

Lloyds TSB Bank plc

Report and Accounts

2008

Member of Lloyds Banking Group

Contents

Directors' report.....	2
Directors	8
Independent auditors' report	9
Consolidated income statement	11
Balance sheets.....	12
Statements of changes in equity	14
Cash flow statements.....	16
Notes to the accounts	17

Directors' report

Results and dividends

The consolidated income statement on page 11 shows a profit attributable to equity shareholders for the year ended 31 December 2008 of £818 million. An interim dividend of £648 million for the year ended 31 December 2008 was paid on 1 October 2008.

Principal activities

The Bank and its subsidiaries provide a wide range of banking and financial services through branches and offices in the UK and overseas.

Business review

The Lloyds TSB Bank Group's strategy is to build strong customer franchises and we have continued to extend the reach and depth of our customer relationships, achieving good sales growth, whilst also improving productivity and efficiency. As a result, the Group's core relationship businesses have continued to perform well, growing market share in many key areas. During 2008 the Group delivered a resilient core business performance against the backdrop of significant turbulence in global financial markets and a marked slowdown in the UK economic environment. Statutory profit attributable to shareholders, however, decreased by 76 per cent to £818 million reflecting the impact of the recent market dislocation, insurance volatility, caused by lower equity markets and wider credit spreads in fixed income markets, and a significant increase in impairment levels. Profit before tax fell by 80 per cent to £825 million.

The Group's income statement includes substantial amounts of income and expenditure attributable to the policyholders of the Group's long-term assurance funds, which are consolidated to meet the requirements of accounting standards. These amounts are volatile and can cause significant variations in net interest income, other income and insurance claims. However, they have no overall effect upon profit attributable to equity shareholders. Fluctuations in the value of the Group's investments supporting its insurance liabilities can also result in significant volatility in profit before tax. In order to provide a clearer representation of the underlying performance of the business, the impact of policyholder items has been excluded and an expected return on the Group's investments supporting its insurance liabilities has been included: the difference between this and the actual return is disclosed as insurance volatility. In addition the profit on sale of businesses, a provision in respect of certain historic US dollar payments, the Financial Services Compensation Scheme levy, goodwill impairment and, in 2007, discontinued businesses and costs of settling overdraft claims have been excluded. Where appropriate, these items have also been excluded from the commentary that follows.

Like many other financial institutions, the Group's Corporate Markets business has been significantly affected by the ongoing impact of market dislocation. However, the relationship focus of our strategy and conservative risk management approach has meant that the impact on the Group's profit before tax was relatively limited, compared to many global banking peers, at £1,270 million during 2008 (£925 million reduction in income; £345 million increase in impairment). In the extremely challenging and turbulent operating environment in global financial markets, this compares favourably to the impact on many other major financial services' companies. The market dislocation largely reflects the impact of continuing mark-to-market adjustments in certain legacy trading portfolios, resulting from the marketwide repricing of liquidity and credit, together with the write-down of a number of asset backed securities. Notably, even after fully absorbing this impact, the Wholesale and International Banking division delivered profit before tax of £274 million.

Directors' report

A reconciliation of Group and divisional performance, calculated on the basis set out above, to the statutory results is set out below.

Summarised segmental analysis**2008**

	UK Retail Banking £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Group excluding insurance gross up £m	Insurance gross up £m	Group £m
Net interest income	4,110	(62)	3,303	(239)	7,112	651	7,763
Other income	1,766	1,749	829	(268)	4,076	(3,624)	452
Total income	5,876	1,687	4,132	(507)	11,188	(2,973)	8,215
Insurance claims	–	(193)	–	–	(193)	3,052	2,859
Total income, net of insurance claims	5,876	1,494	4,132	(507)	10,995	79	11,074
Operating expenses	(2,611)	(591)	(2,350)	3	(5,549)	(69)	(5,618)
Trading surplus	3,265	903	1,782	(504)	5,446	10	5,456
Impairment	(1,472)	(2)	(1,508)	(30)	(3,012)	–	(3,012)
Profit (loss) before tax*	1,793	901	274	(534)	2,434	10	2,444
Volatility:							
– Insurance	–	(746)	–	–	(746)	–	(746)
– Policyholder interests	–	–	–	–	–	(471)	(471)
Asset Finance goodwill impairment	–	–	(100)	–	(100)	–	(100)
Provision in respect of certain historic US dollar payments	–	–	(180)	–	(180)	–	(180)
Provision for Financial Services Compensation Scheme levy	(119)	(3)	–	–	(122)	–	(122)
Profit (loss) before tax	1,674	152	(6)	(534)	1,286	(461)	825

2007

	UK Retail Banking £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Group excluding insurance gross up £m	Insurance gross up £m	Group £m
Net interest income	3,695	(106)	2,380	(334)	5,635	421	6,056
Other income	1,797	1,741	1,644	378	5,560	6,233	11,793
Total income	5,492	1,635	4,024	44	11,195	6,654	17,849
Insurance claims	–	(302)	–	–	(302)	(6,615)	(6,917)
Total income, net of insurance claims	5,492	1,333	4,024	44	10,893	39	10,932
Operating expenses	(2,548)	(611)	(2,152)	33	(5,278)	(13)	(5,291)
Trading surplus	2,944	722	1,872	77	5,615	26	5,641
Impairment	(1,224)	–	(572)	–	(1,796)	–	(1,796)
Profit before tax*	1,720	722	1,300	77	3,819	26	3,845
Volatility:							
– Insurance	–	(277)	–	–	(277)	–	(277)
– Policyholder interests	–	–	–	–	–	(222)	(222)
Discontinued businesses	–	145	28	–	173	(11)	162
Profit on sale of businesses	–	272	385	–	657	–	657
Settlement of overdraft claims	(76)	–	–	–	(76)	–	(76)
Profit (loss) before tax	1,644	862	1,713	77	4,296	(207)	4,089

*Excluding volatility, Asset Finance goodwill impairment, a provision in respect of certain historic US dollar payments, a provision for the Financial Services Compensation Scheme levy; and, in 2007, results of discontinued businesses, profit on sale of businesses and the settlement of overdraft claims.

The Group continues to maintain a strong funding and liquidity profile and has continued to obtain funding at market leading rates, with the overall margin impact of funding the Group's balance sheet remaining broadly unchanged. The Group has benefited from improvements in a number of individual product margins, particularly in new mortgages and corporate lending, however the lower interest rate environment in the second half of the year has led to increased pressure on deposit spreads.

Directors' report

Profit before tax, excluding the impact of market dislocation, decreased by £411 million, or 10 per cent, to £3,714 million, as good relationship banking and insurance business momentum was offset by a significant increase in levels of impairment.

Overall income growth of 8 per cent, excluding the impact of market dislocation, reflected continued good progress in delivering our divisional strategies. We have increased income from both new and existing customers, with strong growth in both assets and liabilities leading to higher net interest income, as well as an increase in fee-related income.

Group net interest income, excluding insurance grossing, increased by £1,477 million, or 26 per cent, to £7,112 million. Over the last 12 months, total assets increased by 23 per cent to £436 billion, with a 16 per cent increase in loans and advances to customers, reflecting strong levels of customer lending growth in Commercial Banking, Corporate Markets and mortgages. Customer deposits increased by 10 per cent to £172 billion, supported by strong growth in savings balances in the retail bank, where bank savings increased by 12 per cent and wealth management balances by 20 per cent. Customer deposits in our Corporate Markets, Commercial and International businesses increased by 15 per cent.

The net interest margin from our banking businesses was unchanged at 2.78 per cent, as improved product margins offset an adverse mix effect. Overall product margins were 12 basis points higher, reflecting stronger new business product margins in the mortgage and corporate businesses. Stronger growth in finer margin corporate and mortgage lending than in the wider margin unsecured consumer lending contributed to the negative mix effect which offset the increase in product margins.

Other income, net of insurance claims and excluding insurance grossing, decreased by £1,375 million, or 26 per cent, to £3,883 million, largely reflecting the impact of market dislocation. In the retail bank, higher fees and commissions receivable as a result of good growth in added value current accounts and card services were offset by lower creditor insurance commissions and the impact of changes in product design leading to a greater proportion of earnings being recognised as net interest income rather than fee income. In addition, good levels of growth were achieved in fee based product sales to Commercial Banking customers.

The Group continues to invest in improving processing efficiency, resulting in continued tight control over day-to-day operating costs. During 2008, operating expenses increased by 5 per cent to £5,549 million excluding the insurance grossing adjustment. Over the last 12 months, staff numbers increased by 678 (1 per cent) to 58,756, as investment in higher levels of customer facing staff more than offset further efficiency improvements in back-office processing centres. These improvements in operational effectiveness have resulted in a further reduction in the Group cost:income ratio, excluding market dislocation, from 47.6 per cent to 46.8 per cent. The Group's programme of productivity initiatives has continued to deliver significant benefits, improving underlying cost efficiency and creating greater headroom for further investment in the business. During 2008 the Group exceeded its expected net cost benefits target of £250 million by delivering a total of £311 million net cost benefits from the programme.

In UK Retail Banking, impairment losses increased by £248 million, or 20 per cent, to £1,472 million, largely reflecting the impact of lower house prices on the mortgage impairment charge. In terms of unsecured lending, our asset quality and arrears performance remains satisfactory. However, in the context of the uncertain UK economic environment and the potential for increased consumer arrears and insolvencies, we are continuing to enhance our underwriting, collections and fraud prevention procedures.

Mortgage credit quality remains good although the slowdown in economic activity and rising unemployment in the UK has led to arrears rising by 44 per cent over the last 12 months, a trend that is expected to continue. The fall in the house price index during the year has led to an increase of approximately £150 million in the house price index related charge for impairment. Looking forward, our view is for a fall of a similar magnitude in the house price index during 2009.

The Wholesale and International Banking charge for impairment losses increased significantly by £936 million to £1,508 million, including a £345 million impairment charge relating to the impact of market dislocation during 2008. The remaining charge reflects an increase in the level of impairments as a result of the economic slowdown in the UK and the impact of a number of high profile financial services company collapses.

Overall, impairment losses increased by 68 per cent to £3,012 million. Our impairment charge on loans and advances expressed as a percentage of average lending was 1.13 per cent, excluding the impact of market dislocation, compared to 0.82 per cent in 2007 (also excluding the impact of the 2007 Finance Act). Impaired assets increased by 64 per cent to £8,700 million and now represent 3.5 per cent of total lending, up from 2.5 per cent at 31 December 2007.

Directors' report

The current turbulence in global capital markets has been a severe examination of the banking system's capacity to absorb sudden significant changes in the funding and liquidity environment, and individual institutions have faced varying, but significant, degrees of stress. Throughout this period, the Group has maintained a strong liquidity position which is supported by our strong and stable retail and corporate deposit base. Both retail and corporate deposit inflows have been robust and the Group continues to benefit from its diversity of funding sources. The Group's wholesale funding base has proved to be resilient, supporting the Group's balance sheet growth with an increased level of longer term funding (greater than 1 year).

New initiatives introduced during the course of 2008 by The Bank of England and HM Treasury to facilitate banks' access to senior funding include the Special Liquidity Scheme and Credit Guarantee Scheme, respectively. The Group welcomed these initiatives and, like many of its peers, continues to make use of them for term funding. Going forward, where markets permit and it is economic to do so, the Group expects to reduce this utilisation and further develop and diversify its unguaranteed funding programmes.

Provision relating to certain historic US dollar payments

In January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney's Office in relation to a previously disclosed investigation involving those agencies into certain historic US dollar payment practices by Lloyds TSB. The Group disclosed in its interim results for the first half of 2008 that it was in discussions regarding a resolution of the investigation and that it had provided £180 million in respect of this matter. The provision was hedged into US dollars at the time and fully covers the settlement amount announced in January 2009. The Group is continuing discussions with the Office of Foreign Assets Control (OFAC) regarding the terms of the resolution of its investigation. OFAC has confirmed to the Group that the amount paid to the US Department of Justice and the New York County District Attorney's Office will be credited towards satisfying any penalty it imposes. The Group does not currently believe that any additional liability requiring provision will arise following the conclusion of the discussions with OFAC. The Group does not anticipate any further enforcement actions with regard to these issues.

Provision for Financial Services Compensation Scheme levy

The recent arrangements put in place to protect the depositors of Bradford & Bingley and other failed deposit taking institutions involving the Financial Services Compensation Scheme ('FSCS') will result in a significant increase in the levies made by the FSCS on the industry. The Group has made a provision of £122 million in its 2008 accounts in respect of its current obligation for the estimated interest cost on the FSCS borrowings. Going forward further provisions in respect of these costs are likely to be necessary until the borrowings are repaid. The ultimate cost to the industry, which will also include the cost of any compensation payments made by the FSCS and if necessary the cost of meeting any shortfall after recoveries on the borrowings entered into by the FSCS, remains uncertain although it may be significant.

Goodwill impairment

During the year, the basis of goodwill allocation in parts of our Asset Finance business has been changed to treat the consumer finance business as a single cash generating unit encompassing the motor and personal finance operations which provide direct and point of sale finance. The markets in which these units operate have been affected by the UK economic downturn, which has been characterised by falling demand and increasing arrears at this point of the cycle. This, together with uncertainties over the likely short-term macroeconomic environment, has resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £100 million at 31 December 2008.

Balance sheet

Shareholders' equity decreased by £3,889 million to £9,266 million, following negative valuation adjustments in respect of available-for-sale investments. Risk-weighted assets increased 20 per cent to £170 billion, reflecting good growth in mortgages and corporate lending. At the end of 2008, the risk asset ratio was 11.3 per cent for total capital.

Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Bank and its subsidiary undertakings, in relation to the use of financial instruments, is given in note 50 on pages 73 to 98.

Group structure

On 16 January 2009, the Bank's ultimate parent company, Lloyds TSB Group plc, changed its name to Lloyds Banking Group plc, following the acquisition of HBOS plc.

Directors' report

Directors

The names of the directors of the Bank are shown on page 8.

Ms T A Dial and Mr M E Fairey left the board on 18 April 2008 and 30 June 2008, respectively.

Sir David Manning, Mr M A Scicluna, Ms C J McCall and Mr T J W Tookey joined the board on 1 May 2008, 1 September 2008, 1 October 2008 and 30 October 2008, respectively, and Mr T T Ryan and Mr A Watson have been appointed directors from 1 March 2009 and 2 April 2009, respectively.

Directors' interests

The directors are also directors of Lloyds Banking Group plc and their interests in the share and loan capital of Lloyds Banking Group plc and its subsidiaries are shown in the report and accounts of that company.

Directors' indemnities

The directors, including two former directors who left during the year, have entered into individual contracts of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. These contracts were in force during the whole of the financial year or from the date of appointment in respect of the four directors who joined the board in 2008. The contracts remain in force and are available for inspection at the Bank's registered office.

Statement of directors' responsibilities

The directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the consolidated and parent company financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the parent company and the Group and of the profit or loss of the Group for that period. The directors consider that, in preparing the financial statements on pages 11 to 107, the Bank and the Group have used appropriate accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, and that all accounting standards which they consider applicable have been followed.

The directors have responsibility for ensuring that the Bank and the Group keep proper accounting records which disclose with reasonable accuracy the financial position of the Bank and the Group and which enable them to ensure that the financial statements comply with the Companies Act 1985 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation. They have a general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Bank and the Group and to prevent and detect 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 statutory and audited information in relation to the Bank on that website. Information published on the internet is accessible in many countries with different legal requirements. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Going concern

The going concern of the Bank 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 Bank and the Group have adequate resources to continue to operate for the foreseeable future the directors have considered a number of key dependencies as discussed in note 1. Having considered projections of the Group's capital and funding position, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Directors' report

Employees

The Bank 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, the Bank 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.

Policy and practice on payment of creditors

The Bank follows 'The Better Payment Practice Code' published by the Department of Business Enterprise and Regulatory Reform ('BERR') regarding the making of payments to suppliers. A copy of the code and information about it may be obtained from The BERR Publications Orderline 0845 015 0010, quoting ref URN 04/606. Alternatively, visit www.payontime.co.uk for details.

The Bank'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 Bank 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 1985, is 26. 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 2008 bears to the aggregate of the amounts invoiced by suppliers during the year.

Directors' responsibility statement

Each of the current directors, whose names are shown on page 8 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Bank 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 Bank and Group, together with a description of the principal risks and uncertainties 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 Bank'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 Bank's auditors are aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of section 234ZA of the Companies Act 1985.

On behalf of the board

Harry F Baines

Company Secretary
26 February 2009

Directors

Sir Victor Blank *Chairman*

J E Daniels *Chief Executive*

T J W Tookey *Finance Director*

W C G Berndt

E Brown CBE FRSE

J P du Plessis

P N Green

Sir Julian Horn-Smith

A G Kane

Lord Leitch

Sir David Manning GCMG CVO

C J McCall OBE

T T Ryan, Jr
(from 1 March 2009)

M A Scicluna

G T Tate

A Watson CBE
(from 2 April 2009)

H A Weir CBE

Independent auditors' report

To the members of Lloyds TSB Bank plc

We have audited the consolidated and parent company financial statements (the 'financial statements') of Lloyds TSB Bank plc for the year ended 31 December 2008 which comprise the consolidated income statement, the consolidated and parent company balance sheets, the consolidated and parent company statements of changes in equity, the consolidated and parent company cash flow statements and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the annual report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the statement of directors' responsibilities within the directors' report.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, 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.

We report to you our opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Companies Act 1985 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation. We also report to you whether, in our opinion, the information given in the directors' report is consistent with the financial statements.

In addition, we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the annual report and consider whether it is consistent with the audited financial statements. The other information comprises only the directors' report and all of the information listed on the contents page. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Independent auditors' report

Opinion

In our opinion:

- the consolidated financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2008 and of its profit and cash flows for the year then ended;
- the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent company's affairs as at 31 December 2008 and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation; and
- the information given in the directors' report is consistent with the financial statements.

PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors

Southampton

26 February 2009

Consolidated income statement
for the year ended 31 December 2008

	Note	2008 £ million	2007 £ million
Interest and similar income		17,569	16,874
Interest and similar expense		(9,797)	(10,741)
Net interest income	5	7,772	6,133
Fee and commission income		3,231	3,227
Fee and commission expense		(694)	(600)
Net fee and commission income	6	2,537	2,627
Net trading income	7	(9,255)	3,136
Insurance premium income	8	5,412	5,430
Other operating income	9	532	952
Other income		(774)	12,145
Total income		6,998	18,278
Insurance claims	10	2,859	(7,522)
Total income, net of insurance claims		9,857	10,756
Operating expenses	11	(6,020)	(5,528)
Trading surplus		3,837	5,228
Impairment	12	(3,012)	(1,796)
Profit on sale of businesses	13	–	657
Profit before tax		825	4,089
Taxation	14	19	(673)
Profit for the year		844	3,416
Profit attributable to minority interests		26	32
Profit attributable to equity shareholders		818	3,384
Profit for the year		844	3,416

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

Balance sheets
at 31 December 2008

	Note	The Group		The Bank	
		2008 £ million	2007 £ million	2008 £ million	2007 £ million
Assets					
Cash and balances at central banks		5,008	4,330	4,890	4,211
Items in the course of collection from banks		946	1,242	909	1,196
Trading and other financial assets at fair value through profit or loss	15	45,115	58,096	3,679	9,184
Derivative financial instruments	16	28,884	8,688	26,704	8,624
Loans and advances to banks	17	40,758	34,845	38,993	28,447
Loans and advances to customers	18	242,735	209,814	251,201	212,738
Available-for-sale financial assets	20	55,707	20,196	58,444	4,260
Investment property	21	2,631	3,722	–	–
Goodwill	22	2,256	2,358	–	–
Value of in-force business	23	1,893	2,218	–	–
Other intangible assets	24	197	149	100	53
Current tax recoverable		440	–	702	93
Deferred tax assets	39	837	–	1,161	619
Tangible fixed assets	25	2,965	2,839	1,333	1,235
Investment in subsidiary undertakings	26	–	–	15,992	16,137
Other assets	28	5,819	5,046	2,553	2,163
Total assets		436,191	353,543	406,661	288,960

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

The directors approved the financial statements on 26 February 2009.

