disclosed and authorised by the Board. In the view of the Nomination & Governance Committee, Glen Moreno, who between January and August 2009, was acting Chairman of United Kingdom Financial Investments (UKFI), the body which manages the Government's shareholding in the Group, continues to exercise his own, and robustly independent judgement, at all times.

Board changes

Non-Executive Directors

The Nomination & Governance Committee is responsible for leading and overseeing appointments to the Board. The process of identification of potential new Non-Executive Directors, is undertaken on a rolling basis alongside the continuous review of the composition of the Board. Where appropriate, this is conducted with the support of an executive search firm.

On 1 February 2012 the Group announced the appointment of Sara Weller as a Non-Executive Director and as a member of each of the Remuneration and Risk Committees. Sara's career, characterised by strong advocacy of customers and of the application of new technology, directly supports the Group's strategy. In addition, her background in a range of retail and associated sectors enhances the diversity of perspectives on the Board.

On 27 February 2012, the Group announced that with effect from 17 May 2012, the Board had appointed David Roberts as Deputy Chairman and Tony Watson as Senior Independent Director.

Group Chief Executive succession and interim arrangements

On 1 March 2011, António Horta-Osório was appointed Group Chief Executive replacing Eric Daniels who retired on 28 February 2011. Consistent with his contractual entitlement to notice, Eric Daniels remained employed by the Group until the end of September 2011.

The detailed process leading to the appointment of António Horta-Osório was explained in the 2010 Corporate Governance Report. He joined the Board as an Executive Director on 17 January 2011. This allowed him time to get to know the business and to complete an orderly handover before assuming the role of Group Chief Executive on 1 March 2011.

On 2 November 2011, the Board announced that, acting on medical advice, António Horta-Osório would be taking a short leave of absence due to exhaustion. He returned to work in full health on 9 January 2012. In the period from 2 November 2011 to 8 January 2012, Tim Tookey was appointed Interim Group Chief Executive in addition to his role as Group Finance Director. Interim governance arrangements were implemented to ensure that:

– all authorities vested in the Group Chief Executive were automatically deemed to vest in the Interim Group Chief Executive for as long as that office was required; and
– where internal governance arrangements required a 'four eyes' approval, these could not be achieved by one person acting in the capacity of both the Group Chief Executive and Group Finance Director. Arrangements were put in place to ensure that either the Chief Risk Officer or Company Secretary provided the necessary second pair of eyes.

Throughout António's absence, the Board kept its contingency arrangements under review. On 21 November 2011, the Board announced that one of its Non-Executive Directors, David Roberts, would be appointed to the role of Interim Group Chief Executive in the event that António Horta-Osório was unable to return by the end of the year. In the event, this contingency was not required.

The Board kept in close contact with António during his absence. Prior to his return to work, the Board followed a rigorous process to ensure that it was in the best interests of the Group and its shareholders for António to return as Group Chief Executive. This process involved independent medical assessment as well as individual meetings between António and each Board member. As a result of this process, the Board concluded that António was fit to return to work on 9 January 2012. To avoid a recurrence and to assist him in adjusting to the role, the Board agreed to an initiative from António to restructure and reduce his direct reporting lines in order to strengthen the accountabilities of his senior management team. The new structure was announced on 1 February 2012.

CORPORATE GOVERNANCE REPORT

Retirements

The following retirements took place in the course of the year:

- Eric Daniels: see Group Chief Executive succession above;
- Archie Kane: Group Executive Director, Insurance who retired at the Company's general meeting on 18 May 2011; and
- Helen Weir: Group Executive Director, Retail who stepped down at the Company's general meeting on 18 May 2011.

On 19 September 2011, we announced the retirement of Lord Leitch as Deputy Chairman of the Group and Chairman of Scottish Widows. Lord Leitch will remain on the Board until 29 February 2012.

On 19 September, the Group also announced that Tim Tookey would stand down as Group Finance Director with effect from the end of February 2012 to pursue interests outside the Group. On 24 February 2012, the Group announced that Tim Tookey would stand down as Group Finance Director with effect from that date.

Since the year end the following announcements have been made:

- On 1 February 2012, the Group announced that Sir Julian Horn-Smith would retire from the Board at the annual general meeting and would not stand for re-election as a Director;
- On 6 February 2012, the Group announced that Truett Tate would resign from the Board with immediate effect; and
- On 27 February 2012, the Group announced that Glen Moreno would retire from the Board at the annual general meeting and would not stand for re-election as a Director.

Time commitments

In 2011, as in 2009 and 2010, the time commitment demanded of all Non-Executive Directors was considerable and substantially in excess of the time envisaged in their terms of appointment. The detail set out on page 182 shows the Board meetings that the directors have attended including those called at short notice. There has been no increase to fees since January 2008 to reflect the increased workload and additional time spent on Lloyds Banking Group business.

Election and re-election

As indicated in 2010, in the interests of good corporate governance and in accordance with provisions of the Code now in force, Directors will retire voluntarily and submit themselves for re-election at the annual general meeting. Biographies of the career experience of the current directors are set out on pages 172 to 173. To assist in the voting process, details of the Directors seeking re-election at the annual general meeting are set out in the notice of meeting sent to all shareholders.

Succession planning

The Nomination & Governance Committee oversees the Board's arrangements for the longer term succession of Board and Committee members.

Non-Executive succession planning

Non-executive director succession planning is addressed as part of the ongoing review of Board composition. The policy takes account of the need regularly to refresh the intake of Non-Executives to bring new perspectives, to ensure appropriate representation on each of the Board's Committees and to plan for longer term succession. The average tenure of the Non-Executive Directors is just over two years. Following the move to annual re-election of directors, non-executive directors are appointed on a rolling 12 months basis.

Executive Directors and senior executives

The Nomination & Governance Committee and the Board are responsible for oversight of the process for succession and management development of the most senior executives both at and below Board level, including Executive Directors and members of the Group Executive Committee. The primary responsibility rests with the Group Chief Executive who is responsible for developing and maintaining a succession plan for key leadership positions in the senior executive team. Arrangements are reviewed with the Nomination & Governance Committee at least annually with the latest review taking place in September 2011.

The Chairman is responsible for developing and maintaining a succession plan in relation to the Group Chief Executive and for reviewing the plan with the Nomination & Governance Committee at least annually. During 2011, emphasis was also placed on contingency arrangements during the Group Chief Executive's leave of absence.

Board training

Directors' induction

All Directors are expected to make an informed contribution based on an understanding of the Group's business model and the key challenges facing the Group and its businesses. To ensure that they can contribute from an early stage, all Directors undergo an extensive three stage induction on appointment comprising:

- a corporate induction, which provides an overview of the Group, its strategy, operational structures and main business activities;
- governance and directors' responsibilities, which explains the role and statutory duties of a Non-Executive Director including the roles and responsibilities owed by banks and other financial services firms to the FSA and other regulatory bodies; and
- a bespoke induction plan prepared in consultation with the Chairman, tailored to the individual needs of the director, to the specific role that they will carry out, and their skills/experience to date.

CORPORATE GOVERNANCE REPORT

Board training

The Board receives regular refresher training and information sessions to address current business or emerging issues. In the course of 2011, Non-Executives Directors undertook approximately two days of training, including nine hours of structured training during Board meetings. This is delivered through a variety of means, including sessions on matters such as capital and liquidity (including stress testing requirements); regulatory updates for approved persons; accounting development updates and updates on credit rating agency developments. In addition, the Audit Committee arranged a series of 'deep dives' to which all Board members were invited, and which provided an in-depth review of the operations of each of the business divisions and of the latest accounting standards and operating methodologies. Sessions were delivered for several business areas amounting to three and a half days in total.

Board evaluation and performance

Having conducted thorough and rigorous externally facilitated evaluations in 2009 and 2010 (as well as in earlier years), the Board accepted the recommendation of the Nomination & Governance Committee that the 2011 evaluation should be facilitated internally, reverting to an external review for 2012.

The 2011 Board evaluation process was overseen by the Nomination & Governance Committee and took the form of:

- a detailed questionnaire, drafted by Group Secretariat in conjunction with the Chairman, to assess the effectiveness of the Board, its Committees and individual Directors;
- individual follow up interviews with the Chairman; and
- formulation of an action plan for adoption by the Board.

Remuneration

The Remuneration Committee, chaired by Anthony Watson, is responsible for overseeing the Group's remuneration arrangements and compliance with the FSA's Remuneration Code. The Remuneration Committee's terms of reference are available on the website at www.lloydsbankinggroup.com.

An overview of the Remuneration Committee is set out on page 184. The work of the Remuneration Committee is explained in the Directors' remuneration report on pages 187 to 204.

Shareholder engagement

The Board recognises the importance of promoting mutual understanding between the Company and its shareholders through greater engagement. In 2011, there was regular dialogue with institutional shareholders with more than 400 equity investor meetings undertaken in the year. Many of these meetings were undertaken by senior management (primarily the Group Chief Executive and Group Finance Director) or Board members. The Chairman has also attended a number of meetings with shareholders to discuss governance and strategic direction. Anthony Watson, as Chairman of the Remuneration Committee, regularly meets the larger shareholders to discuss executive remuneration issues while the Senior Independent Director separately meets with a range of major shareholders.

The Board is kept advised of the views of major shareholders by means of regular updates at Board and Committee meetings. It also receives monthly reports on market and investor sentiment and shareholder analysis.

Investor Relations has primary responsibility for managing day-to-day communications with institutional shareholders. Supported by the Group Chief Executive and Group Finance Director, they achieve this through a combination of briefings to analysts and institutional shareholders (both at results briefings and throughout the year), as well as site visits and individual discussions with institutional shareholders.

The Company Secretary oversees communications with private shareholders. The Group's annual general meeting provides an opportunity to meet the Group's Directors and to hear more about the strategy of the Group. Shareholders are encouraged to attend the annual general meeting and to raise any questions at the meeting or in advance, using the email address shown in the pack which will be sent to shareholders in March 2012.

Scottish Widows Investment Partnership, one of Europe's largest asset managers and a Group company, complies with the principles of the Financial Reporting Council's Stewardship Code, as published in July 2010. Details of Scottish Widows Investment Partnership's approach to stewardship and corporate governance can be found on its website, www.swip.com.

Conclusion

In conclusion, the Group confirms its compliance with all relevant provisions of the Code throughout the year ending 31 December 2011.

CORPORATE GOVERNANCE REPORT

Attendance at meetings

The attendance of Directors at Board meetings and at meetings of the Audit, Nomination & Governance, Remuneration and Risk Committees of which they were members during 2011 is shown in the table. In addition, the Audit Committee arranged five half day and one full day 'deep dive' meetings during 2011 which were open to, and attended by, other members of the Board.

Numbers in brackets show the maximum number of meetings that each Director could have attended in 2011 including ad hoc meetings or those called at short notice.

	Board meetings			Audit Committee		Nomination & Governance Committee	Remuneration Committee	Risk Committee	
	Regular	Ad hoc	Total	Regular	Ad hoc	Regular	Regular	Regular	Ad hoc
Number of meetings during the year	9	7	16	8	7	4	12	6	1
Current directors who served during 2011									
Sir Winfried Bischoff	9	7			6	4	12	5	1
António Horta-Osório[1]	7(7)	4(5)							
A M Frew	9	5		7	6			5	1
Sir Julian Horn-Smith[2]	7	4			2	3	8	2	
Lord Leitch[3]	9	5		8	4	4	11		
G R Moreno[2]	9	5			3	4			
D L Roberts	9	6		8	7	4	12	6	1
T T Ryan	8	3		8	5		10	6	1
M A Scicluna	9	7		8	7	4		6	1
Anthony Watson	9	5		8	7	4	12		
Former directors who served during 2011									
J E Daniels[4]	2(2)	2(3)							
A G Kane[5]	3(4)	3(4)							
G T Tate[6]	9	6							
T J W Tookey[7]	9	7							
H A Weir[8]	2(4)	3(4)							

[1] Appointed to the Board on 17 January 2011. On leave of absence from 2 November 2011 to 8 January 2012 and was therefore absent from meetings between these dates. See page 179 for details.
[2] Director until 17 May 2012.
[3] Director until 29 February 2012.
[4] Director until 28 February 2011.
[5] Director until 18 May 2011. Archie Kane attended all Board meetings prior to the announcement that he would be retiring from the Board.
[6] Director until 6 February 2012.
[7] Director until 24 February 2012.
[8] Director until 18 May 2011. Helen Weir attended all Board meetings prior to the announcement that she would be stepping down from the Board.

Some Directors attended Committee meetings as attendees periodically throughout the year. This attendance is not shown in the table.

CORPORATE GOVERNANCE REPORT

Board committees

The tables below set out a summary of the membership and role of each of the Board Committees, along with the activities they performed during 2011. There is a standing invitation for all Non-Executive Directors to attend Committee meetings of which they are not members. All Committee terms of reference are displayed on the website, www.lloydsbankinggroup.com or are available from the Company Secretary.

Committee	Purpose
Audit **Chairman** Martin Scicluna **Members** Anita Frew Lord Leitch (until 29 February 2012) David Roberts Tim Ryan Anthony Watson	To monitor and review the formal arrangements established by the Board in respect of: (a) the financial statements and reporting of the Group; (b) internal controls and the risk management framework; (c) internal audit; and (d) the Group's relationship with its external auditors. **Responsibilities** – reviews the financial statements published in the name of the Board and the quality and acceptability of the related accounting policies, practices and financial reporting disclosures; – reviews the scope of the work of the Group Audit Department, reports from that department and the adequacy of its resources; – reviews the effectiveness of the systems for internal control, risk management and compliance with financial services legislation and regulations; – approves the external auditors' terms of engagement and remuneration; – assesses the external auditors' independence and objectivity; – recommends the external auditors' appointment, re-appointment and removal; – reviews the results of the external audit and its cost effectiveness; – reviews reports from the auditors on audit planning and their findings on accounting and internal control systems; and – reviews procedures for handling complaints regarding accounting, internal accounting controls or auditing matters and for staff to raise concerns in confidence. **2011 Activities** – reviewed and recommended to the Board the Group annual and interim reports and accounts; – reviewed significant accounting matters as discussed with the auditors; – reviewed the Group's position as a going concern; – reviewed the appointment of the auditors and approved their remuneration; – attended one full day and five half day 'deep dive' sessions with each of the divisions; – reviewed litigation and regulatory risks; – received reports from the Divisional Financial Control Committees and the Group Risk Committee; – received reports from the internal audit department on internal controls, including SOX reports; – reviewed the Group's key finance programmes; – reviewed details of the Group's whistle blowing procedures and incidents; and – discussed the level of impairments.

CORPORATE GOVERNANCE REPORT

Committee	Purpose
Nomination & Governance	To keep the Board's governance arrangements under review and make appropriate recommendations to the Board to ensure that the Company's arrangements are consistent with best practice corporate governance standards.
Chairman Sir Winfried Bischoff **Members** Sir Julian Horn-Smith (until 17 May 2012) Lord Leitch (until 29 February 2012) Glen Moreno (until 17 May 2012) David Roberts Martin Scicluna Anthony Watson	**Responsibilities** – reviews the structure, size and composition of the Board; – oversees the selection process for prospective directors; – makes recommendations to the Board on potential appointments and reappointments of Directors at the end of their specified term; – considers Board succession; – oversees the annual evaluation of the performance of the Board; – reviews the Board's governance arrangements; – oversees the Group's implementation of governance requirements; and – oversees the process for appointments of new Non-Executive Directors and makes recommendations to the Board. **2011 Activities** – reviewed Board composition including the Group's response to the Davies Review and diversity targets; – oversaw the search and selection process for new non executive directors and the Group Finance Director; – oversaw the Board Evaluation process including formulation of the action plan; – reviewed the Governance Framework to ensure consistency with the Group Strategic Review, organisational changes and emerging developments; and – reviewed the adequacy of the Group's succession plan, including contingency arrangements during the Group Chief Executive's leave of absence.

Committee	Purpose
Remuneration	To set the principles and parameters of remuneration policy for the Group, and to oversee remuneration policy and outcomes for those colleagues specified in the terms of reference.
Chairman Anthony Watson **Members** Sir Winfried Bischoff Sir Julian Horn-Smith (until 17 May 2012) Lord Leitch (until 29 February 2012) David Roberts Tim Ryan Sara Weller (from 1 February 2012)	**Responsibilities** Information about the Remuneration Committee's responsibilities is given in the Directors' remuneration report on pages 187 to 204. **2011 Activities** Information about the Remuneration Committee's activities during 2011 is given in the Directors' remuneration report on pages 187 to 204.

CORPORATE GOVERNANCE REPORT

Committee	Purpose
Risk **Chairman** David Roberts **Members** Sir Winfried Bischoff Anita Frew Sir Julian Horn-Smith (until 17 May 2012) Tim Ryan Martin Scicluna Sara Weller (from 1 February 2012)	To review and report its conclusions to the Board on: (a) the Group's risk appetite; and (b) the Group's risk management framework, taking a forward looking perspective and anticipating changes in business conditions. **Responsibilities** – facilitates the involvement of Non-Executive Directors in risk issues and aids their understanding of these issues; – oversees adherence to Group risk policies and standards and considers any material amendments to them; and – reviews the work of the Group Risk Division. **2011 Activities** – reviewed the Group consolidated risk report and received an update from the Chief Risk Officer at each meeting; – reviewed the risk and control frameworks; – reviewed the Internal Capital Adequacy Assessment Process report; – reviewed the Group's funding plan and stress testing process; – participated in deep dives in conjunction with each division and with members of the group risk team; – reviewed the Group's risk appetite framework; and – reviewed the Group's report on financial crime.

Compliance with the British Bankers' Association Code for Financial Reporting Disclosure

In September 2010, the British Bankers' Association published a Code for Financial Reporting Disclosure (the 'Disclosure Code'). The Disclosure Code sets out five disclosure principles together with supporting guidance. The principles are that UK banks: commit to providing high quality, meaningful and decision-useful disclosures; commit to ongoing review of, and enhancement to, their financial instrument disclosures for key areas of interest; will assess the applicability and relevance of good practice recommendations to their disclosures acknowledging the importance of such guidance; will seek to enhance the comparability of financial statement disclosures across the UK banking sector; and will clearly differentiate in their annual reports between information that is audited and information that is unaudited.

The Group and other major UK banks have voluntarily adopted the Disclosure Code in their 2011 financial statements. The Group's 2011 financial statements have therefore been prepared in compliance with the Disclosure Code's principles.

CORPORATE GOVERNANCE REPORT

Internal control

The Board of Directors is responsible for the establishment and review of the Group's system of internal control, which is designed to ensure effective and efficient operations, quality of internal and external reporting, internal control, and compliance with laws and regulations. It should be noted, however, that such a system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives. In establishing and reviewing the system of internal control, the Directors have regard to the nature and extent of relevant risks, the likelihood of a loss being incurred and the costs of control. It follows, therefore, that the system of internal control can only provide reasonable but not absolute assurance against the risk of material loss.

The Directors and senior management are committed to maintaining a control-conscious culture across all areas of operation. This is communicated to all employees by way of published policies and procedures and regular management briefings. A requirement to comply with internal control risk policies is a key component of individual staff objectives expressed in the balanced scorecard. Key business risks are identified, and these are controlled by means of procedures such as physical controls, credit, trading and other authorisation limits and segregation of duties. In addition, there is an annual control self assessment exercise whereby the key businesses and head office functions review specific controls and attest to the accuracy of their assessments. The assessment covers all enterprise-wide risk management categories and is in accordance with the principles of the Code. As in previous years, this exercise was completed for the year ended 31 December 2011. All returns have been satisfactorily completed and appropriately certified.

The effectiveness of the internal control system is reviewed regularly by the Board and the Audit Committee, which also receives reports of reviews undertaken around the Group by group risk and group audit. The Audit Committee receives reports from the Company's auditors, PricewaterhouseCoopers LLP (which include details of significant internal control matters that they have identified), and has a discussion with the auditors at least once a year without executives present, to ensure that there are no unresolved issues of concern.

There is an ongoing process for identifying, evaluating and managing the significant risks faced by the Company. This process has been in place for the year under review and up to the date of the approval of the annual report and is regularly reviewed by the Board. Information regarding the main features of the internal control and risk management systems in relation to the financial reporting process is given within the Risk Management Report on pages 99 to 170.

Auditor independence and remuneration

Both the Board and the external auditors have safeguards in place to protect the independence and objectivity of the external auditors. The Audit Committee has a comprehensive policy to regulate the use of auditors for non-audit services. This policy sets out the nature of work the external auditors may not undertake, which includes work which will ultimately be subject to external audit, internal audit services and secondments to senior management positions in the Group that involve decision-making. It also includes the Group's policy on hiring former external audit staff. For those services that are deemed appropriate for the auditors to carry out, the policy sets out the approval process that must be followed for each type of assignment. The Chairman of the Audit Committee must be consulted regarding potential instructions in respect of allowable non-audit services with a value above defined fee limits.

Each year the Audit Committee establishes a limit on the fees that can be paid to the external auditors in respect of non-audit services and monitors quarterly the amounts paid to the auditors in this regard. The external auditors also report regularly to the Audit Committee on the actions that they have taken to comply with professional and regulatory requirements and current best practice in order to maintain their independence. This includes the rotation of key members of the audit team. Total auditor remuneration analysed between audit and other services is shown in note 11 to the financial statements on page 243.

The Audit Committee evaluated the performance of the external auditors during the year and will periodically continue to do so. The Audit Committee has not considered it necessary to require an independent tender process.

DIRECTORS' REMUNERATION REPORT

Statement by the Chairman of the Remuneration Committee

As Chairman of the Group's Remuneration Committee, I am pleased to introduce the Directors' Remuneration Report for 2011 and highlight some of the key decisions and activities of the Remuneration Committee this year.

Once again, there has been considerable external focus and scrutiny of executive remuneration in the past twelve months. In light of this we have worked as a Committee to ensure that we motivate, incentivise and retain our talent while continuing to be mindful both of the economic outlook and the views of our numerous stakeholders.

During 2011, a thorough Strategic Review of the business was conducted by the Board, which is now in its implementation phase. Following this review, the Remuneration Committee has worked towards translating our new strategic objectives into meaningful metrics against which to measure performance.

We believe that the introduction of a balanced scorecard approach to measure long-term performance from 2012 will enable the Committee to assess the performance of the Company and its senior executives in a consistent and performance driven way. These targets are described on pages 190 and 191.

While there have been no material changes to the overall structure of executive remuneration, we have continued to maintain an open and transparent dialogue with shareholders. This valuable engagement is something we will seek to continue into 2012, as we recognise our responsibilities to the providers of our equity capital in setting fair and appropriate remuneration policies.

The approximate make-up of the main components of our package for Executive Directors on an expected value basis is shown below:

Long-term incentive	20%	Based on a combination of performance targets comprising economic profit, absolute total shareholder return and strategic financial objectives	Paid in shares after three years
Short-term incentive	35%	Based on financial measures and on a balanced scorecard of non-financial measures	Deferred into shares until at least March 2014, subject to malus
Salary	35%	Based on role, market competitiveness, and performance	Paid in cash
Pension and benefits	10%	Based on role and market competitiveness	Paid into pension or taken as cash

The split in the components in the above chart are for Executive Directors. Comparable numbers for the Group Chief Executive are: long-term incentive 24 per cent, short-term incentive 32 per cent, salary 29 per cent and pension and benefits 15 per cent.

We have continued to be mindful of the need to exercise restraint as part of the effective governance of executive pay. In particular, we have focused on the need to manage aggregate variable pay in the prevailing environment. This has been demonstrated through a number of decisions made in the last twelve months including not increasing fixed pay, as others in the market have done, and the decision by the Group Chief Executive not to be considered for a bonus for 2011.

Furthermore, the Committee has proactively taken the decision to adjust bonus awards made to Executive Directors and certain senior executives in respect of the performance year 2010 to reflect the PPI provision made in this year's accounts. While there is no suggestion of wrongdoing or culpability, the Committee has made the adjustment, known as malus, to reflect the provision that was made after the annual results and bonus awards were finalised in February 2011.

The Remuneration Committee carefully considered what size bonus pool would be appropriate to distribute across the Bank as a whole. In making their decision, the Committee took into account the success of the integration programme, the Group's overall performance and the views of shareholders and the general public. As a result, the bonus pool was reduced by 30 per cent with the greater reductions being applied to more senior staff. Annual incentives for Executive Directors and the Group Executive Committee are down approximately 50 per cent against 2010 on a like for like basis.

Salary increases have also been restricted. Salaries as part of the annual review will increase by less than 2.5 per cent, with lower or zero increases at more senior levels.

The Long Term Incentive Plan remains a core part of our reward strategy. We have changed the performance conditions to better ensure alignment with the objectives and timeline of the Strategic Plan as well as to link to retaining our key employees and align with other elements of reward.

DIRECTORS' REMUNERATION REPORT

The Committee believes the LTIP will be more motivational by introducing measures with clear milestones and outcomes that can be communicated regularly, providing a sense of purpose and achievement throughout the life of the plan. The Committee recognises that core financial measures remain an important element for top management to ensure alignment with shareholders. Accordingly, it is proposed that Economic Profit and Absolute Total Shareholder Return targets remain in place for Executive Directors, but at a reduced level, with a significant percentage of LTIP based on balanced scorecard measures.

Despite the uncertain economic outlook, the market for talent is no less competitive and the Group must compete for this in the UK and overseas markets with varying levels of regulation and scrutiny. Nonetheless, the Committee recognises the impact that recruitment premiums can have on the total pay bill, and therefore we have continued to recruit successfully paying at appropriate market levels. Where possible, we also seek to link recruitment awards to Company performance (as demonstrated by the share price targets applied to the Group Chief Executive's pension opportunity) and through a recently introduced process to carefully monitor new joiners' performance as they become established in their roles.

In the same way, for leavers we are conscious of the importance of mitigating the Company's costs and not paying more than is appropriate through previously agreed exit terms. Other than in exceptional circumstances we pay only that required under contractual entitlements.

As a Committee we are also keen to maintain alignment between our senior executives and shareholders so that executives share the same experience in terms of Company and share price performance. As such, we will continue to operate a stringent deferral policy to ensure senior executives experience variability in remuneration dependent on Company performance.

The final point I want to touch on is the importance of risk in the formulation and evaluation of our remuneration policies and practices. Given the events in the financial services sector over the past few years, the impact of risk underpins every decision we make as a Committee, manifested through our use of economic profit to measure performance and therefore determine remuneration levels. We consider risk when making decisions on remuneration outcomes and re-consider the Group's experience when deferred awards come to vest, demonstrated by the adjustment made to 2010 bonus awards.

The Committee is dedicated to ensuring that remuneration policies and practices set out in this Report are well placed to support the successful delivery of the business strategy going forward. This Report will be tabled for shareholder approval at the AGM, which I hope you will support.

Anthony Watson CBE
Chairman, Remuneration Committee

This is a report made by the Board of Lloyds Banking Group plc, on the recommendation of the Remuneration Committee. It covers the current and proposed components of the remuneration policy and details the remuneration for each serving Director during 2011.

The Group has complied throughout the period with the requirements of the UK Corporate Governance Code (previously known as the Combined Code) in relation to Directors' remuneration. In addition, the report has been prepared in accordance with the Large and Medium sized Companies and Groups (Accounts and Reports) Regulations 2008.

The Committee recognises the attention which Bank remuneration receives and is very aware both of the importance of getting the right balance between the linkage of rewards to performance and the competitive process; recruiting, retaining and motivating staff as well as a more widely perceived concept of fairness for all involved.

DIRECTORS' REMUNERATION REPORT

Governance and Risk Management

An essential component of our approach to remuneration is the governance process that underpins it. This ensures that our policy is robustly applied and risk is managed appropriately.

The overarching purpose of the Remuneration Committee is to consider, agree and recommend to the board an overall remuneration policy and philosophy for the Group that is defined by, supports and is closely aligned to its long-term business strategy, business objectives, risk appetite and values and recognises the interests of relevant stakeholders. The Group has a conservative business model characterised by a risk culture founded on prudence and accountability. The remuneration policy and philosophy covers the whole Group, but the Committee pays particular attention to the top management population, including the highest paid employees in each division, those colleagues who perform significant influence functions for the Group and those who could have a material impact on the Group's risk profile. The Committee's role is to ensure that these colleagues are provided with appropriate incentives and reward to encourage them to enhance the performance of the Group and that they are recognised for their individual contribution to the success of the organisation, whilst ensuring that there is no reward for excessive risk taking. The Committee works closely with the Risk Committee in ensuring the bonus pool is moderated. The two Committees meet every year to determine whether the proposed bonus pool and performance assessments adequately reflected the risk appetite and framework of the Group; whether it took account of current and future risks; and whether any further adjustment is required or merited. We are also determined to ensure that the aggregate of the variable remuneration for all our colleagues is appropriate and balanced with the interests of shareholders and all other stakeholders.

The Committee determines the pensions policy for the Group and advises on other major changes to employee benefits schemes. It also agrees the policy for authorising claims for expenses from the Group Chief Executive and the Chairman. It has delegated power for settling remuneration for the Chairman, the Group Executive Directors, the Company Secretary and any group employee whose salary and annual bonus exceeds a specified amount, currently £750,000. To ensure compliance with the FSA Code of Practice, the Committee approves remuneration for Code Staff and that of senior risk and compliance officers.

The Committee monitors the application of the authority delegated to the Group Chief Executive who in turn delegates to the Group Executive Committee, the Executive Compensation Committee and the divisional Remuneration Committees, to ensure that policies and principles are being fairly and consistently applied. The Committee liaises closely with the Risk Committee and the risk function in relation to risk-adjusted performance measures, including consideration of both current and future risk. Together the management of remuneration and risk form an integral part of the Board's determination of Group corporate strategy.

All the independent Non-Executive Directors are invited to attend meetings and have the opportunity to comment on proposals and have their views taken into account before the Committee's decisions are implemented.

The Committee's terms of reference are available from the Company Secretary and are displayed on the Group's website, www.lloydsbankinggroup.com. These terms were last updated in March 2011 to ensure continued compliance with the FSA Code.

The members of the Committee during 2011 were as follows:

– Anthony Watson (chairman)
– Sir Winfried Bischoff
– Sir Julian Horn-Smith
– Lord Leitch
– David Roberts (also chairman of the Risk Committee)
– Tim Ryan

During 2011, the Committee met 12 times and considered the following principal matters:

– Review of remuneration arrangements for senior executives
– Determination of the appropriate remuneration packages for a number of senior new hires
– Determination of bonus pools based on Group performance and adjustment for risk
– Performance conditions for the Long-Term Incentive Plan
– Bonus and salary awards for Executive Directors and key senior managers
– Approval of remuneration and terms of service that fall within the Committee's terms of reference, including new appointments
– Feedback from the Remuneration Committee Chairman on his meetings with the FSA and shareholders

We thank all committee members for their commitment during the last year and attendance at meetings.

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. During the year, Deloitte LLP advised the Committee. Deloitte has voluntarily signed up to the Remuneration Consultants' Code of Conduct and are judged by the Committee to be independent. Deloitte's fees for 2011 amounted to £350,000.

During 2011, Deloitte provided information on behalf of the Committee for the testing of TSR performance conditions for the Group's long-term incentive plans (calculated by reference to both dividends and growth in share price).

Eric Daniels (until 28 February 2011), António Horta-Osório (from 1 March 2011), Angie Risley (Group HR Director) and Liz Jackson (HR Director, Reward) provided guidance to the Committee (other than for their own remuneration). Juan Colombás (Chief Risk Officer) and Tim Tookey (Group Finance Director) also attended the Committee to advise as and when necessary on risk and financial matters.

DIRECTORS' REMUNERATION REPORT

Directors' remuneration policy

The Group's remuneration policy continues to support our business values and strategy, based on building long-term relationships with our customers and employees and managing the financial consequences of our business decisions across the entire economic cycle.

Our policy is intended to ensure that our remuneration offer is both cost effective and enables us to attract and retain Executive Directors and senior management of the highest calibre, motivating them to perform to the highest standards.

Our objective is to align individual reward with the Group's performance, the interests of its shareholders, and a prudent approach to risk management. In this way we balance the requirements of our various stakeholders: our customers, shareholders, employees, and regulators. This approach is in line with the Association of British Insurers best practice code on remuneration and the FSA Remuneration Code of Practice, as the policy seeks to reward long-term value creation whilst not encouraging excessive risk taking.

Our overall policy objective is met by a focus on the particular aspects detailed below.

Policy objective	How achieved
Building long-term relationships	We build relationships with our customers and people. Working for Lloyds Banking Group is about more than pay. Our relationship with our people means that we want to pay them fairly and competitively, but our pay is positioned conservatively against the market and we do not seek to align with the highest payers in the sector. In setting pay for Executive Directors and senior managers, we take account of relative pay positioning and target levels of variable remuneration opportunity for all levels of employees in the Group. Our incentive measures are not just financial. Our Balanced Scorecards, which all of our senior executives have as part of their objectives for the year, include objectives that cover effective risk management, lending to Corporates including SMEs and retail customers, performance against targets that measure how satisfied our customers are and the extent to which our employees feel engaged with and committed to working for Lloyds Banking Group.
Managing the financial consequences of our business through the economic cycle	Economic profit is a key measure by which we manage our business. This measure takes into account the level of capital required to generate profits as well as the risks taken. The same level of profit generated at lower risk results in higher economic profit. Economic profit also measures risk based on an assessment of how the business will perform through the economic cycle and is a key measure for short term incentives. For example, in good times, when default rates on loans are low, we adjust the economic profit measure downwards based on a higher average expected default experience over the economic cycle. This encourages us to avoid business and funding strategies that are only profitable during boom times but turn bad in a recession. Economic profit plays a prominent role in our incentive plans for executives, with its inclusion in both the annual and LTIP performance measures.
Aligning individual rewards with Group performance and shareholders	Our executives' annual incentives are based on stretching performance objectives and targets in the Group Balanced Scorecard. This Balanced Scorecard is derived from the Medium Term Plan which defines the financial and non-financial targets within our agreed risk appetite over a three year period. Any annual bonus for Executive Directors is deferred into shares and released over time, helping to increase alignment with shareholders. These deferrals are subject to malus in the event of unsustainable performance. Executives are also aligned with shareholders through the LTIP, which pays out in shares based on performance against Group financial targets over a three year period. In addition to purely financial metrics of Economic Profit and Total Shareholder Return, the performance conditions for the 2012 LTIP will comprise measures linked to the Strategic Review that reflect the wider Group objectives. These measures are short-term funding as a percentage of total funding, non-core assets at the end of 2014, run-rate simplification benefits achieved at the end of 2014 and customer satisfaction. We operate tough contract provisions relative to market practice, whereby no executive has an entitlement to more than 12 months' notice (not taking into account recruitment provisions), pay in lieu of notice is limited to basic salary, is paid monthly over 12 months and is mitigated if the executive gets another job. This approach avoids the risk of payment for failure.
A prudent approach to risk management	We also have non-financial measures of performance against risk objectives in both the annual and long-term plans for executives. For the 2011 annual incentive plan we continue to align the award to long-term prudent risk management by deferring 100 per cent of the award for Executive Directors, which is subject to malus. Executive Directors are also required to retain any shares vesting from LTIP awards for a further 2 years, after allowing for tax and national insurance requirements. For other employees, the immediate cash bonus award is limited to £2,000 with a percentage of larger bonuses being subject to deferral and malus. If the performance is unsustainable during the deferral period some or all of the award may be forfeited. We have a robust governance framework with an independent Remuneration Committee reviewing all compensation decisions for senior executives. This approach to governance and review is cascaded through the organisation. We also ensure that all control function employees are assessed and their remuneration determined jointly by the relevant business Director and the control function Director. Senior risk and compliance officers are also reviewed by the Remuneration Committee.

DIRECTORS' REMUNERATION REPORT

Policy objective	How achieved
Cost effective packages to attract and retain executives	We aim to ensure that the totality of remuneration for Executive Directors is competitive against our benchmark groups. These groups are other major UK banks and the top 20 companies in the FTSE 100, reflecting practices in large UK companies across all sectors. We aim to be competitively but conservatively positioned against the market. We select incentive plan targets that are directly linked to the business strategy and priorities, ensuring alignment with company performance, targets that are meaningful to executives and incentive packages that are valued by executives and cost effective.

Summary

Following extensive consultation with shareholders, the Remuneration Committee is proposing a package for Executive Directors for 2012 that is closely based on the structure and principles applied in previous years as follows:

Element	Level/design for 2012	Key purpose
Base salary	Base pay should be set relative to FTSE 20 and banking sector competitors There are no increases to base salaries for Executive Directors	To provide the basis for a competitive package
Pension	Defined contribution pension provision for new entrants	Enable executives to build long-term retirement savings Retention
Annual incentive	200 per cent of salary maximum (225 per cent for the Group Chief Executive) Based on Group financial targets relating to profit before tax and economic profit as well as Balanced Scorecard measures covering divisional financial targets, customers (e.g. SME lending), people, risk and building the business Subject to deferral and malus in line with FSA requirements	Alignment with Group performance Motivation of executives Pay for performance Alignment with sound risk management
Long-term incentive plan	Annual awards of 275 per cent of salary for the Group Chief Executive and 225 per cent for other Executive Directors. Vesting based on financial measures comprising Absolute Total Shareholder Return, Economic Profit and strategic financial objectives. Details of the performance conditions are as follows:	Motivation and retention of executives Alignment with sound risk management Alignment with long-term shareholder interests

Measure	Basis	Metric	Weighting
Economic Profit	Payout range set relative to 2014 targets	Threshold: £160 million Maximum: £1,653 million	30%
Absolute TSR	Growth in share price including dividends	Threshold: 12% per annum Maximum: 30% per annum	30%
Short term funding as % of total funding	Payout range set relative to 2014 targets	Threshold: 20% Maximum: 15%	10%
Non-core assets at end of 2014		Threshold: <= £95 billion Maximum: <= £80 billion	10%
Net simplification benefits (run rate achieved at 2014 year-end)		Threshold: £1.5 billion Maximum: £1.8 billion	10%
Customer satisfaction (FSA reportable complaints per 1,000 customers over 3 years)		Threshold: 1.5 Maximum: 1.3	10%

DIRECTORS' REMUNERATION REPORT

Base salary

Base salaries are reviewed annually, taking into account individual performance and market information (which is provided by Towers Watson and supplemented with information from Deloitte LLP) and normally adjusted from 1 January of the relevant year. The remuneration committee confirmed during the 2011 review that the FTSE remains the most appropriate comparator group to use to benchmark overall competitiveness of the remuneration package whilst taking particular account of the remuneration practice of our direct competitors, namely the major UK banks.

No increase to salaries will be made in 2012.

Name	A Horta-Osório	G T Tate	T J W Tookey
At 1 January 2012	£1,061,000	£656,000	£615,000
At 1 January 2011	£1,061,000[1]	£656,000	£615,000

[1] With effect from 17 January 2011.

Annual incentive plan

The annual incentive scheme for Executive Directors is designed to reflect specific goals linked to the performance of the business.

Incentive awards for Executive Directors are based upon individual contribution and overall corporate results. Incentive opportunity is driven by corporate performance based on profit before tax and economic profit, together with divisional achievement and individual performance. Individual targets relevant to improving overall business performance are contained in a Balanced Scorecard and are grouped under the following headings:

– Financial
– Building the Business
– Customer Service
– Risk
– People Development

These targets apply differently for the Executive Directors, reflecting differing strategic priorities. The non-financial measures include key performance indicators relating to risk management, SME lending, process efficiency, service quality and employee engagement.

The remuneration committee believes that the structure of the incentive – in particular the use of risk-adjusted and non-financial measures – has been highly successful in promoting a long-term focus within the senior management team.

The maximum annual incentive opportunity is 200 per cent (225 per cent for the Group Chief Executive) of base salary for the achievement of exceptional performance targets.

Consistent with the aim of ensuring that short-term financial results are only rewarded if they promote sustainable growth, the 2011 annual incentive is subject to deferral in shares until at least 2014. This deferred amount is subject to malus if the performance that generated the incentive is found to be unsustainable.

The committee reserves the right to exercise its discretion in reducing any payment that otherwise would have been earned, if they deem this appropriate.

The key achievements of the Group are set out in the Group Chief Executive's review on pages 14 to 19 of this Annual Report.

The calculation of the annual incentive plan outcomes for Executive Directors, based on the achievement of performance against targets in respect of performance in 2011, has been vigorously discussed by the Remuneration Committee. Mr Horta-Osório advised the Board that he did not wish to be considered for a bonus in respect of the 2011 performance year. The bonuses awarded to directors are shown in the table below:

Name	A Horta-Osório	G T Tate	T J W Tookey
Maximum Opportunity	225%	200%	200%
% awarded for 2011	Declined bonus	53%	20%
Bonus awarded for 2011	–	£345,000	£120,000

DIRECTORS' REMUNERATION REPORT

Long-term incentive award

The current LTIP rules allow for awards to be made of up to 400 per cent of base salary. Under normal circumstances, awards can be made of up to 300 per cent of salary with the additional 100 per cent available for circumstances that the Remuneration Committee deems to be exceptional. In 2011, awards were made of up to 300 per cent of base salary to the Executive Directors and 420 per cent for the Group Chief Executive. The award for Mr Horta-Osório was made in order to facilitate his appointment as Group Chief Executive. In 2012, the committee intends to make an award of 275 per cent of salary to Mr Horta-Osório. Mr Tookey and Mr Tate are not eligible to receive an award following Mr Tookey's resignation and Mr Tate's retirement from the Group.

Long-term incentive performance measures

During 2011, the Committee has consulted widely with shareholders on the topic of performance measures and sharing the growth in the Company appropriately between shareholders and management. The Committee believes that the performance measures for the 2012 LTIP award for the Executive Committee should be Economic Profit, Absolute Total Shareholder Return and strategic financial measures. These measures capture risk measurement, profit growth and shareholder experience and align shareholder experience and management reward.

Details of current LTIP awards are provided on page 201.

Pension

Executive directors may participate in the Group's defined contribution scheme (under which their pension entitlement will be based upon both employer and employee contributions). Company contributions are 25 per cent of salary, with the exception of António Horta-Osório who is eligible for 50 per cent of reference salary, including his flexible benefit allowance. These can be taken as cash or pension contributions, or a mixture of each.

Details of pension contributions and accruals are shown on page 197.

Other share plans

The Executive Directors are also eligible to participate in the Group's 'sharesave' and 'share incentive' plans. These are 'all-employee' share plans.

Shareholding guidelines

Directors are required to build up a holding in Lloyds Banking Group shares of value equal to 1.5 times gross salary (2 times gross salary for the Group Chief Executive) and expected to achieve these targets within 5 years of joining the Board. They are required to retain any shares vesting from the share price performance element of the 2010 LTIP and 2011 LTIP for a further two years post vesting. The Group Chief Executive is making significant progress in reaching this target.

Chairman's remuneration

The Chairman's remuneration comprises salary and benefits. He does not participate in the annual bonus and long-term incentive arrangements, nor is he entitled to pension benefits.

The Chairman's salary remained unchanged in 2011, at £700,000 per annum.

DIRECTORS' REMUNERATION REPORT

Independent Non-Executive Directors' fees

The fees of the Independent Non-Executive Directors are agreed by the Board within a total amount determined by the shareholders. Non-Executive Directors may also receive fees, agreed by the Board, for membership of Board Committees. The fees are designed to recognise the various responsibilities of a Non-Executive Director's role and to attract individuals with relevant skills, knowledge and experience. The fees are neither performance related nor pensionable and are comparable with those paid by other companies. The annual fees were reviewed in 2011 and remain unchanged as listed below.

Non-Executive Director – base fee	£65,000
Deputy Chairman	£100,000
Senior Independent Director	£60,000
Audit Committee Chairmanship	£50,000
Audit Committee Membership	£20,000
Remuneration Committee Chairmanship	£30,000
Remuneration Committee Membership	£15,000
Risk Committee Chairmanship	£40,000
Risk Committee Membership	£15,000
Nomination & Governance Committee Membership	£5,000

In the case of the Nomination & Governance Committee, membership currently comprises the Deputy Chairman, Senior Independent Director and chairs of the Board Committees (the fees for which include membership of the Nomination & Governance Committee) and one other Independent Non-Executive Director. Only this director receives an attendance fee, which is £5,000.

Independent Non-Executive Directors who serve on the Boards of subsidiary companies may also receive fees from the subsidiaries.

2011 Non-Executive Directors' fees (£)

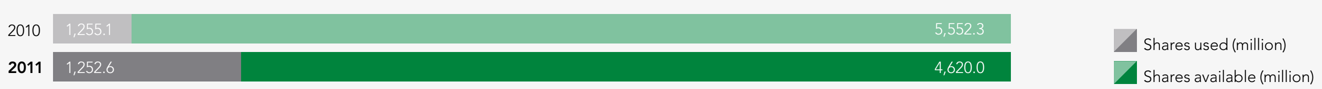
	Board	Deputy Chairman	Senior Independent Director	Audit Committee	Remuneration Committee	Nomination & Governance Committee	Risk Committee	SW Board fees[1]	2011 Total
A M Frew	65			20			15		100
Sir Julian Horn-Smith	65				15	5	15		100
Lord Leitch	65	100		20	15			120	320
G R Moreno	65		60						125
D L Roberts	65			20	15		40		140
T T Ryan	65			20	15		15		115
M A Scicluna	65			50			15		130
Anthony Watson	65			20	30				115

[1] Scottish Widows Services Limited

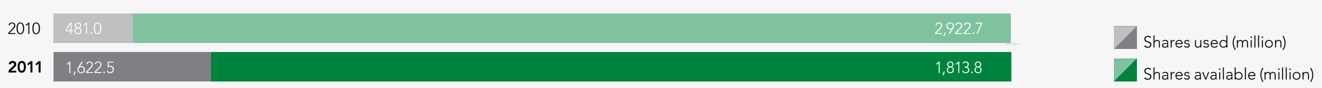
Dilution limits

The following charts illustrate the shares available for the Group's share plans.

ALL PLANS (10% OF THE ISSUED ORDINARY SHARE CAPITAL OF THE GROUP IN ANY CONSECUTIVE 10 YEARS)



EXECUTIVE PLANS (5% OF THE ISSUED ORDINARY SHARE CAPITAL OF THE GROUP IN ANY CONSECUTIVE 10 YEARS)



DIRECTORS' REMUNERATION REPORT

Service agreements

The Group's policy is for Executive Directors to have service agreements with notice periods of no more than one year. All current Executive Directors are entitled to receive 12 months' notice from the Group, but would be required to give at least six months' notice.

It is the Group's policy that where compensation on early termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured, and that bonus payments should relate to the period of actual service, rather than the full notice period, and will be determined on the basis of performance.

Any entitlements under the pension scheme or equity plans will be in accordance with the scheme rules on leaving.

	Notice to be given by the Company	Date of service agreement/letter of appointment
Sir Winfried Bischoff	6 months	27 July 2009
António Horta-Osório	12 months	3 November 2010
G T Tate	12 months	9 February 2009
T J W Tookey	12 months	26 January 2009

Independent Non-Executive Directors do not have service agreements and their appointment may be terminated, in accordance with the articles of association, at any time without compensation.

External appointments

The Group recognises that Executive Directors may be invited to become Non-Executive Directors of other companies and that these appointments may broaden their knowledge and experience, to the benefit of the Group. Fees are normally retained by the individual directors as the post entails personal responsibility.

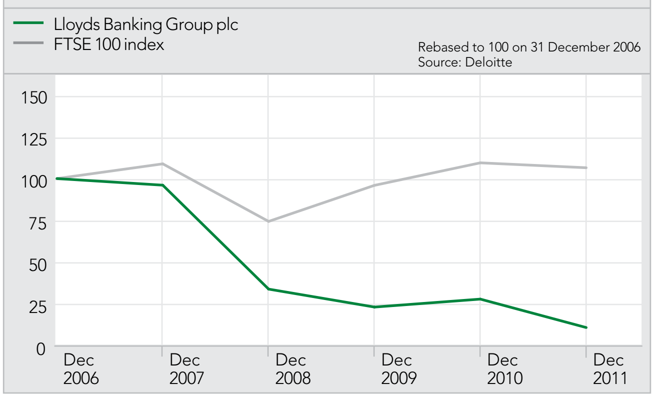
Executive Directors are generally allowed to accept one Non-Executive Directorship.

During 2011, Eric Daniels received fees of £76,000 which was retained by him, for serving as Non-Executive Director of BT plc. Truett Tate received fees of £30,000 as chairman of Arora Holdings Ltd and £20,000 as a Director of Towergate Partnership Ltd. These fees were retained by him.

Performance graph

The graph below illustrates the performance of the Group measured by TSR against a 'broad equity market index' over the past five years. The Group has been a constituent of the FTSE 100 index throughout this five year period.

Total shareholder return – FTSE 100 index



DIRECTORS' REMUNERATION REPORT

Directors' emoluments for 2011 (audited)

	Salaries/ fees £000	Pension allowance[1] £000	Other benefits: One-off payments[2] £000	Other benefits: Other cash benefits[3] £000	Other benefits: Non-cash benefits[4] £000	Performance-related payments[5] £000	2011 Total £000	2010[6] Total £000
Current Directors who served during 2011								
Executive Directors								
António Horta-Osório (from 17 January 2011)	1,019	514	172	50	10		1,765	
Non-Executive Directors								
Sir Winfried Bischoff	700			12	1		713	712
A M Frew	100						100	8
Sir Julian Horn-Smith	100						100	100
Lord Leitch	320						320	308
G R Moreno	125						125	134
D L Roberts	140						140	104
T T Ryan	115						115	113
M A Scicluna	130						130	130
Anthony Watson	115						115	115
Former Directors who served during 2011								
J E Daniels (until 28 February 2011)	776		25	40	14		855	2,572
A G Kane (until 18 May 2011)	590	80		24	27		721	1,408
G T Tate (until 6 February 2012)	656	164		27	26	345	1,218	1,745
T J W Tookey (until 24 February 2012)	615	90	73	36	5	120	939	1,579
H A Weir (until 18 May 2011)	625	125		35	6		791	1,578
Others (for 2010 only)								35
	6,126	973	270	224	89	465	8,147	10,641

[1] Following changes to the amount of tax relief available on pension contributions in each year, Directors may elect to receive some or all of their allowances as cash. Contributions into the pensions scheme shown on page 197 are commensurately reduced.

[2] One-off payments comprise a contractual cash payment to António Horta-Osório as part of the buyout of his benefits from his previous employer, an allowance to Tim Tookey to reflect his additional responsibilities as Interim Group Chief Executive and a tax planning allowance for Eric Daniels.

[3] Other cash benefits includes flexible benefits payments (4 per cent of basic salary), payments to certain directors who elect to take cash rather than a company car under the car scheme.

[4] The non-cash benefits column includes amounts relating to the use of a company car, use of a company driver and private medical insurance. It also includes a spouse's travel allowance for Truett Tate, Sir Winfried Bischoff and Eric Daniels and the value of any matching shares which are received under the terms of Sharematch, through which employees have the opportunity to purchase shares up to a maximum of £125 per month and receive matching shares on a one for one basis up to a maximum value of £30 per month, rounded down to the nearest whole share.

[5] Bonuses awarded in respect of 2011 performance will be subject to 100 per cent deferral into shares until at least 2014.

[6] Bonus awards made to Executive Directors in respect of 2010 were amended in February 2012 by reducing the amounts awarded in Deferred Shares. The reduction amounted to 40 per cent of the award in respect of Mr Daniels and 25 per cent of the awards in respect of Mr Kane, Mr Tate, Mr Tookey and Mrs Weir. The Board's decision is based on the fact that had the outcome of the Judicial Review into Payment Protection Insurance (PPI) in April 2011 been known, and had the consequential provision made been effected at the time of the award of the 2010 bonus in February 2011, the bonus pool would have been lower and individual bonus awards would also have been lower.

DIRECTORS' REMUNERATION REPORT

Directors' pensions (audited)

The Executive Directors are members of one of the pension schemes provided by Lloyds Banking Group with benefits either on a defined benefit or defined contribution basis. There are now no Directors accruing further pensionable service on a defined benefit basis.

Defined benefit scheme members

	Accrued pension at 31 December 2011 £000 (a)	Accrued pension at 31 December 2010 £000 (b)	Change in accrued pension £000 (a)-(b)	Transfer value at 31 December 2011 £000 (c)	Transfer value at 31 December 2010 £000 (d)	Change in transfer value £000 (c)-(d)	Additional pension earned to 31 December 2011 £000 (e)	Transfer value of the increase £000 (f)
J E Daniels	223	210	13	5,081	5,030	51	13	294
A G Kane	379	372	7	8,734	8,657	77	7	154

Columns (a) and (b) represent the deferred pension to which the directors would have been entitled had they left the Group on 31 December 2011 and 2010, respectively. For Mr Daniels the 2011 figure is the pension put into payment upon retirement on 30 September 2011. For Mr Kane, the 2011 figure is the deferred pension entitlement as at the date of opting-out of the pension scheme on 15 June 2011.

Column (c) is the transfer value of the deferred pension in column (a) calculated as at 31 December 2011 based on factors supplied by the actuary of the pension scheme.

Column (d) is the equivalent transfer value, but calculated as at 31 December 2010 on the assumption that the Director left service at that date.

Column (e) is the increase in pension built up during the year, recognising (i) the accrual rate for the additional service based on the pensionable salary in force at the year end, and (ii) where appropriate the effect of pay changes in 'real' (inflation adjusted) terms on the pension already earned at the start of the year.

Column (f) is the capital value of the pension in column (e).

The disclosures in columns (e) and (f) are as required by the UK Listing Authority listing rules. The requirements of the listing rules differ from those of the Companies Act. The listing rules require the additional pension earned over the year to be calculated as the difference between the pension accrued at the end of the financial year and the pension accrued at the start of the financial year less the increase in the pension earned over the year solely due to inflation. The transfer value in column (f) can differ significantly from the change in transfer value as required by the Companies Act because the additional pension accrued over the year calculated in accordance with the listing rules makes allowance for inflation, and the change in the transfer value required by the Companies Act will be significantly influenced by changes in the assumptions underlying the transfer value calculation at the beginning and end of the financial year.

Benefits from a registered pension scheme are subject to the Lifetime Allowance, currently £1.8 million, which is equivalent to an annual pension of £90,000. Any benefit in excess of this amount will incur a tax charge for the individual. The Lifetime Allowance will decrease to £1.5 million from April 2012. The Group has agreed that if an Executive Director has benefits in excess of the Lifetime Allowance he may cease to accrue benefits in the Scheme and receive a salary supplement as an alternative. This will not cost the Group more than the current arrangements. The Group will not compensate any individual in respect of any tax liability arising from the provision of pension.

Defined contribution scheme members

During the year to 31 December 2011 the Group has made the following contributions to the defined contribution scheme:

	Pension contributions £000
António Horta-Osório	31
G T Tate	41
T J W Tookey	64
H A Weir	31

DIRECTORS' REMUNERATION REPORT

Directors' interests (audited)

The beneficial interests, of those who were directors at 31 December 2011 in ordinary shares of Lloyds Banking Group were:

Number of shares

	At 1 January 2011 (or later date of appointment)	**At 31 December 2011**	At 27 February 2012
Executive Directors			
António Horta-Osório[1]	100,000	**1,067,099**	
G T Tate[1]	529,015	**789,181**	789,745[2]
T J W Tookey	123,891	**315,957**	316,943[3]
Non-Executive Directors			
Sir Winfried Bischoff	800,000	**1,100,000**	
A M Frew	–	**300,000**	
Sir Julian Horn-Smith	227,890	**227,890**	
Lord Leitch	55,787	**55,787**	
G R Moreno[1]	500,000	**1,200,000**	
D L Roberts	378,670	**968,641**	
T T Ryan[1]	100,877	**400,877**	
M A Scicluna	56,226	**92,572**	
Anthony Watson	226,357	**376,357**	

[1] Shareholdings held by Mr A Horta-Osório, Mr G T Tate, Mr G R Moreno and Mr T T Ryan are either wholly or partially in the form of ADRs.

[2] The beneficial interests for Mr G T Tate relate to changes to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2011 and 6 February 2012, the date of his resignation from the Board of Lloyds Banking Group.

[3] The beneficial interests for Mr T J W Tookey relate to changes to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2011 and 24 February 2012, the date of his resignation from the Board of Lloyds Banking Group.

A summary of the awards vested, purchases and sales made by directors is shown on page 204.

DIRECTORS' REMUNERATION REPORT

Interests in share options (audited)

	At 1 January 2011	Granted during the year	Exercised during the year	Lapsed during the year	At 31 December 2011	Exercise price	Exercise periods From	To	Notes
António Horta-Osório	–	342,265	342,265	–	–	–	–	–	j, k
	–	1,452,401	–	–	1,452,401	–	15/6/2011	30/3/2021	j
	–	662,116	–	–	662,116	–	31/1/2012	30/3/2021	j
	–	1,452,401	–	–	1,452,401	–	15/6/2012	30/3/2021	g, j
	–	438,846	–	–	438,846	–	31/1/2013	30/3/2021	g, j
	–	1,707,763	–	–	1,707,763	–	15/6/2013	30/3/2021	g, j, l
Former directors who served during 2011									
J E Daniels	265,051	–	–	–	265,051	207.97p	18/3/2007	30/9/2012	c, e, h
	867,914	–	–	–	867,914	235.26p	17/3/2008	30/9/2012	d, e, h
	19,399	–	–	–	19,399	46.78p	1/10/2011	31/3/2012	a, i
A G Kane	70,068	–	–	70,068	–	324.92p	6/3/2004	5/3/2011	b, f
	147,669	–	–	–	147,669	207.97p	18/3/2007	17/3/2014	c, e
	499,709	–	–	–	499,709	235.26p	17/3/2008	16/3/2015	d, e
	19,399	–	–	–	19,399	46.78p	1/06/2013	30/11/2013	a, g
G T Tate	129,820	–	–	–	129,820	207.97p	18/3/2007	17/3/2014	c, e
	55,147	–	–	–	55,147	199.91p	12/8/2007	11/8/2014	c, e
	499,709	–	–	–	499,709	235.26p	17/3/2008	16/3/2015	d, e
	19,399	–	–	–	19,399	46.78p	1/6/2013	30/11/2013	a, g
T J W Tookey	19,399	–	–	–	19,399	46.78p	1/6/2013	30/11/2013	a, g
H A Weir	156,968	–	–	–	156,968	210.70p	29/4/2007	28/4/2014	c, e
	499,709	–	–	–	499,709	235.26p	17/3/2008	16/3/2015	d, e
	19,399	–	–	19,399	–	46.78p	–	–	a

a Sharesave. Mrs Weir's Sharesave award lapsed during 2011 at her request.
b Executive option granted in March 2001.
c Executive option granted between March 2004 and August 2004.
d Executive option granted between March 2005 and August 2005.
e Exercisable to the extent that the performance condition was satisfied.
f Lapsed on 10th anniversary of date of grant as the performance conditions had not been met.
g Not exercisable as the option has not been held for the period required by the relevant scheme.
h Exercisable for period of one year from date of leaving.
i Exercisable for period of six months from date of leaving.
j Share buy out award granted on 30 March 2011 for the loss of deferred share awards forfeited on leaving the Santander Group. Awards are consistent with those forfeited and have a nil option price.
k Award exercised on 30 March 2011 at a price of 58.75p.
l The extent that the award will become exercisable is subject to performance. The performance condition has not changed since the award was made.

None of the other directors at 31 December 2011 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

The market price for a share in the Company at 1 January 2011 and 31 December 2011 was 65.70p and 25.91p, respectively. The range of prices between 1 January 2011 and 31 December 2011 was 21.84p to 69.61p.

The following table contains information on the performance conditions for executive options granted since 2001.

The Remuneration Committee chose the relevant performance conditions because they were felt to be challenging, aligned to shareholders' interests and appropriate at the time.

DIRECTORS' REMUNERATION REPORT

Options granted	Performance conditions
March 2001	Growth in earnings per share which is equal to the aggregate percentage change in the retail price index plus three percentage points for each complete year of the relevant period plus a further condition that the Company's ranking based on TSR over the relevant period should be in the top 50 companies of the FTSE 100. As the performance conditions for those options granted in March 2001 were not met, the options lapsed in March 2011.
March 2004 – August 2004	That the Company's ranking based on TSR over the relevant period against a comparator group (17 UK and international financial services companies including Lloyds Banking Group) must be at least ninth, when 14 per cent of the option will be exercisable. If the Company is ranked first in the group, then 100 per cent of the option will be exercisable and if ranked tenth or below the performance condition is not met. Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 24 per cent for Truett Tate's March option and at 14 per cent for all other options granted to Executive Directors during 2004.
March 2005 – August 2005	That the Company's ranking based on TSR over the relevant period against a comparator group (15 companies including Lloyds Banking Group) must be at least eighth, when 30 per cent of the option will be exercisable. If the Company is ranked first to fourth position in the group, then 100 per cent of the option will be exercisable and if ranked ninth or below, the performance condition is not met. Options granted in 2005 became exercisable as the performance condition was met when tested. Grants vested at 82.5 per cent for all options granted to Executive Directors.
March 2011 (Applicable only to award made to António Horta-Osório on 30 March 2011 over 1,707,763 shares)	That the Company's ranking based on TSR over the relevant period against a comparator group (18 companies including Lloyds Banking Group) must be at least ninth, when 30 per cent of the option will be exercisable. If the Company is ranked first to fifth position in the group, then 100 per cent of the option will be exercisable and if ranked tenth or below, the performance condition is not met.

Lloyds TSB executive retention plan 2006

On 26 March 2008 (prior to his appointment as an Executive Director), Tim Tookey was granted an award under the Lloyds TSB Executive Retention Plan 2006. The award is satisfied in cash only and, subject to continued employment, gave him the right to receive an amount equal to the total value of 218,400 Lloyds Banking Group shares on the dates of vesting. On 26 March 2011 50 per cent of his award vested at 60.48p. Mr Tookey had agreed to reinvest the cash proceeds and he acquired 52,896 Lloyds Banking Group shares. Following notification of Mr Tookey's resignation from Lloyds Banking Group, the remaining 50 per cent of the award lapsed.

DIRECTORS' REMUNERATION REPORT

Lloyds TSB long-term incentive plan (audited)

The following table shows conditional shares awarded under the plan. Further information regarding this plan can be found on pages 202 and 203.

	At 1 January 2011	Awarded during the year	Vested during the year	Lapsed during the year	At 31 December 2011	End of performance period	Notes
António Horta-Osório	–	7,154,187	–	–	7,154,187	31/12/2013	b
Former Directors who served during 2011							
J E Daniels	1,690,757	–	–	1,690,757	–	31/12/2010	
	2,304,135	–	–	–	2,304,135	31/12/2011	
	3,456,204	–	–	–	3,456,204	31/12/2011	
	5,135,781	–	–	–	5,135,781	31/12/2012	c
A G Kane	833,165	–	–	833,165	–	31/12/2010	
	1,313,469	–	–	–	1,313,469	31/12/2011	
	1,970,202	–	–	–	1,970,202	31/12/2011	
	2,927,643	–	–	–	2,927,643	31/12/2012	c
G T Tate	1,045,491	–	–	1,045,491	–	31/12/2010	
	1,424,778	–	–	–	1,424,778	31/12/2011	
	2,137,169	–	–	–	2,137,169	31/12/2011	
	3,175,748	–	–	–	3,175,748	31/12/2012	c
	–	3,159,517	–	–	3,159,517	31/12/2013	b
T J W Tookey	143,567	–	46,430	101,933	–	31/12/2010	a
	1,335,730	–	–	–	1,335,730	31/12/2011	
	2,003,597	–	–	–	2,003,597	31/12/2011	
	2,977,264	–	–	–	2,977,264	31/12/2012	c
	–	2,962,047	–	–	2,962,047	31/12/2013	b
H A Weir	1,020,987	–	–	1,020,987	–	31/12/2010	
	1,391,386	–	–	–	1,391,386	31/12/2011	
	2,087,079	–	–	–	2,087,079	31/12/2011	
	3,101,317	–	–	–	3,101,317	31/12/2012	c

a Award vested at 29 per cent for Tim Tookey as he was not a director at the time the award was made. The 'vested during the year' figure includes 4,796 dividend shares accumulated prior to the stopping of dividend payments. The closing market price of the Group's ordinary shares on the date of release was 58.54p.

b Award price 62.288p.

c The Absolute Share Price element of this award has an end of performance period date of 26 March 2013.

Mr Daniels' LTIP and Integration Awards will continue, but will be pro-rated to reflect the number of months employed during each performance period. For the awards made on 8 April 2009, this will be 33 months and for the award made on 26 March 2010, this will be 21 months.

Mr Tookey's unvested awards all lapsed upon his departure from the Group on 24 February 2012.

DIRECTORS' REMUNERATION REPORT

The following table contains information on the performance conditions for awards made under the long-term incentive plan. The Remuneration Committee chose the relevant performance conditions because they were felt to be challenging, aligned to shareholders' interests and appropriate at the time.

LTIP awarded	Performance conditions
March and April 2008	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. For the other 50 per cent of the award (the 'TSR Award') – the Group's TSR needed 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 TSR was equal to median and vesting would occur on a straight line basis in between these points. Where the Group's TSR was below the median of the comparator group, the TSR Award would lapse. The relevant period commenced on 6 March 2008 (the date of award) and ended on 5 March 2011. At the end of the relevant period, neither of the performance conditions had been met and the Awards lapsed. Tim Tookey was not an Executive Director when his award was made in 2008, and as such his award vested at 29 per cent on the same basis as other award recipients below the Group Executive Committee level.
April 2009	**EPS:** The release of 50 per cent of the shares will be dependent on the extent to which growth in EPS achieves cumulative EPS targets over the three year period from January 2009 to December 2011. **Economic profit:** The release of the remaining 50 per cent of shares will be dependent on the extent to which the Group achieves cumulative Economic Profit targets over the three year period from January 2009 to December 2011.

EPS	Vesting %	Growth in EPS
Threshold	25%	26%
Maximum	100%	36%

Economic profit	Vesting %	Absolute improvement in adjusted EP
Threshold	25%	100%
Maximum	100%	202%

LTIP awarded	Performance conditions
April 2009 Integration award	**Synergy Savings:** The release of 50 per cent of the shares 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. **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.

DIRECTORS' REMUNERATION REPORT

March 2010

EPS: Relevant to 36 per cent of the award. Performance will be measured based on absolute improvement in adjusted EPS over the three financial years starting on 1 January 2010 relative to an adjusted fully diluted 2009 EPS base.

Economic Profit: Relevant to 36 per cent of the award. Performance will be measured based on the compound annual growth rate of adjusted Economic Profit over the three financial years starting on 1 January 2010 relative to 2009 adjusted Economic Profit base.

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.

The targets are:

EPS	Vesting %	Absolute improvement in adjusted EPS
Threshold	25%	158%
Maximum	100%	180%

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

Economic profit	Vesting %	Compound annual growth rate of adjusted EP
Threshold	25%	57% per annum
Maximum	100%	77% per annum

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

Absolute Share Price	Vesting %	Absolute Share Price
Threshold	0%	75p
Maximum	100%	114p

Vesting between threshold and maximum will be on a straight line basis, provided that shares comprised in the Absolute Share Price element of the award may only be released if both the EPS and Economic Profit performance measures have been satisfied at the threshold level or above.

March 2011

EPS: Relevant to 33$^1/_3$ per cent of the award. Performance will be based on 2013 EPS outcome.

Economic Profit: Relevant to 33$^1/_3$ per cent of the award. The performance target is based on 2013 adjusted Economic Profit.

Absolute Total Shareholder Return: Relevant to 33$^1/_3$ per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2013.

The targets are:

EPS	Vesting %	Target
Threshold	25%	6.4p
Maximum	100%	7.4p

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

Economic profit	Vesting %	Target
Threshold	25%	£567m
Maximum	100%	£1,234m

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

Absolute Total Shareholder Return	Vesting %	Annualised Absolute Shareholder Return
Threshold	25%	8%
Maximum	100%	14%

Vesting between threshold and maximum will be on a straight line basis, provided that shares comprised in the Absolute Share Price element of the award may only be released if both the EPS and Economic Profit performance measures have been satisfied at the threshold level or above.

Deloitte provided information for the testing of the TSR performance conditions for the Company's long-term incentive plan. EPS is the Group's normalised earnings per share as shown in the Group's report and accounts, subject to such adjustments as the Remuneration Committee regards as necessary for consistency.

None of those who were Directors at the end of the year had any other interest in the capital of Lloyds Banking Group plc or its subsidiaries.

The register of Directors' interests, which is open to inspection, contains full particulars of Directors' shareholdings and options to acquire shares in Lloyds Banking Group.

On behalf of the Board

Harry F Baines
Company Secretary
27 February 2012

OTHER REMUNERATION DISCLOSURES

Emoluments of the eight highest paid senior executives (unaudited)

Emoluments of the eight highest paid senior executives can be found on the Group's website at www.lloydsbankinggroup.com

Directors' interests – summary of awards vested, purchases and sales made by directors in 2011 (unaudited)

	At 1 January 2011 (or appointment date)	Transactions during year Date	Shares	Notes	31 December 2011
Executive Directors					
António Horta-Osório	100,000	1/3/11		Purchase on appointment	
		30/3/11	167,099	March 2011 Share Buy Out award	
		5/8/11	200,000	Purchase	
		15/12/11	600,000	Purchase (150,000 ADRs)	1,067,099
G T Tate	529,015				
		Monthly	4,420	2011 Share Incentive Plan purchase and matching shares	
		23/8/11	175,746	Purchase	
		24/8/11	80,000	Purchase (20,000 ADRs)	789,181
T J W Tookey	123,891				
		Monthly	4,420	2011 Share Incentive Plan purchase and matching shares	
		30/3/11	22,750	2008 Long Term Incentive Plan release	
		30/3/11	52,896	2006 Executive Retention Plan release	
		8/6/11	57,810	2008 Deferred Bonus Plan release	
		8/6/11	-57,810	Sale	
		24/11/11	112,000	Purchase	315,957
Non-Executive Directors					
Sir Winfried Bischoff	800,000				
		5/8/11	200,000	Purchase	
		24/11/11	100,000	Purchase	1,100,000
A M Frew	–				
		28/2/11	50,000	Purchase	
		28/2/11	50,000	Purchase	
		19/8/11	100,000	Purchase	
		19/8/11	100,000	Purchase	300,000
Sir Julian Horn-Smith	227,890		–		227,890
Lord Leitch	55,787		–		55,787
G R Moreno	500,000				
		25/2/11	200,000	Purchase (50,000 ADRs)	
		5/8/11	300,000	Purchase (75,000 ADRs)	
		23/11/11	200,000	Purchase (50,000 ADRs)	1,200,000
D L Roberts	378,670				
		5/8/11	479,102	Purchase	
		24/11/11	110,869	Purchase	968,641
T T Ryan	100,877				
		28/2/11	100,000	Purchase	
		5/8/11	200,000	Purchase	400,877
M A Scicluna	56,226				
		6/5/11	36,346	Purchase	92,572
Anthony Watson	226,357				
		5/8/11	50,000	Purchase	
		15/8/11	50,000	Purchase	
		19/8/11	50,000	Purchase	376,357

FINANCIAL STATEMENTS

REPORT OF THE INDEPENDENT AUDITORS ON THE CONSOLIDATED FINANCIAL STATEMENTS

Independent auditors' report to the members of Lloyds Banking Group plc

We have audited the group financial statements of Lloyds Banking Group plc for the year ended 31 December 2011 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated balance sheet, the consolidated statement of changes in equity, the consolidated cash flow statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement on page 176, the directors are responsible for the preparation of the group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the group financial statements:

– give a true and fair view of the state of the group's affairs as at 31 December 2011 and of its loss and cash flows for the year then ended;

– have been properly prepared in accordance with IFRSs as adopted by the European Union; and

– have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

– the information given in the Directors' Report for the financial year for which the group financial statements are prepared is consistent with the group financial statements; and

– the information given in the Corporate Governance Report set out on pages 177 to 186 with respect to internal control and risk management systems and about share capital structures is consistent with the financial statements.

REPORT OF THE INDEPENDENT AUDITORS ON THE CONSOLIDATED FINANCIAL STATEMENTS

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

– certain disclosures of directors' remuneration specified by law are not made; or

– we have not received all the information and explanations we require for our audit; or

– a corporate governance statement has not been prepared by the parent company.

Under the Listing Rules we are required to review:

– the directors' statement, on page 174, in relation to going concern;

– the part of the Corporate Governance Report relating to the company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and

– certain elements of the report to shareholders by the Board on directors' remuneration.

Other matter

We have reported separately on the parent company financial statements of Lloyds Banking Group plc for the year ended 31 December 2011 and on the information in the Directors' Remuneration Report that is described as having been audited.

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

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December

	Note	**2011 £ million**	2010 £ million	2009 £ million
Interest and similar income		**26,316**	29,340	28,238
Interest and similar expense		**(13,618)**	(16,794)	(19,212)
Net interest income	5	**12,698**	12,546	9,026
Fee and commission income		**4,935**	4,992	4,728
Fee and commission expense		**(1,391)**	(1,682)	(1,517)
Net fee and commission income[1]	6	**3,544**	3,310	3,211
Net trading income	7	**(368)**	15,724	19,098
Insurance premium income	8	**8,170**	8,148	8,946
Other operating income	9	**2,768**	4,316	5,490
Other income		**14,114**	31,498	36,745
Total income		**26,812**	44,044	45,771
Insurance claims[1]	10	**(6,041)**	(19,088)	(22,493)
Total income, net of insurance claims		**20,771**	24,956	23,278
Government Asset Protection Scheme fee		**–**	–	(2,500)
Payment protection insurance provision		**(3,200)**	–	–
Other operating expenses		**(13,050)**	(13,270)	(13,484)
Total operating expenses	11	**(16,250)**	(13,270)	(15,984)
Trading surplus		**4,521**	11,686	7,294
Impairment	12	**(8,094)**	(10,952)	(16,673)
Share of results of joint ventures and associates	13	**31**	(88)	(752)
Gain on acquisition	14	**–**	–	11,173
Loss on disposal of businesses	15	**–**	(365)	–
(Loss) profit before tax		**(3,542)**	281	1,042
Taxation	16	**828**	(539)	1,911
(Loss) profit for the year		**(2,714)**	(258)	2,953
Profit attributable to non-controlling interests		**73**	62	126
(Loss) profit attributable to equity shareholders		**(2,787)**	(320)	2,827
(Loss) profit for the year		**(2,714)**	(258)	2,953
Basic earnings per share	17	**(4.1)p**	(0.5)p	7.5p
Diluted earnings per share	17	**(4.1)p**	(0.5)p	7.5p

[1] See notes 6 and 10.

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December

	2011 £ million	2010 £ million	2009 £ million
(Loss) profit for the year	**(2,714)**	(258)	2,953
Other comprehensive income			
Movements in revaluation reserve in respect of available-for-sale financial assets:			
Change in fair value	**2,603**	1,231	2,035
Income statement transfers in respect of disposals	**(343)**	(399)	(97)
Income statement transfers in respect of impairment	**80**	114	621
Other income statement transfers	**(155)**	(110)	(93)
Taxation	**(575)**	(343)	(417)
	1,610	493	2,049
Movement in cash flow hedging reserve:			
Effective portion of changes in fair value taken to other comprehensive income	**916**	(1,048)	(530)
Net income statement transfers	**70**	932	121
Taxation	**(270)**	30	119
	716	(86)	(290)
Currency translation differences:			
Currency translation differences, before tax	**(84)**	(129)	162
Taxation	**–**	–	(182)
	(84)	(129)	(20)
Other comprehensive income for the year, net of tax	**2,242**	278	1,739
Total comprehensive income for the year	**(472)**	20	4,692
Total comprehensive income attributable to non-controlling interests	**72**	57	107
Total comprehensive income attributable to equity shareholders	**(544)**	(37)	4,585
Total comprehensive income for the year	**(472)**	20	4,692

CONSOLIDATED BALANCE SHEET

at 31 December

	Note	2011 £ million	2010 £ million
Assets			
Cash and balances at central banks		60,722	38,115
Items in the course of collection from banks		1,408	1,368
Trading and other financial assets at fair value through profit or loss	18	139,510	156,191
Derivative financial instruments	19	66,013	50,777
Loans and receivables:			
Loans and advances to banks	20	32,606	30,272
Loans and advances to customers	21	565,638	592,597
Debt securities	24	12,470	25,735
		610,714	648,604
Available-for-sale financial assets	26	37,406	42,955
Held-to-maturity investments	27	8,098	7,905
Investment properties	28	6,122	5,997
Investments in joint ventures and associates	13	334	429
Goodwill	29	2,016	2,016
Value of in-force business	30	6,638	7,367
Other intangible assets	31	3,196	3,496
Tangible fixed assets	32	7,673	8,190
Current tax recoverable		434	621
Deferred tax assets	44	4,496	4,164
Retirement benefit assets	43	1,338	736
Other assets	33	14,428	12,643
Total assets		970,546	991,574

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

CONSOLIDATED BALANCE SHEET

at 31 December

Equity and liabilities	Note	2011 £ million	2010 £ million
Liabilities			
Deposits from banks	34	39,810	50,363
Customer deposits	35	413,906	393,633
Items in course of transmission to banks		844	802
Trading and other financial liabilities at fair value through profit or loss	36	24,955	26,762
Derivative financial instruments	19	58,212	42,158
Notes in circulation		1,145	1,074
Debt securities in issue	37	185,059	228,866
Liabilities arising from insurance contracts and participating investment contracts	38	78,991	80,729
Liabilities arising from non-participating investment contracts	40	49,636	51,363
Unallocated surplus within insurance businesses	41	300	643
Other liabilities	42	32,041	29,696
Retirement benefit obligations	43	381	423
Current tax liabilities		103	149
Deferred tax liabilities	44	314	247
Other provisions	45	3,166	1,532
Subordinated liabilities	46	35,089	36,232
Total liabilities		923,952	944,672
Equity			
Share capital	47	6,881	6,815
Share premium account	48	16,541	16,291
Other reserves	49	13,818	11,575
Retained profits	50	8,680	11,380
Shareholders' equity		45,920	46,061
Non-controlling interests		674	841
Total equity		46,594	46,902
Total equity and liabilities		970,546	991,574

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

The directors approved the consolidated financial statements on 27 February 2012.

Sir Winfried Bischoff
Chairman

António Horta-Osório
Group Chief Executive

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2011	23,106	11,575	11,380	46,061	841	46,902
Comprehensive income						
(Loss) profit for the year	–	–	(2,787)	(2,787)	73	(2,714)
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,611	–	1,611	(1)	1,610
Movements in cash flow hedging reserve, net of tax	–	716	–	716	–	716
Currency translation differences, net of tax	–	(84)	–	(84)	–	(84)
Total other comprehensive income	–	2,243	–	2,243	(1)	2,242
Total comprehensive income	–	2,243	(2,787)	(544)	72	(472)
Transactions with owners						
Dividends	–	–	–	–	(50)	(50)
Issue of ordinary shares	316	–	–	316	–	316
Movement in treasury shares	–	–	(276)	(276)	–	(276)
Value of employee services:						
Share option schemes	–	–	125	125	–	125
Other employee award schemes	–	–	238	238	–	238
Change in non-controlling interests	–	–	–	–	(189)	(189)
Total transactions with owners	316	–	87	403	(239)	164
Balance at 31 December 2011	23,422	13,818	8,680	45,920	674	46,594

Further details of movements in the Group's share capital and reserves are provided in notes 47, 48, 49 and 50.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2010	24,944	7,217	11,117	43,278	829	44,107
Comprehensive income						
(Loss) profit for the year	–	–	(320)	(320)	62	(258)
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	498	–	498	(5)	493
Movements in cash flow hedging reserve, net of tax	–	(86)	–	(86)	–	(86)
Currency translation differences, net of tax	–	(129)	–	(129)	–	(129)
Total other comprehensive income	–	283	–	283	(5)	278
Total comprehensive income	–	283	(320)	(37)	57	20
Transactions with owners						
Dividends	–	–	–	–	(47)	(47)
Issue of ordinary shares	2,237	–	–	2,237	–	2,237
Redemption of preference shares	11	(11)	–	–	–	–
Cancellation of deferred shares	(4,086)	4,086	–	–	–	–
Movement in treasury shares	–	–	20	20	–	20
Value of employee services:						
Share option schemes	–	–	154	154	–	154
Other employee award schemes	–	–	409	409	–	409
Change in non-controlling interests	–	–	–	–	2	2
Total transactions with owners	(1,838)	4,075	583	2,820	(45)	2,775
Balance at 31 December 2010	23,106	11,575	11,380	46,061	841	46,902

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2009	3,609	(2,345)	8,129	9,393	306	9,699
Comprehensive income						
Profit for the year	–	–	2,827	2,827	126	2,953
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	2,248	–	2,248	–	2,248
Movements in cash flow hedging reserve, net of tax	–	(290)	–	(290)	–	(290)
Currency translation differences, net of tax	–	(200)	–	(200)	(19)	(219)
Total other comprehensive income	–	1,758	–	1,758	(19)	1,739
Total comprehensive income	–	1,758	2,827	4,585	107	4,692
Transactions with owners						
Dividends	–	–	–	–	(116)	(116)
Issue of ordinary shares:						
Placing and open offer	649	3,781	–	4,430	–	4,430
Issued on acquisition of HBOS	1,944	5,707	–	7,651	–	7,651
Placing and compensatory open offer	3,905	–	–	3,905	–	3,905
Rights issue	13,112	–	–	13,112	–	13,112
Issued to Lloyds TSB Foundations	41	–	–	41	–	41
Adjustment on acquisition	–	–	–	–	5,567	5,567
Transfer to merger reserve	(1,000)	1,000	–	–	–	–
Redemption of preference shares	2,684	(2,684)	–	–	–	–
Movement in treasury shares	–	–	10	10	–	10
Value of employee services:						
Share option schemes	–	–	116	116	–	116
Other employee award schemes	–	–	35	35	–	35
Extinguishment of non-controlling interests	–	–	–	–	(5,035)	(5,035)
Total transactions with owners	21,335	7,804	161	29,300	416	29,716
Balance at 31 December 2009	24,944	7,217	11,117	43,278	829	44,107

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December

	Note	2011 £ million	2010 £ million	2009 £ million
(Loss) profit before tax		**(3,542)**	281	1,042
Adjustments for:				
Change in operating assets	57(A)	**44,097**	31,860	61,942
Change in operating liabilities	57(B)	**(19,187)**	(45,683)	(105,927)
Non-cash and other items	57(C)	**(1,339)**	11,173	8,907
Tax (paid) received		**(136)**	332	301
Net cash provided by (used in) operating activities		**19,893**	(2,037)	(33,735)
Cash flows from investing activities				
Purchase of financial assets		**(28,995)**	(46,890)	(455,816)
Proceeds from sale and maturity of financial assets		**36,523**	45,999	490,561
Purchase of fixed assets		**(3,095)**	(3,216)	(2,689)
Proceeds from sale of fixed assets		**2,214**	1,354	2,129
Acquisition of businesses, net of cash acquired	57(E)	**(13)**	(73)	16,227
Disposal of businesses, net of cash disposed	57(F)	**298**	428	411
Net cash provided by (used in) investing activities		**6,932**	(2,398)	50,823
Cash flows from financing activities				
Dividends paid to non-controlling interests		**(50)**	(47)	(116)
Interest paid on subordinated liabilities		**(2,126)**	(1,942)	(2,622)
Proceeds from issue of subordinated liabilities		**–**	3,237	4,187
Proceeds from issue of ordinary shares		**–**	–	21,533
Repayment of subordinated liabilities		**(1,074)**	(684)	(6,897)
Change in non-controlling interests		**8**	2	(33)
Net cash (used in) provided by financing activities		**(3,242)**	566	16,052
Effects of exchange rate changes on cash and cash equivalents		**6**	479	(210)
Change in cash and cash equivalents		**23,589**	(3,390)	32,930
Cash and cash equivalents at beginning of year		**62,300**	65,690	32,760
Cash and cash equivalents at end of year	57(D)	**85,889**	62,300	65,690

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of preparation

The consolidated financial statements of Lloyds Banking Group plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts. As stated on page 174, 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: £606 million; 2010: £577 million; 2009: £474 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 53.