Sir Victor Blank
Chairman

J Eric Daniels
Chief Executive

Tim J W Tookey
Finance Director

Balance sheets
at 31 December 2008

	Note	The Group		The Bank	
		2008 £ million	2007 £ million	2008 £ million	2007 £ million
Equity and liabilities					
Liabilities					
Deposits from banks	29	66,514	39,091	80,529	48,940
Customer accounts	30	172,364	156,713	184,041	163,245
Items in course of transmission to banks		508	668	467	613
Trading and other financial liabilities at fair value through profit or loss	31	6,754	3,206	6,754	3,206
Derivative financial instruments	16	28,189	7,751	29,730	8,365
Debt securities in issue	32	73,066	49,828	74,559	36,647
Liabilities arising from insurance contracts and participating investment contracts	33	33,827	38,192	–	–
Liabilities arising from non-participating investment contracts	35	14,243	18,197	–	–
Unallocated surplus within insurance businesses	36	270	554	–	–
Other liabilities	37	11,494	9,751	4,955	4,123
Retirement benefit obligations	38	1,771	2,144	1,354	1,623
Current tax liabilities		–	414	–	–
Deferred tax liabilities	39	–	949	–	–
Other provisions	40	230	209	206	165
Subordinated liabilities	41	17,389	12,437	16,853	11,903
Total liabilities		426,619	340,104	399,448	278,830
Equity					
Share capital	42	1,542	1,542	1,542	1,542
Share premium account	43	2,960	2,960	2,960	2,960
Other reserves	44	(2,824)	(411)	(249)	(44)
Retained profits	45	7,588	9,064	2,960	5,672
Shareholders' equity		9,266	13,155	7,213	10,130
Minority interests		306	284	–	–
Total equity		9,572	13,439	7,213	10,130
Total equity and liabilities		436,191	353,543	406,661	288,960

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

Statement of changes in equity

The Group

	Attributable to equity shareholders					
	Share capital and premium £m	Other reserves £m	Retained profits £m	Total £m	Minority interests £m	Total £m
Balance at 1 January 2007	4,502	(15)	7,637	12,124	352	12,476
Movement in available-for-sale financial assets, net of tax:						
– change in fair value	–	(436)	–	(436)	–	(436)
– transferred to income statement in respect of disposals	–	(5)	–	(5)	–	(5)
– transferred to income statement in respect of impairment	–	49	–	49	–	49
– disposal of businesses	–	(6)	–	(6)	–	(6)
Movement in cash flow hedges, net of tax	–	(15)	–	(15)	–	(15)
Currency translation differences	–	17	–	17	(1)	16
Net income recognised directly in equity	–	(396)	–	(396)	(1)	(397)
Profit for the year	–	–	3,384	3,384	32	3,416
Total recognised income for 2007	–	(396)	3,384	2,988	31	3,019
Dividends	–	–	(1,957)	(1,957)	(19)	(1,976)
Repayment of capital to minority shareholders	–	–	–	–	(80)	(80)
Balance at 31 December 2007	4,502	(411)	9,064	13,155	284	13,439
Movement in available-for-sale financial assets, net of tax:						
– change in fair value	–	(2,059)	–	(2,059)	28	(2,031)
– transferred to income statement in respect of disposals	–	(19)	–	(19)	–	(19)
– transferred to income statement in respect of impairment	–	102	–	102	–	102
– other transfers to income statement	–	(66)	–	(66)	–	(66)
Movement in cash flow hedges, net of tax	–	(12)	–	(12)	–	(12)
Currency translation differences	–	(359)	–	(359)	–	(359)
Net income recognised directly in equity	–	(2,413)	–	(2,413)	28	(2,385)
Profit for the year	–	–	818	818	26	844
Total recognised income for 2008	–	(2,413)	818	(1,595)	54	(1,541)
Dividends	–	–	(2,294)	(2,294)	(29)	(2,323)
Repayment of capital to minority shareholders	–	–	–	–	(3)	(3)
Balance at 31 December 2008	4,502	(2,824)	7,588	9,266	306	9,572

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

Statement of changes in equity

The Bank

Attributable to equity shareholders

	Share capital and premium £m	Other reserves £m	Retained profits £m	Total £m
Balance at 1 January 2007	4,502	4	4,257	8,763
Movement in available-for-sale financial assets, net of tax:				
– change in fair value	–	(84)	–	(84)
– transferred to income statement in respect of disposals	–	(5)	–	(5)
– transferred to income statement in respect of impairment	–	49	–	49
– disposal of businesses	–	(6)	–	(6)
Movement in cash flow hedges, net of tax	–	(15)	–	(15)
Currency translation differences	–	13	–	13
Net income recognised directly in equity	–	(48)	–	(48)
Profit for the year	–	–	2,799	2,799
Total recognised income for 2007	–	(48)	2,799	2,751
Dividends	–	–	(1,957)	(1,957)
Adjustment arising on transfer of C&G business (note 27)	–	–	573	573
Balance at 31 December 2007	4,502	(44)	5,672	10,130
Movement in available-for-sale financial assets, net of tax:				
– change in fair value	–	(244)	–	(244)
– transferred to income statement in respect of disposals	–	(19)	–	(19)
– transferred to income statement in respect of impairment	–	102	–	102
– other transfers to income statement	–	(66)	–	(66)
Movement in cash flow hedges, net of tax	–	(12)	–	(12)
Currency translation differences	–	34	–	34
Net income recognised directly in equity	–	(205)	–	(205)
Loss for the year	–	–	(418)	(418)
Total recognised income for 2008	–	(205)	(418)	(623)
Dividends	–	–	(2,294)	(2,294)
Balance at 31 December 2008	4,502	(249)	2,960	7,213

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

Cash flow statements
for the year ended 31 December 2008

	Note	The Group		The Bank	
		2008 £ million	2007 £ million	2008 £ million	2007 £ million
Profit (loss) before tax		825	4,089	(857)	3,256
Adjustments for:					
Change in operating assets	52a	(42,842)	(15,113)	(62,304)	(13,548)
Change in operating liabilities	52b	82,449	18,607	110,400	19,443
Non-cash and other items	52c	(4,525)	2,689	4,473	757
Tax paid		(887)	(827)	(620)	(273)
Net cash provided by operating activities		35,020	9,445	51,092	9,635
Cash flows from investing activities:					
Purchase of available-for-sale financial assets		(144,680)	(21,667)	(153,091)	(8,197)
Proceeds from sale and maturity of available-for-sale financial assets		110,470	19,468	99,811	8,022
Purchase of fixed assets		(1,436)	(1,334)	(610)	(300)
Proceeds from sale of fixed assets		579	982	30	44
Additional capital injections to subsidiaries		–	–	(50)	(313)
Capital repayments by subsidiaries		–	–	805	977
Acquisition of businesses, net of cash acquired	52f	(19)	(8)	(817)	(18)
Disposal of businesses, net of cash disposed	52g	–	1,476	187	518
Net cash (used in) generated by investing activities		(35,086)	(1,083)	(53,735)	733
Cash flows from financing activities:					
Dividends paid to equity shareholders		(2,294)	(1,957)	(2,294)	(1,957)
Dividends paid to minority interests	52e	(29)	(19)	–	–
Interest paid on subordinated liabilities		(819)	(733)	(745)	(695)
Proceeds from issue of subordinated liabilities	52e	3,021	1,098	3,021	1,098
Repayment of subordinated liabilities	52e	(381)	(300)	(381)	(300)
Repayment of capital to minority shareholders	52e	(3)	(80)	–	–
Net cash used in financing activities		(505)	(1,991)	(399)	(1,854)
Effect of exchange rate changes on cash and cash equivalents		1,440	82	1,439	78
Change in cash and cash equivalents		869	6,453	(1,603)	8,592
Cash and cash equivalents at beginning of year		31,891	25,438	24,027	15,435
Cash and cash equivalents at end of year	52d	32,760	31,891	22,424	24,027

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

Notes to the accounts

1 Basis of preparation

During 2008, global financial markets experienced difficult conditions which have been characterised by a marked reduction in liquidity. As a consequence of this, Governments and central banks carried out a series of actions to address the lack of liquidity within their respective banking systems. In the UK these actions have included the introduction of the Bank of England's Special Liquidity Scheme whereby banks and building societies can exchange eligible securities for UK Treasury bills; and the creation of a credit guarantee scheme by HM Treasury, providing a Government guarantee for certain short and medium-term senior debt securities issued by eligible banks. During 2008 the Group has made use of these measures in order to maintain and improve a stable funding position. The Group's management of liquidity and funding risks is described in Note 50.

In the context of this continued turbulence and uncertainty in the financial markets, combined with a deteriorating global economic outlook, Lloyds Banking Group has also taken steps to strengthen its capital position in order to provide a buffer against further shocks arising from the financial systems and to ensure that it remains competitive.

There is a risk that, despite the substantial measures taken by Governments, further deterioration in the markets could occur. In addition the economic conditions in the UK are deteriorating more quickly than previously anticipated placing greater strain on the Group's capital resources. The key dependencies on successfully funding the Group's balance sheet include the continued functioning of the money and capital markets at their current levels; the continued access of the Group to central bank and Government sponsored liquidity facilities, including issuance under HM Treasury's credit guarantee scheme and access to the Bank of England's various facilities; limited further deterioration in the Group's credit ratings; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or Government support schemes. Based upon projections prepared by management which take into account the Group's current ability to fund in the market and the assumption that the announced Government sponsored schemes will continue to be available, the directors are satisfied that the Bank and the Group have adequate resources to continue in business for the foreseeable future. Accordingly, the financial statements of the Bank and the Group have been prepared on a going concern basis.

2 Accounting policies

The financial statements 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 and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The following relevant IFRS pronouncements have been adopted in these financial statements:

- (i) IFRIC 11 *IFRS 2 – Group and Treasury Share Transactions*. This interpretation clarifies the application of IFRS 2 *Share-based Payment* to certain share-based payment arrangements involving own equity instruments and arrangements involving equity instruments of a parent entity. The application of this new interpretation has not had any impact for amounts recognised in these financial statements.
- (ii) IFRIC 14 *IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirement and their Interaction*. This interpretation provides guidance on assessing the amount of a pension surplus that can be recognised as an asset and explains how a minimum funding requirement might either affect the availability of reductions in future contributions or give rise to a liability. The application of this new interpretation has not had any impact for amounts recognised in these financial statements.
- (iii) Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures – Reclassification of Financial Assets*. The amendment to IAS 39 permits reclassification of non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the fair value through profit or loss category in certain circumstances and permits the transfer of a financial asset from the available-for-sale category to the loans and receivables category where that financial 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. The amendment to IFRS 7 requires additional disclosures about the situations in which any such reclassification is made and the effects on the financial statements including details of the carrying amounts and fair values for all financial assets that have been reclassified until they are derecognised and the fair value gain or loss that would have been recognised in the income statement or equity, as appropriate, if the financial asset had not been reclassified. For eligible reclassifications made before 1 November 2008, these amendments became effective from 1 July 2008. Details of the financial assets reclassified in accordance with this amendment are set out in note 50.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2008 and which have not been applied in preparing these financial statements are given in note 53.

The accounting policies are set out below:

a Consolidation

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include all 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. Group undertakings are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Open Ended Investment Companies (OEICs) where the Group, through the Group's life funds, has a controlling interest are consolidated; the unitholders' interest is reported in other liabilities. Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The Group applies a policy of treating transactions with minority interests as transactions with parties external to the Group. Disposals to minority interests result in gains and losses for the Group that are recorded in the income statement. Purchases from minority interests result in goodwill, being the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary.

Notes to the accounts

2 Accounting policies (continued)

b Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable net assets and contingent liabilities of the acquired entity at the date of acquisition. 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. At the date of disposal of a Group undertaking, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

c Other intangible assets

Other intangible assets comprise capitalised software enhancements and customer lists. Capitalised software enhancements are amortised over periods not exceeding five years, being their estimated useful lives, using the straight-line method. Customer lists are amortised over periods not exceeding 15 years, being their estimated useful lives, in line with the income expected to arise from those customers, and are subject to annual reassessment. All other intangible assets are reviewed for impairment whenever events or any 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.

d Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the 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, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by the Group including expected early redemptions and related penalties and premiums and discounts that are an integral part of the overall return as well as direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument. 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 j).

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. 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 assurance and general insurance business are detailed below (see s).

e Trading securities, other financial assets and liabilities at fair value through profit or loss, and available-for-sale financial assets

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 are classified as trading securities and recognised in the balance sheet at their fair value. Gains and losses arising from changes in their fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

Other financial assets and liabilities at fair value through profit or loss are designated as such by management upon initial recognition. Such assets and liabilities are carried in the balance sheet at their fair value and gains and losses arising from changes in fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

Financial assets and liabilities are designated as at fair value through profit or loss on acquisition in the following circumstances:

- When doing so results in more relevant information because either:
 - it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on them on different bases; or
 - 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.
- Where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Valuation of financial instruments) and note 50 (Financial risk management: 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'.

Debt securities and equity shares, other than those classified as trading securities or at fair value through profit or loss, are classified as available-for-sale and recognised in the balance sheet at their fair value; available-for-sale investments 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 equity, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in equity is recognised in the income statement. Interest calculated using the effective interest method is recognised in the income statement.

Notes to the accounts

2 Accounting policies (continued)

The Group is permitted to transfer, at fair value at the date of 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. For assets transferred, gains or losses recognised in equity in respect of those assets as at the date of transfer are amortised to profit or loss over the remaining life of the asset using the effective interest method.

Purchases and sales of securities and other financial assets and liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset. Trading securities and other financial assets and liabilities at fair value through profit or loss are initially recognised at fair value. Available-for-sale financial assets are initially recognised at fair value inclusive of transaction costs. These financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

f Loans and advances to banks and customers

Loans and advances to banks and customers, including any eligible assets transferred into these categories out of the fair value through profit or loss or available-for-sale financial assets categories, are accounted for at amortised cost using the effective interest method, except those which the Group intends to sell in the near term and which are accounted for at fair value, with the gains and losses arising from changes in their fair value reflected in the income statement. Loans and advances are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs. Loans and advances are derecognised when the rights to receive cash flows from them have expired or where the Group has transferred substantially all risks and rewards of ownership.

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. Such financial assets continue to be recognised by the Group, together with a corresponding liability for the funding except in those cases where substantially all of the risks and rewards associated with the assets have been transferred or a significant proportion but not all of the risks and rewards have been transferred and the transferee has the ability to sell the assets when the assets are derecognised in full. If a fully proportional share of all, or of specifically identified, cash flows have been transferred, then that proportion of the assets is derecognised.

g Sale and repurchase agreements

Securities sold subject to repurchase agreements ('repos') are recognised on the balance sheet where all of the risks and rewards are retained; the counterparty liability is included in deposits from banks or customer accounts, as appropriate. Securities purchased under agreements to resell ('reverse repos') are recorded as loans and advances to banks or customers, as appropriate. 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.

h 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 options 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: Valuation of financial instruments) and note 50 (Financial risk management: 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, 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 the derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Derivatives may only be designated as hedges provided certain strict criteria are met. At the inception of a hedge its terms must be clearly documented and there must be an expectation that the derivative will be highly effective in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship must be tested throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its objective the hedge relationship is terminated.

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 attributable to the hedged risk are no longer recognised in the income statement; the adjustment that has been made to the carrying amount of a hedged item is amortised to the income statement 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 equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are recycled 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 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.

Notes to the accounts

2 Accounting policies (continued)

(3) *Net investment hedges*

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity; 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.

i 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.

j 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, there is objective evidence that a financial asset or group of financial assets has become impaired.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss include:

- Delinquency in contractual payments of principal and/or interest;
- Indications that the borrower or group of borrowers is experiencing significant financial difficulty;
- Restructuring of debt to reduce the burden on the borrower;
- Breach of loan covenants or conditions; and
- Initiation of bankruptcy proceedings.

The estimated period between a loss occurring and its identification is determined by local management for each identified portfolio. In general, the periods used vary between two months and twelve months.

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original effective interest rate. For the Group's portfolios of smaller balance homogenous loans, such as the residential mortgage, personal lending and credit card portfolios, allowances are calculated for groups of assets taking into account historical cash flow experience. For the Group's other lending portfolios, allowances are established on a case-by-case basis. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised asset or group of assets reflects the cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

If there is no objective evidence of individual impairment the asset is included in a group of financial assets with similar credit risk characteristics and collectively assessed for impairment. Segmentation takes into account such factors as the type of asset, industry, 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. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the Group and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss 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.

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.

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 (as a result of the customer's insolvency, ceasing to trade or other reason) 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.

(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 removed from equity and recognised in 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 the available-for-sale reserve. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(3) *Renegotiated loans*

Loans that are either subject to collective impairment assessment or individually significant and whose terms have been renegotiated are no longer considered to be past due but are treated as new loans. In subsequent years, the asset is considered to be past due and disclosed only if further renegotiated.

k Investment property

Property held for long-term rental yields and capital appreciation within the long-term assurance funds is classified as investment property. Investment property comprises freehold and long leasehold land and buildings and is carried in the balance sheet at fair value, being the open market value as determined in accordance

Notes to the accounts

2 Accounting policies (continued)

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 on less active markets. 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 values are recorded in the income statement.

l 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 or the remaining period of the lease
- Leasehold improvements: shorter of 10 years or, 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.

m Leases

(1) *As lessee*

The leases entered into by the Group are primarily operating leases. Operating lease rentals are charged to the income statement on a straight-line basis over the period of the lease.

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

(2) *As lessor*

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee; all other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments is recognised as a receivable within loans and advances to banks and customers. Finance lease income is recognised over the term of the lease using the net investment method (before tax) reflecting a constant periodic rate of return.

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.

n Investment in subsidiary undertakings

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

o Borrowings

Borrowings (which include deposits from banks, customer accounts, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. Borrowings 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.

p 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 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.

Notes to the accounts

2 Accounting policies (continued)

The Group's balance sheet includes the net surplus or deficit, being the fair value of scheme assets less the discounted value of scheme liabilities adjusted for the corridor. 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.

q Share-based compensation

Lloyds Banking Group operates a number of equity-settled, share-based compensation plans. 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 except where the charge is levied by the parent company. 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.

r 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 assurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on equity holders' returns. This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is determined using tax rates that have been enacted or substantially enacted by the balance sheet date which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Deferred tax is provided on temporary differences arising from investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future. 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 tax related to fair value re-measurement of available-for-sale investments and cash flow hedges, which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement together with the deferred 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.

s Insurance

The Group undertakes both life assurance and general insurance business.

For accounting purposes the life assurance business issues three types of contract:

Insurance contracts – these contracts contain significant insurance risk, which the Group defines 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.

Investment contracts containing a discretionary participation feature – these contracts do not contain significant insurance risk, but contain features which entitle the holder to receive, in addition to the guaranteed benefits, further amounts that are likely to be a significant proportion of the total benefits and the amount and timing of which is at the discretion of the Group and based upon the performance of specified assets. Contracts with a discretionary participation feature are referred to as participating investment contracts.

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

For accounting purposes the general insurance business only issues insurance contracts.

(1) Life assurance 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 as detailed below in respect of unit-linked contracts.

Claims are recorded as an expense when they are incurred.

Liabilities

– insurance or participating investment contracts in the Group's With Profit Fund

Liabilities of the Group's With Profit Fund, including guarantees and options embedded within products written by that fund, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime, except that projected transfers out of the fund into other group funds are not treated as liabilities. Further details on the realistic capital regime are given in note 51.

Notes to the accounts

2 Accounting policies (continued)*– insurance or participating investment contracts which are not unit-linked or in the Group's With Profit Fund*

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 assurance 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.

– insurance or participating investment contracts which are unit-linked

Allocated premiums in respect of unit-linked contracts that are either insurance or participating investment contracts are recognised as liabilities. These liabilities are increased or reduced by the change in the unit prices and are reduced by policy administration fees, mortality and surrender charges and any withdrawals. The mortality charges deducted in each period from the policyholders as a group are considered adequate to cover the expected total death benefit claims in excess of the contract account balances in each period and hence no additional liability is established for these claims. Revenue consists of fees deducted for mortality, policy administration and surrender charges. Interest or changes in the unit prices credited to the account balances and excess benefit claims in excess of the account balances incurred in the period are charged as expenses in the income statement.

Unallocated surplus

Any amounts in the With Profit Fund not yet determined as being due to policyholders are recognised as an unallocated surplus which is shown separately from other liabilities.

Value of in-force business

The Group recognises as an asset the value of in-force business in respect of life insurance 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 conditions and other matters 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.

(ii) Accounting for non-participating investment contracts

All of the Group's non-participating investment contracts are 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.

Deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability.

The Group receives investment management fees 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 instrument. 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 on a straight-line basis over the estimated lives of the contracts.

Directly incremental commissions that vary with and are related to either securing new or renewing existing non-participating investment contracts are deferred; all other costs are recognised as expenses when incurred. 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 expenses 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, net of refunds, in the period in which insurance cover is provided to the customer; premiums received relating to future periods are deferred and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

The underwriting business makes provision for the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The provision for the cost of claims notified but not settled is based upon a best estimate of the cost of settling the outstanding claims after taking into account all known facts. In those cases where there is insufficient information to determine the required provision, statistical techniques are used which take into account the cost of claims that have recently been settled and make assumptions about the future development of the outstanding cases. Similar statistical techniques are used to determine the provision for claims incurred but not reported at the balance sheet date. Claims liabilities are not discounted.

(3) Liability adequacy test

At each balance sheet date liability adequacy tests are performed to ensure the adequacy of insurance and participating investment contract liabilities net of related deferred tax assets and acquired value of in-force business. In performing these tests current best estimates of discounted future contractual cash flows and claims handling and administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to profit or loss 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. Insurance contracts entered into by the Group under which the contract holder is another insurer (inwards reinsurance) are included with insurance contracts.

Notes to the accounts

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 insurance contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured insurance contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Reinsurance liabilities are primarily premiums payable for reinsurance contracts and are recognised as an expense when due.

Foreign currency translation

These financial statements are presented in sterling, which is the Bank's functional currency.

Foreign currency transactions are translated into the 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 deferred in equity 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 measured at fair value are recognised in profit or loss, except for differences on available-for-sale non-monetary financial assets such as equity shares, which are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

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 revenues 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. Foreign exchange differences arising on the translation of a foreign operation are recognised directly in equity and included in profit or loss on its disposal.

u Provisions

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.

v Dividends

Dividends on ordinary shares are recognised in equity in the period in which they are paid.

w 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.

3 Critical accounting estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions 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. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to the Group's results and financial position, based upon materiality and significant judgements and estimates, are discussed below.

Impairment of financial assets

Loan impairment allowances

The Group regularly reviews its loan portfolios to assess for impairment. Impairment allowances are established to recognise incurred impairment losses in its loan portfolios carried at amortised cost. In determining whether an impairment has occurred at the balance sheet date the Group considers whether there is any observable data indicating that there has been a measurable decrease in the estimated future cash flows or their timings; such observable data includes information as to whether there has been an adverse change in the payment status of borrowers or changes in economic conditions that correlate with defaults on loan repayment obligations. Where this is the case, the impairment loss is the difference between the carrying value of the loan and the present value of the estimated future cash flows discounted at the loan's original effective interest rate.

At 31 December 2008 gross loans and advances to customers and banks totalled £287,220 million (2007: £247,067 million) against which impairment allowances of £3,727 million (2007: £2,408 million) had been made.

There are two components of the Group's loan impairment allowances: individual and collective. All impaired loans which exceed a certain threshold, principally within the Group's corporate banking business, are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security. The determination of these allowances often 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. 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.

Impairment allowances for portfolios of smaller balance homogenous loans, such as residential mortgages, personal loans and credit card balances 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. Collective impairment allowances are calculated on a portfolio basis using formulae which take into account factors such as the length of time that the customer's account has been out of order, historical loss rates, the credit quality of the portfolios and the value of any security held, which is estimated, where appropriate, using indices such as house price indices. The variables used in the formulae are kept under regular review to ensure that as far as possible they reflect

Notes to the accounts

3 Critical accounting estimates and judgements (continued)

current economic circumstances; however changes in interest rates, unemployment levels and bankruptcy trends, particularly in the UK, could result in actual losses differing from reported impairment allowances.

Assumptions used in calculating provisions for loan impairment have been updated to reflect market conditions, including those in respect of house price inflation, forced sale discount and probability of borrower default. If average house prices were 12.5 per cent lower than those in place as at 31 December 2008, the house price index related impact on the impairment charge would be an increase of approximately £85 million.

Impairment of available-for-sale financial assets

In determining whether an impairment loss has been incurred in respect of an available-for-sale financial asset, the Group performs an objective review of the current financial circumstances and future prospects of the issuer and, in the case of equity shares, considers whether there has been a significant or prolonged decline in the fair value of that asset below its cost. This consideration requires management judgement. Among factors considered by the Group is whether the decline in fair value is a result of a change in the quality of the asset or from a downward movement in the market as a whole. An assessment is performed of the future cash flows expected to be realised from the asset, taking into account, where appropriate, the quality of underlying security and credit protection available. The reduction in the fair value of available-for-sale financial assets during the year was £2,721 million (2007: £483 million). Impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement totalled £130 million (2007: £70 million).

Valuation of financial instruments

Trading securities, other financial assets and liabilities at fair value through profit or loss, derivatives and available-for-sale financial assets are stated at fair value. The fair value of these financial instruments is the amount for which an instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The fair values of financial instruments are determined by reference to unadjusted quoted prices in active markets where these are available. Where market prices are not available or are unreliable because of poor liquidity, fair values are determined using valuation techniques which, to the extent possible, use market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to similar instruments.

The Group uses widely recognised valuation models for determining the fair value of common and less complex financial instruments that use only observable market data. Observable prices and model inputs are usually available in the market for listed debt and equity securities, exchange traded derivatives and simple over-the-counter derivatives like interest rate swaps. Availability of observable market prices and model inputs reduces the need for management judgement and estimation and any uncertainty associated with determination of fair values. Availability of that observable information depends on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

Financial markets in certain financial instruments such as asset backed securities (ABS), which were previously active and had been valued using market observable inputs in previous years, became inactive during 2008. The fair values of those assets are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar bonds with the same obligor, market standard consensus pricing services, broker quotes and other research data. For interest rate and foreign exchange option products and more complex option products, some or all of the inputs into the Group's valuation models may not be observable in the market, and are derived from market prices or rates or are estimated based on market standard consensus data. The process of calculating the fair value of these instruments may necessitate the estimation of certain pricing parameters, assumptions or model characteristics. Management judgement and estimation are usually required when determining such matters as the expected cash flows on the financial instruments being valued, the probability of counterparty default, prepayment assumptions, and selection of appropriate discount rates.

The fair values of the Group's financial assets and liabilities are disclosed within note 50 on pages 97 and 98 together with an indication of the valuation technique used for each major asset or liability category, the inputs into valuation models that have the potential to significantly impact the value determined, assumptions, if any, used for those inputs and the effects of applying reasonably possible alternative assumptions or, in the case of ABS within available-for-sale financial assets, a shift in credit spreads.

Pensions

The net liability recognised in the balance sheet at 31 December 2008 in respect of the Group's retirement benefit obligations was £1,771 million (2007: £2,144 million) of which £1,657 million (2007: £2,033 million) related to defined benefit pension schemes. This liability excludes actuarial losses of £267 million (2007: gains of £1,350 million) which the Group is permitted to leave unrecognised. The defined benefit pension schemes' gross deficit totalled £1,924 million (2007: £683 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The schemes' liabilities are calculated using the projected unit credit method, which takes into account projected earnings increases, using actuarial assumptions that give the best estimate of the future cash flows that will arise under the scheme liabilities. The resulting estimated cash flows are discounted at a rate equivalent to the market yield at the balance sheet date on high quality bonds with a similar duration and currency to the schemes' liabilities. In order to estimate the future cash flows, a number of financial and non-financial assumptions are made by management, changes to which could have a material impact upon the overall deficit or the net cost recognised in the income statement.

Two important assumptions are the rate of inflation and the expected lifetime of the schemes' members. The assumed rate of inflation affects the rate at which salaries are projected to grow and therefore the size of the pension that employees receive upon retirement and also the rate at which pensions in payment increase. Over the longer term rates of inflation can vary significantly; at 31 December 2008 it was assumed that the rate of inflation would be 3.0 per cent per annum (2007: 3.3 per cent), although if this was increased by 0.2 per cent the overall deficit would increase by approximately £451 million and the annual cost by approximately £17 million. A reduction of 0.2 per cent would reduce the overall deficit by approximately £437 million and the annual cost by approximately £16 million.

The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience, however given the rates of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience. An increase of one year in the expected lifetime of scheme members would increase the overall deficit by approximately £318 million and the annual cost by approximately £22 million; a reduction of one year would reduce the overall deficit by approximately £323 million and the annual cost by approximately £24 million.

The size of the overall deficit is also sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variations. At 31 December 2008 the discount rate used was 6.3 per cent (2007: 5.8 per cent); a reduction of 0.2 per cent would increase the overall deficit by

Notes to the accounts

3 Critical accounting estimates and judgements (continued)

approximately £469 million and the annual cost by approximately £7 million, while an increase of 0.2 per cent would reduce the net deficit by approximately £393 million and the annual cost by approximately £9 million.

Goodwill

At 31 December 2008 the Group carried goodwill on its balance sheet totalling £2,256 million (2007: £2,358 million), substantially all of which relates to acquisitions made a number of years ago.

The Group reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place. The impairment review is performed by projecting future cash flows, excluding finance and tax, based upon budgets and plans and making appropriate assumptions about rates of growth and discounting these using a rate that takes into account prevailing market interest rates and the risks inherent in the business. If the present value of the projected cash flows is less than the carrying value of the underlying net assets and related goodwill an impairment charge is required in the income statement. This calculation requires the exercise of significant judgement by management; if the estimates made prove to be incorrect or performance does not meet expectations which affects the amount and timing of future cash flows, goodwill may become impaired in future periods. Further details are given in note 22.

Insurance

Life assurance business

The Group carries in its balance sheet an asset representing the value of in-force business in respect of life insurance and participating investment contracts of £1,893 million at 31 December 2008 (2007: £2,218 million). This asset, which is presented gross of attributable tax, represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. This is determined after making appropriate assumptions about future economic conditions and other matters 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 valuation of the Group's annuity business has been affected by the recent upheaval in the capital markets which has caused a significant widening in corporate bond spreads. Based on available market analysis, an element of this widening in corporate bond spreads has been assessed as arising from an increase in the illiquidity premium. Annuity contracts cannot be surrendered and have reasonably certain cash flows best matched by assets of equivalent maturity with similar liquidity characteristics. As a result, in 2008 the value of in-force business asset for annuity business has been calculated after taking into account an estimate of the market premium for illiquidity derived from market and other published sources using a portfolio of investment grade bonds with similar cash flow characteristics to the annuity liabilities. The effect of this has been to increase the value of in-force business by £842 million as at 31 December 2008 with a similar increase in profit before tax disclosed within other operating income. It is not practicable to estimate the effect of this change on the results of future periods.

The assumptions made to derive the discount rates and cash flows are inherently uncertain and changes could significantly affect the value attributed. The process for determining key assumptions that have been made at 31 December 2008 is detailed in notes 23 and 33.

At 31 December 2008 the Group also carried substantial liabilities to holders of life, pensions and investment contracts in its balance sheet. The methodology used to value the liabilities is described in note 2 (s) (1). Liabilities arising from insurance contracts and participating investment contracts were £21,553 million and £11,619 million respectively (2007: £22,655 million and £14,874 million) and those arising from non-participating investment contracts totalled £14,243 million (2007: £18,197 million). Elements of the liabilities require assumptions about future investment returns, future mortality rates and future policyholder behaviour. The impact on profit before tax of changes in key assumptions is detailed in note 34.

General insurance business

At 31 December 2008 the Group held a provision of £183 million (2007: £207 million) in respect of 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.

While management believes that the liability carried at year end is adequate, the application of statistical techniques requires significant judgment. An increase of 10 per cent in the cost of claims would result in the recognition of an additional loss of approximately £18 million. Similarly, an increase of 10 per cent in the ultimate number of such claims would lead to an additional loss of approximately £18 million; some relief would arise from reinsurance contracts held.

Notes to the accounts

3 Critical accounting estimates and judgements (continued)

Taxation

At 31 December 2008 the Group had a current tax asset of £440 million and a deferred tax asset of £837 million (2007: a current tax liability of £414 million and a deferred tax liability of £949 million). During 2008 the Group's net tax position has shifted from a liability of £1,363 million at 31 December 2007 to an asset of £1,277 million at 31 December 2008. While the Group has taken account of tax issues that are subject to ongoing discussion with HM Revenue & Customs and other tax authorities in recognising these assets a significant feature is the management judgement in determining the timing, forecasting and probability of them reversing. This involved a detailed review of profit and loss numbers for 2007 and 2008 to ensure any carry forward positions were optimised at 31 December 2008. The outcome of this exercise has been mapped into 2009 profit and loss estimates and beyond and supports the above assets.

Inherent in this exercise has been management's assessment of legal and professional advice, case law and other relevant guidance. The various risks are categorised and appropriate weightings applied in arriving at the numbers. Where the expected tax outcome of these tax risks is different from the amounts that were initially recorded, such differences will impact the current and deferred tax numbers in the period in which such determination is made.

4 Segmental analysis

Lloyds TSB Bank Group is a leading financial services group, whose businesses provide a wide range of banking and financial services predominantly in the UK.

At 31 December 2008 the Group's activities were organised into three segments: UK Retail Banking, Insurance and Investments and Wholesale and International Banking. Services provided by UK Retail Banking encompass the provision of banking and other financial services to personal customers, private banking and mortgages. Insurance and Investments offers life assurance, pensions and savings products, general insurance and asset management services. Wholesale and International Banking provides banking and related services for major UK and multinational companies, banks and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers, manages the Group's activities in financial markets through its treasury function and provides banking and financial services in some overseas locations.

Under the Group's transfer pricing arrangements, 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 those derivative contracts entered into by business units for risk management purposes, the business unit retains the amount that would have been recognised on an accrual accounting basis (an amount equal to the interest element of the next payment on the swap) and transfers the remainder of the fair value of the swap to the central group segment where the resulting accounting volatility is managed 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, records volatility where it is managed and provides a fair presentation of the segments' operating performance. It is the basis on which the segments are managed and measured internally and is the basis of the Group's internal segmental reporting to the board.

As part of its transition to Basel II on 1 January 2008, the Group has updated its capital and liquidity pricing methodology. The main difference in this approach is to allocate a greater share of certain funding costs, previously allocated to the Central group items segment, to individual divisions. To enable a meaningful period-on-period comparison, the segmental analysis for the year ended 31 December 2007 has been restated to reflect these changes.

Notes to the accounts

4 Segmental analysis (continued)

	UK Retail Banking £m	General insurance £m	Life, pensions and asset management £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Inter-segment eliminations £m	Total £m
Year ended 31 December 2008								
Interest and similar income	9,437	25	1,048	1,073	10,561	1,742	(5,244)	17,569
Interest and similar expense	(5,327)	(19)	(456)	(475)	(7,258)	(1,981)	5,244	(9,797)
Net interest income	4,110	6	592	598	3,303	(239)	-	7,772
Other income (net of fee and commission expense)	1,766	579	(3,680)	(3,101)	829	(268)	-	(774)
Total income	5,876	585	(3,088)	(2,503)	4,132	(507)	-	6,998
Insurance claims	-	(193)	3,052	2,859	-	-	-	2,859
Total income, net of insurance claims	5,876	392	(36)	356	4,132	(507)	-	9,857
Operating expenses	(2,730)	(161)	(502)	(663)	(2,630)	3	-	(6,020)
Trading surplus (deficit)	3,146	231	(538)	(307)	1,502	(504)	-	3,837
Impairment	(1,472)	-	(2)	(2)	(1,508)	(30)	-	(3,012)
Profit (loss) before tax	1,674	231	(540)	(309)	(6)	(534)	-	825
External revenue	9,804	1,176	(2,130)	(954)	7,679	960	-	17,489
Inter-segment revenue	1,002	65	120	185	2,395	1,152	(4,734)	-
Segment revenue	10,806	1,241	(2,010)	(769)	10,074	2,112	(4,734)	17,489
External assets	127,502	1,123	65,426	66,549	238,832	3,308	-	436,191
Inter-segment assets	5,679	564	2,779	3,343	143,842	98,190	(251,054)	-
Total assets	133,181	1,687	68,205	69,892	382,674	101,498	(251,054)	436,191
External liabilities	97,929	904	56,509	57,413	249,149	22,128	-	426,619
Inter-segment liabilities	31,361	74	7,088	7,162	128,681	83,850	(251,054)	-
Total liabilities	129,290	978	63,597	64,575	377,830	105,978	(251,054)	426,619
Other segment items:								
Capital expenditure	167	9	227	236	837	196	-	1,436
Depreciation and amortisation	215	16	34	50	421	-	-	686
Movement in value of in-force business	-	-	(325)	(325)	-	-	-	(325)
Impairment of goodwill	-	-	-	-	100	-	-	100
Defined benefit scheme charges	103	2	19	21	85	(45)	-	164

Notes to the accounts

4 Segmental analysis continued

	UK Retail Banking £m	General insurance £m	Life, pensions and asset management £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Inter-segment eliminations £m	Total £m
Year ended 31 December 2007								
Interest and similar income	7,964	23	1,040	1,063	9,762	1,386	(3,301)	16,874
Interest and similar expense	(4,269)	(18)	(682)	(700)	(7,353)	(1,720)	3,301	(10,741)
Net interest income	3,695	5	358	363	2,409	(334)	–	6,133
Other income (net of fee and commission expense)	1,797	554	7,643	8,197	1,773	378	–	12,145
Total income	5,492	559	8,001	8,560	4,182	44	–	18,278
Insurance claims	–	(302)	(7,220)	(7,522)	–	–	–	(7,522)
Total income, net of insurance claims	5,492	257	781	1,038	4,182	44	–	10,756
Operating expenses	(2,624)	(154)	(501)	(655)	(2,282)	33	–	(5,528)
Trading surplus	2,868	103	280	383	1,900	77	–	5,228
Impairment	(1,224)	–	–	–	(572)	–	–	(1,796)
Profit on sale of businesses	–	–	272	272	385	–	–	657
Profit before tax	1,644	103	552	655	1,713	77	–	4,089
External revenue	9,132	1,235	8,854	10,089	10,082	316	–	29,619
Inter-segment revenue	958	49	181	230	1,487	1,591	(4,266)	–
Segment revenue	10,090	1,284	9,035	10,319	11,569	1,907	(4,266)	29,619
External assets	115,012	1,164	72,213	73,377	163,294	1,860	–	353,543
Inter-segment assets	5,093	361	3,777	4,138	91,246	64,654	(165,131)	–
Total assets	120,105	1,525	75,990	77,515	254,540	66,514	(165,131)	353,543
External liabilities	96,166	870	65,304	66,174	162,376	15,388	–	340,104
Inter-segment liabilities	20,321	12	5,930	5,942	86,159	52,709	(165,131)	–
Total liabilities	116,487	882	71,234	72,116	248,535	68,097	(165,131)	340,104
Other segment items:								
Capital expenditure	80	11	452	463	613	178	–	1,334
Depreciation and amortisation	205	14	37	51	374	–	–	630
Movement in value of in-force business	–	–	(93)	(93)	–	–	–	(93)
Defined benefit scheme charges	114	3	26	29	92	(60)	–	175

As the activities of the Group are predominantly carried out in the UK, no geographical analysis is presented.

Notes to the accounts

5 Net interest income

	Weighted average effective interest rate		2008 £m	2007 £m
	2008 %	2007 %		
Interest receivable:				
Loans and advances to customers	6.31	6.88	13,855	13,209
Loans and advances to banks	4.63	5.14	1,861	2,025
Lease and hire purchase receivables	7.62	6.34	706	602
Interest receivable on loans and receivables	6.10	6.58	16,422	15,836
Available-for-sale financial assets	4.58	4.83	1,147	1,038
Total interest receivable	5.97	6.43	17,569	16,874
Interest payable:				
Deposits from banks	3.65	5.00	(1,540)	(1,919)
Customer accounts	3.22	3.55	(4,946)	(5,097)
Debt securities in issue	4.19	5.11	(2,154)	(2,620)
Subordinated liabilities	6.28	6.16	(901)	(755)
Liabilities under sale and repurchase agreements	4.45	4.81	(256)	(155)
Interest payable on liabilities held at amortised cost	3.67	4.24	(9,797)	(10,546)
Other	-	4.28	-	(195)
Total interest payable	3.61	4.24	(9,797)	(10,741)
Net interest income			7,772	6,133

Included within interest receivable is £435 million (2007: £395 million) in respect of impaired financial assets. Net interest income also includes a charge of £16 million (2007: credit of £1 million) transferred from the cash flow hedging reserve (see note 44).

6 Net fee and commission income

	2008 £m	2007 £m
Fee and commission income:		
Current accounts	707	693
Insurance broking	549	648
Credit and debit card fees	581	536
Trust and other fiduciary fees	413	362
Other	981	988
	3,231	3,227
Fee and commission expense	(694)	(600)
Net fee and commission income	2,537	2,627

As discussed in note 2(d), 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.

Notes to the accounts

7 Net trading income

	2008 £m	2007 £m
Foreign exchange translation gains	58	33
Gains on foreign exchange trading transactions	75	159
Total foreign exchange	133	192
Investment property losses (note 21)	(1,058)	(321)
Securities and other (losses) gains (see below)	(8,330)	3,265
Net trading income	(9,255)	3,136

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

	2008 £m	2007 £m
Net income (expense) arising on assets held at fair value through profit or loss:		
Loans and advances to banks and customers	20	23
Debt securities	918	673
Equity shares	(7,770)	2,419
Total net (expense) income arising on assets held at fair value through profit or loss	(6,832)	3,115
Net expense arising on liabilities held at fair value through profit or loss – debt securities in issue	(232)	(153)
Total net (losses) gains arising on assets and liabilities held at fair value through profit or loss	(7,064)	2,962
Net (losses) gains on financial instruments held for trading	(1,266)	303
Securities and other (losses) gains	(8,330)	3,265

8 Insurance premium income

	2008 £m	2007 £m
<i>Life insurance</i>		
Gross premiums	4,841	4,937
Ceded reinsurance premiums	(41)	(98)
Net earned premiums	4,800	4,839
<i>Non-life insurance</i>		
Gross premiums written	651	632
Ceded reinsurance premiums	(23)	(23)
Net premiums	628	609
Change in provision for unearned premiums	(16)	(18)
Net earned premiums	612	591
Total net earned premiums	5,412	5,430

Life insurance gross written premiums can be further analysed as follows:

	2008 £m	2007 £m
Life and pensions	4,182	4,233
Annuities	645	689
Other	14	15
Gross premiums	4,841	4,937

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

	2008 £m	2007 £m
Credit protection	203	212
Home	441	412
Health	7	8
	651	632

Notes to the accounts

9 Other operating income

	2008 £m	2007 £m
Operating lease rental income	392	393
Rental income from investment property (note 21)	209	227
Other rents receivable	32	31
Gains less losses on disposal of available-for-sale financial assets (note 44)	19	5
Movement in value of in-force business (note 23)	(325)	(93)
Car dealership income	–	49
Other income	205	340
	532	952

10 Insurance claims

	2008 £m	2007 £m
Insurance claims comprise:		
<i>Life insurance and participating investment contracts</i>		
Claims and surrenders:		
Gross	(4,710)	(5,432)
Reinsurers' share	65	73
	(4,645)	(5,359)
Change in liabilities:		
Gross	7,364	(1,955)
Reinsurers' share	49	(20)
	7,413	(1,975)
Change in unallocated surplus (note 36)	284	114
Total life insurance and participating investment contracts	3,052	(7,220)
<i>Non-life insurance</i>		
Claims and claims paid:		
Gross	(219)	(250)
Reinsurers' share	7	–
	(212)	(250)
Change in liabilities:		
Gross	24	(58)
Reinsurers' share	(5)	6
	19	(52)
Total non-life insurance	(193)	(302)
Total insurance claims credit/(expense)	2,859	(7,522)
Life insurance gross claims can also be analysed as follows:		
Deaths	(289)	(296)
Maturities	(1,888)	(1,516)
Surrenders	(1,960)	(2,994)
Annuities	(516)	(568)
Other	(57)	(58)
	(4,710)	(5,432)

A non-life insurance claims development table is included in note 33.