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 58.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies

The Group's 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, associates and joint ventures.

(1) Subsidiaries

Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 9 to the parent company financial statements.

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

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

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

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see (E)(5) below) or share capital (see (R)(1) below). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) Joint ventures and associates

Joint ventures are entities over which the Group has joint control under a contractual arrangement with other parties. Associates are entities over which the Group has significant influence, but not control or joint control, over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity and is normally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting and are initially recorded at cost and adjusted each year to reflect the Group's share of the post-acquisition results of the joint venture or associate based on audited accounts which are coterminous with the Group or made up to a date which is not more than three months before the Group's reporting date. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

(B) Goodwill

Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates; goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. Goodwill arising on acquisitions of associates and joint ventures is included in the Group's investment in joint ventures and associates. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

(C) Other intangible assets

Other intangible assets include brands, core deposit intangibles, purchased credit card relationships, customer-related intangibles and both internally and externally generated capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 5 years
Brands (which have been assessed as having finite lives)	10-15 years
Customer-related intangibles	up to 10 years
Core deposit intangibles	up to 8 years
Purchased credit card relationships	5 years

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

(D) Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the effective interest method, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group including expected early redemption fees and related penalties and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account in the calculation. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see (H) below).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to life insurance and general insurance business are detailed below (see (O) below).

(E) Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. Purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

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

– substantially all of the risks and rewards of ownership have been transferred; or

– the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

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

(1) Financial instruments at fair value through profit or loss

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

Other financial assets and liabilities at fair value through profit or loss are designated as such by management upon initial recognition. Such assets and liabilities are carried in the balance sheet at their fair value and gains and losses arising from changes in fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur. Financial assets and liabilities are designated at fair value through profit or loss on acquisition in the following circumstances:

– it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases. The main type of financial assets designated by the Group at fair value through profit or loss are assets backing insurance contracts and investment contracts issued by the Group's life insurance businesses. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available-for-sale financial assets.

– the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis. As noted in (A)(2) above certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.

– where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 55(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, held-to-maturity investments or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Available-for-sale financial assets are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

(3) Loans and receivables

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

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) Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity other than:

– those that the Group designates upon initial recognition as at fair value through profit or loss;

– those that the Group designates as available-for-sale; and

– those that meet the definition of loans and receivables.

These are initially recognised at fair value including direct and incremental transaction costs and measured subsequently at amortised cost, using the effective interest method, less any provision for impairment.

(5) Borrowings

Borrowings (which include deposits from banks, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense.

An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss together with any related costs or fees incurred.

(6) Sale and repurchase agreements

Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities lent to counterparties are retained in the financial statements. Securities borrowed are not recognised in the financial statements, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability.

(F) Derivative financial instruments and hedge accounting

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 55(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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

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.

(3) Net investment hedges

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instrument used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

(G) Offset

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

(H) Impairment of financial assets

(1) Assets accounted for at amortised cost

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition of the financial asset and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

Where such an event has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's wholesale lending portfolios in the Wholesale, Commercial 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 divisions that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

Individual assessment

In respect of individually significant financial assets in the Group's wholesale lending portfolios, assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watch list where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that would lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower, (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

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, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

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

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

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data about economic and credit conditions (including unemployment rates and borrowers' behaviour) to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

Incurred but not yet identified impairment

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

Loan renegotiations and forbearance

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. 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 (see note 56 Credit risk sections F and G). 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

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; a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(I) Investment property

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital appreciation or both. The Group's investment property primarily relates to property held for long-term rental yields and capital appreciation within the life insurance funds. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income.

(J) Tangible fixed assets

Tangible fixed assets are included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

– Freehold/long and short leasehold premises: shorter of 50 years and the remaining period of the lease

– Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease

Equipment:

– Fixtures and furnishings: 10-20 years

– Other equipment and motor vehicles: 2-8 years

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

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

(K) Leases

(1) As lessee

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

(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, or in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

The Group's income statement charge includes the current service cost of providing pension benefits, the expected return on the schemes' assets, net of expected administration costs, and the interest cost on the schemes' liabilities. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10 per cent of the scheme assets or liabilities ('the corridor approach'). In these circumstances the excess is charged or credited to the income statement over the employees' expected average remaining working lives. Past service costs are charged immediately to the income statement, unless the charges are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date adjusted for any cumulative unrecognised actuarial gains or losses. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

The Group recognises the effect of material changes to the terms of its defined benefit pension plans which reduce future benefits as curtailments; gains and losses are recognised in the income statement when the curtailments occur.

The costs of the Group's defined contribution plans are charged to the income statement in the period in which they fall due.

(M) Share-based compensation

The Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments, with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement over the remaining vesting period, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and in accordance with IFRS 2 (Revised) the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement over any remaining vesting period.

(N) Taxation

Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

For the Group's long-term insurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on equity holders' returns. This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is determined using tax rates that have been enacted or substantially enacted by the balance sheet date which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the gain or loss.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

(O) Insurance

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

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

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

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

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

The general insurance business issues only insurance contracts.

(1) Life insurance business

(i) Accounting for insurance and participating investment contracts

Premiums and claims

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

Liabilities

– *Insurance and participating investment contracts in the Group's with-profit funds*

Liabilities of the Group's with-profit funds, including guarantees and options embedded within products written by these funds, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in the unallocated surplus (see below). Further details on the realistic capital regime are given on page 123. 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

Unallocated surplus

Any amounts in the with-profit funds not yet determined as being due to policyholders or shareholders are recognised as an unallocated surplus which is shown separately from liabilities arising from insurance contracts and participating investment contracts.

(ii) Accounting for non-participating investment contracts

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment returns (including movements in fair value and investment income) allocated to those contracts are recognised in insurance claims.

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 are 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2: Accounting policies (continued)

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.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

– The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.
– The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see (F)(3) above). On disposal of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal.

(Q) Provisions and contingent liabilities

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

The Group recognises provisions in respect of vacant leasehold property where the unavoidable costs of the present obligations exceed anticipated rental income.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

(R) Share capital

(1) Share issue costs

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

(2) Dividends

Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

(3) Treasury shares

Where the Company or any member of the Group purchases the Company's share capital, the consideration paid is deducted from shareholders' equity as treasury shares until they are cancelled. Where such shares are subsequently sold or reissued, any consideration received is included in shareholders' equity.

(S) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 3: Critical accounting estimates and judgements

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows.

Allowance for impairment losses on loans and receivables

At 31 December 2011 gross loans and receivables totalled £629,736 million (2010: £667,555 million) against which impairment allowances of £19,022 million (2010: £18,951 million) had been made (see note 25). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2(H)(1); this note also provides an overview of the methodologies applied.

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's wholesale lending portfolios. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in the current economic environment in assessing the borrower's cash flows and debt servicing capability together with the realisable value of collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the Retail portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were ten per cent lower than those estimated at 31 December 2011, the impairment charge would increase by approximately £285 million in respect of UK mortgages and a further £75 million in respect of Irish mortgages.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the Wholesale division, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £181 million (at 31 December 2010, a one month increase in the loss emergence period would have increased the collective unimpaired provision by an estimated £333 million).

Unwind of HBOS acquisition fair value adjustments

The acquisition of HBOS in January 2009 required the Group to recognise the identifiable assets acquired and liabilities assumed at their acquisition-date fair values. The overall effect was to increase the book value of HBOS's net assets by £1,241 million primarily reflecting a reduction in the value of HBOS's debt securities and subordinated liabilities of £15,439 million, partially offset by a reduction in the carrying value of HBOS's loans and receivables of £14,880 million, including loans and advances to customers of £13,512 million (see note 14).

In the periods subsequent to the acquisition, all of the fair value adjustments unwind. The fair value adjustments made to debt securities and subordinated liabilities unwind over the expected remaining life of the related securities except in the event that the liability is extinguished, in which case the remaining unamortised fair value adjustment is recognised in the income statement immediately. The timing of the unwind of the fair value adjustment relating to loans and receivables requires significant management judgement. This includes the identification of losses which were expected at the date of acquisition and assessing whether anticipated losses will still be incurred. In 2011, there was a benefit of £1,943 million (2010: £3,118 million) to the income statement either from the reversal of a fair value adjustment being credited to the income statement or through a lower impairment charge as a result of the initial HBOS acquisition fair value adjustments.

Fair value of financial instruments

In accordance with IFRS 7, 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 3: Critical accounting estimates and judgements (continued)

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

At 31 December 2011, the Group classified £7,646 million of financial assets and £790 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 55. Details about sensitivities to market risk arising from trading assets and other treasury positions can be found in the Risk Management section on page 164.

Recoverability of deferred tax assets

At 31 December 2011 the Group carried deferred tax assets on its balance sheet of £4,496 million (2010: £4,164 million) and deferred tax liabilities of £314 million (2010: £247 million) (note 44). 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 44 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;

– The retail banking business disposal as required by the European Commission; and

– Future regulatory change.

The Group's total deferred tax asset includes £5,862 million (2010: £6,572 million) in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc and Lloyds TSB Bank plc. The deferred tax asset 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 44, deferred tax assets totalling £1,288 million (2010: £685 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.

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 £957 million (comprising an asset of £1,338 million and a liability of £381 million) (2010: a net asset of £313 million) of which an asset of £1,131 million (2010: £479 million) related to defined benefit pension schemes. As explained in note 2(L), the Group adopts the corridor approach to the recognition of actuarial gains and losses in respect of its pension schemes and as a consequence has not recognised actuarial losses of £539 million (2010: £959 million). After allowing for this, the defined benefit pension schemes' net accounting surplus totalled £592 million (2010: deficit of £480 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 43.

Valuation of assets and liabilities arising from life insurance business

At 31 December 2011, the Group recognised a value in-force business asset of £5,247 million (2010: £5,898 million) and an acquired value in-force business asset of £1,391 million (2010: £1,469 million). The value 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 in-force business asset represents the contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers. The methodology used to value these assets is set out in note 2(O)(1). The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to these assets. The key assumptions that have been made in determining the carrying value of the value in-force business assets at 31 December 2011 are set out in note 30.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 3: Critical accounting estimates and judgements (continued)

At 31 December 2011, the Group carried liabilities arising from insurance contracts and participating investment contracts of £78,991 million (2010: £80,729 million). The methodology used to value these liabilities is described in note 2(O)(1). Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The key assumptions that have been made in determining the carrying value of these liabilities are set out in note 38.

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 39.

Payment protection insurance

The Group has charged a provision of £3,200 million 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 45 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 £70 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.

Provision in relation to German insurance business litigation

Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. CMIG's strategy includes defending claims robustly and appealing against adverse judgments. The ultimate financial effect, which could be significant, will only be known once all relevant claims have been resolved. The Group has charged a provision of £175 million (see note 54 for more information). Management believes this represents the most appropriate estimate of the financial impact, based upon a series of assumptions, including the number of claims received, the proportion upheld, and resulting legal and administration costs.

This provision requires significant judgement by management in determining appropriate assumptions, including the number of claims received, the proportion upheld, and resulting legal and administration costs. Assuming that all other assumptions remain unchanged, if in the longer term the level of claims was ten percentage points higher (lower) than estimated then the cost would increase (decrease) by approximately £3 million; and if uphold rates were ten percentage points higher (lower) than estimated then the cost would increase (decrease) by approximately £13 million.

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis

Lloyds Banking Group provides a wide range of banking and financial services in the UK and in certain locations overseas.

The Group Executive Committee has been determined to be the chief operating decision maker for the Group. The Group's operating segments reflect its organisational and management structures. The Group Executive Committee reviews the Group's internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment's net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

During 2011 the chief operating decision maker has commenced reviewing the results of the Group's Commercial business separately to the Wholesale segment. As a consequence, the Group's activities are now organised into five financial reporting segments: Retail, Wholesale, Commercial, Wealth and International, and Insurance. The comparatives for 2009 include the pre-acquisition results of HBOS for the period from 1 January 2009 to 16 January 2009.

During the third quarter of 2011, the Group implemented a new approach to its allocation methodologies for funding costs and capital that ensures that the cost of funding is more fully reflected in each segment's results. The new methodology is designed to ensure that funding costs are allocated to the segments and that the allocation is more directly related to the size and behavioural duration of asset portfolios, with a similar approach applied to recognise the value to the business from the Group's growing deposit base. Comparative figures have been restated. The impact of this restatement on the year ended 31 December 2010 was to reduce net interest income and profit before tax in Retail by £730 million, in Wholesale by £404 million, in Commercial by £48 million and in Wealth and International by £126 million; and to increase net interest income and profit before tax in Insurance by £224 million, in Group Operations by £11 million and in Central items by £1,073 million.

Retail offers a broad range of retail financial service products in the UK, including current accounts, savings, personal loans, credit cards and mortgages. It is also a major general insurance and bancassurance distributor, selling a wide range of long-term savings, investment and general insurance products.

The Wholesale division serves businesses with turnover above £15 million with a range of propositions segmented according to customer need. The division comprises Wholesale Banking and Markets, Wholesale Business Support Unit and Asset Finance.

Commercial serves in excess of a million small and medium-sized enterprises and community organisations with a turnover of up to £15 million. Customers extend from start-up enterprises to established corporations, and are supported with a range of propositions aligned to customer needs. Commercial comprises Commercial Banking and Commercial Finance, the invoice discounting and factoring business.

Wealth and International was created to give increased focus and momentum to the Group's private banking and asset management activities and to closely co-ordinate the management of its international businesses. Wealth comprises the Group's private banking, wealth and asset management businesses in the UK and overseas. International comprises corporate, commercial, asset finance and retail businesses, principally in Australia and Continental Europe.

Insurance provides long-term savings, investment and protection products distributed through the bancassurance, intermediary and direct channels in the UK. It is also a distributor of home insurance in the UK with products sold through the retail branch network, direct channels and strategic corporate partners. The business consists of Life, Pensions and Investments UK; Life, Pensions and Investments Europe; and General Insurance.

Other includes the costs of managing the Group's technology platforms, branch and head office property estate, operations (including payments, banking operations and collections) and procurement services, the costs of which are predominantly recharged to the other divisions. It also reflects other items not recharged to the divisions, including hedge ineffectiveness, UK bank levy, Financial Services Compensation Scheme costs, gains on liability management, volatile items such as hedge accounting volatility managed centrally, and other gains from the structural hedging of interest rate risk.

Inter-segment services are generally recharged at cost, with the exception of the internal commission arrangements between the UK branch and other distribution networks and the insurance product manufacturing businesses within the Group, where a profit margin is also charged. Inter-segment lending and deposits are generally entered into at market rates, except that non-interest bearing balances are priced at a rate that reflects the external yield that could be earned on such funds.

For the majority of those derivative contracts entered into by business units for risk management purposes, the business unit recognises the net interest income or expense on an accrual accounting basis and transfers the remainder of the fair value of the swap to the central group segment where the resulting accounting volatility is managed where possible through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the swap and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results and records volatility in the central group segment where it is managed.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

	Retail £m	Wholesale £m	Commercial £m	Wealth and International £m	Insurance £m	Other £m	Reported basis total £m
Year ended 31 December 2011							
Net interest income	7,497	2,139	1,251	828	(67)	585	12,233
Other income (net of fee and commission expense)	1,649	3,335	446	1,197	2,687	(7)	9,307
Effects of liability management, volatile items and asset sales	48	(1,415)	–	–	–	1,293	(74)
Total income	9,194	4,059	1,697	2,025	2,620	1,871	21,466
Insurance claims	–	–	–	–	(343)	–	(343)
Total income, net of insurance claims	9,194	4,059	1,697	2,025	2,277	1,871	21,123
Operating expenses	(4,438)	(2,518)	(948)	(1,548)	(812)	(357)	(10,621)
Trading surplus	4,756	1,541	749	477	1,465	1,514	10,502
Impairment	(1,970)	(2,901)	(303)	(4,610)	–	(3)	(9,787)
Share of results of joint ventures and associates	11	14	–	3	–	(1)	27
Profit (loss) before tax and fair value unwind	2,797	(1,346)	446	(4,130)	1,465	1,510	742
Fair value unwind	839	2,174	53	194	(43)	(1,274)	1,943
Profit (loss) before tax	3,636	828	499	(3,936)	1,422	236	2,685
External revenue	12,267	2,895	1,263	2,144	3,253	(356)	21,466
Inter-segment revenue	(3,073)	1,164	434	(119)	(633)	2,227	–
Segment revenue	9,194	4,059	1,697	2,025	2,620	1,871	21,466
Segment external assets	356,295	320,435	28,998	74,623	140,754	49,441	970,546
Segment customer deposits	247,088	91,357	32,107	42,019	–	1,335	413,906
Segment external liabilities	279,162	259,209	32,723	75,791	129,350	147,717	923,952
Other segment items reflected in income statement above:							
Depreciation and amortisation	364	967	53	60	91	67	1,602
Increase (decrease) in value of in-force business	–	–	–	3	(625)	–	(622)
Defined benefit scheme charges	121	33	33	25	23	(36)	199
Other segment items:							
Additions to tangible fixed assets	189	1,435	2	212	451	806	3,095
Investments in joint ventures and associates at end of year	147	80	–	104	–	3	334

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

	Retail £m	Wholesale £m	Commercial £m	Wealth and International £m	Insurance £m	Other £m	Reported basis total £m
Year ended 31 December 2010							
Net interest income	8,648	2,847	1,127	1,050	(39)	510	14,143
Other income (net of fee and commission expense)	1,607	3,974	457	1,123	2,799	(24)	9,936
Effects of liability management, volatile items and asset sales	–	(295)	–	37	15	150	(93)
Total income	10,255	6,526	1,584	2,210	2,775	636	23,986
Insurance claims	–	–	–	–	(542)	–	(542)
Total income, net of insurance claims	10,255	6,526	1,584	2,210	2,233	636	23,444
Costs:							
Operating expenses	(4,644)	(2,752)	(992)	(1,536)	(854)	(150)	(10,928)
Impairment of tangible fixed assets	–	(150)	–	–	–	–	(150)
	(4,644)	(2,902)	(992)	(1,536)	(854)	(150)	(11,078)
Trading surplus	5,611	3,624	592	674	1,379	486	12,366
Impairment	(2,747)	(4,064)	(382)	(5,988)	–	–	(13,181)
Share of results of joint ventures and associates	17	(95)	–	(8)	(10)	5	(91)
Profit (loss) before tax and fair value unwind	2,881	(535)	210	(5,322)	1,369	491	(906)
Fair value unwind	1,105	3,049	81	372	(43)	(1,446)	3,118
Profit (loss) before tax	3,986	2,514	291	(4,950)	1,326	(955)	2,212
External revenue	13,603	3,911	1,378	3,000	3,180	(1,086)	23,986
Inter-segment revenue	(3,348)	2,615	206	(790)	(405)	1,722	–
Segment revenue	10,255	6,526	1,584	2,210	2,775	636	23,986
Segment external assets[1]	369,170	327,055	28,938	85,508	143,300	37,603	991,574
Segment customer deposits	235,591	92,951	31,311	32,784	–	996	393,633
Segment external liabilities	275,945	289,257	31,952	65,658	132,133	149,727	944,672
Other segment items reflected in income statement above:							
Depreciation and amortisation	384	1,071	62	87	135	64	1,803
Increase in value of in-force business	–	–	–	2	787	–	789
Defined benefit scheme charges	176	52	37	36	28	126	455
Other segment items:							
Additions to tangible fixed assets	126	1,703	5	20	585	777	3,216
Investments in joint ventures and associates at end of year	139	127	–	158	–	5	429

[1] Segment external assets as at 31 December 2010 have been restated to reflect the reclassification of certain central adjustments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

	Retail £m	Wholesale £m	Commercial £m	Wealth and International £m	Insurance £m	Other £m	Reported basis total £m
Year ended 31 December 2009							
Net interest income	7,543	3,447	1,084	1,140	(59)	(89)	13,066
Other income (net of fee and commission expense)	1,804	3,787	489	1,128	2,944	(69)	10,083
Effects of liability management, volatile items and asset sales	–	(77)	–	–	–	1,529	1,452
Total income	9,347	7,157	1,573	2,268	2,885	1,371	24,601
Insurance claims	–	–	–	–	(637)	–	(637)
Total income, net of insurance claims	9,347	7,157	1,573	2,268	2,248	1,371	23,964
Operating expenses	(4,566)	(3,018)	(1,088)	(1,544)	(974)	(419)	(11,609)
Trading surplus	4,781	4,139	485	724	1,274	952	12,355
Impairment	(4,227)	(14,861)	(822)	(4,078)	–	–	(23,988)
Share of results of joint ventures and associates	(6)	(720)	–	(21)	(22)	2	(767)
Profit (loss) before tax and fair value unwind	548	(11,442)	(337)	(3,375)	1,252	954	(12,400)
Fair value unwind	407	6,760	137	942	(49)	(2,097)	6,100
Profit (loss) before tax	955	(4,682)	(200)	(2,433)	1,203	(1,143)	(6,300)
External revenue	14,221	2,719	1,446	2,859	3,780	(424)	24,601
Inter-segment revenue	(4,874)	4,438	127	(591)	(895)	1,795	–
Segment revenue	9,347	7,157	1,573	2,268	2,885	1,371	24,601
Other segment items reflected in income statement above:							
Depreciation and amortisation	196	1,214	70	84	152	147	1,863
(Decrease) increase in value of in-force business	–	–	–	(5)	1,097	–	1,092
Defined benefit scheme charges	190	65	47	40	39	156	537
Other segment items:							
Additions to tangible fixed assets	65	2,960	9	53	255	487	3,829
Investments in joint ventures and associates at end of year	30	189	–	123	(14)	151	479

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

Reconciliation of reported basis to statutory results

The reported basis is the basis on which financial information is presented to the chief operating decision maker which excludes certain items included in the statutory results. The table below reconciles the statutory results to the reported basis.

	Lloyds Banking Group statutory £m	Removal of: Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Legal and regulatory provisions[2] £m	Fair value unwind £m	Reported basis £m
Year ended 31 December 2011							
Net interest income	**12,698**	**(820)**	**(19)**	**(336)**	**–**	**710**	**12,233**
Other income	**14,114**	**894**	**857**	**(5,530)**	**–**	**(1,028)**	**9,307**
Effects of liability management, volatile items and asset sales		**(74)**	**–**	**–**	**–**	**–**	**(74)**
Total income	**26,812**	**–**	**838**	**(5,866)**	**–**	**(318)**	**21,466**
Insurance claims	**(6,041)**	**–**	**–**	**5,698**	**–**	**–**	**(343)**
Total income, net of insurance claims	**20,771**	**–**	**838**	**(168)**	**–**	**(318)**	**21,123**
Operating expenses	**(16,250)**	**2,014**	**–**	**168**	**3,375**	**72**	**(10,621)**
Trading surplus (deficit)	**4,521**	**2,014**	**838**	**–**	**3,375**	**(246)**	**10,502**
Impairment	**(8,094)**	**–**	**–**	**–**	**–**	**(1,693)**	**(9,787)**
Share of results of joint ventures and associates	**31**	**–**	**–**	**–**	**–**	**(4)**	**27**
Fair value unwind		**–**	**–**	**–**	**–**	**1,943**	**1,943**
(Loss) profit before tax	**(3,542)**	**2,014**	**838**	**–**	**3,375**	**–**	**2,685**

[1] Comprises integration and simplification costs related to severance, IT and business costs of implementation (£1,282 million), EC mandated retail business disposal costs (£170 million), amortisation of purchased intangibles (£562 million) and the effects of liability management. volatile items and asset sales (£74 million).

[2] Comprises the payment protection insurance provision (£3,200 million) and the provision in relation to German insurance business litigation (£175 million).

	Lloyds Banking Group statutory £m	Removal of: Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Customer goodwill payments provision and loss on disposal of businesses £m	Fair value unwind £m	Reported basis £m
Year ended 31 December 2010							
Net interest income	12,546	321	26	949	–	301	14,143
Other income	31,498	(228)	(332)	(19,739)	–	(1,263)	9,936
Liability management gains		(93)	–	–	–	–	(93)
Total income	44,044	–	(306)	(18,790)	–	(962)	23,986
Insurance claims	(19,088)	–	–	18,544	–	2	(542)
Total income, net of insurance claims	24,956	–	(306)	(246)	–	(960)	23,444
Costs:							
Operating expenses	(13,068)	1,320	–	246	500	74	(10,928)
Impairment of tangible fixed assets	(202)	52	–	–	–	–	(150)
	(13,270)	1,372	–	246	500	74	(11,078)
Trading surplus (deficit)	11,686	1,372	(306)	–	500	(886)	12,366
Impairment	(10,952)	–	–	–	–	(2,229)	(13,181)
Share of results of joint ventures and associates	(88)	–	–	–	–	(3)	(91)
Loss on disposal of businesses	(365)	–	–	–	365	–	–
Fair value unwind		–	–	–	–	3,118	3,118
Profit (loss) before tax	281	1,372	(306)	–	865	–	2,212

[1] Comprises the pension curtailment gain (£910 million, see note 43), integration costs (£1,653 million), amortisation of purchased intangibles (£629 million) and the effects of liability management, volatile items and asset sales (£93 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4: Segmental analysis (continued)

		Removal of:					
	Lloyds Banking Group statutory £m	Pre-acquisition results of HBOS £m	Government Asset Protection Scheme fee and acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Fair value unwind £m	Reported basis £m
Year ended 31 December 2009							
Net interest income	9,026	243	340	11	1,280	2,166	13,066
Other income	36,745	(1,123)	(1,792)	(479)	(22,133)	(1,135)	10,083
Effects of liability management, volatile items and asset sales		–	1,452	–	–	–	1,452
Total income	45,771	(880)	–	(468)	(20,853)	1,031	24,601
Insurance claims	(22,493)	1,349	–	–	20,792	(285)	(637)
Total income, net of insurance claims	23,278	469	–	(468)	(61)	746	23,964
Operating expenses	(15,984)	(293)	4,589	–	61	18	(11,609)
Trading surplus (deficit)	7,294	176	4,589	(468)	–	764	12,355
Impairment	(16,673)	(456)	–	–	–	(6,859)	(23,988)
Share of results of joint ventures and associates	(752)	–	–	(10)	–	(5)	(767)
Gain on acquisition	11,173	–	(11,173)	–	–	–	–
Fair value unwind	–	–	–	–	–	6,100	6,100
Profit (loss) before tax	1,042	(280)	(6,584)	(478)	–	–	(6,300)

[1] Comprises the gain on acquisition (£11,173 million), the Government Asset Protection Scheme fee (£2,500 million), integration costs (£1,096 million), amortisation of purchased intangibles (£753 million), goodwill impairment (£240 million) and the effects of liability management, volatile items and asset sales (£1,452 million).

Geographical areas

The Group's activities are focused in the UK and the analyses of income and assets below are based on the location of the branch or entity recording the income or assets.

	2011			2010			2009		
	UK £m	**Non-UK £m**	**Total £m**	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
Total income	**24,392**	**2,420**	**26,812**	39,840	4,204	44,044	43,046	2,725	45,771
Total assets	**875,918**	**94,628**	**970,546**	873,138	118,436	991,574	916,734	110,521	1,027,255

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 5: Net interest income

	Weighted average effective interest rate 2011 %	2010[1] %	2009[1] %	2011 £m	2010 £m	2009 £m
Interest and similar income:						
Loans and advances to customers, excluding lease and hire purchase receivables	**4.00**	4.37	3.67	**23,208**	25,459	24,171
Loans and advances to banks	**0.78**	0.72	1.18	**628**	512	769
Debt securities held as loans and receivables	**3.17**	4.41	3.68	**590**	1,377	1,469
Lease and hire purchase receivables	**5.13**	6.74	6.01	**742**	626	852
Interest receivable on loans and receivables	**3.63**	4.03	3.50	**25,168**	27,974	27,261
Available-for-sale financial assets	**2.58**	2.88	1.78	**886**	1,311	977
Held-to-maturity investments	**3.29**	2.51	–	**262**	55	–
Total interest and similar income	**3.58**	3.95	3.39	**26,316**	29,340	28,238
Interest and similar expense:						
Deposits from banks, excluding liabilities under sale and repurchase transactions	**0.80**	0.78	0.95	**(222)**	(319)	(883)
Customer deposits, excluding liabilities under sale and repurchase transactions	**1.66**	1.56	1.29	**(6,080)**	(5,381)	(4,410)
Debt securities in issue	**2.22**	2.49	2.56	**(5,045)**	(5,833)	(6,318)
Subordinated liabilities	**6.35**	10.98	10.05	**(2,155)**	(3,619)	(4,325)
Liabilities under sale and repurchase agreements	**1.39**	1.18	1.95	**(335)**	(744)	(1,655)
Interest payable on liabilities held at amortised cost	**2.04**	2.22	2.17	**(13,837)**	(15,896)	(17,591)
Other	**(1.14)**	6.97	14.92	**219**	(898)	(1,621)
Total interest and similar expense	**1.95**	2.31	2.34	**(13,618)**	(16,794)	(19,212)
Net interest income				**12,698**	12,546	9,026

[1] During 2011 the Group has revised its treatment of offset accounts; average balances for 2009 and 2010 have been restated accordingly.

Included within interest and similar income is £1,405 million (2010: £1,288 million; 2009: £971 million) in respect of impaired financial assets. Net interest income also includes a charge of £70 million (2010: charge of £932 million; 2009: charge of £121 million) transferred from the cash flow hedging reserve (see note 49).

During December 2011, the Group completed the exchange of certain subordinated debt securities issued by Lloyds TSB Bank plc and HBOS plc for new subordinated debt securities issued by Lloyds TSB Bank plc. As part of the exchange, the Group announced that all decisions to exercise calls on those original securities that remained outstanding following the exchange offer would be made with reference to the prevailing regulatory, economic and market conditions at the time. These securities will not, therefore, be called at their first available call date which will lead to coupons continuing to be being paid until possibly the final redemption date of the securities. Consequently, the Group is required to adjust the carrying amount of these securities to reflect the revised estimated cash flows over their revised life and to recognise this change in carrying value in interest expense. Included within net interest income is a credit of £570 million in respect of the securities that remained outstanding following the exchange offer.

In December 2011, the Group decided to defer payment of non-mandatory coupons on certain securities and, instead, settle them using an Alternative Coupon Satisfaction Mechanism on their contractual terms. This change in expected cashflows resulted in a gain of £126 million in net interest income from the recalculation of the carrying value of these securities.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 6: Net fee and commission income

	2011 £m	2010 £m	2009 £m
Fee and commission income:			
Current accounts	**1,053**	1,086	1,088
Credit and debit card fees	**877**	812	765
Other[1]	**3,005**	3,094	2,875
Total fee and commission income	**4,935**	4,992	4,728
Fee and commission expense	**(1,391)**	(1,682)	(1,517)
Net fee and commission income	**3,544**	3,310	3,211

[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: £606 million; 2010: £577 million; 2009: £474 million) are now included within net fee and commission income.

As discussed in note 2, fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

Note 7: Net trading income

	2011 £m	2010 £m	2009 £m
Foreign exchange translation gains	**317**	70	283
Gains on foreign exchange trading transactions	**341**	377	488
Total foreign exchange	**658**	447	771
Investment property (losses) gains (note 28)	**(107)**	434	(214)
Securities and other (losses) gains (see below)	**(919)**	14,843	18,541
Net trading income	**(368)**	15,724	19,098

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

	2011 £m	2010 £m	2009 £m
Net income arising on assets held at fair value through profit or loss:			
Debt securities, loans and advances	**5,293**	2,292	4,297
Equity shares	**(4,917)**	10,333	11,475
Total net income arising on assets held at fair value through profit or loss	**376**	12,625	15,772
Net expense arising on liabilities held at fair value through profit or loss – debt securities in issue	**(230)**	(231)	(125)
Total net gains arising on assets and liabilities held at fair value through profit or loss	**146**	12,394	15,647
Net (losses) gains on financial instruments held for trading	**(1,065)**	2,449	2,894
Securities and other (losses) gains	**(919)**	14,843	18,541

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 8: Insurance premium income

	2011 £m	2010 £m	2009 £m
Life insurance			
Gross premiums	**7,276**	7,026	7,768
Ceded reinsurance premiums	**(322)**	(253)	(308)
Net earned premiums	**6,954**	6,773	7,460
Non-life insurance			
Gross written premiums	**1,198**	1,332	1,390
Ceded reinsurance premiums	**(52)**	(104)	(101)
Net written premiums	**1,146**	1,228	1,289
Change in provision for unearned premiums (note 38(2))	**70**	156	171
Change in provision for ceded unearned premiums (note 38(2))	**–**	(9)	26
Net earned premiums	**1,216**	1,375	1,486
Total net earned premiums	**8,170**	8,148	8,946

Life insurance gross premiums can be further analysed as follows:

	2011 £m	2010 £m	2009 £m
Life and pensions	**6,737**	6,428	7,070
Annuities	**529**	583	685
Other	**10**	15	13
Gross premiums	**7,276**	7,026	7,768

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

	2011 £m	2010 £m	2009 £m
Credit protection	**231**	363	417
Home	**963**	964	968
Health	**4**	5	5
Gross written premiums	**1,198**	1,332	1,390

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 9: Other operating income

	2011 £m	2010 £m	2009 £m
Operating lease rental income	**1,268**	1,410	1,509
Rental income from investment properties (note 28)	**388**	337	358
Other rents receivable	**34**	41	51
Gains less losses on disposal of available-for-sale financial assets (note 49)	**343**	399	97
Movement in value of in-force business (note 30)	**(622)**	789	1,169
Liability management gains	**599**	423	1,498
Other income	**758**	917	808
Total other operating income	**2,768**	4,316	5,490

Liability management gains

During December 2011, the Group completed the exchange of certain subordinated debt securities issued by Lloyds TSB Bank plc and HBOS plc 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 31 December 2012. This exchange resulted in a gain on extinguishment of the existing securities of £599 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.

On 18 February 2010, as part of the Group's recapitalisation and exit from its proposed participation in the Government Asset Protection Scheme, Lloyds Banking Group plc issued 3,141 million ordinary shares in exchange for certain existing preference shares and preferred securities. This exchange resulted in a gain of £85 million. During March 2010 the Group entered into a bilateral exchange, under which certain Enhanced Capital Notes denominated in Japanese yen were exchanged for an issue of new Enhanced Capital Notes denominated in US dollars; the securities subject to the exchange were cancelled and a profit of £20 million arose. In addition, during May and June 2010 the Group completed the exchange of a number of outstanding capital securities issued by Lloyds Banking Group plc and certain of its subsidiaries for ordinary shares in Lloyds Banking Group plc. The securities subject to exchange were cancelled, generating a total profit of £318 million for the Group.

In the first half of 2009, undated subordinated securities issued by a number of Group companies were exchanged for innovative tier 1 securities and senior unsecured securities issued by Lloyds TSB Bank plc. These exchanges resulted in a gain of £745 million. In July 2009, dated and undated subordinated securities issued by Clerical Medical Finance plc were exchanged for senior unsecured securities issued by Lloyds TSB Bank plc resulting in a gain of £30 million. In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. This suspension gave rise to a partial extinguishment of the original liability, equivalent to the present value of the suspended cash flows. During December 2009, as part of the Group's recapitalisation and exit from GAPS, preference shares, preferred securities and undated subordinated securities were exchanged for Enhanced Capital Notes. These exchanges, together with the partial extinguishment of liabilities arising from the suspension of payments of coupons, resulted in a gain of £723 million.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 10: Insurance claims

Insurance claims comprise:

	2011 £m	2010 £m	2009 £m
Life insurance and participating investment contracts			
Claims and surrenders:			
Gross	(8,622)	(9,397)	(8,010)
Reinsurers' share	230	159	146
	(8,392)	(9,238)	(7,864)
Change in insurance and participating investment contract liabilities (note 38(1)):			
Change in gross liabilities	1,383	(4,622)	(5,922)
Change in reinsurers' share of liabilities	451	256	177
	1,834	(4,366)	(5,745)
Change in non-participating investment contract liabilities:			
Change in gross liabilities[1]	520	(5,449)	(7,932)
Change in reinsurers' share of liabilities	–	65	–
	520	(5,384)	(7,932)
Change in unallocated surplus (note 41)	340	439	(318)
Total life insurance and participating investment contracts	(5,698)	(18,549)	(21,859)
Non-life insurance			
Claims and claims paid:			
Gross	(521)	(470)	(542)
Reinsurers' share	4	11	16
	(517)	(459)	(526)
Change in liabilities (note 38(2)):			
Gross	186	(82)	(111)
Reinsurers' share	(12)	2	3
	174	(80)	(108)
Total non-life insurance	(343)	(539)	(634)
Total insurance claims	(6,041)	(19,088)	(22,493)
Life insurance and participating investment contracts gross claims can also be analysed as follows:			
Deaths	(625)	(662)	(637)
Maturities	(1,861)	(1,763)	(2,107)
Surrenders	(5,041)	(5,904)	(4,225)
Annuities	(764)	(741)	(710)
Other	(331)	(327)	(331)
Total life insurance gross claims	(8,622)	(9,397)	(8,010)

[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: £606 million; 2010: £577 million; 2009: £474 million) are now included within net fee and commission income.

A non-life insurance claims development table is included in note 38.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11: Operating expenses

	2011 £m	2010 £m[1]	2009 £m
Staff costs:			
Salaries	**3,784**	3,787	3,902
Performance-based compensation	**361**	533	491
Social security costs	**432**	396	383
Pensions and other post-retirement benefit schemes (note 43):			
Curtailment gain[2]	**–**	(910)	–
Other	**401**	628	744
	401	(282)	744
Restructuring costs	**124**	119	412
Other staff costs	**1,064**	1,069	743
	6,166	5,622	6,675
Premises and equipment:			
Rent and rates	**547**	602	569
Hire of equipment	**22**	18	20
Repairs and maintenance	**188**	199	226
Other	**294**	358	341
	1,051	1,177	1,156
Other expenses:			
Communications and data processing	**954**	1,126	668
Advertising and promotion	**398**	362	335
Professional fees	**576**	742	540
Customer goodwill payments provision (note 45)	**–**	500	–
UK bank levy	**189**	–	–
Financial services compensation scheme management expenses levy (note 54)	**179**	46	73
Provision in relation to German insurance business litigation (note 45)	**175**	–	–
Other	**1,122**	1,061	1,237
	3,593	3,837	2,853
Depreciation and amortisation:			
Depreciation of tangible fixed assets (note 32)	**1,434**	1,635	1,716
Amortisation of acquired value of in-force non-participating investment contracts (note 30)	**78**	76	75
Amortisation of other intangible assets (note 31)	**663**	721	769
	2,175	2,432	2,560
Impairment of tangible fixed assets[3] (note 32)	**65**	202	–
Goodwill impairment	**–**	–	240
Total operating expenses, excluding payment protection insurance provision and Government Asset Protection Scheme fee	**13,050**	13,270	13,484
Payment protection insurance provision (note 45)	**3,200**	–	–
Government Asset Protection Scheme fee	**–**	–	2,500
Total operating expenses	**16,250**	13,270	15,984

[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] Following changes by the Group to the terms of its defined benefit pension schemes in 2010, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee's actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of 2010 there was a change in commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group's defined benefit obligation of £1,081 million and a reduction in the Group's unrecognised actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement and a reduction in the balance sheet liability.

[3] £65 million (2010: £52 million; 2009: £nil) of the impairment of tangible fixed assets relates to integration activities.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11: Operating expenses (continued)

Performance-based compensation

The table below analyses the Group's performance-based compensation costs (excluding branch-based sales incentives) between those relating to the current performance year and those relating to earlier years.

	2011 £m	2010 £m	2009 £m
Performance-based compensation expense comprises:			
Awards made in respect of the year ended 31 December	363	505	480
Awards made in respect of earlier years	(2)	28	11
	361	533	491
Performance-based compensation expense deferred until later years comprises:			
Awards made in respect of the year ended 31 December	43	39	60
Awards made in respect of earlier years	29	39	11
	72	78	71

Performance-based awards expensed in 2011 include cash awards amounting to £160 million (2010: £163 million; 2009: £180 million).

Average headcount

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

	2011	2010	2009
UK	116,371	118,149	125,109
Overseas	4,078	4,830	6,891
Total	120,449	122,979	132,000

Fees payable to the auditors

Fees payable to the Company's auditors by the Group are as follows:

	2011 £m	2010 £m	2009 £m
Fees payable for the audit of the Company's current year annual report	1.7	1.9	2.2
Fees payable for other services:			
Audit of the Company's subsidiaries pursuant to legislation	16.9	17.9	18.8
Other services supplied pursuant to legislation	4.8	6.2	4.2
Total audit fees	23.4	26.0	25.2
Other services – audit related fees	2.9	1.8	5.3
Total audit and audit related fees	26.3	27.8	30.5
Services relating to taxation	1.1	1.0	1.0
Other non-audit fees:			
Services relating to corporate finance transactions	6.3	1.9	0.3
Other services	2.6	9.7	8.9
Total other non-audit fees	8.9	11.6	9.2
Total fees payable to the Company's auditors by the Group	36.3	40.4	40.7

Other non-audit fees cover a variety of services and in 2009 and 2010 included the costs associated with the Group's preparations for ensuring that the heritage HBOS businesses complied fully with the requirements of the Sarbanes-Oxley Act by 31 December 2010.