Notes to the accounts

11 Operating expenses

	2008 £m	2007 £m
Salaries	2,183	2,127
Social security costs	176	167
Pensions and other post-retirement benefit schemes (note 38)	235	238
Other staff costs	337	372
Staff costs	2,931	2,904
Other administrative expenses:		
Operating lease rentals	265	250
Repairs and maintenance	151	154
Communications and data processing	455	462
Advertising	194	192
Professional fees	224	279
Provision in respect of certain historic US dollar payments (note 49)	180	–
Provision for Financial Services Compensation Scheme levy (note 49)	122	–
Settlement of overdraft claims	–	76
Other	712	581
	2,303	1,994
Depreciation of tangible fixed assets (note 25)	648	594
Amortisation of other intangible assets (note 24)	38	36
Goodwill impairment charge (note 22)	100	–
Total operating expenses	6,020	5,528

The average number of persons on a headcount basis employed by the Group during the year was 66,473 (2007: 69,533) of which 64,355 (2007: 67,616) were employed in the UK and 2,118 (2007: 1,937) overseas.

Fees payable to the Bank's auditors

During the year the auditors earned the following fees:

	2008 £m	2007 £m
Fees payable for the audit of the Bank's annual report	7.0	6.7
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	2.5	2.5
Other services supplied pursuant to legislation	3.0	2.7
Other services relating to taxation	0.5	0.7
Services relating to corporate finance transactions	0.4	0.7
All other services	6.0	1.2
Total fees payable to the Bank's auditors	19.4	14.5

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

	2008 £m	2007 £m
Audits of the Group pension schemes	0.2	0.2
Audits of unconsolidated Open Ended Investment Companies managed by the Group	0.5	0.4
Reviews of the financial position of corporate and other borrowers	1.4	2.8
Acquisition due diligence and other work performed in respect of potential venture capital investments	1.0	0.6

12 Impairment

	2008 £m	2007 £m
Impairment losses on loans and advances (note 19)	2,876	1,721
Other credit risk provisions (note 40)	6	5
	2,882	1,726
Impairment of available-for-sale financial assets	130	70
Total impairment charged to the income statement	3,012	1,796

Notes to the accounts

13 Profit on sale of businesses

	2008 £m	2007 £m
Profit on sale of Lloyds TSB Registrars	–	407
Profit on sale of Abbey Life	–	272
Other, including adjustments in respect of businesses sold in prior years	–	(22)
Profit on sale of businesses	<u>–</u>	<u>657</u>

During 2007 the Group completed the sale of the business and assets of Lloyds TSB Bank plc's company registration business, Lloyds TSB Registrars, the sale of Abbey Life Assurance Company Limited, a UK life operation which had been closed to new business since 2000, and the sale of the Dutton-Forshaw Group Limited, a medium-size car dealership. In addition, provision was made for payments under an indemnity given in relation to a business sold in an earlier year. The businesses sold in 2007 did not represent separate material lines of business and consequently they were not treated as discontinued operations.

14 Taxation

	2008 £m	2007 £m
a Analysis of credit/(charge) for the year		
UK corporation tax:		
Current tax on profit for the year	(642)	(778)
Adjustments in respect of prior years	(40)	67
	<u>(682)</u>	<u>(711)</u>
Double taxation relief	39	60
	<u>(643)</u>	<u>(651)</u>
Foreign tax:		
Current tax on profit for the year	(104)	(97)
Adjustments in respect of prior years	4	3
	<u>(100)</u>	<u>(94)</u>
Current tax charge	(743)	(745)
Deferred tax (note 39)	762	72
Tax credit (charge)	<u>19</u>	<u>(673)</u>

As a result of the Finance Act 2007, the statutory rate of corporation tax was reduced from 30 per cent to 28 per cent with effect from 1 April 2008. Therefore the charge for tax on the profit for the year is based on a UK corporation tax rate of 28.5 per cent (2007: 30 per cent).

The Group, as a proxy for policyholders in the UK, is required to record taxes on investment income, gains and losses each year. Accordingly, the tax attributable to UK life insurance policyholder earnings is included in income tax expense. The tax credit attributable to policyholders was £471 million (2007: tax credit of £243 million), including a prior year tax charge of £4 million (2007: tax charge of £5 million).

In addition to the income statement current tax charge, a total of £675 million of current tax has been credited to equity (2007: a total of £128 million credit to equity); a credit of £584 million (2007: a credit of £103 million) in respect of foreign exchange differences and a net credit of £91 million (2007: a net credit of £25 million) in respect of the revaluation of available-for-sale financial assets.

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

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

	2008 £m	2007 £m
Profit before tax	<u>825</u>	<u>4,089</u>
Tax charge thereon at UK corporation tax rate of 28.5% (2007: 30%)	<u>(235)</u>	<u>(1,227)</u>
Factors affecting charge:		
Goodwill impairment	(28)	–
Disallowed and non-taxable items	6	20
Overseas tax rate differences	(39)	4
Gains exempted or covered by capital losses	25	274
Policyholder interests	337	173
UK corporation tax rate change	(6)	110
Other items	(41)	(27)
Tax credit/(charge) on profit on ordinary activities	<u>19</u>	<u>(673)</u>
Effective rate	<u>(2.3%)</u>	<u>16.5%</u>

Notes to the accounts

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

	The Group		The Bank					
	2008 £m	2007 £m	2008 £m	2007 £m				
Trading assets	857	4,663	857	4,663				
Other financial assets at fair value through profit or loss	44,258	53,433	2,822	4,521				
	45,115	58,096	3,679	9,184				
These assets are comprised as follows:								
	2008		2007		2008		2007	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to banks	-	-	29	1	-	-	29	1
Loans and advances to customers	283	325	756	403	283	325	756	403
Debt securities:								
Government securities	38	7,326	62	4,848	38	-	62	1
Other public sector securities	-	18	-	-	-	-	-	-
Bank and building society certificates of deposit	-	433	-	811	-	-	-	-
Mortgage backed securities	-	369	87	70	-	-	87	8
Other asset backed securities	-	1,342	122	1,805	-	105	122	282
Corporate and other debt securities	536	11,120	3,607	13,564	536	2,387	3,607	3,823
	574	20,608	3,878	21,098	574	2,492	3,878	4,114
Equity shares:								
Listed	-	16,620	-	23,783	-	-	-	-
Unlisted	-	6,705	-	8,148	-	5	-	3
	-	23,325	-	31,931	-	5	-	3
	857	44,258	4,663	53,433	857	2,822	4,663	4,521

At 31 December 2008 £44,097 million (2007: £55,914 million) of trading and other financial assets at fair value through profit or loss of the Group and £3,376 million (2007: £8,111 million) of the Bank had a contractual residual maturity of greater than one year.

Other financial assets at fair value through profit or loss represent the following assets designated into that category:

- financial assets backing insurance contracts and investment contracts 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;
- certain loans and advances to customers 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
- certain private equity investments 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 2008 of the loans and advances to banks and customers designated at fair value through profit or loss by the Bank and the Group was £325 million (2007: £404 million); the Bank and the Group do 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; this is determined by reference to the publicly available credit ratings of the instruments involved.

The carrying value of assets of the Group that are subject to stocklending arrangements was £809 million at 31 December 2008 (2007: £1,450 million) all of which the secured party is permitted by contract or custom to sell or repledge.

The Group's Corporate Markets business has no direct exposure to US sub-prime ABS and limited indirect exposure through asset-backed security collateralised debt obligations (ABS CDOs). During 2008, the market value of Corporate Markets' holdings in ABS CDOs reduced and, as a result, there has been an income statement charge of £92 million (2007: £114 million). The Group's Corporate Markets business has no exposure to mezzanine ABS CDOs. In addition, there are £1,867 million (2007: £1,861 million) of ABS CDOs which remain fully cash collateralised by major global financial institutions.

At 31 December 2008, the Group's Corporate Markets business had fair value exposure to one monoline financial guarantor in the form of credit default swap (CDS) protection bought against a £256 million collateralised loan obligation (CLO) (2007: exposure to one monoline against a £198 million CLO and one monoline against a £467 million collateralised debt obligation). The exposure on this CDS was £10 million, following a £28 million adverse credit valuation adjustment. A restructuring of Corporate Markets' other monoline hedged ABS CDO during 2008 has eliminated any reliance on the financial guarantor and has resulted in a much improved risk profile (AA) on a reduced holding of £128 million, included in loans and advances. Credit valuation adjustments and restructuring costs related to the cancelled CDS in the amount of £275 million were recognised in the income statement.

At 31 December 2008, fair values of £956 million (2007: £1,570 million) of the Group's trading and other financial assets classified as fair value through profit or loss, held within the Corporate Markets business, were valued using unobservable inputs. These assets largely represent the Group's venture capital investments, for which values are determined using valuation techniques which follow British Venture Capital Association (BVCA) guidelines. In respect of these assets, during the year to 31 December 2008, a credit of £111 million (2007: credit of £51 million) was recognised in the income statement relating to the change in their fair values.

Notes to the accounts

16 Derivative financial instruments

The principal derivatives used by the Group and the Bank are interest rate and exchange rate contracts; particular attention is paid to the liquidity of the markets and products in which the Group and the Bank trade to ensure that there are no undue concentrations of activity and risk.

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. As discussed in note 18, the Group also uses credit default swaps to securitise, in combination with external funding, £8,360 million (Bank: £2,434 million) of corporate and commercial banking loans (2007: Group £4,325 million; Bank £1,543 million).

Equity derivatives are also used by the Group and the Bank as part of their equity based retail product activity to eliminate the Group's and the Bank's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group and the Bank the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

The principal amount of the contract does not represent the Group's and the Bank's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group or the Bank 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. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and options pricing models, as appropriate.

At 31 December 2008, £578 million (2007: £14 million) of fair value liabilities were valued using unobservable inputs; a charge of £512 million (2007: charge of £14 million) was recognised in the income statement relating to the change in fair value. The effect of using reasonably possible favourable and adverse valuation assumptions would be to increase or decrease net trading income by up to £80 million respectively.

The Group

	2008			2007		
	Contract/ notional amount £m	Fair values		Contract/ notional amount £m	Fair values	
		Assets £m	Liabilities £m		Assets £m	Liabilities £m
Trading						
Exchange rate contracts:						
Spot, forwards and futures	157,572	5,788	4,102	150,450	1,759	1,285
Currency swaps	31,874	4,367	2,409	32,447	832	755
Options purchased	9,185	714	–	7,609	157	–
Options written	10,143	–	743	6,988	–	149
	208,774	10,869	7,254	197,494	2,748	2,189
Interest rate contracts:						
Interest rate swaps	370,333	11,797	12,990	334,159	2,765	3,344
Forward rate agreements	153,930	405	395	102,274	36	34
Options purchased	37,175	843	–	33,147	171	–
Options written	33,130	–	627	22,976	–	171
Futures	587	44	3	35,571	1	–
	595,155	13,089	14,015	528,127	2,973	3,549
Credit derivatives	32,495	4,257	2,670	63,444	1,838	1,057
Equity and other contracts	5,447	234	81	4,439	865	156
Total derivative assets/liabilities held for trading		28,449	24,020		8,424	6,951
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps (including swap options)	37,243	434	1,665	50,734	263	460
Derivatives designated as cash flow hedges:						
Interest rate swaps	867	1	91	630	1	24
Derivatives designated as net investment hedges:						
Cross currency swaps	6,318	–	2,413	5,302	–	316
Total derivative assets/liabilities held for hedging		435	4,169		264	800
Total recognised derivative assets/liabilities		28,884	28,189		8,688	7,751

At 31 December 2008 £16,200 million of total recognised derivative assets of the Group and £15,814 million of total recognised derivative liabilities of the Group (2007: £3,573 million of assets and £4,281 million of liabilities) had a contractual residual maturity of greater than one year.

Notes to the accounts

16 Derivative financial instruments (continued)**The Bank**

	2008			2007		
	Contract/ notional amount £m	Fair values		Contract/ notional amount £m	Fair values	
		Assets £m	Liabilities £m		Assets £m	Liabilities £m
Trading						
Exchange rate contracts:						
Spot, forwards and futures	165,836	5,783	4,228	155,435	1,804	1,306
Currency swaps	36,549	2,372	4,840	38,044	834	1,093
Options purchased	9,220	722	–	8,694	157	–
Options written	10,204	–	763	7,008	–	150
	221,809	8,877	9,831	209,181	2,795	2,549
Interest rate contracts:						
Interest rate swaps	374,626	11,663	12,708	347,033	2,777	3,365
Forward rate agreements	154,330	405	395	103,902	36	34
Options purchased	37,317	859	–	33,543	174	–
Options written	33,564	–	639	23,061	–	174
Futures	–	–	–	35,189	–	–
	599,837	12,927	13,742	542,728	2,987	3,573
Credit derivatives	39,888	4,257	3,986	63,195	1,838	1,053
Equity and other contracts	7,344	208	208	6,728	733	733
Total derivative assets/liabilities held for trading		26,269	27,767		8,353	7,908
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps (including swap options)	38,243	434	1,872	50,209	270	433
Derivatives designated as cash flow hedges:						
Interest rate swaps	867	1	91	630	1	24
Total derivative assets/liabilities held for hedging		435	1,963		271	457
Total recognised derivative assets/liabilities		26,704	29,730		8,624	8,365

At 31 December 2008 £14,817 million of total recognised derivative assets of the Bank and £15,796 million of total recognised derivative liabilities of the Bank (2007: £3,590 million of assets and £4,687 million of liabilities) had a contractual residual maturity of greater than one year.

17 Loans and advances to banks

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Lending to banks	5,104	5,892	14,341	8,474
Money market placements with banks	35,812	28,953	24,810	19,973
Total loans and advances to banks	40,916	34,845	39,151	28,447
Allowance for impairment losses (note 19)	(158)	–	(158)	–
	40,758	34,845	38,993	28,447

At 31 December 2008 £5,459 million (2007: £5,773 million) of loans and advances to banks of the Group and £4,460 million (2007: £4,312 million) of the Bank had a contractual residual maturity of greater than one year.

The Group and the Bank hold collateral with a fair value of £10,739 million (2007: £9,109 million), which they are permitted to sell or repledge, of which £5,492 million (2007: £8,482 million) was repledged or sold to third parties for periods not exceeding three months from the transfer.

Notes to the accounts

18 Loans and advances to customers

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Agriculture, forestry and fishing	3,969	3,226	2,017	1,467
Energy and water supply	2,598	2,102	2,577	2,102
Manufacturing	12,057	8,385	11,074	6,788
Construction	3,016	2,871	2,654	2,531
Transport, distribution and hotels	14,664	11,573	12,773	10,158
Postal and telecommunications	1,060	946	991	907
Property companies	23,318	17,576	21,610	16,303
Financial, business and other services	35,746	29,707	27,362	21,952
Personal:				
Mortgages	114,643	102,739	100,925	90,217
Other	25,318	22,988	20,575	19,120
Lease financing	4,620	4,686	590	–
Hire purchase	5,295	5,423	576	388
Due from fellow Group undertakings	–	–	50,287	42,660
	246,304	212,222	254,011	214,593
Allowance for impairment losses (note 19)	(3,569)	(2,408)	(2,810)	(1,855)
	242,735	209,814	251,201	212,738

At 31 December 2008 £180,197 million (2007: £153,302 million) of loans and advances to customers of the Group and £158,176 million (2007: £129,272 million) of the Bank had a contractual residual maturity of greater than one year.

Included in loans and advances to customers are £6,342 million (2007: £4,201 million) held in Cancara, the Group's hybrid Asset Backed Commercial Paper conduit (see note 20).

During 2008 the Group's Corporate Markets business wrote down the value of its structured investment vehicle (SIV) exposures by £95 million (2007: £22 million) and now has no residual exposure to SIV Capital Notes (2007: exposure of £78 million). Additionally, at 31 December 2008 the Group's Corporate Markets business had a commercial paper back up liquidity facility totalling £22 million (2007: £370 million).

The Group and the Bank hold collateral with a fair value of £1,736 million (2007: £1,975 million), which they are permitted to sell or repledge, of which £366 million (2007: £1,818 million) was repledged or sold to third parties for periods not exceeding three months from the transfer.

Of the Bank's amounts due from fellow Group undertakings at 31 December 2007, US\$5.5 billion was pledged as security against a demand loan made to the Bank by another of its fellow Group undertakings.

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

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Gross investment in finance leases, receivable:				
Not later than 1 year	542	620	54	–
Later than 1 year and not later than 5 years	1,779	1,917	205	–
Later than 5 years	5,639	5,339	748	–
	7,960	7,876	1,007	–
Unearned future finance income on finance leases	(3,038)	(2,875)	(416)	–
Rentals received in advance	(128)	(131)	(1)	–
Commitments for expenditure in respect of equipment to be leased	(174)	(184)	–	–
Net investment in finance leases	4,620	4,686	590	–

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

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Not later than 1 year	329	340	25	–
Later than 1 year and not later than 5 years	978	1,004	116	–
Later than 5 years	3,313	3,342	449	–
	4,620	4,686	590	–

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 2008 and 2007 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 £15 million for the Group (2007: £16 million).

Notes to the accounts

18 Loans and advances to customers (continued)

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

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Not later than 1 year	1	–	–	–
Later than 1 year and not later than 5 years	29	7	15	–
Later than 5 years	3	11	–	–
Total	33	18	15	–

Securitisations

Loans and advances to customers include balances that have been securitised but not derecognised, comprising both residential mortgages and commercial banking loans, the carrying values of which are set out below together with any related liabilities. Residential mortgages are not derecognised because the Group remains exposed to the majority of the risk of any default in respect of them; commercial banking loans are not derecognised because the Group has not transferred the contractual rights to receive the cash flows from those loans nor has it assumed a contractual obligation to pay the cash flows from those loans to a third party.

Beneficial interests in certain residential mortgages have been transferred to special purpose entities which issue floating rate debt securities. Neither the Group nor any entities in the Group are obliged to support any losses that may be suffered by the note holders and do not intend to offer such support. The floating rate note holders only receive payments of interest and principal to the extent that the special purpose entities have received sufficient funds from the transferred mortgages and after certain expenses have been met. In the event of a deficiency, they have no recourse whatsoever to the Group.

At 31 December 2008 the total amount of residential mortgages subject to securitisation for the Group is £34,293 million (2007: £46,284 million) and for the Bank is £34,293 million (2007: £46,284 million) in respect of which external funding at the year end amounted to £9,824 million (2007: £12,403 million) for the Group. £24,457 million (2007: £12,403 million) had been provided to the Bank by a fellow Lloyds Banking Group undertaking. This funding is shown in debt securities in issue (note 32). The Group participates in the securitisation through the provision of administration and other services, the provision of interest rate and currency swaps and in the form of unsecured loan financing which is subordinate to the interests of the floating rate note holders.

A further £40,608 million of residential mortgages are subject to securitisation in a covered bond programme; the related bonds have been issued to Lloyds TSB Bank plc, and are available for use in connection with Lloyds TSB Bank plc's participation in the Bank of England's Special Liquidity Scheme.

In addition the Group has entered into a number of securitisations of elements of its corporate and commercial loan portfolio. The total value of loans so securitised was £8,360 million (£2,434 million for the Bank; 2007: £4,325 million for the Group and £1,543 million for the Bank), utilising a combination of external funding totalling £226 million (2007: £98 million) and credit default swaps.

The external funding is shown in debt securities in issue (see note 32) and the credit default swaps are accounted for as derivatives (see note 16).

19 Allowance for impairment losses on loans and advances**The Group**

	Loans and advances to customers				Loans and advances to banks	
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	£m	Total £m
Balance at 1 January 2007	42	1,918	233	2,193	1	2,194
Exchange and other adjustments	–	–	2	2	–	2
Advances written off	(25)	(1,439)	(78)	(1,542)	–	(1,542)
Recoveries of advances written off in previous years	2	133	2	137	–	137
Unwinding of discount	–	(101)	(3)	(104)	–	(104)
Charge (credit) to the income statement	18	1,518	186	1,722	(1)	1,721
At 31 December 2007	37	2,029	342	2,408	–	2,408
Exchange and other adjustments	–	–	43	43	–	43
Advances written off	(23)	(1,382)	(205)	(1,610)	–	(1,610)
Recoveries of advances written off in previous years	1	111	–	112	–	112
Unwinding of discount	–	(100)	(2)	(102)	–	(102)
Charge to the income statement	171	1,687	860	2,718	158	2,876
At 31 December 2008	186	2,345	1,038	3,569	158	3,727

The analysis of allowances for impairment 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.

Notes to the accounts

19 Allowance for impairment losses on loans and advances (continued)

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2(j). All impaired loans which exceed a certain threshold, principally within the Group's corporate banking business, are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security.

Included in loans and advances to customers and to banks were loans and advances individually determined to be impaired whose gross amount before impairment allowances was £2,699 million (2007: £684 million) and in respect of which collateral with a fair value of £518 million (2007: £193 million) was held.

The Bank

	Loans and advances to customers				Loans and advances to banks	
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	£m	Total £m
Balance at 1 January 2007	–	1,499	201	1,700	1	1,701
Exchange and other adjustments	–	–	1	1	–	1
Transfer of C&G business (note 27)	23	–	–	23	–	23
Advances written off	(4)	(1,246)	(35)	(1,285)	–	(1,285)
Recoveries of advances written off in previous years	–	113	1	114	–	114
Unwinding of discount	–	(101)	(3)	(104)	–	(104)
Charge (credit) to the income statement	13	1,256	137	1,406	(1)	1,405
At 31 December 2007	32	1,521	302	1,855	–	1,855
Exchange and other adjustments	–	–	43	43	–	43
Advances written off	(20)	(1,204)	(173)	(1,397)	–	(1,397)
Recoveries of advances written off in previous years	1	102	–	103	–	103
Unwinding of discount	–	(106)	(2)	(108)	–	(108)
Charge to the income statement	162	1,379	773	2,314	158	2,472
At 31 December 2008	175	1,692	943	2,810	158	2,968

Included in loans and advances to customers and to banks were loans and advances individually determined to be impaired whose gross amount before impairment allowances was £2,559 million (2007: £646 million) and in respect of which collateral with a fair value of £420 million (2007: £147 million) was held.

20 Available-for-sale financial assets

The Group	2008			2007		
	Cancara £m	Other £m	Total £m	Cancara £m	Other £m	Total £m
Debt securities:						
Government securities	–	868	868	–	319	319
Other public sector securities	–	12	12	–	5	5
Bank and building society certificates of deposit	–	9,602	9,602	–	1,825	1,825
Mortgage backed securities	3,176	1,253	4,429	4,136	1,914	6,050
Other asset backed securities	853	4,103	4,956	1,015	3,056	4,071
Corporate and other debt securities	2,244	4,346	6,590	3,117	3,153	6,270
	6,273	20,184	26,457	8,268	10,272	18,540
Equity shares:						
Listed	–	3	3	–	1	1
Unlisted	–	38	38	–	28	28
	–	41	41	–	29	29
Treasury bills and other bills:						
Treasury bills and similar securities	–	2,402	2,402	–	1,608	1,608
Other bills	–	26,807	26,807	–	19	19
	–	29,209	29,209	–	1,627	1,627
	6,273	49,434	55,707	8,268	11,928	20,196

Notes to the accounts

20 Available-for-sale financial assets (continued)

The Bank	2008 £m	2007 £m
Debt securities:		
Government securities	510	–
Other public sector securities	12	5
Bank and building society certificates of deposit	7,663	1,283
Mortgage backed securities	18,758	1,464
Other asset backed securities	1,932	413
Corporate and other debt securities	2,676	1,027
	31,551	4,192
Equity shares:		
Listed	–	1
Unlisted	36	28
	36	29
Treasury bills and other bills:		
Treasury bills and similar securities	50	20
Other bills	26,807	19
	26,857	39
	58,444	4,260

Cancara is the Group's hybrid Asset Backed Commercial Paper conduit. Total exposures in Cancara were £12,615 million (2007: £12,469 million) comprising the £6,273 million (2007: £8,268 million) of debt securities detailed above and £6,342 million (2007: £4,201 million) of loans and advances to customers (see note 18). Cancara, which is fully consolidated in the Group's accounts, is managed in a very conservative manner, which is demonstrated by the quality and ratings stability of its underlying asset portfolio. At 31 December 2008, the asset-backed securities in Cancara were 91.8 per cent and 94.2 per cent (2007: 100 per cent) Aaa/AAA rated by Moody's and Standard & Poor's respectively, and there was no exposure either directly or indirectly to sub-prime US mortgages within Cancara's debt security portfolio. At 31 December 2008 loans and advances included no US sub-prime mortgage exposure (2007: £115 million).

The other asset-backed securities of the Group not in the Cancara conduit of £4,103 million (2007: £3,056 million) comprise £2,917 million (2007: £2,643 million) of US government guaranteed student loan asset-backed securities and £1,186 million (2007: £413 million) of unhedged asset-backed security collateralised debt obligations.

At 31 December 2008 £15,627 million (2007: £15,265 million) of available-for-sale financial assets of the Group and £17,331 million (2007: £2,294 million) of the Bank had a contractual residual maturity of greater than one year.

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(j). Included in available-for-sale financial assets at 31 December 2008 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £282 million (2007: £75 million) and in respect of which no collateral was held. In addition, included in available-for-sale financial assets at 31 December 2008 are equity securities individually determined to be impaired whose gross amount before impairment allowances was £31 million (2007: £nil).

At 31 December 2008, the Bank had sold £478 million (2007: £607 million) of debt securities to one of its subsidiary undertakings; however the related agreements are such that the Bank has retained substantially all of the risks and rewards of ownership and, as a consequence, the debt securities continue to be recognised on the Bank's balance sheet.

21 Investment property of the Group

	2008 £m	2007 £m
At 1 January	3,722	4,739
Exchange and other adjustments	66	5
Additions:		
Acquisitions of new properties	85	302
Additional expenditure on existing properties	116	181
Total additions	201	483
Disposals	(300)	(271)
Adjustments on deconsolidation of OEICs	–	(881)
Changes in fair value (note 7)	(1,058)	(321)
Disposal of businesses	–	(32)
At 31 December	2,631	3,722

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.

Notes to the accounts

21 Investment property of the Group (continued)

In addition the following amounts have been recognised in the income statement:

	2008	2007
	£m	£m
Rental income	209	227
Direct operating expenses arising from investment properties that generate rental income	29	24
<hr/>		
Capital expenditure in respect of investment properties:	2008	2007
	£m	£m
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	82	111

22 Goodwill

	The Group		The Bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
At 1 January	2,358	2,377	–	8
Exchange and other adjustments	(2)	–	–	–
Disposals	–	(19)	–	(8)
Impairment charged to the income statement	(100)	–	–	–
At 31 December	2,256	2,358	–	–
<hr/>				
Cost*	2,362	2,364	–	–
Accumulated impairment losses	(106)	(6)	–	–
At 31 December	2,256	2,358	–	–

*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 £2,256 million (2007: £2,358 million), £1,836 million (or 81 per cent of the total) has been allocated to Scottish Widows and £410 million (or 18 per cent of the total) to Asset Finance.

The recoverable amount of Scottish Widows has been based on a value in use calculation. The calculation uses 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 (gross of tax). The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady 3 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions 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 cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 15 per cent (gross of tax). The discount rate has been set at a premium over Lloyds Banking Group's weighted average cost of capital to take into account the specific risk profile of the Asset Finance business. The cash flows for each of the businesses of Asset Finance beyond the five-year period are extrapolated using steady growth rates, in each case not exceeding 2.5 per cent nor the long-term average growth rates for the markets in which the respective businesses of Asset Finance participate.

During 2008, the basis of goodwill allocation and the related value in use calculation have been changed to treat the consumer finance business as a single cash generating unit encompassing the motor and personal finance operations which provide direct and point of sale finance; this reflects the strategic and operational interdependencies and shared market dynamics of these units. The markets in which these units operate have been affected by the UK economic downturn, which has been characterised by a fall off in demand and increasing arrears at this point of the cycle. This, together with continuing uncertainties over the likely short-term macroeconomic environment, has resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £100 million at 31 December 2008.

Notes to the accounts

23 Value of in-force business of the Group

The asset in the consolidated balance sheet and movement recognised in the income statement are as follows:

	2008	2007
	£m	£m
Gross value of in-force insurance and participating investment business	2,218	2,723
At 1 January		
Movements in the year:		
New business	368	264
Existing business:		
Expected return	(112)	(166)
Experience variances	(46)	(38)
Assumption changes	(92)	69
Economic variance	(443)	(222)
Movement in value of in-force business taken to income statement (note 9)	(325)	(93)
Disposal of business	-	(412)
At 31 December	1,893	2,218

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown contributes to profit before tax, which would also contain changes in the other assets and liabilities of the relevant businesses. Economic variance is the element of earnings which is generated from changes to economic experience in the period and to 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 the risk-free rate and all cash flows are discounted at the 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 UK gilt yield curve in line with Scottish Widows' FSA realistic balance sheet assumptions.

The valuation of the Group's annuity business has been affected by the recent upheaval in the capital markets which has caused a significant widening in corporate bond spreads in 2008. Based on available market analysis, an element of this widening in corporate bond spreads has been assessed as arising from an increase in the illiquidity premium. Annuity contracts cannot be surrendered and have reasonably certain cash flows best matched by assets of equivalent maturity with similar liquidity characteristics. As a result, in 2008 the value of in-force business asset for annuity business has been calculated after taking into account an estimate of 154 basis points for the market premium for illiquidity, which has been derived from market and other published sources using a portfolio of investment grade bonds with similar cash flow characteristics as the annuity liabilities. The effect of this has been to increase the value of in-force business by £842 million as at 31 December 2008 with a similar increase in profit before tax. This is reflected as an economic variance in the table above, together with other market movements.

The risk-free rate assumed in valuing the in-force asset for annuity business is presented as a single risk-free rate to allow easier comparison to the rate used for other business. That single risk-free rate has been derived to give the equivalent value to the annuity book, had the book been valued using the UK gilt yield curve increased to reflect the illiquidity premium as described above. For 2008, the risk-free rate assumed in valuing the in-force asset for non-annuity business is the 15-year gilt yield.

The table below shows the range of resulting yields and other key assumptions at 31 December:

	2008	2007
	%	%
Risk-free rate (value of in-force non-annuity business)	3.74	4.65
Risk-free rate (value of in-force annuity business)	5.22	4.65
Risk-free rate (financial options and guarantees)	1.11 to 4.24	4.28 to 4.81
Retail price inflation	2.75	3.28
Expense inflation	3.50	4.18

- *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 and the With Profit Fund there are asymmetries in the range of potential outcomes for which an explicit allowance is made.

- *Non-economic assumptions.* Future mortality, morbidity, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and represent management's best estimate of likely future experience. Further information about the effect of changes in key assumptions is given in note 33.

Notes to the accounts

24 Other intangible assets

	The Group			The Bank
	Customer lists £m	Software enhancements £m	Total £m	Software enhancements £m
Cost:				
At 1 January 2007	54	198	252	127
Additions	3	47	50	29
Disposals	–	(5)	(5)	–
At 31 December 2007	57	240	297	156
Additions	6	80	86	65
At 31 December 2008	63	320	383	221
Accumulated amortisation:				
At 1 January 2007	–	114	114	90
Charge for the year	5	31	36	13
Disposals	–	(2)	(2)	–
At 31 December 2007	5	143	148	103
Charge for the year	7	31	38	18
At 31 December 2008	12	174	186	121
Balance sheet amount at 31 December 2008	51	146	197	100
Balance sheet amount at 31 December 2007	52	97	149	53

Software enhancements of the Bank and the Group principally comprise identifiable and directly associated internal staff and other costs.

25 Tangible fixed assets

	The Group				The Bank		
	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m	Premises £m	Equipment £m	Total tangible fixed assets £m
Cost:							
At 1 January 2007	1,488	2,849	2,866	7,203	1,081	2,323	3,404
Exchange and other adjustments	–	2	(24)	(22)	–	1	1
Adjustments on disposal of businesses	(53)	(89)	–	(142)	(6)	(56)	(62)
Adjustments on deconsolidation of subsidiaries	–	–	(1,015)	(1,015)	–	–	–
Additions	60	286	549	895	55	266	321
Disposals	(58)	(177)	(945)	(1,180)	(47)	(108)	(155)
At 31 December 2007	1,437	2,871	1,431	5,739	1,083	2,426	3,509
Exchange and other adjustments	2	18	70	90	2	18	20
Additions	96	341	556	993	91	316	407
Disposals	(19)	(82)	(493)	(594)	(16)	(40)	(56)
At 31 December 2008	1,516	3,148	1,564	6,228	1,160	2,720	3,880
Accumulated depreciation and impairment:							
At 1 January 2007	675	1,960	316	2,951	595	1,525	2,120
Exchange and other adjustments	–	2	(3)	(1)	–	1	1
Adjustments on disposal of businesses	(11)	(35)	–	(46)	(4)	(6)	(10)
Adjustments on deconsolidation of subsidiaries	–	–	(86)	(86)	–	–	–
Charge for the year	83	242	269	594	72	214	286
Disposals	(29)	(162)	(321)	(512)	(26)	(97)	(123)
At 31 December 2007	718	2,007	175	2,900	637	1,637	2,274
Exchange and other adjustments	1	10	21	32	1	10	11
Charge for the year	81	254	313	648	71	228	299
Disposals	(11)	(63)	(243)	(317)	(9)	(28)	(37)
At 31 December 2008	789	2,208	266	3,263	700	1,847	2,547
Balance sheet amount at 31 December 2008	727	940	1,298	2,965	460	873	1,333
Balance sheet amount at 31 December 2007	719	864	1,256	2,839	446	789	1,235

Notes to the accounts

25 Tangible fixed assets (continued)

At 31 December the future minimum rentals receivable by the Group under non-cancellable operating leases were as follows:	2008	2007
	£m	£m
Receivable within 1 year	294	259
1 to 5 years	320	271
Over 5 years	9	9
	623	539

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2007 and 2008 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £102 million for the Group and £93 million for the Bank at 31 December 2008 (£113 million for the Group and £104 million for the Bank at 31 December 2007) is expected to be received under non-cancellable sub-leases of premises.

26 Investment in subsidiary undertakings

	2008	2007
	£m	£m
At 1 January	16,137	18,527
Additions	817	2,933
Additional capital injections and transfers	50	313
Capital repayments	(805)	(5,628)
Disposals	(187)	(8)
Permanent diminution in value	(20)	–
At 31 December	15,992	16,137

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

	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Lloyds TSB Commercial Finance Limited	England	100%	Credit factoring
Lloyds TSB Leasing Limited	England	100%	Financial leasing
Lloyds TSB Private Banking Limited	England	100%	Private banking
The Agricultural Mortgage Corporation PLC	England	100%	Long-term agricultural finance
Lloyds TSB Offshore Limited	Jersey	100%*	Banking and financial services
Lloyds TSB Scotland plc	Scotland	100%	Banking and financial services
Lloyds TSB General Insurance Limited	England	100%*	General insurance
Scottish Widows Investment Partnership Group Limited	England	100%*	Investment management
Lloyds TSB Insurance Services Limited	England	100%*	Insurance broking
Lloyds TSB Asset Finance Division Limited	England	100%	Consumer credit, leasing and related services
Black Horse Limited	England	100%*	Consumer credit, leasing and related services
Scottish Widows plc	Scotland	100%*	Life assurance
Scottish Widows Annuities Limited	Scotland	100%*	Life assurance

*Indirect interest.

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

None of the Bank's subsidiaries has experienced any significant restrictions 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.

Notes to the accounts

27 Transfer of mortgage and banking business of Cheltenham & Gloucester plc in 2007

The mortgage and banking business of the Bank's wholly-owned subsidiary, Cheltenham & Gloucester plc (C&G), was transferred to the Bank on 1 October 2007 under a Court approved scheme pursuant to Part VII of the Financial Services and Markets Act 2000. Consideration for the transfer was nil and the reserve arising on transfer was reduced by the carrying value of most of the Bank's investment in C&G. The assets and liabilities transferred were as follows:

	£m
Loans and advances to customers (net of impairment allowances of £23 million)	87,142
Customer accounts	(14,826)
Debt securities in issue	(13,255)
Subordinated liabilities	(700)
Funding from the Bank no longer required	(55,374)
Other net liabilities	(669)
	<u>2,318</u>
Consideration paid	–
	<u>2,318</u>
Reduction in the Bank's investment in C&G	(1,745)
Net amount arising from transfer credited to retained profits	<u>573</u>

28 Other assets

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Assets arising from reinsurance contracts held (note 33)	385	350	–	–
Deferred acquisition costs	196	212	–	–
Settlement balances	751	205	493	54
Other assets and prepayments	4,487	4,279	2,060	2,109
	<u>5,819</u>	<u>5,046</u>	<u>2,553</u>	<u>2,163</u>

At 31 December 2008 £1,838 million (2007: £1,785 million) of other assets of the Group and £245 million (2007: £226 million) of the Bank had a contractual residual maturity of greater than one year.

	2008 £m	2007 £m
Deferred acquisition costs of the Group:		
At 1 January	212	443
Acquisition costs deferred, net of amounts amortised to the income statement	(16)	(22)
Disposal of businesses and other adjustments	–	(209)
At 31 December	<u>196</u>	<u>212</u>

29 Deposits from banks

The breakdown of deposits from banks between domestic and international offices is set out below:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Domestic:				
Non-interest bearing	131	101	2,671	104
Interest bearing	58,471	32,335	69,847	42,107
	<u>58,602</u>	<u>32,436</u>	<u>72,518</u>	<u>42,211</u>
International:				
Non-interest bearing	23	46	23	46
Interest bearing	7,889	6,609	7,988	6,683
	<u>7,912</u>	<u>6,655</u>	<u>8,011</u>	<u>6,729</u>
	<u>66,514</u>	<u>39,091</u>	<u>80,529</u>	<u>48,940</u>

At 31 December 2008 £1,956 million (2007: £25 million) of deposits from banks of the Group and £2,489 million (2007: £563 million) of the Bank had a contractual residual maturity of greater than one year.

Included in deposits from banks, for both the Group and the Bank, were deposits of £2,574 million (2007: £1,509 million) held as collateral, principally in relation to derivative contracts. The fair value of those deposits approximates the carrying amount.

Notes to the accounts

30 Customer accounts

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Non-interest bearing current accounts	4,176	3,807	3,936	3,588
Interest bearing current accounts	47,109	45,726	44,101	42,586
Savings and investment accounts	76,144	71,905	64,653	62,178
Other customer deposits	44,935	35,275	71,351	54,893
Customer accounts	172,364	156,713	184,041	163,245

The breakdown of customer accounts between domestic and international offices is set out below:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Domestic:				
Non-interest bearing	4,685	3,476	6,504	5,717
Interest bearing	163,075	149,501	171,490	151,654
	167,760	152,977	177,994	157,371
International:				
Non-interest bearing	646	400	650	699
Interest bearing	3,958	3,336	5,397	5,175
	4,604	3,736	6,047	5,874
Customer accounts	172,364	156,713	184,041	163,245

At 31 December 2008 £3,166 million (2007: £1,950 million) of customer accounts of the Group and £9,476 million (2007: £12,199 million) of the Bank had a contractual residual maturity of greater than one year.

Included in customer accounts were deposits of £1,002 million (2007: £777 million) of the Group and £982 million (2007: £629 million) of the Bank held as collateral, principally in relation to derivative contracts. The fair value of those deposits approximates the carrying amount.

31 Trading and other financial liabilities at fair value through profit or loss

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Liabilities held at fair value through profit or loss (debt securities)	6,748	3,107	6,748	3,107
Trading liabilities	6	99	6	99
Trading and other financial liabilities at fair value through profit or loss	6,754	3,206	6,754	3,206

At 31 December 2008, for both the Group and the Bank, £6,525 million (2007: £2,032 million) of trading and other liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2008 was £6,517 million (2007: £3,131 million), which was £231 million lower (2007: £24 million higher) than the balance sheet carrying value. At 31 December 2008 there was a cumulative £44 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 the Bank. Of the £44 million, £36 million arose in 2008 and £8 million arose in 2007.

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.

32 Debt securities in issue

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Euro medium-term note programme	9,178	4,692	9,178	4,692
Other bonds and medium-term notes	10,051	12,753	24,457	12,403
Certificates of deposit issued	33,207	14,995	33,060	14,501
Commercial paper	20,630	17,388	7,864	5,051
Total debt securities in issue	73,066	49,828	74,559	36,647

At 31 December 2008 £16,121 million (2007: £16,860 million) of debt securities in issue of the Group and £26,231 million (2007: £16,565 million) of the Bank had a contractual residual maturity of greater than one year.