The following types of services are included in the categories listed above:

Audit fees: This category includes fees in respect of the audit of the Group's annual financial statements and other services in connection with regulatory filings. Other services supplied pursuant to legislation relate primarily to the costs associated with the Sarbanes-Oxley Act audit requirements together with the cost of the audit of the Group's Form 20-F filing.

Audit related fees: This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements, for example acting as reporting accountants in respect of prospectuses and circulars required by the UKLA listing rules.

Services relating to taxation: This category includes tax compliance and tax advisory services.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11: Operating expenses (continued)

Other non-audit fees: This category includes due diligence relating to corporate finance, including venture capital transactions and other assurance and advisory services.

It is the Group's policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants. Such assignments typically relate to the provision of advice on tax issues, assistance in transactions involving the acquisition and disposal of businesses and accounting advice.

The Group has procedures that are designed to ensure auditor independence, including that fees for audit and non-audit services are approved in advance. This approval can be obtained either on an individual engagement basis or, for certain types of non-audit services, particularly those of a recurring nature, through the approval of a fee cap covering all engagements of that type provided the fee is below that cap. All statutory audit work as well as non-audit assignments where the fee is expected to exceed the relevant fee cap must be pre-approved by the Audit Committee on an individual engagement basis. On a quarterly basis, the Audit Committee receives a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

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

	2011 £m	2010 £m	2009 £m
Audits of Group pension schemes	0.4	0.3	0.3
Audits of the unconsolidated Open Ended Investment Companies managed by the Group	0.6	0.8	0.6
Reviews of the financial position of corporate and other borrowers	11.0	17.2	19.3
Acquisition due diligence and other work performed in respect of potential venture capital investments	1.0	1.2	1.4

Note 12: Impairment

	2011 £m	2010 £m	2009 £m
Impairment losses on loans and receivables:			
Loans and advances to banks	–	(13)	(3)
Loans and advances to customers	8,020	10,727	15,783
Debt securities classified as loans and receivables	49	57	248
Total impairment losses on loans and receivables (note 25)	8,069	10,771	16,028
Impairment of available-for-sale financial assets	80	106	602
Other credit risk provisions (note 45)	(55)	75	43
Total impairment charged to the income statement	8,094	10,952	16,673

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 13: Investments in joint ventures and associates

The Group's share of results of and investments in joint ventures and associates comprises:

	Joint ventures			Associates			Total		
	2011 £m	2010 £m	2009 £m	**2011 £m**	2010 £m	2009 £m	**2011 £m**	2010 £m	2009 £m
Share of income statement amounts:									
Income	**316**	318	708	**160**	135	5	**476**	453	713
Expenses	**(261)**	(209)	(544)	**(161)**	(91)	(96)	**(422)**	(300)	(640)
Impairment	**(20)**	(126)	(272)	**1**	(92)	(114)	**(19)**	(218)	(386)
Insurance claims	**–**	–	(465)	**–**	–	–	**–**	–	(465)
Profit (loss) before tax	**35**	(17)	(573)	**–**	(48)	(205)	**35**	(65)	(778)
Tax	**(4)**	(22)	24	**–**	(1)	2	**(4)**	(23)	26
Share of post-tax results	**31**	(39)	(549)	**–**	(49)	(203)	**31**	(88)	(752)
Share of balance sheet amounts:									
Current assets	**3,346**	3,370	2,754	**246**	378	605	**3,592**	3,748	3,359
Non-current assets	**2,148**	2,868	4,662	**976**	1,184	1,611	**3,124**	4,052	6,273
Current liabilities	**(714)**	(588)	(2,175)	**(293)**	(433)	(494)	**(1,007)**	(1,021)	(2,669)
Non-current liabilities	**(4,471)**	(5,324)	(4,871)	**(904)**	(1,026)	(1,613)	**(5,375)**	(6,350)	(6,484)
Share of net assets at 31 December	**309**	326	370	**25**	103	109	**334**	429	479
Movement in investments over the year:									
At 1 January	**326**	370	55	**103**	109	–	**429**	479	55
Exchange and other adjustments	**(3)**	(8)	(15)	**(1)**	40	60	**(4)**	32	45
Adjustment on acquisition	**–**	–	956	**–**	–	219	**–**	–	1,175
Additional investments	**7**	71	140	**3**	6	12	**10**	77	152
Acquisitions	**–**	–	3	**–**	–	60	**–**	–	63
Disposals	**(47)**	(68)	(199)	**(79)**	(2)	(39)	**(126)**	(70)	(238)
Share of post-tax results	**31**	(39)	(549)	**–**	(49)	(203)	**31**	(88)	(752)
Dividends paid	**(5)**	–	(21)	**(1)**	(1)	–	**(6)**	(1)	(21)
Share of net assets at 31 December	**309**	326	370	**25**	103	109	**334**	429	479

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 (2009: £64 million) and of joint ventures is £85 million in 2011 (2010: £180 million; 2009: £424 million). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £56 million (2010: £104 million; 2009: £64 million) and of joint ventures is £299 million (2010: £339 million; 2009: £424 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 14: Gain on acquisition in 2009

On 16 January 2009, the Group acquired 100 per cent of the ordinary share capital of HBOS plc, which together with its subsidiaries undertakes banking, insurance and other financial services related activities in the UK and in certain overseas locations.

The table below sets out the fair value of the identifiable net assets acquired.

At the time of the recommended offer for HBOS in September 2008, it had become increasingly difficult for HBOS to raise funds in wholesale markets and their Board sought to restore confidence and stability through an agreement to be acquired by Lloyds TSB Group plc announced on 18 September 2008 at the original terms of 0.833 Lloyds TSB Group plc shares for each HBOS share. However turbulence in the markets continued and the UK Government decided in October 2008 that it would be appropriate for the UK banking sector to increase its level of capitalisation. As a consequence of the recapitalisation of HBOS and the impact of the deteriorating market conditions the terms of the final agreed offer were revised down to a ratio of 0.605 per HBOS share.

As the fair value of the identifiable net assets acquired was greater than the total consideration paid, negative goodwill arose on the acquisition. The negative goodwill was recognised as a 'Gain on acquisition' in the income statement for the year ended 31 December 2009. In accordance with accounting requirements, the measurement period for the fair values of the acquired assets and liabilities ended on 15 January 2010 (one year from the date of acquisition); no further fair value adjustments were made beyond those reflected in the Group's 31 December 2009 financial statements.

	Book value at 16 January 2009 £m	Fair value adjustments £m	Fair value at 16 January 2009 £m
Assets			
Cash and balances at central banks	2,123	–	2,123
Items in the course of collection from banks	523	–	523
Trading and other financial assets at fair value through profit or loss	83,857	–	83,857
Derivative financial instruments	54,840	(808)	54,032
Loans and receivables:			
Loans and advances to banks	15,751	43	15,794
Loans and advances to customers	450,351	(13,512)	436,839
Debt securities	39,819	(1,411)	38,408
Available-for-sale financial assets	27,151	–	27,151
Investment properties	3,002	–	3,002
Investments in joint ventures and associates	1,152	23	1,175
Value of in-force business	3,152	561	3,713
Other intangible assets	104	4,650	4,754
Tangible fixed assets	5,721	(14)	5,707
Current tax recoverable	1,050	–	1,050
Deferred tax assets	2,556	(602)	1,954
Other assets	7,601	(905)	6,696
Total assets	698,753	(11,975)	686,778

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 14: Gain on acquisition in 2009 (continued)

	Book value at 16 January 2009 £m	Fair value adjustments £m	Fair value at 16 January 2009 £m
Liabilities			
Deposits from banks	87,731	109	87,840
Customer deposits	223,859	835	224,694
Items in course of transmission to banks	521	–	521
Trading and other financial liabilities at fair value through profit or loss	16,360	–	16,360
Derivative financial instruments	45,798	–	45,798
Notes in circulation	936	–	936
Debt securities in issue	191,566	(6,247)	185,319
Liabilities arising from insurance contracts and participating investment contracts	36,405	282	36,687
Liabilities arising from non-participating investment contracts	28,168	13	28,181
Unallocated surplus within insurance businesses	526	–	526
Other liabilities	14,732	(312)	14,420
Retirement benefit obligations	(474)	832	358
Current tax liabilities	58	–	58
Deferred tax liabilities	245	(142)	103
Other provisions	146	606	752
Subordinated liabilities	29,240	(9,192)	20,048
Total liabilities	675,817	(13,216)	662,601
Net assets acquired	22,936	1,241	24,177

Fair value of net assets acquired	24,177
Adjust for:	
Preference shares[1]	(3,917)
Non-controlling interests	(1,300)
Adjusted net assets of HBOS acquired	18,960
Consideration inclusive of acquisition costs:	
Issue of 7,776 million ordinary shares of 25p in Lloyds Banking Group plc[2]	(7,651)
Fees and expenses related to the transaction	(136)
Total consideration	(7,787)
Gain on acquisition in 2009	11,173

[1] On 16 January 2009, the Group cancelled the following HBOS preference share issuances in exchange for preference shares issued by Lloyds Banking Group plc: 6.475 per cent non-cumulative preference shares of £1 each, 6.3673 per cent non-cumulative fixed to floating preference shares of £1 each and 6.0884 per cent non-cumulative preference shares of £1 each. The fair value of the Lloyds Banking Group preference shares issued was deducted from the net assets acquired for the purposes of calculating the gain arising on acquisition.

[2] The calculation of consideration was based on the closing price of Lloyds TSB ordinary shares of 98.4p on 16 January 2009; 12,852 million HBOS shares were exchanged for Lloyds Banking Group shares at a ratio of 0.605 shares per HBOS share.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 15: Loss on disposal of businesses in 2010

During 2009, the Group acquired an oil drilling rig construction business through a previous lending relationship and consolidated the results and net assets of the business from the date it exercised control.

In the first half of 2010, as a result of a deteriorating market, the Group impaired the oil drilling rigs under construction held by the business by £150 million to reflect their reduced value in use. This impairment was recognised in the Wholesale segment.

In the second half of 2010, the Group reached agreement to dispose of its interests in the two wholly-owned subsidiary companies through which this business operates; the sale was completed in January 2011. These companies, which had gross assets of £860 million, were sold to Seadrill Limited; a loss of £365 million arose on disposal.

The Group extended vendor financing, on normal commercial terms and negotiated on an arms length basis, to Seadrill to facilitate the acquisition of the rig holding companies. The loan is not contingent on the performance of the oil rigs under construction. Accordingly, as at 31 December 2010, the subsidiaries were derecognised.

Note 16: Taxation

(A) Analysis of tax credit (charge) for the year

	2011 £m	2010 £m	2009 £m
UK corporation tax:			
Current tax on profit for the year	(93)	(146)	(227)
Adjustments in respect of prior years	(146)	310	(310)
	(239)	164	(537)
Double taxation relief	–	1	10
	(239)	165	(527)
Foreign tax:			
Current tax on profit for the year	(90)	(82)	(221)
Adjustments in respect of prior years	36	49	40
	(54)	(33)	(181)
Current tax (charge) credit	(293)	132	(708)
Deferred tax (note 44):			
Origination and reversal of temporary differences	1,621	(393)	2,429
Reduction in UK corporation tax rate	(404)	(137)	–
Adjustments in respect of prior years	(96)	(141)	190
	1,121	(671)	2,619
Tax credit (charge)	**828**	(539)	1,911

The credit (charge) for tax on the profit for 2011 is based on a UK corporation tax rate of 26.5 per cent (2010 and 2009: 28.0 per cent).

The above income tax credit (charge) is made up as follows:

	2011 £m	2010 £m	2009 £m
Tax credit (charge) attributable to policyholders	72	(315)	(410)
Shareholder tax credit (charge)	756	(224)	2,321
Tax credit (charge)	**828**	(539)	1,911

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 Taxation (continued)

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

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

	2011 £m	2010 £m	2009 £m
(Loss) profit before tax	(3,542)	281	1,042
Tax credit (charge) thereon at UK corporation tax rate of 26.5 per cent (2010 and 2009: 28.0 per cent)	939	(79)	(292)
Factors affecting credit (charge):			
UK corporation tax rate change	(404)	(137)	–
Goodwill	–	–	3,061
Disallowed and non-taxable items	238	5	408
Overseas tax rate differences	17	134	(352)
Gains exempted or covered by capital losses	106	65	(14)
Policyholder interests	53	(227)	(295)
Tax losses where no deferred tax recognised	(261)	(487)	(332)
Deferred tax on tax losses not previously recognised	332	–	–
Adjustments in respect of previous years	(206)	218	(66)
Effect of results of joint ventures and associates	8	(25)	(211)
Other items	6	(6)	4
Tax credit (charge) on (loss) profit on ordinary activities	828	(539)	1,911

Note 17: Earnings per share

	2011 £m	2010 £m	2009 £m
(Loss) profit attributable to equity shareholders – basic and diluted	(2,787)	(320)	2,827
	2011 million	**2010 million**	**2009 million**
Weighted average number of ordinary shares in issue – basic	68,470	67,117	37,674
Adjustment for share options and awards	–	–	255
Weighted average number of ordinary shares in issue – diluted	68,470	67,117	37,929
Basic (loss) earnings per share	(4.1)p	(0.5)p	7.5p
Diluted (loss) earnings per share	(4.1)p	(0.5)p	7.5p

Basic earnings per share are calculated by dividing the net profit attributable to equity shareholders by the weighted average number of ordinary shares in issue during the year, which has been calculated after deducting 10 million (2010: 8 million; 2009: 10 million) ordinary shares representing the Group's holdings of own shares in respect of employee share schemes.

For the calculation of diluted earnings per share the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares, if any, that arise in respect of share options and awards granted to employees. The number of shares that could have been acquired at the average annual share price of the Company's shares based on the monetary value of the subscription rights attached to outstanding share options and awards is determined. This is deducted from the number of shares issuable under such options and awards to leave a residual bonus amount of shares which are added to the weighted-average number of ordinary shares in issue, but no adjustment is made to the profit attributable to equity shareholders.

In December 2009, as part of the Group's recapitalisation and exit from the Government Asset Protection Scheme, the Group entered into an agreement with holders of certain existing liabilities to exchange these for ordinary shares or for cash on 18 February 2010. The weighted average number of anti-dilutive shares arising from this transaction that have been excluded from the calculation of diluted earnings per share was 294 million at 31 December 2009. On 18 February 2010, the above exchange completed and 3,141 million new ordinary shares in Lloyds Banking Group plc were issued.

The weighted-average number of anti-dilutive share options and awards excluded from the calculation of diluted earnings per share was 619 million at 31 December 2011 (2010: 92 million; 2009: 393 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 18: Trading and other financial assets at fair value through profit or loss

These assets are comprised as follows:

	2011			2010		
	Trading assets £m	**Other financial assets at fair value through profit or loss £m**	**Total £m**	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m
Loans and advances to customers	**9,642**	**124**	**9,766**	9,486	325	9,811
Loans and advances to banks	**1,355**	**–**	**1,355**	2,734	–	2,734
Debt securities:						
Government securities	**2,000**	**21,367**	**23,367**	1,623	22,217	23,840
Other public sector securities	**–**	**1,183**	**1,183**	–	919	919
Bank and building society certificates of deposit	**2,863**	**385**	**3,248**	3,692	606	4,298
Asset-backed securities:						
Mortgage-backed securities	**99**	**612**	**711**	–	422	422
Other asset-backed securities	**222**	**1,764**	**1,986**	1,020	1,592	2,612
Corporate and other debt securities	**1,576**	**20,282**	**21,858**	4,919	16,190	21,109
	6,760	**45,593**	**52,353**	11,254	41,946	53,200
Equity shares	**–**	**75,737**	**75,737**	6	90,213	90,219
Treasury and other bills	**299**	**–**	**299**	227	–	227
Total	**18,056**	**121,454**	**139,510**	23,707	132,484	156,191

Other financial assets at fair value through profit or loss include the following assets designated into that category:

(i) financial assets backing insurance contracts and investment contracts of £118,890 million (2010: £129,702 million) which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise;

(ii) loans and advances to customers of £124 million (2010: £109 million) which are economically hedged by interest rate derivatives which are not in hedge accounting relationships and where significant measurement inconsistencies would otherwise arise if the related derivatives were treated as trading liabilities and the loans and advances were carried at amortised cost; and

(iii) private equity investments of £1,850 million (2010: £1,733 million) that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The maximum exposure to credit risk at 31 December 2011 of the loans and advances to banks and customers designated at fair value through profit or loss was £124 million (2010: £325 million); the Group does not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk which is determined by reference to the publicly available credit ratings of the instruments involved.

The Group's Wholesale division had exposure to negative basis asset-backed securities of £150 million (2010: £1,067 million) which were protected by monoline financial guarantors (note 56).

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £10,990 million (2010: £12,211 million). Collateral is held with a fair value of £15,765 million (2010: £14,299 million), all of which the Group is able to repledge. At 31 December 2011, £3,740 million had been repledged (2010: £3,161 million).

For amounts included above which are subject to repurchase agreements see note 56.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 19: 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 56; and

– Derivatives held in policyholder funds as permitted by the investment strategies of those funds.

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 55.

The principal derivatives used by the Group are as follows:

– Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.

– Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.

– Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place. The Group also uses credit default swaps to securitise, in combination with external funding, £3,436 million (2010: £4,149 million) of corporate and commercial banking loans.

– Equity derivatives are also used by the Group as part of its equity based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 19: Derivative financial instruments (continued)

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

	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
At 31 December 2011			
Trading and other			
Exchange rate contracts:			
Spot, forwards and futures	204,629	2,542	2,780
Currency swaps	138,120	3,498	2,027
Options purchased	17,992	610	–
Options written	18,924	–	616
	379,665	6,650	5,423
Interest rate contracts:			
Interest rate swaps	1,627,013	38,806	39,899
Forward rate agreements	261,125	586	606
Options purchased	69,554	3,693	–
Options written	67,858	–	3,524
Futures	118,921	1	2
	2,144,471	43,086	44,031
Credit derivatives	9,980	238	328
Embedded equity conversion feature	–	1,172	–
Equity and other contracts	23,032	2,017	1,184
Total derivative assets/liabilities – trading and other	2,557,148	53,163	50,966
Hedging			
Derivatives designated as fair value hedges:			
Currency swaps	19,130	708	302
Interest rate swaps	93,215	6,720	1,236
Options written	657	–	9
	113,002	7,428	1,547
Derivatives designated as cash flow hedges:			
Interest rate swaps	152,314	5,250	5,608
Futures	103,467	–	–
Currency swaps	16,582	172	90
	272,363	5,422	5,698
Derivatives designated as net investment hedges:			
Cross currency swaps	49	–	1
Total derivative assets/liabilities – hedging	385,414	12,850	7,246
Total recognised derivative assets/liabilities	2,942,562	66,013	58,212

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 56 Credit risk.

The embedded equity conversion feature of £1,172 million (31 December 2010: £1,177 million) reflects the value of the equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009; the loss of £5 million arising from the change in fair value over 2011 (2010: loss of £620 million; 2009: loss of £427 million) is included within net gains on financial instruments held for trading within net trading income (note 7).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 19: Derivative financial instruments (continued)

	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
At 31 December 2010			
Trading and other			
Exchange rate contracts:			
Spot, forwards and futures	212,832	2,513	2,242
Currency swaps	108,216	5,696	1,773
Options purchased	18,096	602	–
Options written	19,387	–	536
	358,531	8,811	4,551
Interest rate contracts:			
Interest rate swaps	1,397,157	28,448	29,202
Forward rate agreements	718,227	309	287
Options purchased	59,578	2,371	–
Options written	60,828	–	2,180
Futures	23,361	3	1
	2,259,151	31,131	31,670
Credit derivatives	7,108	256	207
Embedded equity conversion feature	–	1,177	–
Equity and other contracts	22,597	1,996	1,332
Total derivative assets/liabilities – trading and other	2,647,387	43,371	37,760
Hedging			
Derivatives designated as fair value hedges:			
Currency swaps	9,418	606	35
Interest rate swaps	75,831	4,366	1,200
	85,249	4,972	1,235
Derivatives designated as cash flow hedges:			
Interest rate swaps	112,507	2,199	3,042
Futures	1,299	1	–
Currency swaps	17,745	232	121
	131,551	2,432	3,163
Derivatives designated as net investment hedges:			
Cross currency swaps	86	2	–
Total derivative assets/liabilities – hedging	216,886	7,406	4,398
Total recognised derivative assets/liabilities	2,864,273	50,777	42,158

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 19: 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	**140**	**239**	**475**	**208**	**35**	**355**	**191**	**66**	**1,709**
Forecast payable cash flows	**(178)**	**(181)**	**(63)**	**(81)**	**(78)**	**(1,394)**	**(1,163)**	**(354)**	**(3,492)**
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	**234**	**232**	**388**	**208**	**47**	**383**	**163**	**54**	**1,709**
Forecast payable cash flows	**(224)**	**(154)**	**(53)**	**(81)**	**(145)**	**(1,475)**	**(1,110)**	**(250)**	**(3,492)**

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	223	328	560	434	310	451	445	160	2,911
Forecast payable cash flows	(70)	(44)	(165)	(93)	(67)	(616)	(916)	(200)	(2,171)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	223	445	443	434	310	466	435	155	2,911
Forecast payable cash flows	(70)	(97)	(113)	(93)	(67)	(675)	(884)	(172)	(2,171)

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.

Note 20: Loans and advances to banks

	2011 £m	2010 £m
Lending to banks	**1,810**	1,042
Money market placements with banks	**30,810**	29,250
Total loans and advances to banks before allowance for impairment losses	**32,620**	30,292
Allowance for impairment losses (note 25)	**(14)**	(20)
Total loans and advances to banks	**32,606**	30,272

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £508 million (2010: £4,185 million). Collateral is held with a fair value of £511 million (2010: £3,909 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 21: Loans and advances to customers

	2011 £m	2010 £m
Agriculture, forestry and fishing	5,198	5,558
Energy and water supply	4,013	3,576
Manufacturing	10,061	11,495
Construction	9,722	7,904
Transport, distribution and hotels	32,882	34,176
Postal and telecommunications	1,896	1,908
Property companies	64,752	78,263
Financial, business and other services	64,046	59,363
Personal:		
Mortgages	348,210	356,261
Other	30,014	36,967
Lease financing	7,800	8,291
Hire purchase	5,776	7,208
Total loans and advances to customers before allowance for impairment losses	584,370	610,970
Allowance for impairment losses (note 25)	(18,732)	(18,373)
Total loans and advances to customers	565,638	592,597

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £16,835 million (2010: £3,096 million). Collateral is held with a fair value of £16,936 million (2010: £2,987 million), all of which the Group is able to repledge. Included within this are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £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	1,168	1,358
Later than 1 year and not later than 5 years	2,754	2,522
Later than 5 years	6,355	7,218
	10,277	11,098
Unearned future finance income on finance leases	(2,391)	(2,603)
Rentals received in advance	(56)	(183)
Commitments for expenditure in respect of equipment to be leased	(30)	(21)
Net investment in finance leases	7,800	8,291

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

	2011 £m	2010 £m
Not later than 1 year	724	986
Later than 1 year and not later than 5 years	2,307	1,965
Later than 5 years	4,769	5,340
Net investment in finance leases	7,800	8,291

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 is £92 million (2010: £287 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 21: Loans and advances to customers (continued)

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

	2011 £m	2010 £m
Not later than 1 year	**56**	45
Later than 1 year and not later than 5 years	**137**	101
Later than 5 years	**20**	20
Total unguaranteed residual values	**213**	166

Note 22: Securitisations and covered bonds

Securitisation programmes

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the SPEs are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue. In addition to the SPEs described below, the Group sponsors three conduit programmes, Argento, Cancara and Grampian.

Covered bond programmes

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

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in note 37.

	2011		2010	
	Loans and advances securitised £m	Notes in issue £m	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes[1]				
UK residential mortgages	**129,764**	**94,080**	146,200	114,428
US residential mortgage-backed securities	**398**	**398**	–	–
Commercial loans	**13,313**	**11,342**	11,860	8,936
Irish residential mortgages	**5,497**	**5,661**	6,007	6,191
Credit card receivables	**6,763**	**4,810**	7,327	3,856
Dutch residential mortgages	**4,933**	**4,777**	4,526	4,316
Personal loans	**–**	**–**	3,012	2,011
PFI/PPP and project finance loans	**767**	**110**	776	110
Motor vehicle loans	**3,124**	**2,871**	926	975
	164,559	**124,049**	180,634	140,823
Less held by the Group		**(86,637)**		(100,081)
Total securitisation programmes (note 37)		**37,412**		40,742
Covered bond programmes				
Residential mortgage-backed	**91,023**	**67,456**	93,651	73,458
Social housing loan-backed	**3,363**	**2,605**	3,317	2,181
	94,386	**70,061**	96,968	75,639
Less held by the Group		**(31,865)**		(43,489)
Total covered bond programmes (note 37)		**38,196**		32,150
Total securitisation and covered bond programmes		**75,608**		72,892

[1] Includes securitisations utilising a combination of external funding and credit default swaps.

Cash deposits of £20,435 million (2010: £36,579 million) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs, the term advances relating to covered bonds and other legal obligations.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 23: Special purpose entities

In addition to the special purpose entities discussed in note 22, which are used for securitisation and covered bond programmes, the Group sponsors three asset-backed conduits, Argento, Cancara and Grampian, which invest in debt securities and client receivables. All the external assets in these conduits are consolidated in the Group's financial statements and are included in the credit market exposures set out in note 56. The total consolidated exposures in these conduits are set out in the table below:

	Argento £m	Cancara £m	Grampian £m	Total £m
At 31 December 2011				
Loans and advances	**130**	**3,962**	**73**	**4,165**
Debt securities classified as loans and receivables (note 24):				
Asset-backed securities	**1,022**	**–**	**2,004**	**3,026**
Corporate and other debt securities	**–**	**–**	**–**	**–**
	1,022	**–**	**2,004**	**3,026**
Debt securities classified as available-for-sale financial assets (note 26):				
Asset-backed securities	**733**	**21**	**796**	**1,550**
Corporate and other debt securities	**73**	**–**	**–**	**73**
	806	**21**	**796**	**1,623**
Total assets	**1,958**	**3,983**	**2,873**	**8,814**
At 31 December 2010				
Loans and advances	–	3,957	–	3,957
Debt securities classified as loans and receivables (note 24):				
Asset-backed securities	1,448	–	6,957	8,405
Corporate and other debt securities	202	–	–	202
	1,650	–	6,957	8,607
Debt securities classified as available-for-sale financial assets (note 26):				
Asset-backed securities	1,436	2,587	–	4,023
Corporate and other debt securities	463	–	–	463
	1,899	2,587	–	4,486
Total assets	3,549	6,544	6,957	17,050

Other special purpose entities

During 2009, the Group established Lloyds TSB Pension ABCS (No 1) LLP and Lloyds TSB Pension ABCS (No 2) LLP and transferred approximately £5 billion of assets, primarily comprising notes in certain of the Group's securitisation programmes, in aggregate to these entities. Further details are provided in note 43.

Note 24: Debt securities classified as loans and receivables

Debt securities accounted for as loans and receivables comprise:

	2011 £m	2010 £m
Asset-backed securities:		
Mortgage-backed securities	**7,179**	11,650
Other asset-backed securities	**5,030**	12,827
Corporate and other debt securities	**537**	1,816
Total debt securities classified as loans and receivables before allowance for impairment losses	**12,746**	26,293
Allowance for impairment losses (note 25)	**(276)**	(558)
Total debt securities classified as loans and receivables	**12,470**	25,735

For amounts included above which are subject to repurchase agreements see note 56.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 25: Allowance for impairment losses on loans and receivables

	Loans and advances to customers £m	Loans and advances to banks £m	Debt securities £m	Total £m
At 1 January 2010	14,801	149	430	15,380
Exchange and other adjustments	(2)	(5)	119	112
Advances written off	(6,966)	(111)	(48)	(7,125)
Recoveries of advances written off in previous years	216	–	–	216
Unwinding of discount	(403)	–	–	(403)
Charge (release) to the income statement (note 12)	10,727	(13)	57	10,771
At 31 December 2010	18,373	20	558	18,951
Exchange and other adjustments	**(369)**	**–**	**2**	**(367)**
Advances written off	**(7,487)**	**(6)**	**(341)**	**(7,834)**
Recoveries of advances written off in previous years	**421**	**–**	**8**	**429**
Unwinding of discount	**(226)**	**–**	**–**	**(226)**
Charge to the income statement (note 12)	**8,020**	**–**	**49**	**8,069**
At 31 December 2011	**18,732**	**14**	**276**	**19,022**

Of the total allowance in respect of loans and advances to customers, £17,021 million (2010: £15,585 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £3,832 million (2010: £6,076 million) was assessed on a collective basis.

Note 26: Available-for-sale financial assets

	2011			2010		
	Conduits £m	Other £m	Total £m	Conduits £m	Other £m	Total £m
Debt securities:						
Government securities	**–**	**25,236**	**25,236**	–	12,552	12,552
Other public sector securities	**–**	**27**	**27**	–	29	29
Bank and building society certificates of deposit	**–**	**366**	**366**	–	407	407
Asset-backed securities:						
Mortgage-backed securities	**1,255**	**548**	**1,803**	3,203	1,090	4,293
Other asset-backed securities	**295**	**769**	**1,064**	820	4,399	5,219
Corporate and other debt securities	**73**	**5,172**	**5,245**	463	11,669	12,132
	1,623	**32,118**	**33,741**	4,486	30,146	34,632
Equity shares	**–**	**1,938**	**1,938**	–	2,255	2,255
Treasury and other bills	**–**	**1,727**	**1,727**	–	6,068	6,068
Total available-for-sale financial assets	**1,623**	**35,783**	**37,406**	4,486	38,469	42,955

Details of the Group's asset-backed conduits shown in the table above are included in note 23.

Included within asset-backed securities are £2,867 million (31 December 2010: £9,392 million) managed by the Wholesale division. Further information on these exposures is provided in note 56.

For amounts included above which are subject to repurchase agreements see note 56.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2(H).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 27: Held-to-maturity investments

	2011 £m	2010 £m
Debt securities: government securities	**8,098**	7,905

Note 28: Investment properties

	2011 £m	2010 £m
At 1 January	**5,997**	4,757
Exchange and other adjustments	**(16)**	(6)
Additions:		
Acquisitions of new properties	**396**	398
Consolidation of new subsidiary undertakings	**922**	921
Additional expenditure on existing properties	**81**	52
Total additions	**1,399**	1,371
Disposals	**(1,151)**	(559)
Changes in fair value (note 7)	**(107)**	434
At 31 December	**6,122**	5,997

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)	**388**	337
Direct operating expenses arising from investment properties that generate rental income	**50**	77

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	**33**	86

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 29: Goodwill

	2011 £m	2010 £m
At 1 January and 31 December	**2,016**	2,016
Cost[1]	**2,362**	2,362
Accumulated impairment losses	**(346)**	(346)
At 31 December	**2,016**	2,016

[1] For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is included net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,016 million (31 December 2010: £2,016 million), £1,836 million, or 91 per cent of the total (2010: £1,836 million, 91 per cent of the total) has been allocated to Scottish Widows in the Group's Insurance division and £170 million, or 8 per cent of the total (2010: £170 million, 8 per cent of the total) to Asset Finance in the Group's Wholesale division.

The recoverable amount of Scottish Widows has been based on a value-in-use calculation. The calculation uses post-tax projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 12 per cent (net of tax). The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady three per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of Asset Finance has also been based on a value-in-use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 17.75 per cent (gross of tax). The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Asset Finance participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Asset Finance to fall below the balance sheet carrying value.

Note 30: 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	**1,391**	1,469
Value of in-force insurance and participating investment contracts	**5,247**	5,898
Total value of in-force business	**6,638**	7,367

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	**1,469**	1,545
Amortisation taken to income statement (note 11)	**(78)**	(76)
At 31 December	**1,391**	1,469

The acquired value of in-force non-participating investment contracts includes £329 million (2010: £356 million) in relation to OEIC business.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 30: Value of in-force business (continued)

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

	2011 £m	2010 £m
At 1 January	**5,898**	5,140
Adjustment on acquisition	**–**	–
Exchange and other adjustments	**(29)**	(31)
Movements in the year:		
New business	**552**	497
Existing business:		
Expected return	**(437)**	(400)
Experience variances	**117**	85
Non-economic assumption changes	**(576)**	306
Economic variance	**(278)**	301
Movement in the value of in-force business taken to income statement (note 9)	**(622)**	789
At 31 December	**5,247**	5,898

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown contributes to profit before tax. This will also contain changes in the other assets and liabilities, including the effects of changes in assumptions used to value the liabilities, of the relevant businesses. 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. Further information on options and guarantees can be found on page 127.

The liabilities in respect of the Group's UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings. The illiquidity premium is estimated to be 119 basis points as at 31 December 2011 (31 December 2010: 75 basis points).

The risk-free rate assumed in valuing the non-annuity in-force business is the 15 year government bond yield for the appropriate territory. The risk-free rate assumed in valuing the in-force asset for the UK annuity business is presented as a single risk-free rate to allow a better comparison to the rate used for other business. That single risk-free rate has been derived to give the equivalent value to the UK annuity book, had that book been valued using the UK gilt yield curve increased to reflect the illiquidity premium described above.

The table below shows the resulting range of yields and other key assumptions at 31 December for UK business:

	2011 %	2010 %
Risk-free rate (value of in-force non-annuity business)	**2.48**	3.99
Risk-free rate (value of in-force annuity business)	**3.76**	4.66
Risk-free rate (financial options and guarantees)	**0.22 to 3.36**	0.63 to 4.50
Retail price inflation	**3.35**	3.56
Expense inflation	**4.01**	4.20

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 30: Value of in-force business (continued)

Non-market risk

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk, reinsurer default and the with-profit funds these can be asymmetric in the range of potential outcomes for which an explicit allowance is made.

Non-economic assumptions

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

Mortality and morbidity

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

Lapse (persistency) and paid-up rates

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

Maintenance expenses

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

These assumptions are intended to represent a best estimate of future experience, and further information about the effect of changes in key assumptions is given in note 39.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 31: Other intangible assets

	Brands £m	Core deposit intangible £m	Purchased credit card relationships £m	Customer-related intangibles £m	Capitalised software enhancements £m	Total £m
Cost:						
At 1 January 2010	596	2,770	300	877	487	5,030
Additions	–	–	–	–	153	153
Disposals	–	–	–	–	(30)	(30)
At 31 December 2010	596	2,770	300	877	610	5,153
Exchange and other adjustments	–	–	–	–	5	5
Additions	–	–	–	4	369	373
Disposals	–	–	–	–	(25)	(25)
At 31 December 2011	**596**	**2,770**	**300**	**881**	**959**	**5,506**
Accumulated amortisation:						
At 1 January 2010	21	393	58	237	234	943
Charge for the year	25	400	60	161	75	721
Disposals	–	–	–	–	(7)	(7)
At 31 December 2010	46	793	118	398	302	1,657
Exchange and other adjustments	–	–	–	–	2	2
Charge for the year	19	399	60	88	97	663
Disposals	–	–	–	–	(12)	(12)
At 31 December 2011	**65**	**1,192**	**178**	**486**	**389**	**2,310**
Balance sheet amount at 31 December 2011	**531**	**1,578**	**122**	**395**	**570**	**3,196**
Balance sheet amount at 31 December 2010	550	1,977	182	479	308	3,496

Included within brands above are assets of £380 million (31 December 2010: £380 million) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not have an indefinite useful life.

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income. The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased and the core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 32: Tangible fixed assets

	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:				
At 1 January 2010	2,461	5,122	6,384	13,967
Exchange and other adjustments	26	34	(76)	(16)
Additions	175	766	1,672	2,613
Disposals	(222)	(338)	(1,693)	(2,253)
Disposal of businesses	–	(1,005)	–	(1,005)
At 31 December 2010	2,440	4,579	6,287	13,306
Exchange and other adjustments	**–**	**(45)**	**(22)**	**(67)**
Additions	**149**	**660**	**1,436**	**2,245**
Disposals	**(121)**	**(395)**	**(1,852)**	**(2,368)**
Disposal of businesses	**(14)**	**(7)**	**(330)**	**(351)**
At 31 December 2011	**2,454**	**4,792**	**5,519**	**12,765**
Accumulated depreciation and impairment:				
At 1 January 2010	884	2,597	1,262	4,743
Exchange and other adjustments	2	(3)	30	29
Impairment charged to the income statement	–	202	–	202
Depreciation charge for the year	146	535	954	1,635
Disposals	(31)	(338)	(976)	(1,345)
Disposal of businesses	–	(148)	–	(148)
At 31 December 2010	1,001	2,845	1,270	5,116
Exchange and other adjustments	**–**	**17**	**18**	**35**
Impairment charged to the income statement	**–**	**65**	**–**	**65**
Depreciation charge for the year	**137**	**411**	**886**	**1,434**
Disposals	**(38)**	**(349)**	**(967)**	**(1,354)**
Disposal of businesses	**(3)**	**(6)**	**(195)**	**(204)**
At 31 December 2011	**1,097**	**2,983**	**1,012**	**5,092**
Balance sheet amount at 31 December 2011	**1,357**	**1,809**	**4,507**	**7,673**
Balance sheet amount at 31 December 2010	1,439	1,734	5,017	8,190

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

	2011 £m	2010 £m
Receivable within 1 year	**987**	1,168
1 to 5 years	**1,389**	1,791
Over 5 years	**628**	638
Total future minimum rentals receivable	**3,004**	3,597

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 £40 million at 31 December 2011 (£55 million at 31 December 2010) is expected to be received under non-cancellable sub-leases of the Group's premises.

The impairment charge in 2011 relates to integration activities; the impairment charge of £202 million in 2010 comprised £150 million relating to oil drilling rigs under construction acquired from a previous lending relationship in Wholesale (note 15) and £52 million relating to integration activities (note 11).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 33: Other assets

	2011 £m	2010 £m
Assets arising from reinsurance contracts held (note 38 and note 40)	2,534	2,146
Deferred acquisition and origination costs (see below)	693	602
Settlement balances	1,193	985
Corporate pension asset	3,873	2,320
Other assets and prepayments	6,135	6,590
Total other assets	**14,428**	12,643

Deferred acquisition and origination costs:

	2011 £m	2010 £m
At 1 January	602	533
Costs deferred, net of amounts amortised to the income statement	92	69
Exchange and other adjustments	(1)	–
At 31 December	**693**	602

Note 34: Deposits from banks

	2011 £m	2010 £m
Liabilities in respect of securities sold under repurchase agreements	14,389	24,017
Other deposits from banks	25,421	26,346
Deposits from banks	**39,810**	50,363

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £13,933 million (2010: £22,420 million) and a fair value of £14,258 million (2010: £25,626 million).

Note 35: Customer deposits

	2011 £m	2010 £m
Non-interest bearing current accounts	29,468	22,897
Interest bearing current accounts	72,562	77,785
Savings and investment accounts	238,132	222,226
Liabilities in respect of securities sold under repurchase agreements	7,996	11,145
Other customer deposits	65,748	59,580
Customer deposits	**413,906**	393,633

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £7,987 million (2010: £11,112 million) and a fair value of £8,088 million (2010: £11,278 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £323 million (2010: £122 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 36: Trading and other financial liabilities at fair value through profit or loss

	2011 £m	2010 £m
Liabilities held at fair value through profit or loss (debt securities)	**5,339**	6,665
Trading liabilities:		
Liabilities in respect of securities sold under repurchase agreements	**12,378**	14,612
Short positions in securities	**3,701**	1,755
Other	**3,537**	3,730
	19,616	20,097
Trading and other financial liabilities at fair value through profit or loss	**24,955**	26,762

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2011 was £5,487 million, which was £148 million higher than the balance sheet carrying value (31 December 2010: £6,607 million, which was £58 million lower than the balance sheet carrying value). At 31 December 2011 there was a cumulative £183 million decrease in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of Lloyds TSB Bank plc, the issuing entity within the Group. Of the cumulative amount, a decrease of £194 million arose in 2011 and none arose in 2010.

Liabilities designated at fair value through profit or loss represent debt securities in issue which either contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities, or which are accounted for at fair value to significantly reduce an accounting mismatch.

Note 37: Debt securities in issue

	2011 £m	2010 £m
Medium-term notes issued	**63,366**	80,975
Covered bonds (note 22)	**38,196**	32,150
Certificates of deposit issued	**27,994**	42,276
Securitisation notes (note 22)	**37,412**	40,742
Commercial paper	**18,091**	32,723
Total debt securities in issue	**185,059**	228,866

Note 38: 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	**62,399**	**(2,452)**	**59,947**	61,871	(2,044)	59,827
Participating investment contracts	**15,631**	**–**	**15,631**	17,642	–	17,642
	78,030	**(2,452)**	**75,578**	79,513	(2,044)	77,469
Non-life insurance contracts (see (2) below):						
Unearned premiums	**566**	**(23)**	**543**	632	(22)	610
Claims outstanding	**395**	**(2)**	**393**	584	(15)	569
	961	**(25)**	**936**	1,216	(37)	1,179
Total	**78,991**	**(2,477)**	**76,514**	80,729	(2,081)	78,648

[1] Reinsurance balances are reported within other assets (note 33).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 38: Liabilities arising from insurance contracts and participating investment contracts (continued)

(1) Life insurance

The movement in life insurance contract and participating investment contract liabilities over the year can be analysed as follows:

	Insurance contracts	Participating investment contracts	Gross £m	Reinsurance £m	Net £m
At 1 January 2010	56,800	18,089	74,889	(1,831)	73,058
New business	3,807	325	4,132	(48)	4,084
Changes in existing business	1,348	(858)	490	(208)	282
Change in liabilities charged to the income statement (note 10)	5,155	(533)	4,622	(256)	4,366
Exchange and other adjustments	(84)	86	2	43	45
At 31 December 2010	61,871	17,642	79,513	(2,044)	77,469
New business	**4,340**	**86**	**4,426**	**(156)**	**4,270**
Changes in existing business	**(3,713)**	**(2,096)**	**(5,809)**	**(295)**	**(6,104)**
Change in liabilities charged to the income statement (note 10)	**627**	**(2,010)**	**(1,383)**	**(451)**	**(1,834)**
Exchange and other adjustments	**(99)**	**(1)**	**(100)**	**43**	**(57)**
At 31 December 2011	**62,399**	**15,631**	**78,030**	**(2,452)**	**75,578**

Liabilities for insurance contracts and participating investment contracts can be split into with-profit fund liabilities, accounted for using the FSA's realistic capital regime (realistic liabilities) and non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

	2011			2010		
	With-profit fund £m	Non-profit fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	**13,467**	**48,932**	**62,399**	13,598	48,273	61,871
Participating investment contracts	**9,488**	**6,143**	**15,631**	10,647	6,995	17,642
Total	**22,955**	**55,075**	**78,030**	24,245	55,268	79,513

With-profit fund realistic liabilities

(i) Business description

The Group has with-profit funds within Scottish Widows plc and Clerical Medical Investment Group Limited containing both insurance contracts and participating investment contracts.