Debt securities in issue for the Group at 31 December 2008 included £9,824 million (2007: £12,403 million) of notes issued by the mortgage securitisation vehicles (note 18); debt securities in issue for the Bank at 31 December 2008 included £24,457 million (2007: £12,403 million) of funding provided by those vehicles. Debt securities in issue for the Group at 31 December 2008 also included £226 million (2007: £98 million) in respect of the securitisation of corporate and commercial banking loans (note 18).

Notes to the accounts

33 Liabilities of the Group arising from insurance contracts and participating investment contracts

	2008 £m	2007 £m
Insurance contract liabilities	22,208	23,318
Participating investment contract liabilities	11,619	14,874
	33,827	38,192

At 31 December 2008 £30,002 million (2007: £35,732 million) of liabilities arising from insurance contracts and participating investment contracts had a contractual residual maturity of greater than one year.

Insurance contract liabilities

Insurance contract liabilities, substantially all of which relate to business written in the United Kingdom, are comprised as follows:

	2008			2007		
	Gross £m	Reinsurance* £m	Net £m	Gross £m	Reinsurance* £m	Net £m
Life insurance	21,553	(380)	21,173	22,655	(340)	22,315
Non-life insurance:						
Unearned premiums	472	–	472	456	–	456
Claims outstanding	183	(5)	178	207	(10)	197
	655	(5)	650	663	(10)	653
	22,208	(385)	21,823	23,318	(350)	22,968

*Reinsurance balances receivable are reported within other assets (note 28).

Life insurance

The movement in life insurance contract liabilities over the year can be analysed as follows:

	Gross £m	Reinsurance £m	Net £m
At 1 January 2007	25,920	(425)	25,495
New business	2,428	(18)	2,410
Changes in existing business	(1,344)	15	(1,329)
Disposal of businesses	(4,349)	88	(4,261)
At 31 December 2007	22,655	(340)	22,315
New business	2,915	(32)	2,883
Changes in existing business	(4,017)	(8)	(4,025)
At 31 December 2008	21,553	(380)	21,173

The movement in liabilities arising from participating investment contracts may be analysed as follows:

	£m
At 1 January 2007	15,095
New business	491
Changes in existing business	(712)
At 31 December 2007	14,874
New business	208
Changes in existing business	(3,463)
At 31 December 2008	11,619

Process for determining key assumptions

The process for determining the key assumptions for insurance contracts and participating investment contracts is set out below.

These policy liabilities 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 traditional prospective actuarial discounted cash flow methodology as described in the accounting policies.

With Profit Fund realistic liabilities

The Group's With Profit Fund contains life insurance contracts and participating investment contracts. The calculation of With Profit Fund 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 23. The persistency rates used for the realistic valuation of the With Profit Fund liabilities make an allowance for potential changes in future experience as the guarantees and options within with-profits contracts become more valuable under adverse market conditions.

Notes to the accounts

33 Liabilities of the Group arising from insurance contracts and participating investment contracts (continued)

Other key assumptions 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 UK gilt yield curve.
- *Guaranteed annuity option take-up rates.* The guaranteed annuity option take up rates are set with regard to the Group's actual experience and make allowance for potential increases in take-up rates when the Guaranteed Annuity Options become more valuable to the policyholder.
- *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 2008, the 10 year equity-implied at-the-money assumption was set at 34.6 per cent (31 December 2007: 25.5 per cent). The assumption for property volatility was 15 per cent (31 December 2007: 15 per cent), with swaption volatility of broadly 16 per cent (31 December 2007: broadly 11 per cent).
- *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.* Lapse rates refer to the rate of policy termination and the rate at which policyholders stop paying regular premiums. These rates are based on a combination of historical experience 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.

Non-Profit Fund liabilities

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 FSA Rules. 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 FSA Rules, including reductions made to the available yields to allow for default risk based upon the credit rating of each stock.

- *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.
- *Lapse rates.* Lapse rates, set with regard to the Group's actual experience and with a margin for adverse deviation, are allowed for on some Non-Profit Fund contracts.
- *Maintenance expenses.* Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation.

Key changes in assumptions

During 2008, following a detailed review of the Group's current and expected experience, there has been a change in the key assumption in respect of lapse and paid-up rates. The impact of this change has been to decrease profit before tax by £143 million; this amount includes movements in liabilities and the value of the in-force business in respect of insurance contracts and participating investment contracts.

Non-life insurance

Gross non-life insurance contract liabilities are analysed by line of business as follows:

	2008	2007
	£m	£m
Credit protection	293	274
Home	359	385
Health	3	4
	655	663

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.

Notes to the accounts

33 Liabilities of the Group arising from insurance contracts and participating investment contracts (continued)

The movements in non-life insurance contract liabilities and reinsurance assets over the year have been as follows:

Provisions for unearned premiums

	Gross £m	Reinsurance £m	Net £m
At 1 January 2007	438	–	438
Increase in the year	632	(23)	609
Release in the year	(614)	23	(591)
At 31 December 2007	456	–	456
Increase in the year	651	(23)	628
Release in the year	(635)	23	(612)
At 31 December 2008	472	–	472

These provisions represent the liability for short-term insurance contracts for which the Group's obligations are not expired at the year end.

Claims and loss adjustment expenses

	Gross £m	Reinsurance £m	Net £m
Notified claims	127	(4)	123
Incurred but not reported	22	–	22
At 1 January 2007	149	(4)	145
Cash paid for claims settled in the year	(275)	–	(275)
Increase/(decrease) in liabilities:			
Arising from current year claims	341	(9)	332
Arising from prior year claims	(8)	3	(5)
At 31 December 2007	207	(10)	197
Cash paid for claims settled in the year	(245)	7	(238)
Increase/(decrease) in liabilities:			
Arising from current year claims	221	–	221
Arising from prior year claims	–	(2)	(2)
At 31 December 2008	183	(5)	178
Notified claims	160	(5)	155
Incurred but not reported	23	–	23
At 31 December 2008	183	(5)	178
Notified claims	188	(10)	178
Incurred but not reported	19	–	19
At 31 December 2007	207	(10)	197

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 has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

Non-life insurance all risks – gross

	Accident year					Total £m
	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	
Estimate of ultimate claims costs:						
At end of accident year	227	211	208	317	205	1,168
One year later	209	207	206	311		
Two years later	207	204	204			
Three years later	206	202				
Four years later	206					
Current estimate of cumulative claims	206	202	204	311	205	1,128
Cumulative payments to date	(204)	(197)	(195)	(265)	(99)	(960)
Liability recognised in the balance sheet	2	5	9	46	106	168
Liability in respect of earlier years						8
Total liability included in the balance sheet						176

The liability of £176 million shown in the above table excludes £7 million of unallocated claims handling expenses.

Notes to the accounts

34 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
Non-annuitant mortality ¹	5% reduction	31
Annuitant mortality ²	5% reduction	(77)
Lapse rates ³	10% reduction	38
Future maintenance and investment expenses ⁴	10% reduction	70
Risk-free rate ⁵	0.25% deduction	47
Guaranteed annuity option take up ⁶	5% addition	(22)
Equity investment volatility ⁷	1% addition	(7)
Widening of credit default spreads on corporate bonds ⁸	0.25% addition	(82)
Decrease in illiquidity premia ⁹	0.25% deduction	(134)
		(97)

Assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and statutory reserving bases.

¹This sensitivity shows the impact of reducing mortality and morbidity rates on non-annuity business to 95 per cent of the expected rate.

²This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

³This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

⁴This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

⁵This 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.

⁶This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

⁷This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

⁸This 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.

⁹This sensitivity shows the impact of a 25 basis point reduction 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 risk-free rate are both assumed to be unchanged.

35 Liabilities of the Group 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 2007	24,370	(22)	24,348
New business	2,413	–	2,413
Changes in existing business	(1,303)	22	(1,281)
Disposal of businesses	(7,283)	–	(7,283)
At 31 December 2007	18,197	–	18,197
New business	660	–	660
Changes in existing business	(4,614)	–	(4,614)
At 31 December 2008	14,243	–	14,243

Notes to the accounts

36 Unallocated surplus within insurance businesses for the Group

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

	2008 £m	2007 £m
At 1 January	554	683
Change in unallocated surplus recognised in the income statement (note 10)	(284)	(114)
Disposal of businesses	–	(15)
At 31 December	270	554

37 Other liabilities

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Settlement balances	891	445	548	51
Unitholders' interest in Open Ended Investment Companies	4,336	3,441	–	–
Other creditors and accruals	6,267	5,865	4,407	4,072
	11,494	9,751	4,955	4,123

At 31 December 2008 £5,481 million (2007: £4,369 million) of other liabilities of the Group and £56 million (2007: £36 million) of the Bank had a contractual residual maturity of greater than one year.

38 Retirement benefit obligations

Charge to the Group income statement:

	2008 £m	2007 £m
Defined benefit pension schemes	157	158
Other post-retirement benefit schemes	7	17
Total defined benefit schemes	164	175
Defined contribution pension schemes	71	63
	235	238

Amounts recognised in the balance sheet:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Defined benefit pension schemes	1,657	2,033	1,240	1,512
Other post-retirement benefit schemes	114	111	114	111
	1,771	2,144	1,354	1,623

For accounting purposes, the assets and liabilities of the Group's post-retirement benefit schemes are allocated between the participating employers, including the Bank, in proportion to the cash contributions made in to the schemes.

Pension schemes*Defined benefit schemes*

The Group has established a number of defined benefit pension schemes in the UK and overseas. The majority of the Group's and the Bank's employees are members of the defined benefit sections of the Lloyds TSB Group Pension Schemes No's 1 and 2. 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 is 50.

The latest full valuations of the two main schemes are being carried out as at 30 June 2008. The provisional results have been updated to 31 December 2008 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 2008 by qualified independent actuaries or, in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows.

Notes to the accounts

38 Retirement benefit obligations (continued)

The Group's and the Bank's obligations in respect of defined benefit schemes are funded. The Group currently expects to pay contributions of at least £525 million (the Bank: at least £400 million) to its defined benefit schemes in 2009.

Amounts included in the balance sheet:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Present value of funded obligations	15,617	16,795	12,015	12,899
Fair value of scheme assets	(13,693)	(16,112)	(10,488)	(12,410)
	1,924	683	1,527	489
Unrecognised actuarial (losses)/gains	(267)	1,350	(287)	1,023
Liability in the balance sheet	1,657	2,033	1,240	1,512

Movements in the defined benefit obligation:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	16,795	17,378	12,899	13,166
Current service cost	258	302	188	219
Interest cost	957	866	747	666
Actuarial gains	(1,928)	(971)	(1,476)	(751)
Benefits paid	(597)	(555)	(470)	(436)
Past service cost	21	25	22	23
Curtailments	6	-	-	-
Disposal of businesses	-	(262)	-	-
Exchange and other adjustments	105	12	105	12
At 31 December	15,617	16,795	12,015	12,899

Changes in the fair value of scheme assets:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	16,112	15,279	12,410	11,579
Expected return	1,085	1,035	835	799
Employer contributions	541	446	403	342
Actuarial (losses)/gains	(3,520)	139	(2,762)	114
Benefits paid	(597)	(555)	(470)	(436)
Disposal of businesses	-	(244)	-	-
Exchange and other adjustments	72	12	72	12
At 31 December	13,693	16,112	10,488	12,410
Actual return on scheme assets	(2,435)	1,174	(1,927)	913

Assumptions

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

	2008 %	2007 %
Discount rate	6.30	5.80
Rate of inflation	3.00	3.30
Rate of salary increases	3.75	4.00
Rate of increase for pensions in payment	2.80	3.10
	Years	Years
Life expectancy for member aged 60, on the valuation date:		
Men	26.4	25.9
Women	27.2	27.9
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	27.3	27.1
Women	28.1	29.0

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 as at 31 December 2008 is assumed to live for, on average,

Notes to the accounts

38 Retirement benefit obligations (continued)

26.4 years for a male and 27.2 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.

An analysis of the impact of a reasonable change in these assumptions is provided in note 3.

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

	2008	2007
	%	%
Equities	8.2	8.0
Fixed interest gilts	4.5	4.6
Index linked gilts	4.4	4.2
Non-government bonds	6.0	5.1
Property	6.7	6.5
Money market instruments and cash	4.8	3.9

The expected return on scheme assets in 2009 will be calculated using the following assumptions:

	2009
	%
Equities and alternative assets	8.4
Fixed interest gilts	3.7
Index linked gilts	4.0
Non-government bonds	6.7
Property	6.4
Money market instruments and cash	3.8

Composition of scheme assets:

	The Group		The Bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
Equities	7,040	8,537	5,404	6,557
Fixed interest gilts	1,452	2,041	1,157	1,629
Index linked gilts	1,326	1,433	890	1,093
Non-government bonds	1,721	1,990	1,323	1,543
Property	1,485	1,666	1,192	1,342
Money market instruments, cash and other assets and liabilities	669	445	522	246
At 31 December	13,693	16,112	10,488	12,410

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

The expected return on plan assets was determined by considering the expected returns available on the assets underlying the current investment policy. Expected yields on fixed interest investments are based on gross redemption yields at the balance sheet date at a term and credit rating broadly appropriate for the bonds held. Expected returns on equity and property investment are long-term rates based on the views of the plans' 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.

Notes to the accounts

38 Retirement benefit obligations (continued)

Experience adjustments history (since the date of adoption of IAS 19):

The Group	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Present value of defined benefit obligation	15,617	16,795	17,378	17,320	14,866
Fair value of scheme assets	(13,693)	(16,112)	(15,279)	(14,026)	(11,648)
	1,924	683	2,099	3,294	3,218
Experience losses on scheme liabilities	(39)	(185)	(50)	(69)	(126)
Experience (losses) gains on scheme assets	(3,520)	139	314	1,538	361
The Bank	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Present value of defined benefit obligation	12,015	12,899	13,166	13,134	11,282
Fair value of scheme assets	(10,488)	(12,410)	(11,579)	(10,619)	(8,839)
	1,527	489	1,587	2,515	2,443
Experience losses on scheme liabilities	(23)	(150)	(42)	(53)	(124)
Experience (losses) gains on scheme assets	(2,750)	114	243	1,166	282

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

	2008 £m	2007 £m
Current service cost	258	302
Interest cost	957	866
Expected return on scheme assets	(1,085)	(1,035)
Curtailments	6	-
Past service cost	21	25
Total defined benefit pension expense	157	158

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 2008 the charge to the income statement in respect of these schemes was £71 million (2007: £63 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 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 2007; this valuation has been updated to 31 December 2008 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 7.50 per cent (2007: 7.43 per cent).

Amount included in the balance sheet:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Present value of unfunded obligations	118	123	118	123
Unrecognised actuarial losses	(4)	(12)	(4)	(12)
Liability in the balance sheet	114	111	114	111

Notes to the accounts

38 Retirement benefit obligations (continued)

Movements in the other post-retirement benefits obligation:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	123	110	123	110
Exchange and other adjustments	2	–	2	–
Actuarial (gain) loss	(8)	2	(8)	2
Insurance premiums paid	(6)	(6)	(6)	(6)
Charge for the year	7	17	7	17
At 31 December	118	123	118	123

39 Deferred tax balances

The movement in the net deferred tax balance is as follows:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Liability (asset) at 1 January	949	1,416	(619)	(861)
Exchange and other adjustments	1	1	1	–
Disposals	(96)	(389)	–	–
Income statement (credit) charge:				
Due to change in UK corporation tax rate	–	(110)	–	46
Other	(762)	38	(538)	202
	(762)	(72)	(538)	248
Amount credited to equity:				
Available-for-sale financial assets (note 44)	(566)	(1)	–	–
Net investment hedges (note 44)	(358)	–	–	–
Cash flow hedges (note 44)	(5)	(6)	(5)	(6)
	(929)	(7)	(5)	(6)
(Asset) liability at 31 December	(837)	949	(1,161)	(619)

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

	2008 £m	2007 £m
Accelerated capital allowances	(318)	(32)
Pensions and other post-retirement benefits	118	137
Investment reserve	32	(30)
Allowances for impairment losses	(2)	42
Unrealised gains	(387)	(91)
Tax on value of in-force business	(193)	(108)
Other temporary differences	(12)	10
	(762)	(72)

Deferred tax assets and liabilities are comprised as follows:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Deferred tax assets:				
Pensions and other post-retirement benefits	(503)	(620)	(364)	(453)
Allowances for impairment losses	(103)	(101)	(99)	(97)
Other provisions	(51)	(15)	(38)	(12)
Derivatives	(99)	(185)	(85)	(115)
Available-for-sale asset revaluation	(567)	(1)	–	–
Tax losses carried forward	(856)	(409)	(476)	–
Accelerated capital allowances	–	–	(78)	–
Other temporary differences	(114)	(143)	(41)	(87)
	(2,293)	(1,474)	(1,181)	(764)

Notes to the accounts

39 Deferred tax balances (continued)

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Deferred tax liabilities:				
Accelerated capital allowances	561	979	–	61
Investment reserve	151	119	–	–
Unrealised gains	45	342	–	–
Tax on value of in-force business	459	652	–	–
Other temporary differences	240	331	20	84
	1,456	2,423	20	145

Deferred tax assets

Deferred tax assets are recognised for tax losses and foreign tax credit carry forwards to the extent that the realisation of the related tax benefit through future taxable profits is probable. Scottish Widows plc has recognised a deferred tax asset of £388 million and other Group companies have recognised deferred tax assets totalling £468 million in relation to tax losses carried forward. For all of these losses, after reviewing medium-term profit forecasts the Group considers that there will be sufficient profits in the future against which these losses will be offset.

Deferred tax assets of £252 million for the Group and £43 million for the Bank (2007: £33 million for the Group and £nil for the Bank) 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.

In addition, deferred tax assets have not been recognised in respect of Eligible Unrelieved Foreign Tax (EUFT) and other foreign tax credits carried forward as at 31 December 2008 of £60 million for the Group and £12 million for the Bank (2007: £104 million for the Group and £34 million for the Bank), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. EUFT can be carried forward indefinitely.

Deferred tax liabilities

Deferred tax liabilities have not been recognised for tax that may be payable if earnings of certain subsidiaries were remitted to the UK. Such amounts are either reinvested for the foreseeable future or can be remitted free of tax. Unremitted earnings totalled £1,196 million for the Group and £121 million for the Bank (2007: £928 million for the Group and £111 million for the Bank).

Future transfers from Scottish Widows plc's long-term business funds to its Shareholder Fund will be subject to a shareholder tax charge. Under IAS 12, no provision is required to be made to the extent that the timing of such transfers is under Scottish Widows plc's control. Accordingly, deferred tax liabilities of £90 million (2007: £90 million) have not been recognised.

40 Other provisions

	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Vacant leasehold property and other £m	Total £m
The Group				
At 1 January 2008	29	43	137	209
Exchange and other adjustments	1	–	13	14
Provisions applied	(6)	(9)	(21)	(36)
Amortisation of discount	–	–	2	2
Charge for the year	6	–	35	41
At 31 December 2008	30	34	166	230
The Bank				
At 1 January 2008	29	39	97	165
Exchange and other adjustments	1	–	3	4
Provisions applied	(6)	(8)	(15)	(29)
Amortisation of discount	–	–	1	1
Charge for the year	30	–	35	65
At 31 December 2008	54	31	121	206

Notes to the accounts

40 Other provisions (continued)

Provisions for contingent liabilities and commitments

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

Customer remediation provisions

The Group establishes provisions for the estimated cost of making redress payments to customers in respect of past product sales, in those cases where the original sales processes have been found to be deficient. During 2008 management has reviewed the adequacy of the provisions held having regard to current complaint volumes and the level of payments being made and are satisfied that no additional charge is required. At 31 December 2008 the remaining provisions held relate to past sales of a number of products, including mortgage endowment policies, sold through the branch networks of Lloyds TSB Bank, Lloyds TSB Scotland and Cheltenham & Gloucester and underwritten by life assurance companies within the Group and also by third parties. The principal assumptions that are made in the assessment of the adequacy of the provision relate to the number of cases that are likely to require redress taking into account any time barring, and the estimated average cost per case. The ultimate cost and timing of the payments remains highly uncertain and will be influenced by external factors beyond the control of management, such as regulatory actions, media interest and the performance of the financial markets. However, it is expected that the majority of the remaining expenditure will be incurred within the next five years.

Vacant leasehold property and other

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biennial basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging five years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

The Group also carries provisions in respect of its obligations relating to UIC Insurance Company Limited (UIC), which is in provisional liquidation. The Group has indemnified a third party against losses in the event that UIC does not honour its obligations under a reinsurance contract, which is subject to asbestosis and pollution claims in the US. The ultimate cost of settling the Group's exposure in respect of the insurance business of UIC and the timing remains uncertain. The provision held represents management's current best estimate of the cost after having regard to the financial condition of UIC and actuarial estimates of future claims.

Notes to the accounts

41 Subordinated liabilities**The Group**

	Note	2008 £m	2007 £m
Preferred securities			
6.90% Perpetual Capital Securities (US\$1,000 million)	d,g	756	471
Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million)	a,b	600	–
Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$1,000 million)	a,c	687	–
6% Non-cumulative Redeemable Preference Shares	o	–	–
Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	d,m	459	335
7.875% Perpetual Capital Securities (€500 million)	d,f,p	472	–
7.875% Perpetual Capital Securities (US\$1,250 million)	d,f,p	921	–
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)	d,f,k	512	365
Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	d,n	248	248
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	d,f,k	720	504
		5,375	1,923
Undated subordinated liabilities			
Primary Capital Undated Floating Rate Notes:	d,e		
Series 1 (US\$750 million)		515	374
Series 2 (US\$500 million)		343	249
Series 3 (US\$600 million)		412	299
11 ³ / ₄ % Perpetual Subordinated Bonds (£100 million)		100	100
5 ⁵ / ₈ % Undated Subordinated Step-up Notes callable 2009 (€1,250 million)	d,k	1,212	915
Undated Step-up Floating Rate Notes callable 2009 (€150 million)	d,e	144	110
6 ⁵ / ₈ % Undated Subordinated Step-up Notes callable 2010 (£410 million)	d,i	409	408
5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million)	d,h	536	534
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20,000 million)	d,l	189	111
Undated Subordinated Floating Rate Loan callable 2015 (£600 million)	q	–	600
Undated Subordinated Floating Rate Loan callable 2016 (US\$1,000 million)	q	–	498
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	d,j	455	449
6 ¹ / ₂ % Undated Subordinated Step-up Notes callable 2019 (£270 million)	d,j	241	238
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	d,j	186	188
6 ¹ / ₂ % Undated Subordinated Step-up Notes callable 2029 (£450 million)	d,j	444	444
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	d,j	455	453
		5,641	5,970
Dated subordinated liabilities			
5 ¹ / ₄ % Subordinated Notes 2008 (DM 750 million)		–	281
10 ⁵ / ₈ % Guaranteed Subordinated Loan Stock 2008 (£100 million)	i	–	102
9 ¹ / ₂ % Subordinated Bonds 2009 (£100 million)		100	100
6 ¹ / ₄ % Subordinated Notes 2010 (€400 million)		404	302
12% Guaranteed Subordinated Bonds 2011 (£100 million)	i	107	110
4 ³ / ₄ % Subordinated Notes 2011 (€850 million)		836	609
Subordinated Floating Rate Notes 2011 (£150 million)		150	150
Subordinated Floating Rate Notes 2011 (£100 million)		100	100
Subordinated Floating Rate Notes 2012 (£200 million)		200	200
Subordinated Floating Rate Notes 2013 (£150 million)		150	150
Subordinated Floating Rate Notes 2014 (£464 million)		464	464
5 ⁷ / ₈ % Subordinated Notes 2014 (£150 million)		149	149
6 ⁵ / ₈ % Subordinated Notes 2015 (£350 million)		320	316
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (£300 million)	e	300	300
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (€500 million)	e	480	371
Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)	k,p	992	–
Subordinated Fixed to Floating Rate Notes due 2020 callable 2015 (£750 million)	k,p	754	–
Subordinated Floating Rate Notes 2020 (€100 million)	e	96	73
5.75% Subordinated Step-up Notes 2025 callable 2020 (£350 million)		309	305
9 ⁵ / ₈ % Subordinated Bonds 2023 (£300 million)		312	312
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
		6,373	4,544
Total subordinated liabilities		17,389	12,437

At 31 December 2008 £17,289 million (2007: £12,054 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

Notes to the accounts

41 Subordinated liabilities (continued)**The Bank**

	Note	2008 £m	2007 £m
Preferred securities			
6.90% Perpetual Capital Securities (US\$1,000 million)	d,g	756	471
Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million)	a,b	600	–
Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$1,000 million)	a,c	687	–
6% Non-cumulative Redeemable Preference Shares	o	–	–
Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	d,m	459	335
7.875% Perpetual Capital Securities (€500 million)	d,f,p	472	–
7.875% Perpetual Capital Securities (US\$1,250 million)	d,f,p	921	–
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)	d,f,k	512	365
Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	d,n	248	248
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	d,f,k	720	504
		5,375	1,923
Undated subordinated liabilities			
Primary Capital Undated Floating Rate Notes:	d,e		
Series 1 (US\$750 million)		515	374
Series 2 (US\$500 million)		343	249
Series 3 (US\$600 million)		412	299
11 ³ / ₄ % Perpetual Subordinated Bonds (£100 million)		100	100
5 ⁷ / ₈ % Undated Subordinated Step-up Notes callable 2009 (€1,250 million)	d,k	1,212	915
Undated Step-up Floating Rate Notes callable 2009 (€150 million)	d,e	144	110
6 ⁵ / ₈ % Undated Subordinated Step-up Notes callable 2010 (£410 million)	d,j	409	408
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20,000 million)	d,l	189	111
Undated Subordinated Floating Rate Loan callable 2015 (£600 million)	q	–	600
Undated Subordinated Floating Rate Loan callable 2016 (US\$1,000 million)	q	–	498
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	d,j	455	449
6 ¹ / ₂ % Undated Subordinated Step-up Notes callable 2019 (£270 million)	d,j	241	238
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	d,j	186	188
6 ¹ / ₂ % Undated Subordinated Step-up Notes callable 2029 (£450 million)	d,j	444	444
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	d,j	455	453
		5,105	5,436
Dated subordinated liabilities			
5 ¹ / ₄ % Subordinated Notes 2008 (DM 750 million)		–	281
10 ⁷ / ₈ % Guaranteed Subordinated Loan Stock 2008 (£100 million)	i	–	102
9 ¹ / ₂ % Subordinated Bonds 2009 (£100 million)		100	100
6 ¹ / ₄ % Subordinated Notes 2010 (€400 million)		404	302
12% Guaranteed Subordinated Bonds 2011 (£100 million)	i	107	110
4 ³ / ₄ % Subordinated Notes 2011 (€850 million)		836	609
Subordinated Floating Rate Notes 2011 (£150 million)		150	150
Subordinated Floating Rate Notes 2011 (£100 million)		100	100
Subordinated Floating Rate Notes 2012 (£200 million)		200	200
Subordinated Floating Rate Notes 2013 (£150 million)		150	150
Subordinated Floating Rate Notes 2014 (£464 million)		464	464
5 ⁷ / ₈ % Subordinated Notes 2014 (£150 million)		149	149
6 ⁵ / ₈ % Subordinated Notes 2015 (£350 million)		320	316
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (£300 million)	e	300	300
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (€500 million)	e	480	371
Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)	k,p	992	–
Subordinated Fixed to Floating Rate Notes due 2020 callable 2015 (£750 million)	k,p	754	–
Subordinated Floating Rate Notes 2020 (€100 million)	e	96	73
5.75% Subordinated Step-up Notes 2025 callable 2020 (£350 million)		309	305
9 ⁵ / ₈ % Subordinated Bonds 2023 (£300 million)		312	312
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
		6,373	4,544
Total subordinated liabilities		16,853	11,903

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. Neither the Group nor the Bank has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2007: nil).

At 31 December 2008 £16,753 million (2007: £11,520 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

a) Any repayment of preference shares would require prior notification to the Financial Services Authority. In certain circumstances, the shares may be mandatorily exchanged for qualifying non-innovative tier 1 securities. The Company may declare no dividend or a partial dividend on these preference shares. Dividends may be reduced if the distributable profits of the Company are insufficient to cover the payment in full of the dividends and also the payment in full of all other dividends on shares issued by the Company.

Notes to the accounts

41 Subordinated liabilities (continued)

- b) Dividends will accrue at a rate of 6.369 per cent per annum up to 24 August 2015, and, unless redeemed, at a rate reset quarterly equal to 1.28 per cent per annum above the London interbank offered rate for three-month sterling deposits thereafter. These preference shares can be redeemed at the option of the Bank on 25 August 2015 or quarterly thereafter.
- c) Dividends will accrue at a rate of 6.267 per cent per annum up to 13 November 2016 and, unless redeemed, at a rate reset quarterly equal to 1.035 per cent per annum above the London interbank offered rate for three-month sterling deposits thereafter. These preference shares can be redeemed at the option of the Bank on 14 November 2016 or every 10 years thereafter.
- d) In certain circumstances, these notes, bonds and securities would acquire the characteristics of preference share capital. Any repayments of undated subordinated liabilities would require the prior consent of the Financial Services Authority. They are accounted for as liabilities as coupon payments are mandatory as a consequence of the terms of the 6% Non-cumulative Redeemable Preference Shares.
- e) These notes bear interest at rates fixed periodically in advance based on London interbank rates.
- f) In certain circumstances the interest payments on these securities can be deferred although in this case neither Lloyds TSB Bank plc nor Lloyds Banking Group plc can declare or pay a dividend until any deferred payments have been made. In the event of a winding up of Lloyds TSB Bank plc, these securities will acquire the characteristics of preference shares.
- g) In certain circumstances the interest payments on these securities can be deferred although in this case neither Lloyds TSB Bank plc nor Lloyds Banking Group plc can declare or pay a dividend until payments are resumed. Any deferred payments will be made good on redemption of the securities. The securities can be redeemed at par at the option of Lloyds TSB Bank plc on any coupon date.
- h) In certain circumstances the interest payments on these securities can be deferred although in this case Scottish Widows plc cannot declare or pay a dividend until any deferred payments have been made.
- i) Guaranteed by Lloyds Banking Group plc on a subordinated basis.
- j) At the callable date the coupon on these notes will be reset by reference to the applicable five year benchmark gilt rate.
- k) In the event that these notes are not redeemed at the callable date, the coupon will be reset to a floating rate.
- l) In the event that these notes are not redeemed at the callable date, the coupon will be reset to a margin of 1.60 per cent over the five year Yen swap rate.
- m) These securities constitute limited partnership interests in Lloyds TSB Capital 1 L.P., a Jersey limited partnership in which Lloyds TSB (General Partner) Limited, a wholly owned subsidiary, is the general partner. Non-cumulative income distributions accrue at a fixed rate of 7.375 per cent per annum up to 7 February 2012; thereafter they will accrue at a margin of 2.33 per cent over EURIBOR, to be set annually. This issue was made under the limited subordinated guarantee of Lloyds TSB Bank plc. In certain circumstances these preferred securities will be mandatorily exchanged for preference shares in Lloyds Banking Group plc. Lloyds Banking Group plc has entered into an agreement whereby dividends may only be paid on its ordinary shares if sufficient distributable profits are available for distributions due in the financial year on these preferred securities.
- n) These securities constitute limited partnership interests in Lloyds TSB Capital 2 L.P., a Jersey limited partnership in which Lloyds TSB (General Partner) Limited, a wholly owned subsidiary, is the general partner. Non-cumulative income distributions accrue at a fixed rate of 7.834 per cent per annum up to 7 February 2015; thereafter they will accrue at a margin of 3.50 per cent over a rate based on the yield of specified UK government stock. This issue was made under the limited subordinated guarantee of Lloyds TSB Bank plc. In certain circumstances these preferred securities will be mandatorily exchanged for preference shares in Lloyds Banking Group plc. Lloyds Banking Group plc has entered into an agreement whereby dividends may only be paid on its ordinary shares if sufficient distributable profits are available for distributions due in the financial year on these preferred securities.
- o) Since 2004, the Bank has had in issue 100 6 per cent non-cumulative redeemable preference shares of £1 each. The shares, which are redeemable at the option of the Bank at any time, carry the rights to a fixed rate non-cumulative preferential dividend at a rate 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 Bank.
- p) Issued during 2008 to finance the general business of the Group.
- q) Exchanged during 2008 into Floating Rate Non-cumulative Preference Shares.

Notes to the accounts

42 Share capital**Authorised share capital**

	Group and Bank	
	2008 £m	2007 £m
<i>Sterling</i>		
1,650 million ordinary shares of £1 each	1,650	1,650
1 cumulative floating rate Preference share of £1	-	-
100 6 per cent Non-Cumulative Redeemable Preference shares of £1 each	-	-
175 million Preference shares of 25p each	44	-
	1,694	1,650
<i>US dollars</i>	US\$m	US\$m
160 million Preference shares of 25 cents each	40	-
<i>Euro</i>	€m	€m
160 million Preference shares of 25 cents each	40	-
<i>Japanese yen</i>	¥m	¥m
50 million Preference shares of ¥25 each	1,250	-

During 2008 the Bank's authorised share capital was increased by the creation of 175,000,000 Preference shares of 25 pence each, 160,000,000 Preference shares of US 25 cents each, 160,000,000 Preference shares of €25 cents each, and 50,000,000 Preference shares of ¥25 each.

	2008 Number of shares	2007 Number of shares	2008 £m	2007 £m
Issued and fully paid ordinary shares				
<i>Sterling</i>				
Ordinary shares of £1 each				
At 1 January and 31 December	1,541,680,932	1,541,680,932	1,542	1,542

Issued and fully paid preference shares

Since 2004, the Bank has had in issue 100 6 per cent non-cumulative redeemable preference shares of £1 each. The shares, which are redeemable at the option of the Bank at any time, carry the rights to a fixed rate non-cumulative preferential dividend at a rate 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 Bank. In accordance with the requirements of International Financial Reporting Standards, these shares are reported within liabilities (note 41).

During 2008 the Bank issued 600,000 Floating Rate Non-Cumulative Callable Preference Shares of 25 pence each with a liquidation preference of £1,000 per share and 1,000,000 Floating Rate Non-Cumulative Callable Preference Shares of 25 cents each with a liquidation preference of US\$1,000 per share. Both issues of preference shares are perpetual, although the two issues can be redeemed at the option of the Bank on or after 25 August 2015 and 14 November 2016 respectively and carry the right to non-cumulative dividends which are fixed until those first redemption dates. The terms of these two issues of preference shares are such that the Bank cannot declare and pay a dividend on any other junior class of share (including the mandatory dividend on the 100 6 per cent non-cumulative redeemable preference shares mentioned above) until the coupon has been paid on these preference shares. As the Bank is effectively committed to the payment of a coupon on these shares they are classified as liabilities on the balance sheet in accordance with IFRS (see note 41). The holders of the floating rate non-cumulative callable preference shares, who held less than 0.1 per cent of the total share capital as at 31 December 2008, do not have the right to receive notice of, attend, speak or vote at any general meetings other than on resolutions relating to the variation or abrogation of any of the rights or restrictions attached to the preference shares or the winding up or dissolution of the Bank or if, at the date of the notice of meeting, the dividend payable at the immediately preceding dividend payment date has failed to be declared and paid in full. Upon winding up, the floating rate non-cumulative callable preference shares shall rank equally with the most senior class of preference shares and any other class of shares which are expressed to rank equally.

Any repayment of the floating rate non-cumulative callable preference shares would require prior notification to the Financial Services Authority. The sterling floating rate non-cumulative callable preference shares can be redeemed at the option of the Bank on or after 25 August 2015; at this call date, dividends will be reset at a margin of 1.28 per cent over 3 month LIBOR. The US dollar floating rate non-cumulative callable preference shares can be redeemed at the option of the Bank on or after 14 November 2016; at this call date, dividends will be reset at a margin of 1.035 per cent over 3 month LIBOR. In certain circumstances, the floating rate non-cumulative callable preference shares may be mandatorily exchanged for qualifying non-innovative tier 1 securities and in certain circumstances and subject to compliance with certain requirements, the floating rate non-cumulative callable preference shares may be redeemed by the Bank at certain times in the event that the FSA makes a decision that the preference shares can no longer qualify as non-innovative tier 1 capital. The Bank may declare no dividend or a partial dividend on these preference shares; notwithstanding this discretion, in certain circumstances, the dividends on the floating rate non-cumulative callable preference shares will be mandatorily payable if the preference shares cease to be eligible to qualify as regulatory capital and the Bank is in compliance with relevant FSA regulations regarding capital adequacy. Dividends may be reduced if the distributable profits of the Bank are insufficient to cover the payment in full of the dividends and also the payment in full of all other dividends on shares issued by the Bank.

These securities were issued primarily to finance the development and expansion of the business of the Group.

Notes to the accounts

43 Share premium account

	Group and Bank	
	2008 £m	2007 £m
At 1 January and 31 December	2,960	2,960

44 Other reserves

Other reserves comprise:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Revaluation reserve in respect of available-for-sale financial assets	(2,982)	(399)	(361)	(49)
Cash flow hedging reserve	(15)	(3)	(15)	(3)
Foreign currency translation reserve	173	(9)	127	8
	(2,824)	(411)	(249)	(44)

Movements in other reserves were as follows:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Revaluation reserve in respect of available-for-sale financial assets:				
At 1 January	(399)	–	(49)	(3)
Exchange and other adjustments	(541)	(1)	(85)	–
Change in fair value of available-for-sale financial assets	(2,721)	(483)	(335)	(130)
Change in fair value attributable to minority interests	2	–	–	–
Deferred tax	566	1	–	–
Current tax	94	46	91	46
	(2,059)	(436)	(244)	(84)
Income statement transfers:				
Disposals	(19)	(5)	(19)	(5)
Impairment	130	70	130	70
Current tax	(28)	(21)	(28)	(21)
	102	49	102	49
Other transfers	(91)	–	(91)	–
Current tax	25	–	25	–
	(66)	–	(66)	–
Disposal of businesses	–	(6)	–	(6)
At 31 December	(2,982)	(399)	(361)	(49)
Cash flow hedging reserve:				
At 1 January	(3)	12	(3)	12
Change in fair value of hedging derivatives	(33)	(20)	(33)	(20)
Deferred tax	9	6	9	6
	(24)	(14)	(24)	(14)
Income statement transfer (note 5)	16	(1)	16	(1)
Deferred tax	(4)	–	(4)	–
	12	(1)	12	(1)
At 31 December	(15)	(3)	(15)	(3)
Foreign currency translation reserve:				
At 1 January	(9)	(27)	8	(5)
Currency translation differences arising in the year	2,536	257	119	13
Foreign currency losses on net investment hedges	(3,310)	(342)	–	–
Amounts transferred to the income statement in respect of hedge ineffectiveness	14	–	–	–
Current tax	584	103	–	–
Deferred tax	358	–	–	–
	(2,354)	(239)	–	–
At 31 December	173	(9)	127	8

Notes to the accounts

45 Retained profits

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	9,064	7,637	5,672	4,257
Profit (loss) for the year*	818	3,384	(418)	2,799
Dividends	(2,294)	(1,957)	(2,294)	(1,957)
Transfer of C&G business (note 27)	-	-	-	573
At 31 December	7,588	9,064	2,960	5,672

*No income statement has been shown for the Bank, as permitted by Section 230 of the Companies Act 1985.

46 Ordinary dividends

	2008 £m	2007 £m
Second interim dividend in respect of previous year, declared during the current year	1,646	1,325
First interim dividend in respect of current year	648	632
	2,294	1,957

The directors do not propose a second interim dividend (2007: £1,646 million which was equivalent to 106.77 pence per ordinary share).

47 Share based payments**Charge to the income statement**

The charge to the income statement is set out below:

	2008 £m	2007 £m
Executive and SAYE schemes:		
Options granted in the year	8	6
Options granted in prior years	4	24
	12	30
Share incentive plan:		
Shares granted in the year	10	12
Shares granted in prior years	21	17
	31	29
	43	59

Share based payment scheme details

During the year ended 31 December 2008 Lloyds Banking Group plc operated the following share based payment schemes, all of which are equity settled.

Executive 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.

Notes to the accounts

47 Share based payments (continued)**Performance conditions for executive options****For options granted up to March 2001**

Options granted	Performance conditions
March 1998 – August 1999	Growth in earnings per share which is equal to the aggregate percentage change in the Retail Price Index plus two percentage points for each complete year of the relevant period together with a further condition that Lloyds Banking Group plc's ranking based on 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.
March 2000 – March 2001	As for March 1998 – August 1999 except that there must have been growth in the earnings per share equal to the change in the Retail Price Index plus three percentage points for each complete year of the relevant period.

In respect of options granted between March 1998 and March 2001, the relevant period for the performance conditions begins at the end of the financial year preceding the date of grant and will continue until the end of the third subsequent year following commencement or, if not met, the end of such later year in which the conditions are met. Once the conditions have been satisfied the options will remain exercisable without further conditions. If they are not satisfied by the tenth anniversary of the grant the option will lapse.

For options granted from August 2001 to August 2004

The performance condition is 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 is measured over a three year period commencing at the end of the financial year preceding the grant of the option and continuing until the end of the third subsequent year. If the performance condition is not then met, it will be measured at the end of the fourth financial year. If the condition has not then been met, the options will lapse.

To meet the performance conditions, Lloyds Banking Group plc's ranking against the comparator group must be at least ninth. The full grant of options will only become exercisable if Lloyds Banking Group plc is ranked first. A performance multiplier (of between nil and 100 per cent) will be applied below this level to calculate the number of shares in respect of which options granted to executive directors will become exercisable, and will be calculated on a sliding scale. If Lloyds Banking Group plc is ranked below median the options will not be exercisable.