The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a smoothed investment vehicle to policyholders, protecting them against short-term market fluctuations. Payouts may be subject to a guaranteed minimum payout if certain policy conditions are met. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at retirement.

(ii) Method of calculation of liabilities

With-profit liabilities are stated at their realistic value, the main components of which are:

– With-profit benefit reserve, the total asset shares for with-profit policies;

– Cost of options and guarantees (including guaranteed annuity options);

– Deductions levied against asset shares;

– Planned enhancements to with-profits benefits reserve; and

– Impact of the smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market consistent basis. The calculation of realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 30.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 38: Liabilities arising from insurance contracts and participating investment contracts (continued)

(iii) Assumptions

Key assumptions used in the calculation of with-profit liabilities, and the processes for determining these, are:

Investment returns and discount rates

The realistic capital regime dictates that with-profit fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant government bond yield curve. Further information on significant options and guarantees is given on page 127.

Guaranteed annuity option take-up rates

Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract. For contracts that contain such options, key assumptions in determining the cost of options are economic conditions in which the option has value, mortality rates and take up rates of other options. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

Investment volatility

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical volatility where it is not possible to observe meaningful prices.

Mortality

The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.

Lapse rates (persistency)

Lapse rates refer to the rate of policy termination or the rate at which policyholders stop paying regular premiums due under the contract.

Historical persistency experience is analysed using statistical techniques. As experience can vary considerably between different product types and for contracts that have been in force for different periods, the data is broken down into broadly homogenous groups for the purposes of this analysis.

The most recent experience is considered along with the results of previous analyses and management's views on future experience, taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions, in order to determine a 'best estimate' view of what persistency will be. In determining this best estimate view a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration, any known or expected trends in underlying data and relevant published market data.

Non-profit fund liabilities

(i) Business description

The Group principally writes the following types of life insurance contracts within its non-profit funds. Shareholder profits on these types of business arise from management fees and other policy charges.

Unit-linked business – This includes unit-linked pensions and unit-linked bonds, the primary purpose of which is to provide an investment vehicle where the policyholder is also insured against death.

Life insurance – The policyholder is insured against death or permanent disability, usually for predetermined amounts. Such business includes whole of life and term assurance and long-term creditor policies.

Annuities – The policyholder is entitled to payments for the duration of their life and is therefore insured against surviving longer than expected.

German insurance business is written through the Group's subsidiary Heidelberger Leben and comprises policies similar to the UK definitions above, except that there is participation by the policyholder in the investment, insurance and expense profits of Heidelberger Leben. A minimum level of policyholder participation is prescribed by German law. The following types of life insurance contracts are written:

– Traditional and unit linked endowment or pensions business; and

– Life insurance business.

(ii) Method of calculation of liabilities

The non-profit fund liabilities are determined on the basis of recognised actuarial methods and consistent with the approach required by regulatory rules. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting the cash flows back to the valuation date allowing for probabilities of occurrence.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 38: Liabilities arising from insurance contracts and participating investment contracts (continued)

(iii) Assumptions

Generally, assumptions used to value non-profit fund liabilities are prudent in nature and therefore contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgement and reflects management's views on the inherent level of uncertainty. The key assumptions used in the measurement of non-profit fund liabilities are:

Interest rates

The rates used are derived in accordance with the guidelines set by local regulatory bodies. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the guidelines set by local regulatory bodies, including reductions made to the available yields to allow for default risk based upon the credit rating of the securities allocated to the insurance liability.

Mortality and morbidity

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

Lapse rates (persistency)

Lapse rates are allowed for on some non-profit fund contracts. The process for setting these rates is as described for with-profit liabilities, however a prudent scenario is assumed by the inclusion of a margin for adverse deviation within the non-profit fund liabilities.

Maintenance expenses

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

Key changes in assumptions

A detailed review of the Group's assumptions in 2011 resulted in the following key impacts on profit before tax:

– Change in persistency assumptions (£5 million increase)

– Change in the assumption in respect of current and future mortality rates (£74 million decrease)

– Change in expense assumptions (£22 million increase)

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 38: 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	206	380
Home	753	833
Health	2	3
Total gross non-life insurance contract liabilities	**961**	**1,216**

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	788	(31)	757
Increase in the year	1,230	(104)	1,126
Release in the year	(1,386)	113	(1,273)
Change in provision for unearned premiums charged to income statement (note 8)	(156)	9	(147)
Exchange and other adjustments	–	–	–
At 31 December 2010	632	(22)	610
Increase in the year	1,082	(52)	1,030
Release in the year	(1,152)	52	(1,100)
Change in provision for unearned premiums charged to income statement (note 8)	(70)	–	(70)
Exchange and other adjustments	4	(1)	3
At 31 December 2011	**566**	**(23)**	**543**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 38: 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	289	(9)	280
Incurred but not reported	213	(4)	209
At 1 January 2010	502	(13)	489
Cash paid for claims settled in the year	(467)	11	(456)
Increase (decrease) in liabilities:			
Arising from current year claims	581	(12)	569
Arising from prior year claims	(32)	(1)	(33)
Change in liabilities charged to income statement (note 10)	82	(2)	80
At 31 December 2010	584	(15)	569
Cash paid for claims settled in the year	**(485)**	**–**	**(485)**
Increase (decrease) in liabilities:			
Arising from current year claims	**470**	**–**	**470**
Arising from prior year claims	**(171)**	**12**	**(159)**
Change in liabilities charged to income statement (note 10)	**(186)**	**12**	**(174)**
Exchange and other adjustments	**(3)**	**1**	**(2)**
At 31 December 2011	**395**	**(2)**	**393**
Notified claims	**313**	**(1)**	**312**
Incurred but not reported	**82**	**(1)**	**81**
At 31 December 2011	**395**	**(2)**	**393**
Notified claims	420	(4)	416
Incurred but not reported	164	(11)	153
At 31 December 2010	584	(15)	569

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 38: Liabilities arising from insurance contracts and participating investment contracts (continued)

Non-life insurance claims development table

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year shown has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

Non-life insurance all risks – gross

	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	**2011 £m**	**Total £m**
Accident year								
Estimate of ultimate claims costs:								
At end of accident year	211	208	317	205	639	609	**446**	**2,635**
One year later	207	206	311	199	539	517		
Two years later	204	204	299	195	494			
Three years later	202	204	292	187				
Four years later	201	205	285					
Five years later	201	203						
Six years later	201							
Current estimate in respect of above claims	201	203	285	187	494	517	**446**	**2,333**
Current estimate of claims relating to general insurance business acquired in 2009	273	316	388	256	–	–	**–**	**1,233**
Current estimate of cumulative claims	474	519	673	443	494	517	**446**	**3,566**
Cumulative payments to date	(470)	(514)	(668)	(432)	(463)	(443)	**(195)**	**(3,185)**
Liability recognised in the balance sheet	4	5	5	11	31	74	**251**	**381**
Liability in respect of earlier years								**5**
Total liability included in the balance sheet								**386**

The liability of £386 million shown in the above table excludes £9 million of unallocated claims handling expenses.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 39: Life insurance sensitivity 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.

	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
At 31 December 2011			
Non-annuitant mortality[1]	5% reduction	48	36
Annuitant mortality[2]	5% reduction	(154)	(115)
Lapse rates[3]	10% reduction	123	92
Future maintenance and investment expenses[4]	10% reduction	207	156
Risk-free rate[5]	0.25% reduction	55	41
Guaranteed annuity option take up[6]	5% addition	(4)	(3)
Equity investment volatility[7]	1% addition	(9)	(7)
Widening of credit default spreads on corporate bonds[8]	0.25% addition	(164)	(123)
Increase in illiquidity premia[9]	0.10% addition	87	66

	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
At 31 December 2010			
Non-annuitant mortality[1]	5% reduction	64	46
Annuitant mortality[2]	5% reduction	(131)	(96)
Lapse rates[3]	10% reduction	163	117
Future maintenance and investment expenses[4]	10% reduction	201	145
Risk-free rate[5]	0.25% reduction	61	44
Guaranteed annuity option take up[6]	5% addition	(4)	(3)
Equity investment volatility[7]	1% addition	(8)	(6)
Widening of credit default spreads on corporate bonds[8]	0.25% addition	(152)	(110)
Increase in illiquidity premia[9]	0.10% addition	78	56

Assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and statutory reserving bases.

[1] This sensitivity shows the impact of reducing mortality and morbidity rates on non-annuity business to 95 per cent of the expected rate.

[2] This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

[3] This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

[4] This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

[5] This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

[6] This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

[7] This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

[8] This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Government bond yields, the risk-free rate and illiquidity premia are all assumed to be unchanged.

[9] This sensitivity shows the impact of a 10 basis point increase in the allowance for illiquidity premia. It assumes the overall 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 40: 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	46,348	–	46,348
New business	3,953	(65)	3,888
Changes in existing business	1,070	–	1,070
Exchange and other adjustments	(8)	–	(8)
At 31 December 2010	51,363	(65)	51,298
New business	**4,194**	**(3)**	**4,191**
Changes in existing business	**(5,922)**	**11**	**(5,911)**
Exchange and other adjustments	**1**	**–**	**1**
At 31 December 2011	**49,636**	**(57)**	**49,579**

Note 41: 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	**643**	1,082
Change in unallocated surplus recognised in the income statement (note 10)	**(340)**	(439)
Exchange and other adjustments	**(3)**	–
At 31 December	**300**	643

Note 42: Other liabilities

	2011 £m	2010 £m
Settlement balances	**1,937**	1,269
Unitholders' interest in Open Ended Investment Companies	**18,249**	15,617
Other creditors and accruals	**11,855**	12,810
Total other liabilities	**32,041**	29,696

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 43: Retirement benefit obligations

	2011 £m	2010 £m	2009 £m
Charge (credit) to the income statement			
Defined benefit pension schemes[1]	**186**	(467)	529
Other post-retirement benefit schemes	**13**	12	7
Total defined benefit schemes	**199**	(455)	536
Defined contribution pension schemes	**202**	173	208
Total charge (credit) to the income statement	**401**	(282)	744

[1] In 2010, the amount is shown net of a credit of £910 million following the Group's decision to cap all future increases to pensionable salary in its principal UK defined benefit pension schemes, together with a change in commutation factors in certain schemes (note 11).

	2011 £m	2010 £m
Amounts recognised in the balance sheet		
Defined benefit pension schemes	**1,131**	479
Other post-retirement benefit schemes	**(174)**	(166)
Total amounts recognised in the balance sheet	**957**	313

	2011 £m	2010 £m
Amounts recognised in the balance sheet		
Retirement benefit assets	**1,338**	736
Retirement benefit obligations	**(381)**	(423)
Total amounts recognised in the balance sheet	**957**	313

Pension schemes

Defined benefit schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas, the three most significant being the defined benefit sections of the Lloyds TSB Group Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme. These schemes provide retirement benefits calculated as a percentage of final 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 valuations of the two Lloyds TSB schemes were carried out as at 30 June 2008; the latest full valuation of the HBOS scheme 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; these have been updated to 31 December 2011 by qualified independent actuaries or, in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows.

The Group's obligations in respect of its defined benefit schemes are funded. During 2009, the Group made one-off contributions to the Lloyds TSB Group Pension Scheme No 1 and Lloyds TSB Group Pension Scheme No 2 of approximately £1 billion in aggregate. These contributions took the form of interests in limited liability partnerships for each of the two schemes which contained assets of approximately £5 billion in aggregate entitling the schemes to annual payments of approximately £215 million in aggregate until 31 December 2014. Thereafter, assuming that all distributions have been made, the value of the partnership interests will equate to a nominal amount. At 31 December 2011, the limited liability partnerships held assets of approximately £4.7 billion; cash payments of £215 million were made to the pension schemes during the year (2010: £215 million). The limited liability partnerships are fully consolidated in the Group's balance sheet (see note 23).

The Group currently expects to pay contributions of approximately £650 million to its defined benefit schemes in 2012.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 43: Retirement benefit obligations (continued)

	2011 £m	2010 £m
Amount included in the balance sheet		
Present value of funded obligations	(28,236)	(26,862)
Fair value of scheme assets	28,828	26,382
	592	(480)
Unrecognised actuarial losses	539	959
Net amount recognised in the balance sheet	1,131	479

	2011 £m	2010 £m
Movements in the defined benefit obligation		
At 1 January	(26,862)	(27,073)
Current service cost	(380)	(384)
Employee contributions	(1)	(4)
Interest cost	(1,423)	(1,474)
Actuarial (losses) gains	(514)	140
Benefits paid	912	950
Past service cost	(20)	(46)
Curtailments	25	1,081
Settlements	15	6
Exchange and other adjustments	12	(58)
At 31 December	(28,236)	(26,862)

	2011 £m	2010 £m
Changes in the fair value of scheme assets		
At 1 January	26,382	23,518
Expected return	1,627	1,507
Employer contributions	833	648
Employee contributions	1	4
Actuarial gains	926	1,624
Benefits paid	(912)	(950)
Settlements	(23)	(9)
Exchange and other adjustments	(6)	40
At 31 December	28,828	26,382
Actual return on scheme assets	2,553	3,131

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 43: Retirement benefit obligations (continued)

Assumptions

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

	2011 %	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	**2.80**	3.20
	Years	Years
Life expectancy for member aged 60, on the valuation date:		
Men	**27.3**	27.2
Women	**28.4**	28.3
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**28.8**	28.2
Women	**30.0**	29.9

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 as at 31 December 2011 is assumed to live for, on average, 27.3 years for a male and 28.4 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

Sensitivity analysis

The effect of changes in key assumptions on the pension charge in the Group's income statement and on the net defined benefit pension scheme asset or liability is set out below:

	Increase (decrease) in the income statement charge		Increase (decrease) in the net defined benefit pension scheme asset	
	2011 £m	2010 £m	2011 £m	2010 £m
Inflation:[1]				
Increase of 0.2 per cent	**12**	14	**(798)**	(791)
Decrease of 0.2 per cent	**(6)**	(15)	**783**	754
Discount rate:[2]				
Increase of 0.2 per cent	**(10)**	(20)	**909**	930
Decrease of 0.2 per cent	**17**	15	**(957)**	(976)
Expected life expectancy of members:				
Increase of one year	**38**	40	**(655)**	(620)
Decrease of one year	**(40)**	(41)	**667**	632

[1] At 31 December 2011, the assumed rate of inflation is 3.00 per cent (31 December 2010: 3.40 per cent).

[2] At 31 December 2011, the assumed discount rate is 5.00 per cent (31 December 2010: 5.50 per cent).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 43: Retirement benefit obligations (continued)

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

	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:

	2011 £m	2010 £m
Equities	**10,728**	11,856
Fixed interest gilts	**995**	2,237
Index linked gilts	**6,211**	4,159
Non-government bonds	**4,250**	2,922
Property	**1,708**	1,654
Money market instruments, cash and other assets and liabilities	**4,936**	3,554
At 31 December	**28,828**	26,382

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 investments are long-term rates based on the views of the plan's independent investment consultants. The expected return on equities allows for the different expected returns from the private equity, infrastructure and hedge fund investments held by some of the funded 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:

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Present value of defined benefit obligation	**(28,236)**	(26,862)	(27,073)	(15,617)	(16,795)	(17,378)
Fair value of scheme assets	**28,828**	26,382	23,518	13,693	16,112	15,279
	592	(480)	(3,555)	(1,924)	(683)	(2,099)
Experience gains (losses) on scheme liabilities	**(277)**	496	31	(39)	(185)	(50)
Experience gains (losses) on scheme assets	**926**	1,624	886	(3,520)	139	314

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 43: Retirement benefit obligations (continued)

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

	2011 £m	2010 £m	2009 £m
Current service cost	**380**	384	395
Interest cost	**1,423**	1,474	1,383
Expected return on scheme assets	**(1,627)**	(1,507)	(1,320)
Net actuarial losses recognised in year	**7**	43	–
Curtailments (see below)	**(25)**	(910)	–
Settlements	**8**	3	4
Past service cost	**20**	46	67
Total defined benefit pension expense (credit)	**186**	(467)	529

In 2010 the Group made changes to the terms of its principal UK defined benefit pension schemes, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee's actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of 2010 there was a change in the commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group's defined benefit obligation of £1,081 million and a reduction in the Group's unrecognised actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement in 2010 and an equivalent reduction in the balance sheet liability.

Defined contribution schemes

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally the defined contribution sections of the Lloyds TSB Group Pension Schemes No's 1 and 2.

During the year ended 31 December 2011 the charge to the income statement in respect of defined contribution schemes was £202 million (2010: £173 million; 2009: £208 million), representing the contributions payable by the employer in accordance with each scheme's rules.

Other post-retirement benefit schemes

The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants. The principal scheme relates to former Lloyds Bank staff and under this scheme the Group has undertaken to meet the cost of post-retirement healthcare for all eligible former employees (and their dependants) who retired prior to 1 January 1996. The Group has entered into an insurance contract to provide these benefits and a provision has been made for the estimated cost of future insurance premiums payable.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 30 June 2008; this valuation has been updated to 31 December 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 6.61 per cent (2010: 7.54 per cent).

Amount included in the balance sheet:

	2011 £m	2010 £m
Present value of unfunded obligations	**(188)**	(175)
Unrecognised actuarial losses	**14**	9
Retirement benefit obligation recognised in the balance sheet	**(174)**	(166)

Movements in the other post-retirement benefits obligation:

	2011 £m	2010 £m
At 1 January	**(175)**	(170)
Exchange and other adjustments	**(5)**	2
Insurance premiums paid	**5**	5
Charge for the year	**(13)**	(12)
At 31 December	**(188)**	(175)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 44: Deferred tax

The movement in the net deferred tax balance is as follows:

	2011 £m	2010 £m
Asset at 1 January	**3,917**	4,797
Exchange and other adjustments	**3**	68
Disposals	**10**	–
Income statement credit (charge) (note 16):		
Due to change in UK corporation tax rate	**(404)**	(137)
Other	**1,525**	(534)
	1,121	(671)
Amount (charged) credited to equity:		
Available-for-sale financial assets (note 49)	**(574)**	(330)
Cash flow hedges (note 49)	**(270)**	33
Share-based compensation	**(25)**	20
	(869)	(277)
Asset at 31 December	**4,182**	3,917

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

Statutory position	2011 £m	2010 £m	Tax disclosure	2011 £m	2010 £m
Deferred tax assets	**4,496**	4,164	Deferred tax assets	**7,995**	8,513
Deferred tax liabilities	**(314)**	(247)	Deferred tax liabilities	**(3,813)**	(4,596)
Asset at 31 December	**4,182**	3,917	**Asset at 31 December**	**4,182**	3,917

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 44: Deferred tax (continued)

The deferred tax credit (charge) in the income statement comprises the following temporary differences:

	2011 £m	2010 £m	2009 £m
Accelerated capital allowances	**319**	(470)	1,039
Pensions and other post-retirement benefits	**(153)**	(391)	(199)
Long-term assurance business	**596**	(110)	(188)
Allowances for impairment losses	**(56)**	73	(128)
Trading losses	**(55)**	873	4,000
Tax on fair value of acquired assets	**(107)**	(715)	(2,022)
Other temporary differences	**577**	69	117
Deferred tax credit (charge) in the income statement	**1,121**	(671)	2,619

Deferred tax assets and liabilities are comprised as follows:

	2011 £m	2010 £m
Deferred tax assets:		
Pensions and other post-retirement benefits	**–**	33
Allowances for impairment losses	**559**	612
Other provisions	**218**	231
Derivatives	**–**	221
Available-for-sale asset revaluation	**288**	519
Tax losses carried forward	**5,862**	6,572
Other temporary differences	**1,068**	325
Total deferred tax assets	**7,995**	8,513

	2011 £m	2010 £m
Deferred tax liabilities:		
Accelerated capital allowances	**(243)**	(562)
Long-term assurance business	**(980)**	(1,630)
Pensions and other post-retirement benefits	**(120)**	–
Tax on fair value of acquired assets	**(1,890)**	(2,097)
Effective interest rates	**(45)**	(74)
Other temporary differences	**(535)**	(233)
Total deferred tax liabilities	**(3,813)**	(4,596)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 44: Deferred tax (continued)

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 £394 million, comprising the £404 million charge included in the income statement and a £10 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 estimated at this stage.

Deferred tax assets

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised deferred tax assets of £5,862 million (2010: £6,572 million) in relation to trading tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset (see note 3).

Deferred tax assets of £384 million (31 December 2010: £396 million) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

Deferred tax assets of £733 million (31 December 2010: £227 million) have not been recognised in respect of trading losses carried forward, mainly in certain overseas companies and in respect of other temporary differences in the insurance businesses. Trading losses can be carried forward indefinitely, except losses in Spain which expire after 18 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2011 of £171 million (31 December 2010: £62 million), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

Deferred tax liabilities

Scottish Widows plc has a taxable difference of £152 million (2010: £152 million) in respect of its holding of a life insurance subsidiary. No deferred tax liability is required to be recognised in respect of this taxable temporary difference as Scottish Widows plc does not intend to dispose of this subsidiary company.

Note 45: Other provisions

	Provisions for commitments £m	Customer remediation provisions £m	Customer goodwill payments £m	Vacant leasehold property £m	Other £m	Total £m
At 1 January 2011	154	344	500	146	388	1,532
Exchange and other adjustments	(14)	51	–	(21)	79	95
Provisions applied	(4)	(1,280)	(497)	–	(56)	(1,837)
(Release) charge for the year	(55)	3,381	–	15	35	3,376
At 31 December 2011	**81**	**2,496**	**3**	**140**	**446**	**3,166**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 45: Other provisions (continued)

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 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 financial statements for the year ended 31 December 2011 of £3,200 million in respect of the anticipated costs of such contact and/or redress, including administration expenses. During 2011, the Group made redress payments of £1,045 million to customers. The Group anticipates that all claims will have been 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.

Litigation in relation to insurance branch business in Germany

During the year ended 31 December 2011 the Group has recognised a provision of £175 million in respect of litigation involving Clerical Medical Investment Group Limited in Germany. Further details are provided in note 54.

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 45: Other provisions (continued)

Vacant leasehold property

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biannual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging three years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

Other

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure.

Other provisions include those arising out of the insolvency of a third party insurer, which remains exposed to asbestos and pollution claims in the US. The ultimate cost and timing of payments are uncertain. The provision held of £38 million at 31 December 2011 represents management's current best estimate of the cost after having regard to actuarial estimates of future losses.

Note 46: Subordinated liabilities

	2011 £m	2010 £m
Preference shares	**1,216**	1,165
Preferred securities	**4,893**	4,538
Undated subordinated liabilities	**1,949**	2,002
Enhanced Capital Notes	**9,085**	9,235
Dated subordinated liabilities	**17,946**	19,292
Total subordinated liabilities	**35,089**	36,232

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of holders of the dated subordinated liabilities. The subordination of the dated Enhanced Capital Notes ranks equally with that of the dated subordinated liabilities. The Group has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2010: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the Financial Services Authority.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 46: Subordinated liabilities (continued)

The movement in subordinated liabilities during the year was as follows:

	£m
At 1 January 2011	36,232
Issued during the year	2,302
Repurchases and redemptions during the year	(4,021)
Foreign exchange and other movements	576
At 31 December 2011	**35,089**

During December 2011, the Group completed the exchange of certain subordinated debt securities issued by Lloyds TSB Bank plc and HBOS plc 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 December 2012. This exchange resulted in a gain on the extinguishment of the existing securities of £599 million being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs.

	Note	2011 £m	2010 £m
Preference shares			
6% Non-cumulative Redeemable Preference Shares	a	–	–
7.875% Non-cumulative Preference Shares callable 2013 (US$1,250 million)	b	249	277
7.875% Non-cumulative Preference Shares callable 2013 (€500 million)	b	150	182
6.0884% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (£745 million)	b	10	9
5.92% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (US$750 million)	b	11	9
6.267% Non-cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million)	b	301	269
6.3673% Non-cumulative Fixed to Floating Rate Preference Shares callable 2019 (£335 million)	b	2	2
6.475% Non-cumulative Preference Shares callable 2024 (£186 million)	b	38	34
6.413% Non-cumulative Fixed to Floating Rate Preference Shares callable 2035 (US$750 million)	b	131	113
6.657% Non-cumulative Fixed to Floating Rate Preference Shares callable 2037 (US$750 million)	b	26	5
9.25% Non-cumulative Irredeemable Preference Shares (£300 million)	b	262	235
9.75% Non-cumulative Irredeemable Preference Shares (£100 million)	b	36	30
Total preference shares		**1,216**	1,165

a Since 2004, the Company has had in issue 400 6 per cent non-cumulative preference shares of 25p each. The shares, which are redeemable at the option of the Company at any time, carry the rights to a fixed rate non-cumulative preferential dividend of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Company. The holder of the 400 25p 6 per cent preference shares has waived its right to payment for the period from 1 March 2010 to 1 March 2012.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 46: Subordinated liabilities (continued)

	Note	2011 £m	2010 £m
Preferred securities			
6.90% Perpetual Capital Securities (US$1,000 million)	b	**247**	249
6.85% Non-cumulative Perpetual Preferred Securities (US$1,000 million)	b	**316**	107
8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million)	b, c	**260**	253
7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million)	b, d	**340**	308
7.375% Euro Step-up Non-voting Non-cumulative Preferred Securities callable 2012 (€430 million)	a	**16**	16
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)		**239**	241
6.071% Non-cumulative Perpetual Preferred Securities (US$750 million)		**389**	336
7.834% Sterling Step-up Non-voting Non-cumulative Preferred Securities callable 2015 (£250 million)	a	**5**	4
4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million)	a	**20**	17
7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million)		**112**	119
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	a	**88**	85
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities (£600 million)		**444**	421
13% Step-up Perpetual Capital Securities callable 2019 (£785 million)	a	**12**	10
13% Step-up Perpetual Capital Securities callable 2019 (€532 million)	a	**47**	56
7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million)		**104**	98
12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US$2,000 million)		**1,301**	1,288
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)		**113**	95
13% Step-up Perpetual Capital Securities callable 2029 (£700 million)	a	**612**	662
7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million)		**228**	173
Total preferred securities		**4,893**	4,538

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 46: Subordinated liabilities (continued)

	Note	2011 £m	2010 £m
Undated subordinated liabilities			
6.625% Undated Subordinated Step-up Notes (£410 million)	a, b, c	1	6
Floating Rate Undated Subordinated Step-up Notes (€300 million)	b, e	10	63
6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	b, d, e	4	57
5.375% Undated Fixed to Floating Rate Subordinated Notes (US$1,000 million)	a	12	12
8.625% Perpetual Subordinated Notes (£200 million)	a	24	21
4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	a	75	65
Floating Rate Undated Subordinated Notes (€500 million)	a	45	42
4.25% Perpetual Fixed to Floating Rate Reset Subordinated Guaranteed Notes (€750 million) (Clerical Medical Finance plc)		231	215
10.25% Subordinated Undated Instruments (£100 million)	a	1	1
5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million) (Scottish Widows plc)		554	550
5.125% Undated Subordinated Fixed to Floating Notes (€750 million)	a	52	47
7.5% Undated Subordinated Step-up Notes (£300 million)		5	3
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	a	2	–
6.5% Undated Subordinated Step-up Notes callable 2019 (£270 million)	a	–	1
7.375% Undated Subordinated Guaranteed Bonds (£200 million) (Clerical Medical Finance plc)		36	35
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019 (£500 million)	a	–	–
12% Perpetual Subordinated Bonds (£100 million)	a	30	21
5.75% Undated Subordinated Step-up Notes (£600 million)		3	3
7.375% Subordinated Undated Instruments (£150 million)	a	–	1
8.75% Perpetual Subordinated Bonds (£100 million)	a	4	4
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	a	–	–
9.375% Perpetual Subordinated Bonds (£50 million)	a	17	16
5.75% Undated Subordinated Step-up Notes (£500 million)		3	3
6.5% Undated Subordinated Step-up Notes callable 2029 (£450 million)	a	–	–
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	a	11	10
Floating Rate Primary Capital Notes (US$250 million)	a, b	118	118
Primary Capital Undated Floating Rate Notes:			
Series 1 (US$750 million)	a, b	175	173
Series 2 (US$500 million)	a, b	183	181
Series 3 (US$600 million)	a, b	235	232
13.625% Perpetual Subordinated Bonds (£75 million)	a	16	20
11.75% Perpetual Subordinated Bonds (£100 million)		102	102
Total undated subordinated liabilities		**1,949**	2,002

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

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

c The fixed rate on this security was reset from 6.625 per cent to 4.64821 per cent with effect from 15 July 2010.

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 46: Subordinated liabilities (continued)

With the exception of the two series identified in note b, the ECNs were issued in lower tier 2 format and are convertible into ordinary shares on the breach of a defined trigger. The trigger on the ECNs offered in the exchange will be if the published core tier 1 ratio of the Group falls below 5 per cent (as defined by the Financial Services Authority in May 2009).

	Note	2011 £m	2010 £m
Enhanced Capital Notes			
7.625% Enhanced Capital Notes due 2019 (£151 million)		**142**	142
8.125% Enhanced Capital Notes due 2019 (£4 million)		**4**	4
9% Enhanced Capital Notes due 2019 (£97 million)		**98**	103
7.8673% Enhanced Capital Notes due 2019 (£331 million)		**330**	336
15% Enhanced Capital Notes due 2019 (£775 million)		**1,120**	1,145
15% Enhanced Capital Notes due 2019 (€487 million)		**601**	635
8.875% Enhanced Capital Notes due 2020 (€125 million)		**107**	116
9.334% Enhanced Capital Notes due 2020 (£208 million)		**232**	233
7.375% Enhanced Capital Notes due 2020 (€95 million)		**79**	82
Floating Rate Enhanced Capital Notes due 2020 (€53 million)	a	**38**	41
7.875% Enhanced Capital Notes due 2020 (US$408 million)		**313**	288
11.04% Enhanced Capital Notes due 2020 (£736 million)		**861**	872
7.5884% Enhanced Capital Notes due 2020 (£732 million)		**681**	694
6.385% Enhanced Capital Notes due 2020 (€662 million)		**503**	525
6.439% Enhanced Capital Notes due 2020 (€711 million)		**548**	562
8% Fixed to Floating Rate Undated Enhanced Capital Notes callable 2020 (US$1,259 million)	b	**687**	674
9.125% Enhanced Capital Notes due 2020 (£148 million)		**157**	158
12.75% Enhanced Capital Notes due 2020 (£57 million)		**73**	75
7.869% Enhanced Capital Notes due 2020 (£597 million)		**588**	589
7.625% Enhanced Capital Notes due 2020 (€226 million)		**184**	189
7.875% Enhanced Capital Notes due 2020 (US$986 million)		**629**	631
11.125% Enhanced Capital Notes due 2020 (£39 million)		**44**	45
8.5% Undated Enhanced Capital Notes callable 2021 (US$277 million)	b	**153**	150
14.5% Enhanced Capital Notes due 2022 (£79 million)		**114**	115
9.875% Enhanced Capital Notes due 2023 (£57 million)		**63**	67
11.25% Enhanced Capital Notes due 2023 (£95 million)		**106**	115
10.5% Enhanced Capital Notes due 2023 (£69 million)		**67**	79
11.875% Enhanced Capital Notes due 2024 (£35 million)		**45**	45
7.975% Enhanced Capital Notes due 2024 (£102 million)		**96**	98
16.125% Enhanced Capital Notes due 2024 (£61 million)		**97**	99
15% Enhanced Capital Notes due 2029 (£68 million)		**108**	111
9% Enhanced Capital Notes due 2029 (£107 million)		**112**	112
8.5% Enhanced Capital Notes due 2032 (£104 million)		**105**	105
Total Enhanced Capital Notes		**9,085**	9,235

a Interest is payable quarterly in arrears at a rate of 3 month EURIBOR plus 3.1 per cent per annum.

b Issued in upper tier 2 format.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 46: Subordinated liabilities (continued)

	Note	2011 £m	20010 £m
Dated subordinated liabilities			
9.125% Subordinated Bonds 2011 (£150 million)		–	147
12% Guaranteed Subordinated Bonds 2011 (£100 million)	a	–	109
6.50% Notes 2011 (US$150 million)		–	99
4.75% Subordinated Notes 2011 (€850 million)		–	764
Subordinated Step-up Floating Rate Notes 2016 (€500 million)	b, c	179	432
Subordinated Step-up Floating Rate Notes 2016 (£300 million)	b, c	184	296
Callable Floating Rate Subordinated Notes 2016 (€500 million)	b, c	88	401
Callable Floating Rate Subordinated Notes 2016 (€500 million)	b, c	124	417
Subordinated Callable Notes 2016 (US$750 million)	b, c	191	440
Subordinated Callable Notes 2017 callable 2012 (€1,000 million)	c	219	758
6.75% Subordinated Callable Fixed to Floating Rate Instruments 2017 callable 2012 (Aus$200 million)	c	5	127
Subordinated Callable Floating Rate Instruments 2017 callable 2012 (Aus$400 million)	c	38	255
5.109% Callable Fixed to Floating Rate Notes 2017 callable 2012 (Can$500 million)	c	8	305
6.25% Instruments 2012 (€12.8 million)		8	10
Subordinated Callable Notes 2017 callable 2012 (US$1,000 million)	c	192	548
6.305% Subordinated Callable Fixed to Floating Rate Notes 2017 callable 2012 (£500 million)	c	22	486
5.50% Subordinated Fixed Rate Notes 2012 (€750 million)		640	657
6.125% Notes 2013 (€325 million)		283	289
5.625% Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)		902	946
4.25% Subordinated Guaranteed Notes 2013 (US$1,000 million)		636	619
6.45% Fixed to Floating Subordinated Guaranteed Bonds 2023 (€400 million) (Clerical Medical Finance plc)		176	173
11% Subordinated Bonds 2014 (£250 million)		290	297
5.875% Subordinated Notes 2014 (£150 million)		154	149
5.875% Subordinated Guaranteed Bonds 2014 (€750 million)		713	739
4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)		621	600
4.875% Subordinated Notes 2015 (€1,000 million)		854	838
6.625% Subordinated Notes 2015 (£350 million)		357	343
6.9625% Callable Subordinated Fixed to Floating Rate Notes 2020 callable 2015 (£750 million)		725	715
11.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (€1,147 million)	d	977	–
10.75% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (£466 million)	d	467	–
9.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (US$568 million)	d	368	–
10.125% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Can$387 million)	d	246	–
13% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Aus$417 million)	d	276	–
10.5% Subordinated Bonds 2018 (£150 million)		177	171
6.75% Subordinated Fixed Rate Notes 2018 (US$2,000 million)		1,205	1,176
6.375% Subordinated Instruments 2019 (£250 million)		274	236
6.5% Dated Subordinated Notes 2020 (€1,500 million)		1,407	1,353
7.375% Dated Subordinated Notes 2020		3	4
5.75% Subordinated Fixed to Floating Rate Notes 2025 callable 2020 (£350 million)		367	324
6.5% Subordinated Fixed Rate Notes 2020 (US$2,000 million)		1,360	1,202
Subordinated Floating Rate Notes 2020 (€100 million)		87	86
9.375% Subordinated Bonds 2021 (£500 million)		709	647
5.374% Subordinated Fixed Rate Notes 2021 (€160 million)		150	139
9.625% Subordinated Bonds 2023 (£300 million)		319	332
7.07% Subordinated Fixed Rate Notes 2023 (€175 million)		174	162
4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)		463	463
7.625% Dated Subordinated Notes 2025 (£750 million)		876	763
6% Subordinated Notes 2033 (US$750 million)		432	275
Total dated subordinated liabilities		**17,946**	19,292

a Issued by a group undertaking under the Company's subordinated guarantee.

b 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.

c 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.

d These securities were issued in December 2011 as a result of an exchange offer.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 47: Share capital

(1) Authorised share capital

As permitted by the Companies Act 2006, the Company removed references to authorised share capital from its articles of association at the annual general meeting on 5 June 2009. This change took effect from 1 October 2009.

(2) Issued and fully paid share capital

	2011 Number of shares	2010 Number of shares	2009 Number of shares	2011 £m	2010 £m	2009 £m
Ordinary shares of 10p (formerly 25p) each						
At 1 January	68,074,129,454	63,774,511,536	5,972,855,669	6,807	6,378	1,493
Issued on redemption of preference shares and other subordinated liabilities in 2010	–	4,299,422,579	–	–	429	–
Placing and open offer	–	–	2,596,653,203	–	–	649
Issued on acquisition of HBOS	–	–	7,775,694,993	–	–	1,944
Capitalisation issue	–	–	407,943,501	–	–	102
Placing and compensatory open offer	–	–	10,408,535,000	–	–	2,602
Subdivision	–	–	–	–	–	(4,074)
Rights issue	–	–	36,505,088,579	–	–	3,651
Issued to the Lloyds TSB Foundations	–	–	107,740,591	–	–	11
Issued under employee share schemes	652,497,658	195,339	–	66	–	–
At 31 December	68,726,627,112	68,074,129,454	63,774,511,536	6,873	6,807	6,378
Limited voting ordinary shares of 10p (formerly 25p) each						
At 1 January	80,921,051	80,921,051	78,947,368	8	8	20
Capitalisation issue	–	–	1,973,683	–	–	–
Subdivision	–	–	–	–	–	(12)
At 31 December	80,921,051	80,921,051	80,921,051	8	8	8
Deferred shares of 15p each						
At 1 January	–	27,242,603,417	–	–	4,086	–
Subdivision of ordinary shares	–	–	27,161,682,366	–	–	4,074
Subdivision of limited voting ordinary shares	–	–	80,921,051	–	–	12
Cancellation of deferred shares	–	(27,242,603,417)	–	–	(4,086)	–
At 31 December	–	–	27,242,603,417	–	–	4,086
Total issued share capital				6,881	6,815	10,472

On 5 November 2010 the Company cancelled all of its deferred shares and an amount of £4,086 million was credited to the capital redemption reserve.

Share subdivision in 2009

At the general meeting held on 26 November 2009 the Company's shareholders approved the subdivision of the ordinary shares with each ordinary share of 25 pence subdivided into one ordinary share of 10 pence and a deferred share of 15 pence. In addition, the shareholders approved the subdivision of the limited voting ordinary shares with each share of 25 pence subdivided into one limited voting ordinary share of 10 pence and a deferred share of 15 pence.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 47: Share capital (continued)

Share issuances

The shares issued in 2011 were in respect of employee share schemes.

On 18 February 2010, the Company issued 3,141 million ordinary shares as consideration for the redemption of certain preference shares and preferred securities. During May and June 2010, the Company issued a further 1,158 million ordinary shares in relation to three separate exchanges for preference shares and other subordinated liabilities issued by the Group.

(3) Share capital and control

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association and:

- certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws);
- pursuant to the UK Listing Authority's listing rules where directors and certain employees of the Company require the approval of the Company to deal in the Company's shares; and
- pursuant to the rules of some of the Company's employee share plans where certain restrictions may apply while the shares are subject to the plans.

Where, under an employee share plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised by the registered owner at the direction of the participant. Outstanding awards and options would normally vest and become exercisable on a change of control, subject to the satisfaction of any performance conditions at that time.

In addition, the Company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights.

Information regarding significant direct or indirect holdings of shares in the Company can be found on page 175.

The directors have authority to allot and issue ordinary and preference shares and to make market purchases of ordinary and preference shares as granted at the annual general meeting on 18 May 2011. The authority to issue shares and the authority to make market purchases of shares will expire at the annual general meeting. Shareholders will be asked, at the annual general meeting, to give similar authorities.

Subject to any rights or restrictions attached to any shares, on a show of hands at a general meeting of the Company every holder of shares present in person or by proxy and entitled to vote has one vote and on a poll every member present and entitled to vote has one vote for every share held.

Further details regarding voting at the annual general meeting can be found in the notes to the notice of the annual general meeting.

Ordinary shares

The holders of ordinary shares (excluding the limited voting ordinary shares), who held 99.9 per cent of the total ordinary share capital as at 31 December 2011, are entitled to receive the Company's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares (excluding the limited voting ordinary shares) may also receive a dividend (subject to the provisions of the Company's articles of association and the restrictions noted below) and on a winding up may share in the assets of the Company.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 47: Share capital (continued)

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities for the two-year period from 31 January 2010 to 31 January 2012. Consequently, the terms of these instruments prevented the Company from making dividend payments on ordinary shares during the year.

Limited voting ordinary shares

The limited voting ordinary shares are held by the Lloyds TSB Foundations (the Foundations). The holders of the limited voting ordinary shares, who held 0.1 per cent of the total ordinary share capital as at 31 December 2011, are entitled to receive copies of every circular or other document sent out by the Company to the holders of other ordinary shares. These shares carry no rights to dividends but rank pari passu with the ordinary shares in respect of other distributions and in the event of winding up. These shares do not have any right to vote at general meetings other than on resolutions concerning acquisitions or disposals of such importance that they require shareholder consent, or for the winding up of the Company, or for a variation in the class rights of the limited voting ordinary shares. In the event of an offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting ordinary share will convert into an ordinary share and shall rank equally with the ordinary shares in all respects from the date of conversion.

Preference shares

The Company has in issue various classes of preference shares which are all classified as liabilities under IFRS and details of which are shown in note 46.

Note 48: Share premium account

	2011 £m	2010 £m	2009 £m
At 1 January	**16,291**	14,472	2,096
Issued under employee share schemes	**250**	–	–
Shares issued on redemption and exchange of preference shares and other subordinated liabilities[1]	**–**	1,808	–
Capitalisation issue	**–**	–	(102)
Placing and Compensatory Open Offer of ordinary shares	**–**	–	1,303
Transfer to merger reserve[2]	**–**	–	(1,000)
Rights issue	**–**	–	9,461
Issued to Lloyds TSB Foundations	**–**	–	30
Redemption of preference shares[3]	**–**	11	2,684
At 31 December	**16,541**	16,291	14,472

[1] On 18 February 2010, the Company issued 3,141 million ordinary shares as consideration for the redemption of certain preference shares and preferred securities; and during May and June 2010, the Company issued a further 1,158 million ordinary shares in relation to three separate exchanges for preference shares and other subordinated liabilities issued by the Group. A total share premium of £1,808 million was recorded in respect of these transactions.

[2] Distributable reserves of £1,000 million arose on the issue of preference shares in January 2009 which were classified as debt. In June 2009, these preference shares were redeemed out of the proceeds of the placing and compensatory open offer of ordinary shares and the distributable element of this issue was transferred from the share premium account to the merger reserve.

[3] In January 2010, the Company repurchased and cancelled certain preference shares amounting to £14 million. This resulted in a transfer of £3 million from the merger reserve to the capital redemption reserve and a transfer of £11 million from the merger reserve to the share premium account. In December 2009, the Group redeemed eight issues of preference shares in exchange for the issuance of Enhanced Capital Notes. This resulted in a transfer of £26 million from the merger reserve to the capital redemption reserve and a transfer of £2,684 million from the merger reserve to the share premium account.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 49: Other reserves

	2011 £m	2010 £m	2009 £m
Other reserves comprise:			
Merger reserve	**8,107**	8,107	8,121
Capital redemption reserve	**4,115**	4,115	26
Revaluation reserve in respect of available-for-sale financial assets	**1,326**	(285)	(783)
Cash flow hedging reserve	**325**	(391)	(305)
Foreign currency translation reserve	**(55)**	29	158
At 31 December	**13,818**	11,575	7,217

The merger reserve primarily comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

The revaluation reserve in respect of available-for-sale financial assets represents the cumulative after tax unrealised change in the fair value of financial assets classified as available-for-sale since initial recognition, or in the case of available-for-sale financial assets obtained on acquisitions of businesses, since the date of acquisition.

The cash flow hedging reserve represents the cumulative after tax gains and losses on effective cash flow hedging instruments that will be reclassified to the income statement in the periods in which the hedged item affects profit or loss.

The foreign currency translation reserve represents the cumulative after-tax gains and losses on the translation of foreign operations and exchange differences arising on financial instruments designated as hedges of the Group's net investment in foreign operations.

Movements in other reserves were as follows:

	2011 £m	2010 £m	2009 £m
Merger reserve			
At 1 January	**8,107**	8,121	343
Placing and open offer	**–**	–	3,781
Shares issued on acquisition of HBOS	**–**	–	5,707
Issue of preference shares[1]	**–**	–	1,000
Redemption of preference shares[2]	**–**	(14)	(2,710)
At 31 December	**8,107**	8,107	8,121

	2011 £m	2010 £m	2009 £m
Capital redemption reserve			
At 1 January	**4,115**	26	–
Cancellation of deferred shares (note 47)	**–**	4,086	–
Redemption of preference shares[2]	**–**	3	26
At 31 December	**4,115**	4,115	26

[1] Distributable reserves of £1,000 million arose on the issue of preference shares in January 2009 which were classified as debt. In June 2009, these preference shares were redeemed out of the proceeds of the placing and compensatory open offer of ordinary shares and the distributable element of this issue was transferred to the merger reserve.

[2] In January 2010, the Company repurchased and cancelled certain preference shares amounting to £14 million. This resulted in a transfer of £3 million from the merger reserve to the capital redemption reserve and a transfer of £11 million from the merger reserve to the share premium account. Details of the preference shares repurchased are set out in note 46. In December 2009, the Group redeemed eight issues of preference shares in exchange for the issuance of Enhanced Capital Notes. This resulted in a transfer of £26 million from the merger reserve to the capital redemption reserve and a transfer of £2,684 million from the merger reserve to the share premium account.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 49: Other reserves (continued)

	2011 £m	2010 £m	2009 £m
Revaluation reserve in respect of available-for-sale financial assets			
At 1 January	(285)	(783)	(2,851)
Change in fair value of available-for-sale financial assets	2,603	1,231	2,035
Change in fair value attributable to non-controlling interests	–	–	(1)
Deferred tax	(673)	(460)	(276)
Current tax	–	(8)	(2)
	1,930	763	1,756
Income statement transfers:			
Disposals (note 9)	(343)	(399)	(97)
Deferred tax	30	106	23
	(313)	(293)	(74)
Impairment	80	114	621
Deferred tax	29	(5)	(168)
	109	109	453
Other transfers	(155)	(110)	(93)
Deferred tax	40	29	26
	(115)	(81)	(67)
At 31 December	1,326	(285)	(783)

	2011 £m	2010 £m	2009 £m
Cash flow hedging reserve			
At 1 January	(391)	(305)	(15)
Change in fair value of hedging derivatives	916	(1,048)	(530)
Deferred tax	(257)	272	148
Current tax	–	(3)	–
	659	(779)	(382)
Income statement transfer (note 5)	70	932	121
Deferred tax	(13)	(239)	(29)
	57	693	92
At 31 December	325	(391)	(305)

	2011 £m	2010 £m	2009 £m
Foreign currency translation reserve			
At 1 January	29	158	178
Currency translation differences arising in the year	(58)	33	(652)
Foreign currency losses on net investment hedges	(26)	(162)	814
Current tax	–	–	176
Deferred tax	–	–	(358)
	(26)	(162)	632
At 31 December	(55)	29	158

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 50: Retained profits

	2011 £m	2010 £m	2009 £m
At 1 January	**11,380**	11,117	8,129
(Loss) profit for the year	**(2,787)**	(320)	2,827
Movement in treasury shares	**(276)**	20	10
Value of employee services:			
Share option schemes	**125**	154	116
Other employee award schemes	**238**	409	35
At 31 December	**8,680**	11,380	11,117

Retained profits are stated after deducting £33 million (2010: £47 million; 2009: £48 million) representing 58 million (2010 and 2009: 49 million) treasury shares held.

Note 51: Ordinary dividends

No dividends were paid on ordinary shares during 2010 or 2011 and the directors do not propose to pay a final dividend in respect of 2011; in November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities, for the two year period from 31 January 2010 to 31 January 2012. Consequently, the terms of these instruments prevented the Company from making dividend payments on ordinary shares during the year.

In addition, the trustees of the following holdings of Lloyds Banking Group plc shares in relation to employee share schemes retain the right to receive dividends but chose to waive their entitlement to the dividends on those shares as indicated: the Lloyds Banking Group Share Incentive Plan (holding at 31 December 2011: 8,091,460 shares, at 31 December 2010: 5,744,722 shares, waived right to all dividends), the Lloyds TSB Group Employee Share Ownership Trust (holding at 31 December 2011: 120,085,543 shares, at 31 December 2010: 283,109,984 shares, on which it waived right to all dividends and holding at 31 December 2011: 253,052 shares, at 31 December 2010: nil shares, on which it waived right to all but a nominal amount of one penny in total), Lloyds TSB Group Holdings (Jersey) Limited (holding at 31 December 2011: 42,846 shares, at 31 December 2010: 42,846 shares, waived right to all but a nominal amount of one penny in total) and the Lloyds TSB Qualifying Employee Share Ownership Trust (holding at 31 December 2011: 1,398 shares, at 31 December 2010: 1,398 shares, waived right to all but a nominal amount of one penny in total).

Note 52: Share-based payments

Charge to the income statement

The charge to the income statement is set out below:

	2011 £m	2010 £m	2009 £m
Deferred bonus plan	**221**	355	18
Executive and SAYE plans:			
Options granted in the year	**13**	59	13
Options granted in prior years	**130**	75	98
	143	134	111
Share plans:			
Shares granted in the year	**3**	3	26
Shares granted in prior years	**9**	49	102
	12	52	128
Total charge to the income statement	**376**	541	257

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: Share-based payments (continued)

During the year ended 31 December 2011 the Group operated the following share-based payment schemes, all of which are equity settled.

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. The amounts to be settled in shares are included within the total charge to the income statement detailed above.

Lloyds Banking Group executive share option schemes

The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: 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).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: Share-based payments (continued)

HBOS share option plans

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

	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

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: Share-based payments (continued)

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.

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

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

(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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: Share-based payments (continued)

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**

	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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 52: Shared-based payments (continued)

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.

Note 53: Related party transactions

Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

The table below details, on an aggregated basis, key management personnel compensation:

	2011 £m	2010 £m	2009 £m
Compensation			
Salaries and other short-term benefits	12	7	17
Post-employment benefits	–	2	1
Share-based payments	11	8	–
Total compensation	23	17	18

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 53: Related party transactions (continued)

Aggregate contributions in respect of key management personnel to defined contribution pension schemes were £0.2 million (2010: £0.4 million).

	2011 million	2010 million	2009 million
Share option plans			
At 1 January	6	2	2
Granted, including certain adjustments[1] (includes entitlements of appointed directors)	20	4	–
Exercised/lapsed (includes entitlements of former directors)	(4)	–	–
At 31 December	22	6	2

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

	2011 million	2010 million	2009 million
Share plans			
At 1 January	56	19	7
Granted, including certain adjustments[1] (includes entitlements of appointed directors)	35	39	17
Exercised/lapsed (includes 31 million entitlements of former directors)	(33)	(2)	(5)
At 31 December	58	56	19

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

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

	2011 £m	2010 £m	2009 £m
Loans			
At 1 January	3	2	3
Advanced (includes loans of appointed directors)	1	2	–
Repayments (includes loans of former directors)	(1)	(1)	(1)
At 31 December	3	3	2

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 1.09 per cent and 27.5 per cent in 2011 (2010: 0.5 per cent and 17.90 per cent; 2009: 1.28 per cent and 24.90 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2010 and 2009: £nil).

	2011 £m	2010 £m	2009 £m
Deposits			
At 1 January	4	4	6
Placed (includes deposits of appointed directors)	17	12	12
Withdrawn (includes deposits of former directors)	(15)	(12)	(14)
At 31 December	6	4	4

Deposits placed by key management personnel attracted interest rates of up to 5 per cent (2010: 4.25 per cent; 2009: 6.50 per cent).

At 31 December 2011, the Group did not provide any guarantees in respect of key management personnel (2010 and 2009: none).

At 31 December 2011, transactions, arrangements and agreements entered into by the Group's banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £3 million with four directors and three connected persons (2010: £2 million with six directors and four connected persons; 2009: £2 million with seven directors and four connected persons).

Subsidiaries

Details of the principal subsidiaries are given in note 9 to the parent company financial statements. In accordance with IAS 27, transactions and balances with subsidiaries have been eliminated on consolidation.

UK Government

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 53: Related party transactions (continued)

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:

Government and central bank facilities

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

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 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 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 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, the Company (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 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 Group has incurred sunk costs of £4 million which have been written off.

As at 31 December 2011, the 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 transactions

Pensions funds

The Group provides banking and some investment management services to certain of the Group pension funds. At 31 December 2011, customer deposits of £63 million (2010: £64 million) and investment and insurance contract liabilities of £928 million (2010: £850 million) related to the Group's pension funds. 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 £336 million and to Lloyds TSB Group Pension Scheme No 2 for £67 million.

Open Ended Investment Companies (OEICs)

The Group manages 249 (2010: 402) OEICs, and of these 142 (2010: 111) are consolidated. The Group invested £1,283 million (2010: £1,460 million) and redeemed £884 million (2010: £982 million) in the unconsolidated OEICs during the year and had investments, at fair value, of £4,431 million (2010: £7,920 million) at 31 December. The Group earned fees of £318 million from the unconsolidated OEICs (2010: £271 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 was outstanding at 31 December 2011 (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 other joint ventures and associates.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 53: Related party transactions (continued)

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2011, these companies had total assets of approximately £11,500 million (2010: £12,216 million), total liabilities of approximately £10,807 million (2010: £11,937 million) and for the year ended 31 December 2011 had turnover of approximately £7,376 million (2010: £3,829 million) and made a net loss of approximately £83 million (2010: net profit of £182 million). In addition, the Group has provided £5,767 million (2010: £3,316 million) of financing to these companies on which it received £106 million (2010: £93 million) of interest income in the year.

Note 54: Contingent liabilities and commitments

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 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 OFT 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, recently 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 £179 million (2010: £46 million; 2009: £73 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 54: Contingent liabilities and commitments (continued)

Litigation in relation to insurance branch business in Germany

Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. CMIG has won the majority of decisions to date, although a small number of regional district and appeal courts have found against CMIG on specific grounds. CMIG's strategy includes defending claims robustly and appealing against adverse judgments. The ultimate financial effect, which could be significant, will only be known once all relevant claims have been resolved. However, consistent with this strategy, and having regard to the costs involved in managing these claims, and the inherent risks of litigation, the Group has recognised a provision of £175 million. Management believes this represents the most appropriate estimate of the financial impact, based upon a series of assumptions, including the number of claims received, the proportion upheld, and resulting legal and administration costs.

Shareholder complaints

The Group and two former members of the Group'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. No quantum is specified.

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

The Group 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 the Group at this early stage.

Employee disputes

The Group is aware that a union representing a number of the Group's employees and former employees is seeking to challenge the cap on pensionable pay introduced by the Group in 2011 on the grounds that it is unlawful. This challenge is at a very early stage. The Group will resist the challenge should it be pursued.

The Group also faces a number of other threats of legal action from employees in relation to terms of employment including pay and bonuses. The Group considers that the complaints are without merit and, should proceedings be issued, they will be vigorously defended.

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 54: Contingent liabilities and commitments (continued)

	2011 £m	2010 £m
Contingent liabilities		
Acceptances and endorsements	81	48
Other:		
Other items serving as direct credit substitutes	1,060	1,319
Performance bonds and other transaction-related contingencies	2,729	2,812
	3,789	4,131
Total contingent liabilities	3,870	4,179

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

	2011 £m	2010 £m
Commitments		
Documentary credits and other short-term trade-related transactions	105	255
Forward asset purchases and forward deposits placed	596	887
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	7,383	8,113
Other commitments	56,527	60,528
	63,910	68,641
1 year or over original maturity	40,972	47,515
Total commitments	105,583	117,298

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £53,459 million (2010: £63,630 million) was irrevocable.

Operating lease commitments

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

	2011 £m	2010 £m
Not later than 1 year	348	356
Later than 1 year and not later than 5 years	1,187	1,120
Later than 5 years	1,489	1,706
Total operating lease commitments	3,024	3,182

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

Capital commitments

Excluding commitments in respect of investment property (note 28), capital expenditure contracted but not provided for at 31 December 2011 amounted to £296 million (2010: £339 million). Of this amount, £292 million (2010: £282 million) related to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: 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.

	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	–	–	–	–	–	60,722	–	60,722
Items in the course of collection from banks	–	–	–	–	–	1,408	–	1,408
Trading and other financial assets at fair value through profit or loss	–	18,056	121,454	–	–	–	–	139,510
Derivative financial instruments	12,850	53,163	–	–	–	–	–	66,013
Loans and receivables:								
Loans and advances to banks	–	–	–	–	32,606	–	–	32,606
Loans and advances to customers	–	–	–	–	565,638	–	–	565,638
Debt securities	–	–	–	–	12,470	–	–	12,470
	–	–	–	–	610,714	–	–	610,714
Available-for-sale financial assets	–	–	–	37,406	–	–	–	37,406
Held-to-maturity investments	–	–	–	–	–	8,098	–	8,098
Total financial assets	**12,850**	**71,219**	**121,454**	**37,406**	**610,714**	**70,228**	**–**	**923,871**
Financial liabilities								
Deposits from banks	–	–	–	–	–	39,810	–	39,810
Customer deposits	–	–	–	–	–	413,906	–	413,906
Items in course of transmission to banks	–	–	–	–	–	844	–	844
Trading and other financial liabilities at fair value through profit or loss	–	19,616	5,339	–	–	–	–	24,955
Derivative financial instruments	7,246	50,966	–	–	–	–	–	58,212
Notes in circulation	–	–	–	–	–	1,145	–	1,145
Debt securities in issue	–	–	–	–	–	185,059	–	185,059
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	78,991	78,991
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	49,636	49,636
Unallocated surplus within insurance businesses	–	–	–	–	–	–	300	300
Financial guarantees	–	–	49	–	–	–	–	49
Subordinated liabilities	–	–	–	–	–	35,089	–	35,089
Total financial liabilities	**7,246**	**70,582**	**5,388**	**–**	**–**	**675,853**	**128,927**	**887,996**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

		At fair value through profit or loss						
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2010								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	38,115	–	38,115
Items in the course of collection from banks	–	–	–	–	–	1,368	–	1,368
Trading and other financial assets at fair value through profit or loss	–	23,707	132,484	–	–	–	–	156,191
Derivative financial instruments	7,406	43,371	–	–	–	–	–	50,777
Loans and receivables:								
Loans and advances to banks	–	–	–	–	30,272	–	–	30,272
Loans and advances to customers	–	–	–	–	592,597	–	–	592,597
Debt securities	–	–	–	–	25,735	–	–	25,735
	–	–	–	–	648,604	–	–	648,604
Available-for-sale financial assets	–	–	–	42,955	–	–	–	42,955
Held-to-maturity investments	–	–	–	–	–	7,905	–	7,905
Total financial assets	7,406	67,078	132,484	42,955	648,604	47,388	–	945,915
Financial liabilities								
Deposits from banks	–	–	–	–	–	50,363	–	50,363
Customer deposits	–	–	–	–	–	393,633	–	393,633
Items in course of transmission to banks	–	–	–	–	–	802	–	802
Trading and other financial liabilities at fair value through profit or loss	–	20,097	6,665	–	–	–	–	26,762
Derivative financial instruments	4,398	37,760	–	–	–	–	–	42,158
Notes in circulation	–	–	–	–	–	1,074	–	1,074
Debt securities in issue	–	–	–	–	–	228,866	–	228,866
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	80,729	80,729
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	51,363	51,363
Unallocated surplus within insurance businesses	–	–	–	–	–	–	643	643
Financial guarantees	–	–	54	–	–	–	–	54
Subordinated liabilities	–	–	–	–	–	36,232	–	36,232
Total financial liabilities	4,398	57,857	6,719	–	–	710,970	132,735	912,679

(2) Reclassification of financial assets

No financial assets were reclassified in 2011

In 2010 the Group reviewed its approach to managing a portfolio of government securities held as a separately identifiable component of the Group's liquidity portfolio. Given the long-term nature of this portfolio, the Group concluded that certain of these securities will be able to be held until they reach maturity. Consequently, on 1 November 2010, government securities with a fair value of £3,601 million were reclassified from available-for-sale financial assets to held-to-maturity investments reflecting the Group's positive intent and ability to hold them until maturity.

In 2009, no financial assets were reclassified.

In 2008, in accordance with the amendment to IAS39 that became applicable during that year, the Group reviewed the categorisation of its financial assets classified as held for trading and available-for-sale. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, with effect from 1 July 2008, the Group transferred £2,993 million of assets previously classified as held for trading into loans and receivables. With effect from 1 November 2008, the Group transferred £437 million of assets previously classified as available-for-sale financial assets into loans and receivables. At the time of these transfers, the Group had the intention and ability to hold them for the foreseeable future or until maturity. As at the date of reclassification, the weighted average effective interest rate of the assets transferred was 6.3 per cent with the estimated recoverable cash flows of £3,524 million.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

Carrying value and fair value of reclassified assets

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

	2011		2010		2009		2008	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
From held for trading to loans and receivables	**67**	**56**	750	727	1,833	1,822	2,883	2,926
From available-for-sale financial assets to loans and receivables	**217**	**219**	313	340	394	422	454	402
From available-for-sale financial assets to held-to-maturity investments	**3,624**	**3,846**	3,455	3,539	–	–	–	–
Total carrying value and fair value	**3,908**	**4,121**	4,518	4,606	2,227	2,244	3,337	3,328

During the year ended 31 December 2011, the carrying value of assets reclassified to loans and receivables decreased by £779 million due to sales and maturities of £734 million and foreign exchange and other movements of £58 million less accretion of discount of £13 million.

In respect of government securities reclassified from available-for-sale financial assets to held-to-maturity investments, there was no change in the amounts recognised in the Group's income statement as interest income (2011: £138 million; 2010: £23 million) and, for relevant securities, foreign exchange gains and losses (2011: £14 million loss; 2010: £39 million gain) as such items are recognised in profit or loss on the same basis.

No financial assets were reclassified in accordance with paragraphs 50B, 50D or 50E of IAS 39 in 2011, 2010 and 2009; the following disclosures relate to those assets which were so reclassified in 2008.

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

The table below shows the additional gains (losses) that would have been recognised in the Group's income statement if the reclassifications had not occurred.

	2011 £m	2010 £m	2009 £m	2008 £m
From held for trading to loans and receivables	**(3)**	(34)	208	(347)

The table below shows the additional gains (losses) that would have been recognised in other comprehensive income if the reclassifications had not occurred.

	2011 £m	2010 £m	2009 £m	2008 £m
From available-for-sale financial assets to loans and receivables	**(68)**	69	161	(108)

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 £m	2010 £m	2009 £m	2008 £m
From held for trading to loans and receivables:				
Net interest income	**1**	24	55	31
Impairment losses	**–**	(6)	(49)	(158)
Total amounts recognised	**1**	18	6	(127)

	2011 £m	2010 £m	2009 £m	2008 £m
From available-for-sale financial assets to loans and receivables:				
Net interest income	**2**	1	34	3
Impairment losses	**(8)**	(2)	(56)	(23)
Total amounts recognised	**(6)**	(1)	(22)	(20)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: 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.

	2011		2010	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets				
Cash and balances at central banks	60,722	60,722	38,115	38,115
Items in the course of collection from banks	1,408	1,408	1,368	1,368
Trading and other financial assets at fair value through profit or loss	139,510	139,510	156,191	156,191
Derivative financial instruments	66,013	66,013	50,777	50,777
Loans and receivables:				
Loans and advances to banks	32,606	32,554	30,272	30,236
Loans and advances to customers	565,638	549,829	592,597	580,343
Debt securities	12,470	10,953	25,735	26,937
Available-for-sale financial assets	37,406	37,406	42,955	42,955
Held-to-maturity investments	8,098	8,144	7,905	7,716
Financial liabilities				
Deposits from banks	39,810	40,012	50,363	50,520
Customer deposits	413,906	414,654	393,633	394,393
Items in course of transmission to banks	844	844	802	802
Trading and other financial liabilities at fair value through profit or loss	24,955	24,955	26,762	26,762
Derivative financial instruments	58,212	58,212	42,158	42,158
Notes in circulation	1,145	1,145	1,074	1,074
Debt securities in issue	185,059	183,113	228,866	229,375
Liabilities arising from non-participating investment contracts	49,636	49,636	51,363	51,363
Financial guarantees	49	49	54	54
Subordinated liabilities	35,089	27,838	36,232	38,083

Valuation methodology

Financial instruments include financial assets, financial liabilities and derivatives. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

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, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

Valuation control framework

The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

Fair value of financial instruments carried at amortised cost

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.

Held-to-maturity investments

The fair values of government securities are based on market prices.

Deposits from banks and customer deposits

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

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

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.

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	–	9,766	–	9,766
Loans and advances to banks	–	1,355	–	1,355
Debt securities:				
Government securities	21,326	2,041	–	23,367
Other public sector securities	375	808	–	1,183
Bank and building society certificates of deposit	–	3,248	–	3,248
Asset-backed securities:				
Mortgage-backed securities	187	524	–	711
Other asset-backed securities	178	1,605	203	1,986
Corporate and other debt securities	5,098	15,337	1,423	21,858
	27,164	23,563	1,626	52,353
Equity shares	74,381	41	1,315	75,737
Treasury and other bills	299	–	–	299
Total trading and other financial assets at fair value through profit or loss	101,844	34,725	2,941	139,510
Available-for-sale financial assets				
Debt securities:				
Government securities	25,143	93	–	25,236
Other public sector securities	27	–	–	27
Bank and building society certificates of deposit	323	43	–	366
Asset-backed securities:				
Mortgage-backed securities	–	1,803	–	1,803
Other asset-backed securities	–	807	257	1,064
Corporate and other debt securities	41	5,192	12	5,245
	25,534	7,938	269	33,741
Equity shares	55	96	1,787	1,938
Treasury and other bills	972	755	–	1,727
Total available-for-sale financial assets	26,561	8,789	2,056	37,406
Derivative financial instruments	204	63,160	2,649	66,013
Total financial assets carried at fair value	128,609	106,674	7,646	242,929
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	5,339	–	5,339
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	12,378	–	12,378
Short positions in securities	3,168	533	–	3,701
Other	–	3,537	–	3,537
	3,168	16,448	–	19,616
Total trading and other financial liabilities at fair value through profit or loss	3,168	21,787	–	24,955
Derivative financial instruments	35	57,436	741	58,212
Financial guarantees	–	–	49	49
Total financial liabilities carried at fair value	3,203	79,223	790	83,216

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: 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				
Loans and advances to customers	–	9,811	–	9,811
Loans and advances to banks	–	2,734	–	2,734
Debt securities:				
Government securities	21,053	2,787	–	23,840
Other public sector securities	199	720	–	919
Bank and building society certificates of deposit	–	4,298	–	4,298
Asset-backed securities:				
Mortgage-backed securities	2	420	–	422
Other asset-backed securities	5	2,324	283	2,612
Corporate and other debt securities	2,950	16,973	1,186	21,109
	24,209	27,522	1,469	53,200
Equity shares	88,806	46	1,367	90,219
Treasury and other bills	227	–	–	227
Total trading and other financial assets at fair value through profit or loss	113,242	40,113	2,836	156,191
Available-for-sale financial assets				
Debt securities:				
Government securities	11,517	1,035	–	12,552
Other public sector securities	29	–	–	29
Bank and building society certificates of deposit	15	392	–	407
Asset-backed securities:				
Mortgage-backed securities	–	4,293	–	4,293
Other asset-backed securities	–	4,640	579	5,219
Corporate and other debt securities	711	11,399	22	12,132
	12,272	21,759	601	34,632
Equity shares	49	161	2,045	2,255
Treasury and other bills	2,160	3,908	–	6,068
Total available-for-sale financial assets	14,481	25,828	2,646	42,955
Derivative financial instruments	985	47,806	1,986	50,777
Total financial assets carried at fair value	128,708	113,747	7,468	249,923
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	6,665	–	6,665
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	14,612	–	14,612
Short positions in securities	861	894	–	1,755
Other	3	3,727	–	3,730
	864	19,233	–	20,097
Total trading and other financial liabilities at fair value through profit or loss	864	25,898	–	26,762
Derivative financial instruments	42	41,913	203	42,158
Financial guarantees	–	–	54	54
Total financial liabilities carried at fair value	906	67,811	257	68,974

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

Equity investments (including venture capital)

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

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

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

Unquoted equities and property partnerships in the life funds

Third party valuations are used to obtain the fair value of unquoted investments. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

Derivatives

Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.
- Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

The Group's level 3 derivative assets include £1,172 million (31 December 2010: £1,177 million) in respect of the value of the embedded equity conversion feature of the Enhanced Capital Notes issued in December 2009. The embedded equity conversion feature is valued by comparing the market price of the Enhanced Capital Notes with the market price of similar bonds without the conversion feature. The latter is calculated by discounting the expected enhanced capital note cash flows in the absence of a conversion using prevailing market yields for similar capital securities without the conversion feature. The market price of the Enhanced Capital Notes was calculated with reference to multiple broker quotes. Movements in the fair value of the derivative are recorded in net trading income.

Level 3 derivative assets also include £14 million (31 December 2010: £96 million) in respect of credit default swaps written on level 3 negative basis asset-backed securities calculated as set out in the table below:

	2011 £m	2010 £m
Fair value before credit valuation adjustment	**18**	114
Less: credit valuation adjustment	**(4)**	(18)
Carrying value	**14**	96

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: 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	2,912	2,611	1,937	7,460
Exchange and other adjustments	28	12	2	42
Gains (losses) recognised in the income statement	199	(56)	(667)	(524)
Gains recognised in other comprehensive income	–	271	–	271
Purchases	921	664	–	1,585
Sales	(550)	(560)	–	(1,110)
Transfers into the level 3 portfolio	64	–	780	844
Transfers out of the level 3 portfolio	(738)	(296)	(66)	(1,100)
At 31 December 2010	2,836	2,646	1,986	7,468
Exchange and other adjustments	**(8)**	**(45)**	**(8)**	**(61)**
Gains recognised in the income statement	**139**	**78**	**672**	**889**
Losses recognised in other comprehensive income	**–**	**(148)**	**–**	**(148)**
Purchases	**518**	**343**	**–**	**861**
Sales	**(747)**	**(580)**	**–**	**(1,327)**
Transfers into the level 3 portfolio	**331**	**146**	**47**	**524**
Transfers out of the level 3 portfolio	**(128)**	**(384)**	**(48)**	**(560)**
At 31 December 2011	**2,941**	**2,056**	**2,649**	**7,646**
Gains recognised in the income statement relating to those assets held at 31 December 2011	**203**	**31**	**178**	**412**
Losses recognised in other comprehensive income relating to those assets held at 31 December 2011	**–**	**(132)**	**–**	**(132)**
Gains (losses) recognised in the income statement relating to those assets held at 31 December 2010	151	(81)	(667)	(597)
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	197	38	235
Exchange and other adjustments	13	–	13
Additions	–	16	16
Redemptions	(210)	–	(210)
Transfers into the level 3 portfolio	203	–	203
At 31 December 2010	203	54	257
Losses recognised in the income statement	**585**	**5**	**590**
Redemptions	**–**	**(10)**	**(10)**
Transfers into the level 3 portfolio	**18**	**–**	**18**
Transfers out of the level 3 portfolio	**(65)**	**–**	**(65)**
At 31 December 2011	**741**	**49**	**790**
Losses recognised in the income statement relating to those liabilities held at 31 December 2011	**(93)**	**(5)**	**(98)**
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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

Included within the gains (losses) recognised in the income statement are gains of £412 million (2010: losses of £597 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 £132 million (2010: gains of £269 million) related to financial instruments that are held in the level 3 portfolio at the year end.

			At 31 December 2011			At 31 December 2010		
				Effect of reasonably possible alternative assumptions			Effect of reasonably possible alternative assumptions	
	Valuation basis/technique	Main assumptions	Carrying value £m	Favourable changes £m	Unfavourable changes £m	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss								
Asset-backed securities	Lead manager or broker quote/ consensus pricing from market data provider	Use of single pricing source	**203**	**1**	**(1)**	283	8	(8)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value and earnings multiples, forecast cash flows	**1,823**	**56**	**(59)**	2,072	135	(111)
Unlisted equities and property partnerships in the life funds			**915**	**–**	**–**	481	–	–
			2,941			2,836		
Available-for-sale financial assets								
Asset-backed securities	Lead manager or broker quote/ consensus pricing from market data provider	Use of single pricing source	**257**	**1**	**(1)**	579	34	(34)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	**1,799**	**183**	**(88)**	2,067	141	(91)
			2,056			2,646		
Derivative financial assets								
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves. Equity conversion feature spread	**2,649**	**134**	**(20)**	1,986	157	(27)
Financial assets			**7,646**			7,468		
Derivative financial liabilities								
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**741**	**–**	**–**	203	–	–
Financial guarantees			**49**	**–**	**–**	54	–	–
Financial liabilities			**790**			257		

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

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.

Venture capital and equity investments

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

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

– for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;

– the discount rates used in discounted cash flow valuations; and

– in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

Derivative valuation adjustments

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

(i) Uncollateralised derivative valuation adjustments, excluding monoline counterparties

The following table summarises the movement on this valuation adjustment account during 2011:

	2011 £m	2010 £m
At 1 January	570	662
Income statement charge	718	20
Transfers	(62)	(112)
At 31 December	**1,226**	570

Represented by:

	2011 £m	2010 £m
Credit Valuation Adjustment	1,425	671
Debit Valuation Adjustment	(493)	(298)
Funding Valuation Adjustment	294	197
	1,226	570

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Wholesale division.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

The CVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised asset;

– expectations of future market volatility of the underlying asset; and

– expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one per cent deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £140 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. For these, the CVA is calculated on an add-on basis (in total contributing £84 million of the overall CVA balance at 31 December 2011).

The DVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised liability;

– expectations of future market volatility of the underlying liability; and

– the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £125 million to £618 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £369 million fall in the overall valuation adjustment to £563 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding certain uncollateralised derivative positions where the Group considers that this cost is included in market pricing. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £11 million.

(ii) Uncollateralised derivative valuation adjustments – monoline counterparties

The Group has no significant derivative exposures remaining against monoline counterparties as shown in note 56 Credit risk.

(iii) Market liquidity

The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2011, the Group's derivative trading business held mid to bid-offer valuation adjustments of £85 million (31 December 2010: £66 million).

(iv) Libor/Overnight Index Swap basis

The Group's derivative trading business applies £74 million (31 December 2010: £70 million) of valuation adjustments against the changing market approach to valuing derivatives that are subject to daily collateral margin, where standard market practice is to pay interest on an Overnight Index Swap basis rather than a Libor rate.

No credit valuation adjustment is taken on collateralised swaps.

Own credit adjustments

The carrying amount of issued notes that are designated under the IAS 39 fair value option is adjusted to reflect the effect of changes in own credit spreads. The resulting gain or loss is recognised in the income statement.

At 31 December 2011, the own credit adjustment arising from the fair valuation of £5,339 million (31 December 2010: £6,665 million) of the Group's debt securities in issue designated at fair value through profit or loss resulted in a gain of £194 million (2010: no gain or loss).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 55: Financial instruments (continued)

(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	523	513	824	828
Debt securities classified as loans and receivables	5,045	4,326	1,386	1,043
Available-for-sale financial assets	2,435	2,258	1,467	1,378
Total	8,003	7,097	3,677	3,249

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 22.

Note 56: Financial risk management

As a bancassurer, financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; liquidity risk; capital risk; and insurance risk. Information about the Group's exposure to each of the above risks and capital can be found on pages 99 to 170. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

Market risk

The Group uses various market risk measures for risk reporting and setting risk appetite limits and triggers. These measures include Value at Risk and Stress Scenarios.

Interest rate risk

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There is a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However, a significant proportion of the Group's lending assets, for example many personal loans and mortgages, bear interest rates which are contractually fixed for periods of up to five years or longer.

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate mortgage portfolio.

At 31 December 2011 the aggregate notional principal of interest rate swaps designated as fair value hedges was £93,215 million (2010: £75,831 million) with a net fair value asset of £5,484 million (2010: asset of £3,166 million) (note 19). The gains on the hedging instruments were £1,982 million (2010: gains of £280 million). The losses on the hedged items attributable to the hedged risk were £1,999 million (2010: losses of £452 million).

In addition the Group has cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. Note 19 shows when the hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2011 was £152,314 million (2010: £112,507 million) with a net fair value liability of £358 million (2010: liability of £843 million) (note 19). In 2011, ineffectiveness recognised in the income statement that arises from cash flow hedges was a loss of £13 million (2010: gain of £160 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the market and liquidity risk function in London. Associated VaR and the closing, average, maximum and minimum are disclosed on page 165.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using currency borrowings and cross currency derivatives. At 31 December 2011 the aggregate notional principal of these currency borrowings was £2,245 million; the aggregate notional principal of the cross currency derivatives was £49 million (2010: cross currency derivatives £86 million) with a fair value liability of £1 million (2010: asset of £2 million) and they were designated on an after-tax basis as hedges of net investments in foreign operations. In 2011, an ineffectiveness gain of £23 million before tax and £17 million after tax (2010: ineffectiveness loss of £28 million before tax and £20 million after tax) was recognised in the income statement arising from net investment hedges.

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

Functional currency of Group operations

	2011 £m	2010 £m
Euro:		
Gross exposure	585	2,468
Net investment hedge	(848)	(3,270)
	(263)	(802)
US dollar:		
Gross exposure	341	47
Net investment hedge	(122)	(145)
	219	(98)
Swiss franc:		
Gross exposure	15	53
Net investment hedge	–	–
	15	53
Australian dollar:		
Gross exposure	1,232	1,567
Net investment hedge	(1,226)	(1,634)
	6	(67)
Japanese yen:		
Gross exposure	20	17
Net investment hedge	–	–
	20	17
Other non-sterling	170	155
Total structural foreign currency exposures, after net investment hedges	167	(742)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Credit risk

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

A. Maximum credit exposure

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

	2011 £m	2010 £m
Loans and receivables:		
Loans and advances to banks, net[1]	32,606	30,272
Loans and advances to customers, net[1]	565,638	592,597
Debt securities, net[1]	12,470	25,735
Deposit amounts available for offset[2]	(4,174)	(8,105)
	606,540	640,499
Available-for-sale financial assets (excluding equity shares)	35,468	40,700
Held-to-maturity investments	8,098	7,905
Trading and other financial assets at fair value through profit or loss (excluding equity shares)[3]:		
Loans and advances	11,121	12,545
Debt securities, treasury and other bills	52,652	53,427
	63,773	65,972
Derivative assets:		
Derivative assets, before offsetting under master netting arrangements	66,013	50,777
Amounts available for offset under master netting arrangements[2]	(46,618)	(31,740)
	19,395	19,037
Assets arising from reinsurance contracts held	2,534	2,146
Financial guarantees	10,831	22,975
Irrevocable loan commitments and other credit-related contingencies[4]	57,329	67,809
Maximum credit risk exposure	**803,968**	**867,043**
Maximum credit risk exposure before offset items	**854,760**	**906,888**

[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 54 – Contingent liabilities and commitments for further information.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

B. Credit quality of assets

Loans and receivables

The disclosures in the table below and those on pages 324 to 325 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 date on a gross basis, more fairly reflects the underlying provisioning status of the loans. The remaining acquisition-related fair value adjustments in respect of this lending are therefore identified separately in this table.

The analysis of lending between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

Loans and advances

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2011						
Neither past due nor impaired	**32,494**	**330,727**	**41,448**	**146,655**	**518,830**	**11,121**
Past due but not impaired	**15**	**12,742**	**1,093**	**2,509**	**16,344**	**–**
Impaired – no provision required	**6**	**1,364**	**1,604**	**3,544**	**6,512**	**–**
– provision held	**105**	**6,701**	**2,940**	**44,116**	**53,757**	**–**
Gross	**32,620**	**351,534**	**47,085**	**196,824**	**595,443**	**11,121**
Allowance for impairment losses	**(14)**	**(2,731)**	**(1,848)**	**(23,139)**	**(27,718)**	**–**
Fair value adjustments	**–**				**(2,087)**	**–**
Net balance sheet carrying value	**32,606**				**565,638**	**11,121**
At 31 December 2010						
Neither past due nor impaired	30,259	339,509	45,058	159,274	543,841	12,545
Past due but not impaired	–	13,215	1,289	3,427	17,931	–
Impaired – no provision required	–	2,189	433	5,313	7,935	–
– provision held	20	5,591	5,149	45,931	56,671	–
Gross	30,279	360,504	51,929	213,945	626,378	12,545
Allowance for impairment losses	(20)	(2,073)	(2,587)	(24,975)	(29,635)	–
Fair value adjustments	13				(4,146)	–
Net balance sheet carrying value	30,272				592,597	12,545

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 division, are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances which are individually determined to be impaired with a gross amount before impairment allowances of £48,142 million (31 December 2010: £51,608 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

The table below sets out the reconciliation of the allowance for impairment losses of £18,732 million (31 December 2010: £18,373 million) shown in note 25 to the allowance for impairment losses on a combined businesses basis of £27,718 million (31 December 2010: £29,635 million) shown above:

	2011 £m	2010 £m
Allowance for impairment losses on loans and advances to customers	**18,732**	18,373
HBOS allowance at 16 January 2009[1]	**11,147**	11,147
HBOS charge covered by fair value adjustments[2]	**10,474**	8,823
Amounts subsequently written off	**(13,083)**	(9,136)
	8,538	10,834
Foreign exchange and other movements	**448**	428
Allowance for impairment losses on loans and advances to customers on a combined businesses basis	**27,718**	29,635

[1] Comprises an allowance held at 31 December 2008 of £10,693 million and a charge for the period from 1 January 2009 to 16 January 2009 of £454 million.

[2] This represents the element of the charge on loans and advances to customers in HBOS's results that was included within the Group's fair value adjustments in respect of the acquisition of HBOS on 16 January 2009.

Loans and advances which are neither past due nor impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2011						
Good quality	**32,141**	**323,060**	**29,123**	**71,907**		**11,065**
Satisfactory quality	**171**	**5,432**	**9,747**	**42,311**		**45**
Lower quality	**9**	**970**	**1,127**	**24,676**		**11**
Below standard, but not impaired	**173**	**1,265**	**1,451**	**7,761**		**–**
Total loans and advances which are neither past due nor impaired	**32,494**	**330,727**	**41,448**	**146,655**	**518,830**	**11,121**
At 31 December 2010						
Good quality	29,835	332,614	30,076	57,552		12,220
Satisfactory quality	265	5,259	11,084	42,906		163
Lower quality	16	834	1,170	45,750		83
Below standard, but not impaired	143	802	2,728	13,066		79
Total loans and advances which are neither past due nor impaired	30,259	339,509	45,058	159,274	543,841	12,545

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models. Further information about the Group's internal probabilities of default rating models can be found on pages 129 to 130.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Loans and advances which are past due but not impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2011						
0-30 days	**1**	**5,989**	**868**	**1,163**	**8,020**	**–**
30-60 days	**9**	**2,618**	**195**	**481**	**3,294**	**–**
60-90 days	**4**	**1,833**	**25**	**260**	**2,118**	**–**
90-180 days	**–**	**2,302**	**4**	**159**	**2,465**	**–**
Over 180 days	**1**	**–**	**1**	**446**	**447**	**–**
Total loans and advances which are past due but not impaired	**15**	**12,742**	**1,093**	**2,509**	**16,344**	**–**
At 31 December 2010						
0-30 days	–	6,498	1,004	1,331	8,833	–
30-60 days	–	2,674	246	498	3,418	–
60-90 days	–	1,811	29	394	2,234	–
90-180 days	–	2,223	10	337	2,570	–
Over 180 days	–	9	–	867	876	–
Total loans and advances which are past due but not impaired	–	13,215	1,289	3,427	17,931	–

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Debt securities classified as loans and receivables

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

	AAA £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	**2,008**	**2,326**	**1,423**	**1,024**	**369**	**29**	**7,179**
Other asset-backed securities	**3,585**	**430**	**374**	**237**	**403**	**1**	**5,030**
	5,593	**2,756**	**1,797**	**1,261**	**772**	**30**	**12,209**
Corporate and other debt securities	**150**	**–**	**67**	**–**	**–**	**320**	**537**
Gross exposure	**5,743**	**2,756**	**1,864**	**1,261**	**772**	**350**	**12,746**
Allowance for impairment losses							**(276)**
Total debt securities classified as loans and receivables							**12,470**
At 31 December 2010							
Asset-backed securities:							
Mortgage-backed securities	6,524	2,856	1,057	840	222	151	11,650
Other asset-backed securities	7,535	2,514	1,377	475	823	103	12,827
	14,059	5,370	2,434	1,315	1,045	254	24,477
Corporate and other debt securities	163	164	459	106	166	758	1,816
Gross exposure	14,222	5,534	2,893	1,421	1,211	1,012	26,293
Allowance for impairment losses							(558)
Total debt securities classified as loans and receivables							25,735

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

An analysis of the Group's available-for-sale financial assets is included in note 26. The credit quality of the Group's 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	**19,051**	**6,179**	**–**	**–**	**–**	**6**	**25,236**
Other public sector securities	**–**	**–**	**–**	**–**	**–**	**27**	**27**
Bank and building society certificates of deposit	**81**	**177**	**71**	**37**	**–**	**–**	**366**
Asset-backed securities:							
Mortgage-backed securities	**626**	**491**	**398**	**185**	**103**	**–**	**1,803**
Other asset-backed securities	**399**	**299**	**224**	**34**	**90**	**18**	**1,064**
	1,025	**790**	**622**	**219**	**193**	**18**	**2,867**
Corporate and other debt securities	**1,609**	**856**	**2,351**	**341**	**–**	**88**	**5,245**
Total debt securities	**21,766**	**8,002**	**3,044**	**597**	**193**	**139**	**33,741**
Treasury bills and other bills	**1,717**	**–**	**10**	**–**	**–**	**–**	**1,727**
Total held as available-for-sale financial assets	**23,483**	**8,002**	**3,054**	**597**	**193**	**139**	**35,468**
At 31 December 2010							
Debt securities:							
Government securities	12,462	78	–	–	–	12	12,552
Other public sector securities	–	–	–	–	–	29	29
Bank and building society certificates of deposit	–	225	162	20	–	–	407
Asset-backed securities:							
Mortgage-backed securities	2,809	673	601	202	8	–	4,293
Other asset-backed securities	3,625	781	395	115	79	224	5,219
	6,434	1,454	996	317	87	224	9,512
Corporate and other debt securities	1,135	4,824	5,150	913	42	68	12,132
Total debt securities	20,031	6,581	6,308	1,250	129	333	34,632
Treasury bills and other bills	4,439	–	1,629	–	–	–	6,068
Total held as available-for-sale financial assets	24,470	6,581	7,937	1,250	129	333	40,700

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Held-to-maturity investments

An analysis of the credit quality of the Group's held-to-maturity investments 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							
Government securities	6,319	1,779	–	–	–	–	8,098
At 31 December 2010							
Government securities	7,905	–	–	–	–	–	7,905

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

An analysis of the Group's trading and other financial assets at fair value through profit or loss is included in note 18. The credit quality of the Group's debt securities, treasury and other bills held at fair value through profit or loss is set out below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2011							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets:							
Government securities	1,994	6	–	–	–	–	2,000
Bank and building society certificates of deposit	–	1,147	1,574	142	–	–	2,863
Asset-backed securities:							
Mortgage-backed securities	63	34	1	–	1	–	99
Other asset-backed securities	19	151	52	–	–	–	222
	82	185	53	–	1	–	321
Corporate and other debt securities	304	141	312	489	151	179	1,576
Total debt securities held as trading assets	2,380	1,479	1,939	631	152	179	6,760
Treasury bills and other bills	224	75	–	–	–	–	299
Total held as trading assets	2,604	1,554	1,939	631	152	179	7,059
Other assets held at fair value through profit or loss:							
Government securities	17,667	1,027	950	642	644	437	21,367
Other public sector securities	908	170	35	59	11	–	1,183
Bank and building society certificates of deposit	–	330	55	–	–	–	385
Asset-backed securities:							
Mortgage-backed securities	194	45	255	116	–	2	612
Other asset-backed securities	320	198	794	383	53	16	1,764
	514	243	1,049	499	53	18	2,376
Corporate and other debt securities	3,415	2,111	6,197	5,195	1,199	2,165	20,282
Total other assets held at fair value through profit or loss	22,504	3,881	8,286	6,395	1,907	2,620	45,593
Total held at fair value through profit or loss	25,108	5,435	10,225	7,026	2,059	2,799	52,652

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2010							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets:							
Government securities	651	888	–	84	–	–	1,623
Bank and building society certificates of deposit	–	3,086	506	100	–	–	3,692
Other asset-backed securities	191	633	196	–	–	–	1,020
Corporate and other debt securities	1,205	1,209	1,839	183	13	470	4,919
Total debt securities held as trading assets	2,047	5,816	2,541	367	13	470	11,254
Treasury bills and other bills	219	8	–	–	–	–	227
Total held as trading assets	2,266	5,824	2,541	367	13	470	11,481
Other assets held at fair value through profit or loss:							
Government securities	20,509	1,113	408	33	6	148	22,217
Other public sector securities	778	62	68	2	–	9	919
Bank and building society certificates of deposit	52	107	447	–	–	–	606
Asset-backed securities:							
Mortgage-backed securities	259	68	48	23	–	24	422
Other asset-backed securities	298	372	458	384	70	10	1,592
	557	440	506	407	70	34	2,014
Corporate and other debt securities	3,870	1,619	4,397	3,269	1,275	1,760	16,190
Total other assets held at fair value through profit or loss	25,766	3,341	5,826	3,711	1,351	1,951	41,946
Total held at fair value through profit or loss	28,032	9,165	8,367	4,078	1,364	2,421	53,427

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

Derivative assets

An analysis of derivative assets is given in note 19. 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 £19,395 million (2010: £19,037 million), cash collateral of £5,269 million (2010: £1,429 million) was held and a further £7,875 million was due from OECD banks (2010: £8,385 million).

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2011							
Trading and other	**313**	**25,268**	**14,474**	**6,612**	**3,588**	**2,908**	**53,163**
Hedging	**35**	**8,718**	**3,237**	**786**	**9**	**65**	**12,850**
Total derivative financial instruments	**348**	**33,986**	**17,711**	**7,398**	**3,597**	**2,973**	**66,013**
At 31 December 2010							
Trading and other	157	18,161	13,486	1,006	86	10,475	43,371
Hedging	57	1,992	4,368	46	–	943	7,406
Total derivative financial instruments	214	20,153	17,854	1,052	86	11,418	50,777

Assets arising from reinsurance contracts held

Of the assets arising from reinsurance contracts held at 31 December 2011 of £2,534 million (2010: £2,146 million), £842 million (2010: £671 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

C. Collateral held as security for financial assets

A general description of collateral held as security in respect of financial instruments is provided on pages 131 and 132. 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 £508 million (2010: £4,185 million), against which the Group held collateral with a fair value of £511 million (2010: £3,909 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.

Retail lending

Mortgages

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

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
At 31 December 2011				
Less than 70 per cent	**137,224**	**3,203**	**1,420**	**141,847**
70 per cent to 80 per cent	**60,236**	**1,894**	**843**	**62,973**
80 per cent to 90 per cent	**53,113**	**2,250**	**1,103**	**56,466**
90 per cent to 100 per cent	**40,236**	**2,182**	**1,196**	**43,614**
Greater than 100 per cent	**39,918**	**3,213**	**3,503**	**46,634**
Total	**330,727**	**12,742**	**8,065**	**351,534**

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
At 31 December 2010				
Less than 70 per cent	140,267	3,191	1,376	144,834
70 per cent to 80 per cent	57,979	1,869	787	60,635
80 per cent to 90 per cent	53,732	2,381	1,138	57,251
90 per cent to 100 per cent	43,263	2,413	1,359	47,035
Greater than 100 per cent	44,268	3,361	3,120	50,749
Total	339,509	13,215	7,780	360,504

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

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 £47,085 million (2010: £51,929 million), against which the Group held an impairment allowance of £1,848 million (2010: £2,587 million). Gross impaired non-mortgage lending amounted to £4,544 million (2010: £5,582 million). The fair value of the collateral held in respect of this lending was £43 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 £42,541 million (2010: £46,347 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are thereafter monitored in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is reassessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

Wholesale lending

Reverse repurchase transactions

There were reverse repurchase agreements which are accounted for as collateralised loans with a carrying value of £16,835 million (2010: £3,096 million), against which the Group held collateral with a fair value of £16,936 million (2010: £2,987 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 £196,824 million (2010: £213,945 million), against which the Group held an impairment allowance of £23,139 million (2010: £24,975 million). Gross impaired wholesale lending amounted to £47,660 million (2010: £51,244 million). The fair value of the collateral held in respect of impaired wholesale lending which is secured was £13,977 million (2010: £14,520 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured wholesale lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

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

Unimpaired lending

Wholesale unimpaired lending amounted to £149,164 million (2010: £162,701 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

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 £15,765 million (2010: £14,299 million). Of this, £3,740 million was sold or repledged (2010: £3,161 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £10,438 million (2010: £72,224 million). Of this amount, £5,308 million (2010: £52,393 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 £19,395 million (2010: £19,037 million), cash collateral of £5,269 million (2010: £1,429 million) was held.

Irrevocable loan commitments and other credit-related contingencies

At 31 December 2011, the Group held irrevocable loan commitments and other credit-related contingencies of £57,329 million (2010: £67,809 million). Collateral is held as security, in the event that lending is drawn down, on £13,279 million (2010: £13,011 million) of these balances.

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

D. Collateral pledged as security

Repo and stock lending transactions

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £39,679 million (2010: £53,781 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	3,102	4,289
Loans and advances to customers	37,926	102,151
Debt securities classified as loans and receivables	398	4,324
Available-for-sale financial assets	1,618	13,375
	43,044	124,139

In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 22 and 23.

E. Collateral repossessed

	2011 £m	2010 £m
Residential property	968	1,046
Other	13	32
	981	1,078

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

F. Treatment of customers experiencing financial difficulty

The Group operates a number of schemes to assist borrowers who are experiencing financial difficulties. Details of the material elements of these schemes are set out below and in the Risk Management report on pages 132 to 134.

Retail customers

The Group classifies the treatments offered to customers who have experienced financial difficulty into the following categories:

- Forbearance: a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments, for example capital payment breaks and payment assistance breaks. Any arrears existing at the commencement of the arrangement are retained.
- Financial distress assistance: an arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay and term extensions.
- Repair: an account change used to repair a customer's position when they have emerged from financial difficulty, for example capitalisation of arrears.

Treatments offered to UK retail secured customers in financial difficulty

Forbearance – Capital payment break

These allow customers who are currently on a capital and interest repayment basis to temporarily transfer their loan onto an interest only basis in order to reduce their contractual monthly payment and help them through their period of financial difficulty. During this period, the Group regularly reviews the customer's situation and works with them to try to restore their position and return them to a full capital and interest repayment basis. Prior to allowing the transfer, the Group undertakes a full financial review to confirm the customer's financial difficulty and ability to maintain the revised level of payment. The transfers are initially for twelve months and are limited to a maximum of three years during the lifetime of the mortgage.

Commensurate with the aim of this activity (i.e. to manage customers through their temporary financial difficulty) during the capital payment break arrears accrue based on the temporary interest only contractual monthly payment. On expiry of the break, the customer is transferred back onto capital and interest repayment terms, with the outstanding balance recovered across the remaining term of the original loan.

Forbearance – Payment assistance break

These agreements allow customers to suspend monthly payments for a limited period in order to address short-term financial difficulties. This treatment is only available as a forbearance tool to customers who are less than one monthly payment in arrears and for a maximum period of three months during the term of the mortgage.

Arrears do not accrue during the break. The contractual monthly payment is recalculated at the end of the break to take account of missed interest and, if appropriate, capital payments.

Financial distress – Term extension

These allow customers to permanently extend their mortgage term in order to reduce their contractual monthly payment. Term extensions are rarely granted to customers in financial distress as the focus is on minimising the longer term impact on the customer. The maximum term for the extension is aligned to the overall standard term limits for mortgages and, in general, the mortgage must be up to date.

The contractual monthly payment is reset when the term extension is implemented and any subsequent arrears will accrue based on this revised payment.

Financial distress – Arrangement to pay

Customers who are experiencing short-term financial difficulties may reach agreement with the Group to pay an amount differing from their normal contractual monthly payment for a specified period of time. This is agreed with the customer as being affordable and practical based on their individual circumstances. Arrangements to pay less than the contractual monthly payment can be granted for up to three months after which the customer's circumstances will be reviewed.

During the arrangement period, there is no clearing down of arrears such that, unless the customer is paying more than their contractual monthly payment, arrears balances will remain and the loan will continue to be reported as impaired or past due. When customers come to the end of their arrangement period they will continue to be managed as a mainstream collections case, if still in arrears.

Repair – Capitalisation of arrears

Once customers have evidenced recovery from financial difficulty and re-established a strong payment record, this treatment allows the repair of the customer's financial position through the permanent capitalisation of arrears. Customers must demonstrate that they can meet the contractual terms of their loan by making six consecutive contractual monthly payments and must give their permission for the capitalisation. Arrears may not be capitalised more than twice in a five year period.

The contractual monthly payment is reset when the capitalisation is implemented to enable repayment over the original term. Any subsequent arrears will accrue based on this revised payment.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Customers receiving support from UK Government sponsored programmes

The Group participates in a number of UK Government sponsored programmes designed to support households, which are described on page 133. Where these schemes provide borrowers with a state benefit that is used to service the loan, there is no change in the reported status of the loan which is managed and reported in accordance with its original terms.

The Group assesses whether a loan benefitting from a UK Government sponsored programme is impaired using the same accounting policies and practices as it does for loans not benefitting from such a programme. There is no direct impact on the impairment status of a loan benefitting from the Mortgage Rescue schemes, as these schemes involve the purchase, and eventual sale, of the property. The loans included within the Income Support for Mortgage Interest scheme and the Homeowner Mortgage Support scheme may be impaired, in accordance with the normal definition of impairment.

The Income Support for Mortgage Interest scheme remains the most successful of the Government backed schemes. It is the longest-running, is the most widely known and provides both the customer and the Group with an assurance as to the maintenance of at least two years' worth of interest payments. The Group estimates that around £3 billion of its mortgage exposures are receiving this benefit. This includes those who are also receiving other treatments for financial difficulty.

The Group's own UK retail secured schemes have also shown signs of success with over 86 per cent of customers who have accepted capital payment breaks having maintained or improved their arrears position over the twelve months after transfer. The Group believes that its mortgage payment arrangements continue to be an effective way to manage short-term affordability issues.

Treatments offered to Irish retail secured customers in financial difficulty

While the treatments offered to mortgage customers in financial difficulty in the UK and in Ireland are broadly similar, the current period of economic distress in Ireland and resultant regulatory Code of Conduct on Mortgage Arrears have resulted in an environment of ongoing assistance to customers, with greater flexibility within policy as to the duration and frequency of treatments. Care is taken to keep customers informed of their position and their circumstances are regularly reviewed; at least every six months.

UK and Irish retail secured loans and advances

The amount of UK and Irish retail secured loans and advances subject to forbearance, financial distress and repair treatment at the period end is set out below:

	Total loans and advances receiving treatment		Impairment allowance as % of loans and advances receiving treatment	
	2011 £m	2010 £m	**2011 %**	2010 %
Forbearance	**4,028**	4,424	**2.7**	1.6
Financial distress[1,2]	**729**	603	**9.8**	10.1
Repair[1]	**1,772**	3,719	**6.7**	3.7
Total UK and Irish retail secured loans and advances	**339,121**	348,433	**0.8**	0.6

[1] Where the treatment involves a permanent change to the contractual basis of the customer's account (i.e. capitalisation of arrears and term extensions), those commenced during the year and remaining as customers at the year end are shown.

[2] The financial distress balances include arrangements to pay where the customer is paying less than the contractual payment and had such arrangements at the year end.

The loans analysed above comprise 1.9 per cent of the overall UK and Irish retail secured portfolios at 31 December 2011 (2010: 2.5 per cent). At 31 December 2011, 10.9 per cent (2010: 8.7 per cent) of the balances receiving treatment were impaired.

Collective impairment assessment of retail secured loans subject to forbearance and similar treatments

Loans which have received forbearance or similar treatments are grouped with other assets with similar risk characteristics and assessed collectively for impairment as described below. The loans are not considered as impaired loans unless they meet the standard definitions.

The Group's approach is to ensure that provisioning models, supported by management judgement, appropriately reflect the underlying loss risk of exposures. The Group uses sophisticated behavioural scoring to assess customers' credit risk. The underlying behavioural scorecards consider many different characteristics of customer behaviour, both static and dynamic, from internal sources and also from credit bureaux data, including characteristics that may identify when a customer has been in arrears on products held with other firms. Hence, these models take a range of potential indicators of customer financial distress into account.

The performance of such models is monitored and challenged on an ongoing basis, in line with the Group's model governance policies. The models are also regularly recalibrated to reflect up to date customer behaviour and market conditions. Specifically, regular detailed analysis of modelled provision outputs is undertaken to demonstrate that the risk of forbearance or other similar activities is recognised, that the outcome period adequately captures the risk and that the underlying risk is appropriately reflected. Where this is not the case, additional provisions are applied to capture the risk.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Treatments offered to UK retail unsecured customers in financial difficulty

Customers who are experiencing short-term financial difficulties may reach agreement with the Group to pay an amount differing from their normal contractual payment for a specified period of time. This is agreed with the customer as being affordable and practical based on their individual circumstances. The terms of the arrangements and qualifying criteria depend on the unsecured product and on the assessment of the customer's ability to return to making normal payments.

UK retail unsecured loans and advances

UK retail unsecured loans and advances receiving forbearance and financial distress treatments at 31 December 2011 represent less than 2.5 per cent of the unsecured portfolios and, of that, over 90 per cent is already reported and provisioned for as impaired loans; in aggregate, impairment provisions as a percentage of impaired loans in collections represent 86.5 per cent.

Collective impairment assessment of UK retail unsecured loans and advances subject to forbearance and similar treatments

Credit risk provisioning for the UK retail unsecured portfolio is undertaken on a purely collective basis. The approach used is based on segmented cash flow models, divided into two primary streams for loans judged to be impaired and those that are not. Accounts subject to repayment plans and collections refinance loans are among those considered to be impaired.

For exposures that are judged to be impaired, provisions are determined through modelling the expected cure rates, write-off propensity and cash flows. The segmentation is very granular with segments explicitly relating to repayment plans and refinance loans treatments. Payments of less than the monthly contractual amount are reflected in reduced cash flow forecasts when calculating the impairment allowance for these accounts.

The output of the models is monitored and challenged on an ongoing basis. The models are run monthly meaning that current market conditions and customer processes are reflected in the output. Where the risks identified are not captured in the underlying models, appropriate additional provisions are made.

Wholesale customers

Wholesale credit facilities are reviewed on a regular basis and more frequently where required. When financial stress is exhibited, the customer is typically transferred at an early stage to the specialist Business Support Unit (BSU) and Customer Support teams. In order to support wholesale customers that encounter difficulties during the current economic downturn, the Group increased the size of its dedicated BSU to cover all its UK and International portfolios. The Group has detailed processes to identify customers in financial distress. These are designed to ensure that early warning signs are acted upon and the Group takes appropriate action and, where possible, works with each customer to try to resolve the issues, to restore the business to a financially viable position and to facilitate a business turnaround. The main types of forbearance for wholesale customers in financial distress are set out below.

Treatments offered to wholesale customers

Covenant resets and breach of covenant waivers

This consists of an agreement by the Group either to amend a clause in a loan agreement (or similar document) or to waive a breach of a clause, which will typically relate to a financial commitment linked to the credit quality of the customer. The identification of a covenant breach will usually occur through one of the following:

– the processing of audited or management accounts;

– contact from the customer during preparation of their compliance certificate;

– the receipt of customer information from which covenant compliance is calculated; or

– the receipt of a compliance certificate from a customer or agent.

A customer is not automatically classed as being in default as a result of a covenant breach, but an actual or projected breach will prompt a review of the customer's circumstances and their facilities.

Extension of facilities outside of agreed terms

These allow customers to formally extend their facility term in order to reduce their contractual repayments or to improve their liquidity position. Term extensions are also granted as part of normal corporate activities.

Capital repayment holidays

These allow customers who are currently on a capital and interest repayment basis to temporarily transfer their loan onto an interest-only basis in order to reduce their contractual repayments and help them through their period of financial difficulty. During this period, the Group regularly reviews the customer's situation and works with them to try to restore their position and return them to a full capital and interest repayment basis.

Prior to allowing the transfer, the Group undertakes a full financial review to confirm the customer's financial difficulty and ability to maintain the revised level of repayment. The aim of this activity is to manage customers through their temporary financial distress, and accordingly, on expiry of the break, the customer is transferred back onto capital and interest repayment terms, with the outstanding balance recovered across the remaining term of the original loan.

Debt for equity swaps

This type of forbearance involves the Group writing off debt, either partially or in whole, in exchange for equity in the company, usually in the form of ordinary shares, warrants, options or other equity instruments. The primary goals of debt for equity swaps are to reduce the debt service (capital

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

and interest) burden on the borrower, to encourage early repayment of outstanding loans to the Group, to protect the value of the residual debt provided, and/or to benefit from any future growth in value of the borrower. Debt for equity swaps are typically used as a last resort.

Partial debt write off

An agreement to write off part of a contractual financial obligation in order to facilitate survival of a corporate entity on a going concern basis. Partial debt write-offs are typically used as a last resort.

G. Loans renegotiated during the year

Loans and advances that were renegotiated during the year that would otherwise have been past due or impaired totalled £2,505 million at 31 December 2011 (2010: £5,475 million). Details of loans and advances renegotiated are provided below:

	Total loans and advances renegotiated during the year that would otherwise have been past due or impaired	
	2011 £m	2010 £m
Capitalisation of arrears	1,677	2,804
Interest rate adjustment	28	337
Payment holidays	172	221
Interest capitalisation	269	10
Forbearance of principal	359	2,103
Total	2,505	5,475

H. Credit market exposures

The Group's credit market exposures primarily relate to asset-backed securities exposures held in Wholesale division. An analysis of the carrying value of these exposures, which are classified as loans and receivables (note 24), available-for-sale financial assets (note 26) or trading and other financial assets at fair value through profit or loss (note 18) depending on the nature of the investment, is set out below.

	Loans and receivables £m	Available-for-sale £m	Trading £m	Net exposure at 31 December 2011 £m	Net exposure at 31 December 2010 £m
Asset-backed securities					
Mortgage-backed securities:					
US residential	4,063	–	–	4,063	4,242
Non-US residential	1,837	1,189	99	3,125	7,898
Commercial	1,175	613	–	1,788	3,516
	7,075	1,802	99	8,976	15,656
Collateralised debt obligations:					
Collateralised loan obligations	915	195	52	1,162	4,686
Other	264	–	–	264	494
	1,179	195	52	1,426	5,180
Federal family education loan programme	3,380	146	–	3,526	7,777
Personal sector	145	366	–	511	3,967
Other asset-backed securities	314	322	20	656	1,035
Total uncovered asset-backed securities	12,093	2,831	171	15,095	33,615
Negative basis[1]	–	36	150	186	1,109
Total Wholesale asset-backed securities	12,093	2,867	321	15,281	34,724
Direct	9,067	1,317	321	10,705	22,296
Conduits (note 23)	3,026	1,550	–	4,576	12,428
Total Wholesale asset-backed securities	12,093	2,867	321	15,281	34,724

[1] Negative basis means bonds held with separate matching credit default swap protection.

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Note 56: Financial risk management (continued)

Exposures to monolines

At 31 December 2011, the Group had no direct exposure to sub-investment grade monolines on credit default swap (CDS) contracts. Its exposure to investment grade monolines through CDS contracts was £14 million (gross exposure: £168 million) and through wrapped loans and receivables was £178 million (gross exposure: £274 million).

The exposure to monolines arising from negative basis trades is calculated as the mark-to-market of the CDS protection purchased from the monoline insurer after credit valuation adjustments. The exposure to monolines on wrapped loans and receivables and bonds is the internal assessment of amounts that will be recovered on interest and principal shortfalls.

In addition, the Group has £1,550 million (2010: £1,985 million) of monoline wrapped bonds and £274 million (2010: £425 million) of monoline wrapped liquidity commitments on which the Group currently places no reliance on the guarantor.

An analysis of the Wholesale division's asset-backed securities portfolio by credit rating is provided below.

	Net Exposure £m	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Below B £m
Asset class								
Mortgage-backed securities:								
US residential mortgage-backed securities:								
Prime	777	175	393	97	100	12	–	–
Alt-A	3,286	1,144	781	633	651	77	–	–
Sub-prime	–	–	–	–	–	–	–	–
	4,063	1,319	1,174	730	751	89	–	–
Non-US residential mortgage-backed securities	3,125	1,318	935	399	309	164	–	–
Commercial mortgage-backed securities	1,788	273	604	648	199	64	–	–
	8,976	2,910	2,713	1,777	1,259	317	–	–
Collateralised debt obligations:								
Collateralised loan obligations	1,162	274	455	331	7	50	16	29
Other	264	1	1	–	111	151	–	–
	1,426	275	456	331	118	201	16	29
Federal family education loan programme	3,526	3,419	107	–	–	–	–	–
Personal sector	511	273	165	15	58	–	–	–
Other asset-backed securities	656	61	52	197	94	252	–	–
Total uncovered asset-backed securities	15,095	6,938	3,493	2,320	1,529	770	16	29
Negative basis:[1]								
Monolines	150	–	150	–	–	–	–	–
Banks	36	36	–	–	–	–	–	–
	186	36	150	–	–	–	–	–
Total at 31 December 2011	15,281	6,974	3,643	2,320	1,529	770	16	29
Total at 31 December 2010	34,724	20,805	7,310	3,713	1,764	763	147	222

[1] The external credit rating is based on the bond ignoring the benefit of the CDS.

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Note 56: Financial risk management (continued)

Liquidity risk

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

The table below analyses assets and liabilities of the Group into relevant maturity groupings based on the remaining contractual period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

Maturities of assets and liabilities

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2011						
Assets						
Cash and balances at central banks	60,420	296	6	–	–	60,722
Trading and other financial assets at fair value through profit or loss	10,508	6,791	2,919	7,968	111,324	139,510
Derivative financial instruments	2,327	1,719	3,699	20,498	37,770	66,013
Loans and advances to banks	22,976	3,261	2,241	3,671	457	32,606
Loans and advances to customers	68,983	10,146	31,056	105,808	349,645	565,638
Debt securities held as loans and receivables	98	–	8	689	11,675	12,470
Available-for-sale financial assets	1,389	1,247	712	6,348	27,710	37,406
Held-to-maturity investments	–	–	–	340	7,758	8,098
Other assets	5,273	532	841	448	40,989	48,083
Total assets	171,974	23,992	41,482	145,770	587,328	970,546
Liabilities						
Deposits from banks	19,284	3,680	4,459	11,315	1,072	39,810
Customer deposits	324,702	15,995	33,518	38,067	1,624	413,906
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	10,612	4,838	6,729	21,407	39,581	83,167
Debt securities in issue	31,285	22,158	29,137	55,350	47,129	185,059
Liabilities arising from insurance and investment contracts	11,723	1,786	5,568	19,971	89,879	128,927
Other liabilities	14,951	407	963	3,406	18,267	37,994
Subordinated liabilities	157	149	1,006	7,581	26,196	35,089
Total liabilities	412,714	49,013	81,380	157,097	223,748	923,952
At 31 December 2010						
Assets						
Cash and balances at central banks	37,737	70	308	–	–	38,115
Trading and other financial assets at fair value through profit or loss	7,579	9,541	8,948	6,192	123,931	156,191
Derivative financial instruments	2,889	1,691	3,860	17,492	24,845	50,777
Loans and advances to banks	22,520	2,754	2,550	1,529	919	30,272
Loans and advances to customers	58,392	10,549	28,193	114,102	381,361	592,597
Debt securities held as loans and receivables	57	250	374	2,941	22,113	25,735
Available-for-sale financial assets	2,745	5,503	3,535	12,761	18,411	42,955
Held-to-maturity investments	110	–	–	–	7,795	7,905
Other assets	4,920	585	1,140	604	39,778	47,027
Total assets	136,949	30,943	48,908	155,621	619,153	991,574
Liabilities						
Deposits from banks	24,445	10,308	4,152	9,467	1,991	50,363
Customer deposits	311,899	14,557	30,790	33,802	2,585	393,633
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	11,938	4,313	8,469	20,003	24,197	68,920
Debt securities in issue	24,151	39,243	46,629	67,190	51,653	228,866
Liabilities arising from insurance and investment contracts	15,425	1,550	5,337	20,174	90,249	132,735
Other liabilities	15,426	595	933	8,049	8,920	33,923
Subordinated liabilities	122	1,294	1,317	9,049	24,450	36,232
Total liabilities	403,406	71,860	97,627	167,734	204,045	944,672

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

The above tables are provided on a contractual basis. The Group's assets and liabilities may be repaid or otherwise mature earlier or later than implied by their contractual terms and readers are, therefore, advised to use caution when using this data to evaluate the Group's liquidity position.

The table below analyses financial instrument liabilities of the Group, excluding those arising from insurance and participating investment contracts, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2011						
Deposits from banks	**19,504**	**4,368**	**5,517**	**10,469**	**1,292**	**41,150**
Customer deposits	**322,752**	**16,253**	**33,558**	**41,398**	**1,816**	**415,777**
Trading and other financial liabilities at fair value through profit or loss	**10,284**	**2,336**	**3,516**	**6,491**	**3,602**	**26,229**
Debt securities in issue	**34,801**	**27,173**	**26,040**	**74,735**	**32,855**	**195,604**
Liabilities arising from non-participating investment contracts	**27,429**	**–**	**–**	**–**	**22,207**	**49,636**
Subordinated liabilities	**284**	**392**	**3,538**	**17,296**	**33,604**	**55,114**
Total non-derivative financial liabilities	**415,054**	**50,522**	**72,169**	**150,389**	**95,376**	**783,510**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**28,830**	**4,610**	**6,700**	**26,496**	**17,893**	**84,529**
Gross settled derivatives – inflows	**(2,258)**	**(2,911)**	**(5,655)**	**(21,243)**	**(13,835)**	**(45,902)**
Gross settled derivatives – net flows	**26,572**	**1,699**	**1,045**	**5,253**	**4,058**	**38,627**
Net settled derivatives liabilities	**20,339**	**179**	**1,071**	**2,684**	**863**	**25,136**
Total derivative financial liabilities	**46,911**	**1,878**	**2,116**	**7,937**	**4,921**	**63,763**
At 31 December 2010						
Deposits from banks	24,911	11,804	4,301	10,557	922	52,495
Customer deposits	306,469	15,031	32,626	38,529	3,019	395,674
Trading and other financial liabilities at fair value through profit or loss	11,293	2,218	5,125	5,544	3,632	27,812
Debt securities in issue	31,234	41,143	52,582	91,893	35,201	252,053
Liabilities arising from non-participating investment contracts	12,944	91	265	1,743	36,320	51,363
Subordinated liabilities	–	1,107	4,615	17,702	35,067	58,491
Total non-derivative financial liabilities	386,851	71,394	99,514	165,968	114,161	837,888
Derivative financial liabilities:						
Gross settled derivatives – outflows	26,069	14,832	8,942	65,734	42,410	157,987
Gross settled derivatives – inflows	(10,442)	(14,978)	(9,270)	(66,232)	(41,815)	(142,737)
Gross settled derivatives – net flows	15,627	(146)	(328)	(498)	595	15,250
Net settled derivatives liabilities	2,492	2,066	5,797	11,576	3,331	25,262
Total derivative financial liabilities	18,119	1,920	5,469	11,078	3,926	40,512

In addition, the Group has a maximum credit risk exposure of £10,831 million (2010: £22,975 million) in respect of financial guarantees.

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

The principal amount for undated subordinated liabilities with no redemption option is included within the over five years column; interest of approximately £187 million (2010: £448 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

Further information on the Group's liquidity exposures is provided on pages 112 to 118.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 56: Financial risk management (continued)

Liabilities arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2011	**748**	**1,724**	**5,257**	**18,132**	**53,130**	**78,991**
At 31 December 2010	2,481	1,459	5,072	18,431	53,286	80,729

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

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2011					
Acceptances and endorsements	**81**	**–**	**–**	**–**	**81**
Other contingent liabilities	**1,514**	**1,092**	**426**	**757**	**3,789**
Total contingent liabilities	**1,595**	**1,092**	**426**	**757**	**3,870**
Lending commitments	**71,216**	**13,999**	**17,380**	**2,287**	**104,882**
Other commitments	**701**	**–**	**–**	**–**	**701**
Total commitments	**71,917**	**13,999**	**17,380**	**2,287**	**105,583**
Total contingents and commitments	**73,512**	**15,091**	**17,806**	**3,044**	**109,453**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2010					
Acceptances and endorsements	48	–	–	–	48
Other contingent liabilities	1,897	1,248	269	717	4,131
Total contingent liabilities	1,945	1,248	269	717	4,179
Lending commitments	76,456	22,537	13,424	3,739	116,156
Other commitments	1,038	61	–	43	1,142
Total commitments	77,494	22,598	13,424	3,782	117,298
Total contingents and commitments	79,439	23,846	13,693	4,499	121,477

Capital risk

Capital risk is defined as the risk of the Group having a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Capital risk appetite is set by the Board and reported through various metrics that enable the Group to manage capital constraints and market expectations. The Group Chief Executive, assisted by the Group Asset and Liability Committee, regularly reviews performance against risk appetite. A key metric is the Group's core tier 1 capital ratio which the Group currently aims to maintain prudently in excess of 10 per cent.

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

Additionally an extensive series of stress analyses is undertaken during the year to determine the adequacy of the Group's capital resources against the FSA minimum requirements in severe economic conditions.

Insurance risk

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 57: Consolidated cash flow statement

(A) Change in operating assets

	2011 £m	2010 £m	2009 £m
Change in loans and receivables	39,361	40,101	50,935
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	5,867	(7,378)	12,063
Change in other operating assets	(1,131)	(863)	(1,056)
Change in operating assets	**44,097**	31,860	61,942

(B) Change in operating liabilities

	2011 £m	2010 £m	2009 £m
Change in deposits from banks	(10,480)	(32,162)	(71,267)
Change in customer deposits	20,283	(13,249)	11,474
Change in debt securities in issue	(43,893)	(5,655)	(26,578)
Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss	14,249	160	(27,037)
Change in investment contract liabilities	793	8,161	5,415
Change in other operating liabilities	(139)	(2,938)	2,066
Change in operating liabilities	**(19,187)**	(45,683)	(105,927)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 57: Consolidated cash flow statement (continued)

(C) Non-cash and other items

	2011 £m	2010 £m	2009 £m
Depreciation and amortisation	**2,175**	2,432	2,560
Impairment of tangible fixed assets	**65**	202	–
Revaluation of investment properties	**107**	(434)	214
Allowance for loan losses	**8,069**	10,771	16,028
Write-off of allowance for loan losses	**(7,405)**	(6,909)	(4,090)
Impairment of available-for-sale financial assets	**80**	106	602
Impairment of goodwill	**–**	–	240
Change in insurance contract liabilities	**(2,081)**	4,021	5,986
Customer goodwill payments provision	**–**	500	–
Payment protection insurance provision	**3,200**	–	–
German insurance business litigation provision	**175**	–	–
Other provision movements	**(294)**	49	95
Net charge (credit) in respect of defined benefit schemes	**199**	(455)	529
Gain on acquisition	**–**	–	(11,173)
Impact of consolidation and deconsolidation of OEICs[1]	**(6,094)**	(878)	(660)
Unwind of discount on impairment allowances	**(226)**	(403)	(446)
Foreign exchange impact on balance sheet[2]	**302**	(1,159)	156
Liability management gains within other income[3]	**(599)**	(423)	(1,498)
Interest expense on subordinated liabilities	**2,155**	3,619	2,550
Loss on disposal of businesses	**21**	314	–
Other non-cash items	**1,186**	472	(340)
Total non-cash items	**1,035**	11,825	10,753
Contributions to defined benefit schemes	**(838)**	(653)	(1,867)
Payments in respect of customer goodwill payments provision	**(497)**	–	–
Payments in respect of payment protection insurance provision	**(1,045)**	–	–
Other	**6**	1	21
Total other items	**(2,374)**	(652)	(1,846)
Non-cash and other items	**(1,339)**	11,173	8,907

[1] These OEICs (Open-ended investment companies) are mutual funds which are consolidated if the Group manages the funds and also has a majority beneficial interest. The population of OEICs to be consolidated varies at each reporting date as external investors acquire and divest holdings in the various funds. The consolidation of these funds is effected by the inclusion of the fund investments and a matching liability to the unitholders; and changes in funds consolidated represent a non-cash movement on the balance sheet.

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

[3] A number of capital transactions entered into by the Group in 2009, 2010 and 2011 involved the exchange of existing securities for new issues and as a result there was no related cash flow.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 57: Consolidated cash flow statement (continued)

(D) Analysis of cash and cash equivalents as shown in the balance sheet

	2011 £m	2010 £m	2009 £m
Cash and balances at central banks	60,722	38,115	38,994
Less: mandatory reserve deposits[1]	(1,070)	(1,089)	(728)
	59,652	37,026	38,266
Loans and advances to banks	32,606	30,272	35,361
Less: amounts with a maturity of three months or more	(6,369)	(4,998)	(7,937)
	26,237	25,274	27,424
Total cash and cash equivalents	**85,889**	62,300	65,690

[1] Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

Included within cash and cash equivalents at 31 December 2011 is £21,601 million (2010: £14,694 million; 2009:£13,323 million) held within the Group's life funds, which is not immediately available for use in the business.

(E) Acquisition of group undertakings and businesses

	2011 £m	2010 £m	2009 £m
Net assets of HBOS acquired (note 14)	–	–	18,960
Satisfied by:			
Issue of shares	–	–	(7,651)
Gain on acquisition	–	–	(11,173)
Cash and cash equivalents acquired, net of acquisition costs	–	–	16,341
	–	–	(2,483)
Net cash inflow arising from acquisition of HBOS	–	–	16,477
Acquisition of and additional investment in joint ventures	(10)	(65)	(215)
Net cash (outflow) inflow arising from acquisitions in the year	(10)	(65)	16,262
Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000	(3)	(8)	(35)
Net cash (outflow) inflow	**(13)**	(73)	16,227

(F) Disposal and closure of group undertakings and businesses

	2011 £m	2010 £m	2009 £m
Intangible assets	–	–	170
Other net assets and liabilities	319	742	241
	319	742	411
Loss on sale of businesses	(21)	(314)	–
Net cash inflow from disposals	**298**	428	411

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 58: 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 losses were £539 million. The income statement charge for 2011 would have been approximately £200 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.

Note 59: Approval of financial statements

The consolidated financial statements were approved by the directors of Lloyds Banking Group plc on 27 February 2012.

REPORT OF THE INDEPENDENT AUDITORS ON THE PARENT COMPANY FINANCIAL STATEMENTS

Independent auditors' report to the members of Lloyds Banking Group plc

We have audited the parent company financial statements of Lloyds Banking Group plc for the year ended 31 December 2011 which comprise the parent company balance sheet, the parent company statement of changes in equity, the parent company cash flow statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement on page 176, the directors are responsible for the preparation of the parent company financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the parent company financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the parent company financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2011 and of its cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report for the financial year for which the parent company financial statements are prepared is consistent with the parent company financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Other matter

We have reported separately on the group financial statements of Lloyds Banking Group plc for the year ended 31 December 2011.

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

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

PARENT COMPANY BALANCE SHEET

at 31 December

	Note	2011 £ million	2010 £ million
Assets			
Non-current assets:			
Investment in subsidiaries	9	**40,534**	38,194
Loans to subsidiaries	9	**8,286**	8,332
Deferred tax asset	2	**8**	6
		48,828	46,532
Current assets:			
Derivative financial instruments		**1,660**	1,664
Other assets		**880**	1,040
Amounts due from subsidiaries	3	**212**	217
Cash and cash equivalents		**1,105**	375
Current tax recoverable		**–**	109
		3,857	3,405
Total assets		**52,685**	49,937
Equity and liabilities			
Capital and reserves:			
Share capital	4	**6,881**	6,815
Share premium account	4	**16,541**	16,291
Merger reserve	5	**7,764**	7,764
Capital redemption reserve	5	**4,115**	4,115
Retained profits	6	**2,198**	2,276
Total equity		**37,499**	37,261
Non-current liabilities:			
Debt securities in issue	8	**555**	–
Subordinated liabilities	7	**4,308**	4,074
		4,863	4,074
Current liabilities:			
Debt securities in issue		**–**	549
Current tax liabilities		**10**	–
Other liabilities		**10,313**	8,053
		10,323	8,602
Total liabilities		**15,186**	12,676
Total equity and liabilities		**52,685**	49,937

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

The directors approved the parent company financial statements on 27 February 2012.

Sir Winfried Bischoff
Chairman

António Horta-Osório
Group Chief Executive

PARENT COMPANY STATEMENT OF CHANGES IN EQUITY

at 31 December 2011

	Share capital and premium £ million	Merger reserve £ million	Capital redemption reserve £ million	Retained profits[1] £ million	Total £ million
Balance at 1 January 2009	3,609	–	–	2,147	5,756
Total comprehensive income[1]	–	–	–	303	303
Issue of ordinary shares:					
Placing and open offer	649	3,781	–	–	4,430
Issued on acquisition of HBOS	1,944	5,707		–	7,651
Placing and compensatory open offer	3,905	–	–	–	3,905
Rights issue	13,112	–	–	–	13,112
Issued to Lloyds TSB Foundations	41	–	–	–	41
Transfer to merger reserve	(1,000)	1,000	–	–	–
Redemption of preference shares	2,684	(2,710)	26	–	–
Movement in treasury shares	–	–	–	(12)	(12)
Value of employee services:					
Share option schemes	–	–	–	74	74
Other employee award schemes	–	–	–	35	35
Balance at 31 December 2009	24,944	7,778	26	2,547	35,295
Total comprehensive income[1]	–	–	–	(799)	(799)
Issue of ordinary shares	2,237	–	–	–	2,237
Cancellation of deferred shares	(4,086)	–	4,086	–	–
Redemption of preference shares	11	(14)	3	–	–
Movement in treasury shares	–	–	–	(10)	(10)
Value of employee services:					
Share option schemes	–	–	–	129	129
Other employee award schemes	–	–	–	409	409
Balance at 31 December 2010	23,106	7,764	4,115	2,276	37,261
Total comprehensive income[1]	**–**	**–**	**–**	**(168)**	**(168)**
Issue of ordinary shares	**316**	**–**	**–**	**–**	**316**
Movement in treasury shares	**–**	**–**	**–**	**(291)**	**(291)**
Value of employee services:					
Share option schemes	**–**	**–**	**–**	**143**	**143**
Other employee award schemes	**–**	**–**	**–**	**238**	**238**
Balance at 31 December 2011	**23,422**	**7,764**	**4,115**	**2,198**	**37,499**

[1] Total comprehensive income comprises only the profit (loss) for the year; no income statement has been shown for the parent company, as permitted by section 408 of the Companies Act 2006.

PARENT COMPANY CASH FLOW STATEMENT

at 31 December

	2011 £ million	2010 £ million	2009 £ million
(Loss) profit before tax	**(202)**	(961)	182
Dividend income	**–**	–	(354)
Fair value and exchange adjustments	**329**	198	(428)
Change in other assets	**255**	1,021	(1,277)
Change in other liabilities and other items	**2,576**	(2,466)	7,020
Tax received (paid)	**151**	122	(70)
Net cash provided by (used in) operating activities	**3,109**	(2,086)	5,073
Cash flows from investing activities			
Costs incurred in respect of the acquisition of HBOS plc	**–**	–	(138)
Capital injection into HBOS plc	**–**	–	(8,500)
Capital injection into Lloyds TSB Bank plc	**(2,340)**	–	(5,600)
Amounts advanced to subsidiaries	**–**	(1,425)	(7,593)
Redemption of loans to subsidiaries	**–**	850	1,552
Net cash used in investing activities	**(2,340)**	(575)	(20,279)
Cash flows from financing activities			
Dividends received from subsidiaries	**–**	–	354
Interest paid on subordinated liabilities	**(39)**	–	–
Proceeds from issue of debt securities	**–**	549	–
Repayment of debt securities in issue	**–**	(350)	(2,045)
Proceeds from issue of subordinated liabilities	**–**	–	1,000
Repayment of subordinated liabilities	**–**	–	(4,000)
Proceeds from issue of ordinary shares	**–**	–	21,533
Net cash (used in) provided by financing activities	**(39)**	199	16,842
Change in cash and cash equivalents	**730**	(2,462)	1,636
Cash and cash equivalents at beginning of year	**375**	2,837	1,201
Cash and cash equivalents at end of year	**1,105**	375	2,837

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

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 1: Accounting policies

The Company has applied International Financial Reporting Standards as adopted by the European Union in its financial statements for the year ended 31 December 2011. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Company has not taken advantage of this relaxation, and therefore there is no difference in application to the Company between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of all derivative contracts.

The accounting policies of the Company are the same as those of the Group which are set out in note 2 to the consolidated financial statements, except that it has no policy in respect of consolidation and investments in subsidiaries are carried at historical cost, less any provisions for impairment.

Note 2: Deferred tax asset

The movement in the net deferred tax asset is as follows:

	2011 £m	2010 £m
At 1 January	6	3
Income statement credit	2	3
At 31 December	8	6

The deferred tax asset relates to temporary differences.

Note 3: Amounts due from subsidiaries

These comprise short-term lending to subsidiaries, repayable on demand. The fair values of amounts owed by subsidiaries are equal to their carrying amounts. No provisions have been recognised in respect of amounts owed by subsidiaries.

Note 4: Share capital and share premium

Details of the Company's share capital and share premium account are as set out in notes 47 and 48 to the consolidated financial statements.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 5: Other reserves

The merger reserve comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

Movements in other reserves were as follows:

	2011 £m	2010 £m	2009 £m
Merger reserve			
At 1 January	**7,764**	7,778	–
Placing and open offer	**–**	–	3,781
Shares issued on acquisition of HBOS	**–**	–	5,707
Issue of preference shares[1]	**–**	–	1,000
Redemption of preference shares[2]	**–**	(14)	(2,710)
At 31 December	**7,764**	7,764	7,778

	2011 £m	2010 £m	2009 £m
Capital redemption reserve			
At 1 January	**4,115**	26	–
Redemption of preference shares[2]	**–**	3	26
Cancellation of deferred shares	**–**	4,086	–
At 31 December	**4,115**	4,115	26

[1] Distributable reserves of £1,000 million arose on the issue of preference shares in January 2009 which were classified as debt. In June 2009, these preference shares were redeemed out of the proceeds of the placing and compensatory open offer of ordinary shares and the distributable element of this issue was transferred to the merger reserve.

[2] In January 2010, the Company repurchased and cancelled certain preference shares amounting to £14 million. This resulted in a transfer of £3 million from the merger reserve to the capital redemption reserve and a transfer of £11 million from the merger reserve to the share premium account. Details of the preference shares redeemed are set out in note 46 to the consolidated financial statements. In December 2009, the Group redeemed eight issues of preference shares in exchange for the issuance of Enhanced Capital Notes. This resulted in a transfer of £26 million from the merger reserve to the capital redemption reserve and a transfer of £2,684 million from the merger reserve to the share premium account.

Note 6: Retained profits

	£m
At 1 January 2009	2,147
Profit for the year	303
Movement in treasury shares	(12)
Value of employee services:	
Share option schemes	74
Other employee award schemes	35
At 31 December 2009	2,547
Loss for the year	(799)
Movement in treasury shares	(10)
Value of employee services:	
Share option schemes	129
Other employee award schemes	409
At 31 December 2010	2,276
Loss for the year	**(168)**
Movement in treasury shares	**(291)**
Value of employee services:	
Share option schemes	**143**
Other employee award schemes	**238**
At 31 December 2011	**2,198**

Details of the Company's dividends are as set out in note 51 to the consolidated financial statements.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 7: Subordinated liabilities

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer. Any repayments of subordinated liabilities require the consent of the Financial Services Authority.

	Note	2011 £m	2010 £m
Preference shares			
6% Non-Cumulative Redeemable Preference Shares	a	–	–
7.875% Non-Cumulative Preference Shares callable 2013 (US$1,250 million)	a	170	119
7.875% Non-Cumulative Preference Shares callable 2013 (€500 million)	a	83	57
6.0884% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2015 (£745 million)	a	10	9
5.92% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2015 (US$750 million)	a	124	110
6.267% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million)	a	306	279
6.3673% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2019 (£335 million)	a	2	2
6.475% Non-Cumulative Preference Shares callable 2024 (£186 million)	a	38	34
6.413% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2035 (US$750 million)	a	114	98
6.657% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2037 (US$750 million)	a	131	115
9.25% Non-Cumulative Irredeemable Preference Shares (£300 million)	a	266	239
9.75% Non-Cumulative Irredeemable Preference Shares (£100 million)	a	54	49
Total preference shares		**1,298**	**1,111**
Undated subordinated liabilities			
6.0884% Undated Subordinated Notes callable 2015 (£732 million)		642	578
6.369% Undated Subordinated Notes callable 2015 (£597 million)		533	480
5.92% Undated Subordinated Notes callable 2015 (US$378 million)		188	164
6.267% Undated Subordinated Notes callable 2016 (US$466 million)		227	198
6.3673% Undated Subordinated Notes callable 2019 (£331 million)		291	266
6.475% Undated Subordinated Notes callable 2024 (£102 million)		87	80
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	b	11	11
6.413% Undated Subordinated Notes callable 2035 (US$375 million)		171	155
6.657% Undated Subordinated Notes callable 2037 (US$316 million)		143	130
Total undated subordinated liabilities		**2,293**	**2,062**
Dated subordinated liabilities			
9.125% Subordinated Bonds 2011 (£150 million)		–	152
5.875% Subordinated Guaranteed Bonds 2014 (€750 million)		717	749
Total dated subordinated liabilities		**717**	**901**
Total subordinated liabilities		**4,308**	**4,074**

a Further information regarding these issues can be found in note 46 to the consolidated financial statements.

b In certain circumstances, these bonds would acquire the characteristics of preference share capital. They are accounted for as liabilities as coupon payments are mandatory as a consequence of the terms of the 6 per cent non-cumulative redeemable preference shares. At the callable date the coupon on these bonds will be reset by reference to the applicable five year benchmark gilt rate. Further information regarding this can be found in note 46 to the consolidated financial statements.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 8: Debt securities in issue

These comprise US$862.5 million 7.75% Public Income Notes due 2050 issued by the Company in July 2010.

Note 9: Related party transactions

In January 2009 HM Treasury became a related party of the Company and has remained so during 2010 and 2011. From 1 January 2011, in accordance with IAS 24 (Revised), UK Government-controlled entities also became related parties of the Group. Further information on the relationship and transactions with HM Treasury and UK Government-controlled entities is given in note 53 to the consolidated financial statements.

Key management personnel

The key management personnel of the Group and the Company are the same. The relevant disclosures are given in note 53 to the consolidated financial statements.

The Company has no employees (2010: nil).

As discussed in note 52 to the consolidated financial statements, the Group provides share-based compensation to employees through a number of schemes; these are all in relation to shares in the Company and the cost of providing those benefits is recharged to the employing companies in the Group on a cash basis.

Investment in subsidiaries

	2011 £m	2010 £m
At 1 January	**38,194**	32,584
Capital injections into Lloyds TSB Bank plc	**2,340**	27,005
Transfer of HBOS to Lloyds TSB Bank plc	**–**	(21,395)
At 31 December	**40,534**	38,194

As part of a reorganisation of the Lloyds Banking Group on 1 January 2010, the Company transferred its direct investment in 100 per cent of the issued ordinary share capital of HBOS plc to its subsidiary, Lloyds TSB Bank plc. The consideration for this transfer was the issue of 21.4 million shares by Lloyds TSB Bank plc to the Company for a total value of £21,395 million.

The principal subsidiaries, all of which have prepared accounts to 31 December and whose results are included in the consolidated accounts of Lloyds Banking Group plc, are:

	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Lloyds TSB Bank plc	England	100%	Banking and financial services
Scottish Widows plc	Scotland	100%[1]	Life assurance
HBOS plc	Scotland	100%[1]	Holding company
Bank of Scotland plc	Scotland	100%[1]	Banking and financial services
St. Andrew's Insurance plc	England	100%[1]	General insurance
Clerical Medical Investment Group Limited	England	100%[1]	Life assurance
Clerical Medical Managed Funds Limited	England	100%[1]	Life assurance

[1] Indirect interest.

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

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 9: Related party transactions (continued)

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, Lloyds Banking Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. The Group 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, 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 payments.

Subject to the foregoing, there were no further significant restrictions on any of the Company's subsidiaries in paying dividends or repaying loans and advances. All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

Loans to subsidiaries

	2011 £m	2010 £m
At 1 January	**8,332**	7,466
Exchange and other adjustments	**(46)**	291
Amounts advanced	**–**	1,425
Redemptions	**–**	(850)
At 31 December	**8,286**	8,332

In addition the Company carried out banking activities through its subsidiary, Lloyds TSB Bank plc. At 31 December 2011, the Company held deposits of £1,105 million with Lloyds TSB Bank plc (2010: £375 million). Given the volume of transactions flowing through the account, it is not meaningful to provide gross inflow and outflow information. Included within subordinated liabilities is £2,287 million (2010: £2,073 million) and within other liabilities is £10,261 million (2010: £7,988 million) due to subsidiary undertakings. In addition, at 31 December 2011 the Company had interest rate and currency swaps with Lloyds TSB Bank plc with an aggregate notional principal amount of £2,338 million and a net positive fair value of £1,660 million (2010: notional principal amount of £2,504 million and a net positive fair value of £1,664 million), of which contracts with an aggregate notional principal amount of £1,349 million and a net positive fair value of £314 million (2010: notional principal amount of £1,754 million and a net positive fair value of £330 million) were designated as fair value hedges to manage the Company's issuance of subordinated liabilities and debt securities in issue.

Related party information in respect of other related party transactions is given in note 53 to the consolidated financial statements.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 10: Financial instruments

Measurement basis of financial assets and liabilities

The accounting policies in note 2 to the consolidated financial statements describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the Company's financial assets and liabilities by category and by balance sheet heading.

	Derivatives designated as hedging instruments, held at fair value through profit or loss £m	Held for trading at fair value through profit or loss £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2011					
Financial assets:					
Cash and cash equivalents	**–**	**–**	**–**	**1,105**	**1,105**
Derivative financial instruments	**314**	**1,346**	**–**	**–**	**1,660**
Loans to subsidiaries	**–**	**–**	**8,286**	**–**	**8,286**
Amounts due from subsidiaries	**–**	**–**	**212**	**–**	**212**
Total financial assets	**314**	**1,346**	**8,498**	**1,105**	**11,263**
Financial liabilities:					
Debt securities in issue	**–**	**–**	**–**	**555**	**555**
Subordinated liabilities	**–**	**–**	**–**	**4,308**	**4,308**
Total financial liabilities	**–**	**–**	**–**	**4,863**	**4,863**
At 31 December 2010					
Financial assets:					
Cash and cash equivalents	–	–	–	375	375
Derivative financial instruments	330	1,334	–	–	1,664
Loans to subsidiaries	–	–	8,332	–	8,332
Amounts due from subsidiaries	–	–	217	–	217
Total financial assets	330	1,334	8,549	375	10,588
Financial liabilities:					
Debt securities in issue	–	–	–	549	549
Subordinated liabilities	–	–	–	4,074	4,074
Total financial liabilities	–	–	–	4,623	4,623

Note 55 to the consolidated financial statements outlines the valuation hierarchy into which financial instruments measured at fair value are categorised.

The derivative assets designated as hedging instruments represent level 2 portfolios. Of derivative assets classified as held for trading (not being designated as hedging instruments) shown above, £174 million (31 December 2010: £157 million) represents level 2 portfolios and £1,172 million (31 December 2010: £1,177 million) represents level 3 portfolios. The level 3 derivatives reflect the value of the equity conversion feature of the Enhanced Capital Notes issued in December 2009 as part of Lloyds Banking Group's recapitalisation and exit from the Government Asset Protection Scheme.

The following reconciliation shows the movements in derivative financial instrument assets within level 3 portfolios:

	2011 £m	2010 £m
At 1 January	**1,177**	1,797
Losses recognised in the income statement	**(5)**	(620)
At 31 December	**1,172**	1,177

Interest rate risk and currency risk

The Company is exposed to interest rate risk and currency risk on its debt securities in issue and its subordinated debt.

As discussed in note 9, the Company has entered into interest rate and currency swaps with its subsidiary, Lloyds TSB Bank plc, to manage these risks.

NOTES TO THE PARENT COMPANY FINANCIAL STATEMENTS

Note 10: Financial instruments (continued)

Credit risk

The majority of the Company's credit risk arises from amounts due from its wholly owned subsidiary, Lloyds TSB Bank plc, and subsidiaries of that company.

Liquidity risk

The table below analyses financial instrument liabilities of the Company, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2011						
Debt securities in issue	**11**	**–**	**32**	**688**	**–**	**731**
Subordinated liabilities	**–**	**2**	**165**	**1,934**	**946**	**3,047**
Total financial instrument liabilities	**11**	**2**	**197**	**2,622**	**946**	**3,778**
At 31 December 2010						
Debt securities in issue	11	–	32	728	–	771
Subordinated liabilities	–	–	202	4,024	2,380	6,606
Total financial instrument liabilities	11	–	234	4,752	2,380	7,377

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £303 million (2010: £302 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

Fair values of financial assets and liabilities

The valuation techniques for the Company's financial instruments are as discussed in note 55 to the consolidated financial statements.

	2011		2010	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets:				
Cash and cash equivalents	**1,105**	**1,105**	375	375
Derivative financial instruments	**1,660**	**1,660**	1,664	1,664
Loans to subsidiaries	**8,286**	**8,291**	8,332	8,713
Amounts due from subsidiaries	**212**	**212**	217	217
Financial liabilities:				
Debt securities in issue	**555**	**555**	549	549
Subordinated liabilities	**4,308**	**3,370**	4,074	4,207

Note 11: Approval of the financial statements and other information

The parent company financial statements were approved by the directors of Lloyds Banking Group plc on 27 February 2012.

Lloyds Banking Group plc was incorporated as a public limited company and registered in Scotland under the UK Companies Act 1985 on 21 October 1985 with the registered number 95000. Lloyds Banking Group plc's registered office is The Mound, Edinburgh EH1 1YZ, Scotland, and its principal executive offices in the UK are located at 25 Gresham Street, London EC2V 7HN.

OTHER INFORMATION

SHAREHOLDER INFORMATION

Annual general meeting

The annual general meeting will be held at 11.30am on Thursday 17 May 2012 at the Edinburgh International Conference Centre, The Exchange, Edinburgh, EH3 8EE. Further details about the meeting, including the proposed resolutions, can be found in our Notice of annual general meeting which is sent to all shareholders who have requested paper copy documents. It is also available on our website www.lloydsbankinggroup.com

Shareholder enquiries

The Company's share register and the Lloyds Banking Group Shareholder Account are maintained by Equiniti Limited. Contact them using the details below if you have enquiries about your shareholding, including:

– Change of name or address

– Loss of share certificate

– Dividend information, including loss of dividend warrant or tax voucher.

Equiniti Limited
Aspect House
Spencer Road
Lancing
West Sussex BN99 6DA

Telephone 0871 384 2990[1]
Textphone 0871 384 2255
Overseas +44 (0)121 415 7066

Telephone lines are open 8.30am to 5.30pm, Monday to Friday.

[1] Calls to 0871 numbers are charged at 8p per minute from a BT landline. The price of calls from mobiles and other networks may vary. Calls from outside the United Kingdom are charged at applicable international rates. The call prices we have quoted were correct in February 2012.

Equiniti operates a web based enquiry and portfolio management service for you to receive shareholder communications electronically and to register your proxy appointments or voting instructions online. You can also change your address or bank details either by telephone or online. Visit www.shareview.co.uk for details.

Share price information

Shareholders can access both the latest and historical share prices via our website, www.lloydsbankinggroup.com, as well as listings in most national newspapers. For a real time buying or selling price, you will need to contact a stockbroker, or you can contact the sharedealing providers detailed below.

Share dealing facilities

Lloyds Banking Group offers shareholders a choice of two dealing services:

Lloyds TSB Share Dealing

– Internet dealing. Visit www.lloydstsbsharedealing.com

– Telephone dealing. Call 0845 60 60 560

Internet services are available 24/7 and telephone services are available between 8.00am and 6.00pm, Monday to Friday. Details of any dealing costs are available when you log on to the share dealing website or when you call the above number. To open a Lloyds TSB Share Dealing Account you must be 18 years of age or over and be resident in the UK, the Channel Islands or the Isle of Man. You can apply online or by post.

Halifax Share Dealing

– Internet dealing. Visit www.halifaxsharedealing.co.uk

– Telephone dealing. Call 08457 22 55 25

Internet services are available 24/7 and telephone services are available between 8.00am and 9.15pm, Monday to Friday, and 9.00am to 1.00pm, Saturday. To open a Halifax Share Dealing Account you must be 18 years of age or over and be resident in the UK, Jersey, Guernsey or the Isle of Man.

Shareholders in the Lloyds Banking Group Shareholder Account can only trade by telephone through the Halifax Share Dealing Service.

Individual Savings Accounts (ISAs)

The Company provides a number of options for investing in Lloyds Banking Group shares through an ISA. For details contact: Lloyds TSB Share Dealing, Halifax Share Dealing or Equiniti Limited.

SHAREHOLDER INFORMATION

American Depositary Receipts (ADRs)

Lloyds Banking Group shares are traded in the USA through an NYSE-listed sponsored ADR facility, with The Bank of New York Mellon as the depositary. The ADRs are traded on the New York Stock Exchange under the symbol LYG. The CUSIP number is 539439109 and the ratio of ADRs to ordinary shares is 1:4.

For details contact: The Bank of New York Mellon, PO Box 358516, Pittsburgh, Pennsylvania 15252-8516.
Telephone: 1-866-259-0336 (US toll free), international callers: +1 201-680-6825. Alternatively visit www.adrbnymellon.com or email shrrelations@bnymellon.com

Analysis of shareholders

At 31 December 2011	Shareholders		Number of ordinary shares	
Size of shareholding	Number	%	Millions	%
1 – 99	156,887	5.66	6.1	0.01
100 – 499	1,641,748	59.28	374.4	0.54
500 – 999	449,386	16.23	309.9	0.45
1,000 – 4,999	403,203	14.56	821.7	1.20
5,000 – 9,999	55,675	2.01	388.1	0.56
10,000 – 49,999	54,424	1.96	1,078.3	1.57
50,000 – 99,999	4,674	0.17	313.0	0.46
100,000 – 999,999	2,610	0.09	600.7	0.87
1,000,000 and over	977	0.04	64,834.4	94.34
	2,769,584	100.00	68,726.6	100.00

Share sale fraud

Lloyds Banking Group have been made aware of an increasing number of share sale frauds being reported by listed companies. This involves bogus stockbrokers, usually based overseas, cold calling people to:

– either pressure them into buying shares that promise high returns; or

– offer to buy their shares at an inflated price claiming that there is a 'secret' takeover or merger. This is followed by a request for an upfront cash bond to commit to the deal.

In reality, the shares or secret information are either worthless or nonexistent and if you receive such a call, we strongly recommend that you seek independent investment advice from an FSA authorised adviser before you take any action.

If you are concerned that you may have been targeted by such a scheme, please contact the FSA Consumer Helpline on 0845 606 1234, www.fsa.gov.uk or Action Fraud on 0300 123 2040, www.actionfraud.org.uk for further advice.

FORWARD LOOKING STATEMENTS

This annual report 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 Lloyds Banking Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about Lloyds Banking Group or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will 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 credit ratings; the ability to derive cost savings and other benefits including, without limitation, as a result of the integration of HBOS and the Group's Simplification Programme; changing demographic developments including mortality and changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets including Eurozone instability; 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 the Group as a result of HM Treasury's investment in the Group; the ability to complete satisfactorily the disposal of certain assets as part of the Group's EU State Aid obligations; the extent of any future impairment charges or write-downs caused by depressed asset valuations; market 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.

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

GLOSSARY

Asset-Backed Securities (ABS)	Asset-backed securities are securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages but could also include leases, credit card receivables, motor vehicles, student loans. Further information on the Group's investments in ABS is given in note 56.
Asset Quality Ratio	The impairment charge for the year in respect of loans and advances to customers expressed as a percentage of average loans and advances to customers.
Alt-A	Alt-A are mortgage loans regarded as lower risk than sub-prime, but they share higher risk characteristics than lending under normal criteria. Further information on the Group's exposure to Alt-A investments is given in note 56.
Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency. When a customer is in arrears, the entire outstanding balance is said to be delinquent, meaning that delinquent balances are the total outstanding loans on which payments are overdue.
Asset-backed commercial paper	See **Commercial Paper**
Bank levy	The levy that applies to certain UK banks, UK building societies and the UK operations of foreign banks from 1 January 2011. The levy is payable based on a percentage of the chargeable equity and liabilities of the bank as at the balance sheet date.
Basel II	The capital adequacy framework issued by the Basel Committee on Banking Supervision in June 2006 in the form of the 'International Convergence of Capital Measurement and Capital Standards'.
Basel III	The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in from 1 January 2013 onwards.
Basis point	One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates or yields on securities.
Buy-to-let mortgages	Buy-to-let mortgages are those mortgages offered to customers purchasing residential property as a rental investment.
Collateralised Debt Obligation (CDO)	A security issued by a third party which references ABSs or other assets purchased by the issuer. Lloyds Banking Group has invested in instruments issued by other banking groups, including Collateralised Loan Obligations and Commercial Real Estate CDOs. Details of these investments are given in note 56.
Collateralised Loan Obligation (CLO)	A security backed by the repayments from a pool of commercial loans. CLOs are usually structured products with different tranches whereby senior classes of holder receive repayment before other tranches are repaid.
Collectively assessed loan impairment provision	A provision established following an impairment assessment on a collective basis for homogeneous groups of loans, such as credit card receivables and personal loans, that are not considered individually significant and for loan losses that have been incurred but not separately identified at the balance sheet date.
Commercial Mortgage-Backed Securities	Commercial Mortgage-Backed Securities are securities that represent interests in a pool of commercial mortgages. Investors in these securities have the right to cash received from mortgage repayments of interest and principal. Further information on the Group's investment in CMBS is given in note 56.
Commercial Paper	Commercial paper is an unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date. Commercial Paper can be issued as an unsecured obligation of the Group or, for example when issued by the Group's conduits, as an asset-backed obligation. (in such case it is referred to as **asset-backed commercial paper**). Commercial Paper is usually issued for periods from as little as a week up to nine months.
Commercial Real Estate	Commercial real estate includes office buildings, industrial property, medical centres, hotels, malls, retail stores, shopping centres, farm land, multifamily housing buildings, warehouses, garages, and industrial properties.
Conduits	A financial vehicle that holds asset-backed securities which are financed with short-term deposits (generally commercial paper) that use the asset-backed securities as collateral. The conduit will often have a liquidity line provided by a bank that it can draw down on in the event that it is unable to issue funding to the market. The Group sponsors three asset-backed conduits, Argento, Cancara and Grampian. Further details are provided in note 23.
Contractual maturities	Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.
Core tier 1 capital	As defined by the FSA mainly comprising shareholders' equity and equity non-controlling interests after deducting goodwill, other intangible assets and other regulatory deductions. Further details are given in the Capital Risk section on page 118.

GLOSSARY

Core tier 1 ratio	Core tier 1 capital as a percentage of risk weighted assets.
Cost:Income ratio	Operating expenses compared to total income net of insurance claims. The Group calculates this ratio using the 'reported basis' which is the basis on which financial information is reported internally to management.
Coverage ratio	Impairment provisions as a percentage of impaired loans.
Covered mortgage bonds	A bond backed by a pool of mortgage loans. The mortgages remain on the issuer's balance sheet. The issuing bank can change the make-up of the loan pool or the terms of the loans to preserve credit quality. Covered bonds thus have a higher risk weighting than mortgage-backed securities because the holder is exposed to both the non-payment of the mortgages and the financial health of the issuer. The Group issues covered bonds as part of its funding activities. Further details are provided in note 22.
Credit Default Swap	A credit default swap is also referred to as a credit derivative. It is an arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection. A credit default swap is a contract where the protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.
Credit derivatives	A credit derivative is a financial instrument that derives its value from the credit rating of an underlying instrument carrying the credit risk of the issuing entity. The principal type of credit derivatives are credit default swaps, which are used by the Group as part of its trading activity and to manage its own exposure to credit risk.
Credit Risk	The risk of reductions in earnings and/or value, through financial loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).
Credit risk spread (or credit spread)	The credit spread is the yield spread between securities with the same currency and maturity structure but with different associated credit risks, with the yield spread rising as the credit rating worsens. It is the premium over the benchmark or risk-free rate required by the market to take on a lower credit quality.
Credit valuation adjustments	These are adjustments to the fair values of derivative assets to reflect the creditworthiness of the counterparty. Further details are given in note 55.
Customer deposits	Money deposited by account holders. Such funds are recorded as liabilities of the Group. The Group includes certain **repos** within customer deposits.
Debt restructuring	This is when the terms and provisions of outstanding debt agreements are changed. This is often done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as reducing the debt or interest charged on the loan.
Debt securities	Debt securities are assets held by the Group representing certificates of indebtedness of credit institutions, public bodies or other undertakings, excluding those issued by Central Banks.
Debt securities in issue	These are unsubordinated debt securities issued by the Group. They include commercial paper, certificates of deposit, bonds and medium-term notes.
Delinquency	See **Arrears**.
Embedded equity conversion feature	An embedded equity conversion feature is a derivative contained within the terms and conditions of a debt instrument that enables or requires the instrument to be converted into equity under a particular set of circumstances. The Group's Enhanced Capital Notes (ECNs) contain such a feature whereby these notes convert to ordinary shares in the event that the consolidated core tier 1 ratio of the Group falls below 5 per cent.
Enhanced Capital Notes (ECNs)	The Group's ECN's are subordinated notes issued by the Group that contain an embedded equity conversion feature. Further details of these are given in note 46.
Expected loss	This is the amount of loss that can be expected by the Group calculated in accordance with FSA rules. In broad terms it is calculated by multiplying the Default Frequency by the Loss Given Default by the Exposure at Default.
Exposure at Default	An estimate of the amount expected to be owed by a customer at the time of the customer's default.
Fair value adjustment	Fair value adjustments arise on acquisition when assets and liabilities are acquired at fair values that are different from the carrying values in the acquired company. In respect of the Group's acquisition of HBOS the principal adjustments were write-downs in respect of loans and advances to customers and debt issued.
First/Second Lien	A first lien gives the holder (usually the bank lending the funds) the first right to collect compensation from the sale of the underlying collateral in the event of a default on the loan. A second lien may be issued against the same collateral but in the case of default, compensation for this debt will only be received after the first lien has been repaid.

GLOSSARY

Forbearance	A term generally applied to arrangements provided to support borrowers experiencing temporary financial difficulty. Such arrangements include reduced or nil payments, term extensions, transfers to interest only and the capitalisation of arrears.
Full time equivalent	A full time employee is one that works a standard five day week. The hours or days worked by part time employees are measured against this standard and accumulated along with the number of full time employees and counted as full time equivalents. This is a more consistent measure of the amount of time worked than employee numbers which will fluctuate as the mix of part-time and full-time employees changes.
Funded/unfunded exposures	Exposures where the notional amount of the transaction is either funded or unfunded.
Guaranteed mortgages	Mortgages for which there is a guarantor to provide the lender a certain level of financial security in the event of default of the borrower.
Home Loans	A loan to purchase a residential property which is then used as collateral to guarantee repayment of the loan. The borrower gives the lender a **lien** against the property, and the lender can foreclose on the property if the borrower does not repay the loan per the agreed terms.
Impaired loans	Impaired loans are loans where the Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
Impairment allowances	Impairment allowances are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.
Impairment losses	An impairment loss is the reduction in value that arises following an impairment review of an asset that determines that the asset's value is lower than it's carrying value. For impaired financial assets measured at amortised cost, impairment losses are the difference between the carrying value and the present value of estimated future cash flows, discounted at the asset's original effective interest rate. Impairment losses can be difficult to assess and the critical accounting estimates and judgements in note 3 detail the key assessments made when determining impairment losses.
Individually/Collectively Assessed	Impairment is measured individually for assets that are individually significant, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available.
Individually assessed loan impairment provisions	Impairment loss provisions for individually significant impaired loans are assessed on a case-by-case basis, taking into account the financial condition of the counterparty, any guarantor and the realisable value of any collateral held.
Investment grade	This refers to the highest range of credit ratings, from 'AAA' to 'BBB' as measured by external credit rating agencies.
ISDA (International swaps and derivatives association) master agreement	A standardised contract developed by the ISDA which is used as an umbrella contract for bilateral derivative contracts.
Leverage finance	Funding provided for entities with higher than average indebtedness, which typically arises from sub-investment grade acquisitions or event-driven financing.
Liquidity and Credit enhancements	Credit enhancement facilities are used to enhance the creditworthiness of financial obligations and cover losses due to asset default. Two general types of credit enhancement are third-party loan guarantees (such as **guaranteed mortgages**) and self-enhancement through overcollateralisation (in the case of **covered mortgage bonds**). Liquidity enhancement makes funds available if required, for other reasons than asset default, eg to ensure timely repayment of maturing commercial paper.
Loan to deposit ratio	The ratio of loans and advances to customers net of allowance for impairment losses and excluding reverse repurchase agreements divided by customer deposits excluding repurchase agreements.
Loan-to-value ratio (LTV)	The loan-to-value ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.
Loans past due	Loans are past due when a counterparty has failed to make a payment when contractually due.
Loss emergence period	The loss emergence period is the estimated period between impairment occurring and the loss being specifically identified and evidenced by the establishment of an appropriate impairment allowance.
Loss given default	The estimated loss that will arise if a customer defaults. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.

GLOSSARY

Medium Term Notes	Medium term notes are a form of corporate borrowing covering maturity periods ranging from nine months to 30 years. Details of the notes issued under the Group's medium term notes programmes are given in note 37.
Monolines	A monoline insurer is defined as an entity which specialises in providing credit protection to the holders of debt instruments in the event of default by the debt security counterparty. This protection is typically provided in the form of derivatives such as **credit default swaps** referencing the underlying exposures held.
Mortgage-backed securities	See Residential and Commercial mortgage-backed securities.
Mortgage related assets	Assets which are referenced to underlying mortgages.
Mortgage vintage	The year the mortgage was issued.
Negative basis bonds	**ABS** held with a separately purchased matching **credit default swaps** to protect against the risk of default of the security. The Group refers to ABS without the benefit of CDS protection as **Uncovered ABS**. Details of the Group's exposure to negative basis bonds is given in note 56.
Negative Equity Mortgages	Negative equity occurs when the value of the property purchased using the mortgage is below the balance outstanding on the loan. Negative equity is the value of the asset less the outstanding balance on the loan.
Net asset value per ordinary share	Shareholders' equity divided by the number of ordinary shares and limited voting ordinary shares in issue, adjusted to exclude shares held under certain employee share ownership plans.
Net Interest Income	The difference between interest received on assets and interest paid on liabilities.
Net interest margin	Net interest margin is net interest income as a percentage of average interest-earning assets. Details of the Group's banking net interest margin are given on page 97.
Operational risk	The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people-related or external events.
Over the counter derivatives	Over the counter derivatives are derivatives for which the terms and conditions can be freely negotiated by the counterparties involved, unlike exchange traded derivatives which have standardised terms.
Prime	Prime mortgages are those granted to the most creditworthy category of borrower.
Private equity investments	Private equity is equity securities in operating companies not quoted on a public exchange. Investment in private equity often involves the investment of capital in private companies or the acquisition of a public company that results in the delisting of public equity. Capital for private equity investment is raised by retail or institutional investors and used to fund investment strategies such as leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital.
Probability of default	The likelihood that a customer will default on their obligation within the next year.
Renegotiated loans	Loans and advances are generally renegotiated either as part of an ongoing customer relationship or in response to an adverse change in the circumstances of the borrower. In the latter case renegotiation can result in an extension of the due date of payment or repayment plans under which the Group offers a concessionary rate of interest to genuinely distressed borrowers. This will result in the asset continuing to be overdue and will be impaired where the renegotiated payments of interest and principal will not recover the original carrying amount of the asset. In other cases, renegotiation will lead to a new agreement, which is treated as a new loan.
Repurchase agreements or 'repos'	Short-term funding agreements which allow a borrower to sell a financial asset, such as ABS or Government bonds as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.
Retail loans	Money loaned to individuals rather than institutions. These include both secured and unsecured loans such as mortgages and credit card balances.
Residential Mortgaged-Backed Securities	Residential Mortgage-Backed Securities are a category of **ABS**. They are securities that represent interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).
Risk-weighted assets	A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with the Basel Capital Accord as implemented by the FSA.

GLOSSARY

Securitisation	Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. Securitisation is the process by which ABS are created. A company sells assets to a special purpose entity which then issues securities backed by the assets. This allows the credit quality of the assets to be separated from the credit rating of the original company and transfers risk to external investors. Assets used in securitisations include mortgages to create mortgage-backed securities or Residential Mortgage-Backed Securities as well as commercial mortgage-backed securities. The Group has established several securitisation structures as part of its funding and capital management activities. These generally use mortgages, corporate loans and credit cards as asset pools. A listing of these programmes with the amounts secured and associated funding raised is given in note 22.
Special Purpose Entities (SPEs)	SPEs are entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses a number of SPEs, including those set-up under **securitisation** programmes, and as **conduits**. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group's results.
Specialist mortgages	Specialist mortgages include those mortgage loans provided to customers who have self-certified their income (normally as a consequence of being self-employed) or who are otherwise regarded as a sub-prime credit risk. New mortgage lending of this type has not been offered by the Group since early 2009.
Student loan related assets	Assets which are referenced to underlying student loans (see note 56).
Sub-investment grade	This refers to credit ratings issued by external credit rating agencies that are below 'BBB' grade or its equivalent.
Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer. Details of the Group's subordinated liabilities are set out in note 46.
Sub-Prime	Sub-prime is defined as loans to borrowers typically having weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, high debt-to-income ratios, or other criteria indicating heightened risk of default.
Synthetic CDO	A security that is similar in structure to a CDO whereby the pool of referenced assets is created synthetically usually by credit default swaps.
Tier 1 capital	A measure of a bank's financial strength defined by the FSA. It captures core tier 1 capital plus other tier 1 securities in issue, but is subject to a deduction in respect of material holdings in financial companies. Further details are given in the Capital Risk section on page 118.
Tier 1 capital ratio	Tier 1 capital as a percentage of risk-weighted assets.
Tier 2 capital	A component of regulatory capital defined by the FSA, mainly comprising qualifying subordinated loan capital, certain non-controlling interests and eligible collective impairment allowances. Further details are given in the Capital Risk section on page 118.
Uncovered ABS	ABS held without the benefit of separately purchased matching credit default swaps to protect against the risk of default of the security. Details of the Group's uncovered ABS are given in note 56.
Value at Risk	Value at Risk is an estimate of the potential loss in earnings which might arise from market movements under normal market conditions, if the current positions were to be held unchanged for one business day, measured to a confidence level of 95 per cent.
Wrapped loans and bonds	If a loan or bond (usually an **ABS** security) is originally issued with a credit default swap already attached, the package is called a 'wrapped bond' or 'wrapped loan'. The Group's exposure to wrapped loans and bonds is set out in note 56.
Write Downs	The depreciation or lowering of the value of an asset in the books to reflect a decline in their value, or expected cash flows.

ABBREVIATIONS

ABS	Asset-Backed Securities
ADRs	American Depositary Receipts
AQR	Asset Quality Ratio
ATMs	Automated Teller Machines
BBA	British Bankers' Association
BSU	Business Support Unit
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
CLO	Collateralised Loan Obligation
CMIG	Clerical Medical Investment Group Limited
CRA	Credit Reference Agency
CRD	Capital Requirements Directive
CRR	Capital Resources Requirement
CVA	Credit Valuation Adjustment
DVA	Debit Valuation Adjustment
ECNs	Enhanced Capital Notes
EEI	Employee Engagement Index
EEV	European Embedded Value
EP	Economic Profit
EPS	Earnings Per Share
EU	European Union
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
HMRC	Her Majesty's Revenue & Customs
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICB	Independent Commission on Banking
ICG	Individual Capital Guidance
IFAs	Independent Financial Advisers
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
ISA	Individual Savings Account
KPIs	Key Performance Indicators
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LIBOR	London Inter-Bank Offered Rate
LTIP	Long Term Incentive Plan
LTV	Loan-to-value
MIF	Multilateral Interchange Fee
NSFR	Net Stable Funding Ratio
OEICs	Open Ended Investment Companies
OFAC	Office of Foreign Assets Control
PCA	Personal Current Account
PEI	Performance Excellence Index
PFI	Private Finance Initiative
PPI	Payment Protection Insurance
PPP	Public Private Partnership
PRA	Prudential Regulatory Authority
PVNBP	Present Value of New Business Premiums
RDR	Retail Distribution Review
SAYE	Save-As-You-Earn
SMEs	Small and Medium sized enterprises
SPE	Special Purpose Entity
SWIP	Scottish Widows Investment Partnership
TSR	Total Shareholder Return
UK	United Kingdom of Great Britain and Northern Ireland
UKFI	United Kingdom Financial Investment Limited
US	United States of America
VaR	Value-at-Risk
VVOP	Voluntary Variation of Permission
WBM	Wholesale Banking and Markets

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Designed and produced by Radley Yeldar www.ry.com
Front cover photography – George Brooks
Directors' portraits – Marcus Ginns

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