Options granted to senior executives other than executive directors are not so highly leveraged and, as a result, different performance multipliers are applied to their options. For the majority of executives, options are granted with the performance condition but 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 apply as for grants made up to August 2004, except that:

- the performance condition is 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 has not been met at the end of the third subsequent year, the options will lapse; and
- the full grant of options becomes exercisable only if Lloyds Banking Group plc is ranked in the top four places of the comparator group. A sliding scale applies between fourth and eighth positions. If Lloyds Banking Group is ranked below the median (ninth or below) the options will not be exercisable and will lapse.

Options granted in 2005 became exercisable as the performance condition was met when tested. The performance condition vested at 82.5 per cent for all options granted.

Movements in the number of share options outstanding under the Executive share option schemes during 2006 and 2007 are set out below:

	2008 Number of options	2008 Weighted average exercise price (pence)	2007 Number of options	2007 Weighted average exercise price (pence)
Outstanding at 1 January	20,621,774	480.57	32,459,593	459.84
Exercised	(137,431)	419.25	(267,650)	509.10
Forfeited	(9,280,715)	470.02	(11,570,169)	421.76
Outstanding at 31 December	11,203,628	490.05	20,621,774	480.57
Exercisable at 31 December	9,132,197	453.77	423,300	876.37

The weighted average share price at the time that the options were exercised during 2008 was 453.42 pence (2007: 574.39 pence). The weighted average remaining contractual life of options outstanding at the end of the year was 5.1 years (2007: 6.2 years).

Notes to the accounts

47 Share based payments (continued)**Save-As-You-Earn schemes**

Eligible employees may enter into contracts through the Save-As-You-Earn (SAYE) schemes to save up to £250 per month and, at the expiry of a fixed term of three or five years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in Lloyds Banking Group plc at a price equal to 80 per cent of the market price at the date the options were granted. Grants in periods up to 31 December 2001 also had options exercising after seven years.

Movements in the number of share options outstanding under the SAYE schemes are set out below:

	2008 Number of options	2008 Weighted average exercise price (pence)	2007 Number of options	2007 Weighted average exercise price (pence)
Outstanding at 1 January	85,673,227	342.49	90,220,144	335.94
Granted	215,737,733	173.80	10,759,688	432.00
Exercised	(40,612,608)	290.77	(9,473,792)	351.28
Forfeited	(2,394,415)	388.11	(3,447,524)	363.45
Cancelled	(62,963,491)	373.21	(1,822,417)	397.98
Expired	(4,961,997)	311.47	(562,872)	547.46
Outstanding at 31 December	190,478,449	152.54	85,673,227	342.49
Exercisable at 31 December	3,157,524	332.12	1,560,472	459.01

The weighted average share price at the time that the options were exercised during 2008 was 370.29 pence (2007: 552.20 pence). The weighted average remaining contractual life of options outstanding at the end of the year was 3.4 years (2007: 1.7 years).

The weighted average fair value of SAYE options granted during the year was £0.61 (2007: £1.07). The values for the SAYE options have been determined using a standard Black-Scholes model.

Other share option plans**Lloyds TSB 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 granted to date under this scheme were granted specifically to facilitate recruitment. Options granted under this plan are not subject to any performance conditions.

	2008 Number of options	2008 Weighted average exercise price (pence)	2007 Number of options	2007 Weighted average exercise price (pence)
Outstanding at 1 January	308,718	Nil	357,123	Nil
Granted	681,931	Nil	214,444	Nil
Exercised	(117,236)	Nil	(203,170)	Nil
Forfeited	(15,802)	Nil	(59,679)	Nil
Outstanding at 31 December	857,611	Nil	308,718	Nil

The weighted average fair value of options granted in the year was £2.92 (2007: £5.27). The weighted average share price at the time that the options were exercised during 2008 was 291.04 pence (2007: 539.77 pence). No options outstanding at 31 December were exercisable. The weighted average remaining contractual life of options outstanding at the end of the year was 2.5 years (2007: 1.8 years).

Lloyds TSB Group executive share plan 2005

This plan was adopted by the Group in 2005, specifically to facilitate the recruitment of Ms Dial. Ms Dial was the only participant in the plan. Options granted under this plan were not subject to any performance conditions and would have normally become exercisable if Ms Dial remained as an employee, and had not given notice of resignation, on 31 May 2008. On 28 March 2008, the Group announced that Ms Dial had decided to leave the Group and, in accordance with the terms of the plan, the options lapsed.

	2008 Number of options	2008 Weighted average exercise price (pence)	2007 Number of options	2007 Weighted average exercise price (pence)
Outstanding at 1 January	242,825	Nil	242,825	Nil
Lapsed	(242,825)	Nil	-	-
Outstanding at 31 December	-	-	242,825	Nil

The weighted average remaining contractual life of options outstanding at the end of 2007 was 0.9 years.

Notes to the accounts

47 Share based payments (continued)**Other share plans****Long-Term Incentive Plan**

The Long-Term Incentive Plan introduced in 2006 is a long-term incentive scheme aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Lloyds Banking 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 up to four times annual salary.

The performance conditions for awards made in May and August 2006 are as follows:

- (i) For 50 per cent of the award (the 'EPS Award') – the percentage increase in earnings per share of Lloyds Banking Group plc (on a compound annualised basis) over the relevant period must be at least an average of 6 percentage points per annum greater than the percentage increase (if any) in the Retail Price Index over the same period. If it is less than 3 per cent per annum the EPS Award will lapse. If the increase is more than 3 per cent but less than 6 per cent per annum then the proportion of shares released will be on a straight line basis between 17.5 per cent and 100 per cent. The relevant period commenced on 1 January 2006 and ended on 31 December 2008.
- (ii) For the other 50 per cent of the award (the 'TSR Award') – it will be necessary for Lloyds Banking Group's total shareholder return (calculated by reference to both dividends and growth in share price) to exceed the median of a comparator group (14 companies) over the relevant period by an average of 7.5 per cent per annum for the TSR Award to vest in full. 17.5 per cent of the TSR Award will vest where Lloyds Banking Group plc's total shareholder return is equal to median and vesting will occur on a straight line basis in between these points. Where Lloyds Banking Group plc's total shareholder return is below the median of the comparator group, the TSR Award will lapse. The relevant period commenced on 1 January 2006 and ended on 31 December 2008.

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

- (i) For 50 per cent of the award (the 'EPS Award') – the performance condition is as described for May 2006 with the relevant performance period commencing on 1 January 2007 and ending on 31 December 2009.
- (ii) For the other 50 per cent of the award (the 'TSR Award') – the performance condition is as described for May 2006 with the relevant performance period commencing on 8 March 2007 (the date of the first award) and ending on 7 March 2010.

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

- (i) For 50 per cent of the award (the EPS Award) – the performance condition is as described for May 2006 with the relevant performance period commencing on 1 January 2008 and ending on 31 December 2010.
- (ii) For the other 50 per cent of the award (the TSR Award) – the performance condition is as described for May 2006, except that the comparator group comprises of 13 companies, with the relevant performance period commencing on 6 March 2008 (the date of the first award) and ending on 5 March 2011.

	2008 Number of shares	2007 Number of shares
Outstanding at 1 January	13,209,081	5,788,108
Granted	10,519,609	7,884,787
Forfeited	(1,491,408)	(463,814)
Outstanding at 31 December	22,237,282	13,209,081

The fair value of the share awards granted in 2008 was £2.28 (2007: £3.13).

Performance share plan

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

The performance condition attached to the March 2005 award was met, with Lloyds Banking Group ranked in fifth place. Bonus shares were released on 18 March 2008, with one performance share granted for each bonus share. Performance shares were released on 10 April 2008.

	2008 Number of shares	2007 Number of shares
Outstanding at 1 January	1,767,594	1,849,102
Forfeited	(74,691)	(81,508)
Lapsed	(375,790)	–
Released	(375,789)	–
Outstanding at 31 December	941,324	1,767,594

The weighted average share price at the date the shares were released during 2008 was 446.13 pence.

Notes to the accounts

47 Share based payments (continued)

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

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
31 December 2008									
Exercise price range									
£0 to £1	-	-	-	-	-	-	Nil	2.5	857,611
£1 to £2	-	-	-	139.00	3.5	178,932,603	-	-	-
£2 to £3	-	-	-	284.00	0.4	941,414	-	-	-
£3 to £4	-	-	-	344.75	1.9	7,366,320	-	-	-
£4 to £5	453.77	5.9	9,132,197	423.49	2.0	3,200,532	-	-	-
£5 to £6	551.25	1.2	741,905	588.50	0.3	37,580	-	-	-
£6 to £7	652.30	2.1	997,326	-	-	-	-	-	-
£7 to £8	-	-	-	-	-	-	-	-	-
£8 to £9	863.63	0.3	332,200	-	-	-	-	-	-

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
31 December 2007									
Exercise price range									
£0 to £2	-	-	-	-	-	-	Nil	1.4	551,543
£2 to £3	-	-	-	284.00	0.9	42,651,925	-	-	-
£3 to £4	-	-	-	353.10	1.9	15,775,539	-	-	-
£4 to £5	449.34	6.8	17,898,897	424.23	2.9	26,525,262	-	-	-
£5 to £6	551.09	2.2	815,965	563.65	0.1	720,501	-	-	-
£6 to £7	652.47	3.1	1,114,912	-	-	-	-	-	-
£7 to £8	-	-	-	-	-	-	-	-	-
£8 to £9	871.54	0.7	792,000	-	-	-	-	-	-

The fair value calculations at 31 December 2008 for grants made in the year are based on the following assumptions:

	SAYE	Other option schemes	Other share plans
Risk-free interest rate	3.14%	3.90%	4.04%
Expected life	3.2 years	2.9 years	3.0 years
Expected volatility	40%	29%	23%
Expected dividend yield	3.5%	7.3%	8.9%
Weighted average share price	£2.17	£3.67	£4.24
Weighted average exercise price	£1.74	Nil	Nil
Expected forfeitures	6%	4%	4%

Expected volatility is a measure of the amount by which Lloyds Banking Group plc'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 Lloyds Banking Group plc's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

Share incentive plan**Free shares**

An award of Lloyds Banking Group plc 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 Lloyds Banking 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 employees' behalf. The award is subject to a non-market based condition: if an employee leaves Lloyds Banking Group within this three year period for other than a 'good' reason, all of the shares awarded would be forfeited (for awards made up to April 2005, only a portion of the shares will be forfeited: 75 per cent within one year of the award, 50 per cent within two years and 25 per cent within three years).

The number of shares awarded relating to free shares in 2008 was 8,862,823 (2007: 6,784,201), with an average fair value of £4.38 (2007: £5.82), based on the market price at the date of award.

Matching shares

Lloyds Banking Group undertakes to match shares purchased by employees up to the value of £30 per month, these shares are held in trust for a mandatory period of three years on the employees' behalf. 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 or the accompanying partnership shares are sold within that time, 100 per cent of the matching shares are forfeited (or the portion relating to the shares sold).

The number of shares awarded relating to matching shares in 2008 was 4,475,264 (2007: 2,073,018), with an average fair value of £2.56 (2007: £5.49), based on market prices at the date of award.

Notes to the accounts

48 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 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:

	2008	2007
	£m	£m
<i>Compensation</i>		
Salaries and other short-term benefits	8	15
Post-employment benefits	1	4
Termination benefits	–	–
Share based payments	4	4
Total	13	23

The aggregate of the emoluments of the directors was £5,623,000 (2007: £12,055,000).

The aggregate of the amount of the gains made by directors on the exercise of Lloyds Banking Group plc share options was £nil (2007: £nil).

The number of directors to whom retirement benefits were accruing under defined contribution and defined benefit pension schemes were three and three respectively (2007: two and three). Aggregate company contributions in respect of directors to defined contribution pension schemes were £205,000 (2007: £173,000).

The total for the highest paid director (Mr Daniels), including the £nil (2007: £nil) gain on the exercise of Lloyds Banking Group plc share options, was £1,151,000 (2007: £2,884,000). The amount of his accrued pension at the year end was £175,000, being his pension entitlement based on pensionable service with the Group to 31 December 2008 but payable at normal retirement age.

In addition Mr Fairey retired at 30 June 2008 and received his non-approved benefit entitlement in the form of a lump sum in accordance with the scheme rules. A tax free amount of £4,523,000 was paid from the FURBS, with a further taxable amount of £2,446,000 made by the Group from provisions set aside. The total amount of £6,969,000 covered the Group's liability to provide benefits in respect of salary in excess of the earnings cap.

	2008	2007
	million	million
<i>Share options over Lloyds Banking Group plc shares</i>		
At 1 January	7	11
Granted (including options of appointed directors)	–	–
Exercised/lapsed (including options of former directors)	(5)	(4)
At 31 December	2	7
	2008	2007
	million	million
<i>Share incentive plans over Lloyds Banking Group plc shares</i>		
At 1 January	6	4
Granted (including entitlements of appointed directors)	3	2
Exercised/lapsed (including entitlements of former directors)	(2)	–
At 31 December	7	6

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:

	2008	2007
	£m	£m
<i>Loans</i>		
At 1 January	2	2
Advanced	2	1
Repayments	(1)	(1)
At 31 December	3	2

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 2.14 per cent and 34.01 per cent in 2008 (2007: 4.95 per cent and 30.0 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2007: £nil).

Notes to the accounts

48 Related party transactions (continued)

	2008 £m	2007 £m
<i>Deposits</i>		
At 1 January	5	5
Placed	27	21
Withdrawn	(26)	(21)
At 31 December	6	5

Deposits placed by key management personnel attracted interest rates of up to 6.0 per cent (2007: 8.0 per cent).

At 31 December 2008, the Group did not provide any guarantees in respect of key management personnel (2007: £6,154 in respect of one director).

At 31 December 2008, transactions, arrangements and agreements entered into by the Group and its banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £3 million with eight directors and six connected persons (2007: £2 million with five directors and three connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings*Balances and transactions between members of the Lloyds TSB Bank group*

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

The Bank, as a result of its position as parent of a banking group, has a large number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Bank as follows:

	2008 £m	2007 £m
Assets, included within:		
Derivative financial instruments	616	203
Loans and advances to banks	11,322	6,575
Loans and advances to customers	50,785	42,660
Available-for-sale financial assets	18,575	–
Other assets	411	264
	81,709	49,702
Liabilities, included within:		
Deposits from banks	14,141	10,015
Customer accounts	31,500	25,348
Derivative financial instruments	1,834	702
Debt securities in issue	24,457	–
Other liabilities	571	519
Subordinated liabilities	707	583
	73,210	37,167

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2008 the Bank earned interest income on the above asset balances of £3,007 million (2007: £4,269 million) and incurred interest expense on the above liability balances of £2,989 million (2007: £1,513 million).

In addition, the Bank raised recharges of £515 million (2007: £476 million) on its subsidiaries in respect of costs incurred and also received fees of £688 million (2007: £705 million), and paid fees of £365 million (2007: £125 million), for various services provided between the Bank and its subsidiaries.

Details of contingent liabilities and commitments entered into on behalf of fellow Lloyds Banking Group undertakings are given in note 49.

Notes to the accounts

48 Related party transactions (continued)*Balances and transactions with Lloyds Banking Group plc*

The Bank and its subsidiaries have balances due to and from the Bank's parent company, Lloyds Banking Group plc, which are included on the balance sheet as follows:

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Assets, included within:				
Derivative financial instruments	-	29	-	29
	-	29	-	29
Liabilities, included within:				
Customer accounts	1,426	158	1,394	81
Derivative financial instruments	1,297	169	1,297	169
Subordinated liabilities	2,956	2,765	2,956	2,765
Other liabilities	15	17	15	17
	5,694	3,109	5,662	3,032

These balances include Lloyds Banking Group plc's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2008 the Group and Bank earned no interest income on the above asset balances (2007: Group £1 million; Bank £nil); the Group and Bank incurred an interest expense on the above liability balances of £176 million (2007: Group £176 million; Bank £148 million).

Other related party disclosures

At 31 December 2008, the Group's pension funds had call deposits with Lloyds TSB Bank plc amounting to £23 million (2007: £23 million).

The Group manages 105 (2007: 107) Open Ended Investment Companies (OEICs), and of these 47 (2007: 40) are consolidated. The Group invested £455 million (2007: £1,961 million) and redeemed £343 million (2007: £1,526 million) in the unconsolidated OEICs during the year and had investments, at fair value, of £2,661 million (2007: £2,233 million) at 31 December. The Group earned fees of £206 million from the unconsolidated OEICs (2007: £200 million). The Bank held no investments in OEICs at any time during 2007 or 2008.

The Group has a number of associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2008, these companies had total assets of approximately £5,838 million (2007: £3,184 million), liabilities of approximately £5,780 million (2007: £3,182 million) and for the year ended 31 December 2008 had turnover of approximately £2,088 million (2007: £2,136 million) and made a net loss of approximately £80 million (2007: net profit of £9 million). In addition the Group has provided £825 million (2007: £609 million) of financing to these companies on which it received £46 million (2007: £23 million) of interest income in the year.

49 Contingent liabilities and commitments*Legal proceedings*

The Group has provided information relating to its review of historic US dollar payments involving countries, persons or entities subject to US economic sanctions administered by the Office of Foreign Assets Control (OFAC) to a number of authorities including OFAC, the US Department of Justice and the New York County District Attorney's Office which, along with other authorities, have been reported to be conducting a broader review of sanctions compliance by non-US financial institutions. At 31 December 2008, the discussions with those authorities had advanced towards resolution of their investigations and the Group held an accrual of £180 million in respect of this matter. On 9 January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney's Office in relation to their investigations. The settlement documentation contains details of the results of the investigations including the identification of certain activities relating to Iran, Sudan and Libya which the Group conducted during the relevant period. The provision made by the Group in respect of this matter during 2008 was hedged into US dollars at the time and fully covers the settlement amount. The Group is continuing discussions with OFAC regarding the terms of the resolution of its investigation. OFAC has confirmed to the Group that the amount paid to the US Department of Justice and the New York County District Attorney's Office will be credited towards satisfying any penalty it imposes. The Group does not currently believe that any additional liability requiring provisions will arise following the conclusion of the discussions with OFAC. The Group does not anticipate any further enforcement actions as to these issues.

On 27 July 2007, following agreement between the OFT and a number of UK financial institutions, the OFT issued High Court legal proceedings against those institutions, including Lloyds TSB Bank plc, to determine the legal status and enforceability of certain of the charges applied to their personal customers in relation to requests for unplanned overdrafts. On 24 April 2008, the High Court determined, in relation to the current terms and conditions of those financial institutions (including Lloyds TSB Bank plc), that the relevant charges are not capable of amounting to penalties but that they are assessable for fairness under the Unfair Terms in Consumer Contracts Regulations 1999. On 23 May 2008, Lloyds TSB Bank plc, along with the other relevant financial institutions, was given permission to appeal the finding that unplanned overdraft charges are assessable for fairness. The appeal hearing commenced on 28 October 2008 and concluded on 5 November 2008. On 26 February 2009, the Court of Appeal dismissed the banks' appeal and held that the charges are assessable for fairness. The banks will now be applying to the House of Lords for permission to appeal this judgment.

A further hearing was held on 7 to 9 July 2008 to consider whether those financial institutions' historic terms and conditions are capable of being penalties, and to consider whether their historic terms are assessable for fairness. On 21 January 2009, the court confirmed that the relevant charges under Lloyds TSB Bank plc's historic terms and conditions are not capable of being penalties, to the extent that the bank's contracts with customers included the applicable charging terms. The issue of whether the charges are actually fair will be determined at subsequent hearings. If various appeals are pursued, the proceedings may take a number of years to conclude.

Notes to the accounts

49 Contingent liabilities and commitments (continued)

Cases before the Financial Ombudsman Service and the County Courts are currently stayed pending the outcome of the legal proceedings initiated by the OFT. Lloyds Banking Group intends to continue to defend its position strongly. Accordingly, no provision in relation to the outcome of this litigation has been made. Depending on the High Court's determinations, a range of outcomes is possible, some of which could have a significant financial impact on the Group. The ultimate impact of the litigation on the Group can only be known at its conclusion.

In addition, during the ordinary course of business the Group is subject to threatened or actual legal proceedings. All such material cases 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. No provisions are held against such cases; however the Group does not currently expect the final outcome of these cases to have a material adverse effect on its financial position.

The Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS), the UK's statutory fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS has borrowings from HM Treasury to fund the compensation costs associated with the institutions that have failed in 2008 and will receive the receipts from asset sales, surplus cash flow and other recoveries from these institutions in the future.

The FSCS fulfils its obligations by raising management expenses levies, which include amounts to cover the interest on its borrowings and compensation levies on the industry, each deposit-taking institution contributing in proportion to its share of total protected deposits.

In 2008, the Group has accrued £122 million in respect of its current obligation to meet management expenses levies.

If the FSCS does not receive sufficient funds from the failed institutions to repay HM Treasury in full, it will raise compensation levies. At this time, it is not possible to estimate the quantum or timing of any shortfall resulting from the cash flows received from the failed institutions and accordingly, no provision for compensation levies, which could be significant, has been made in these financial statements.

Contingent liabilities and commitments arising from the banking business

Acceptances and endorsements arise where the Group or the Bank agrees to guarantee payment on a negotiable instrument drawn up by a customer.

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

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

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

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Contingent liabilities				
Acceptances and endorsements	49	40	49	42
Other:				
Other items serving as direct credit substitutes	1,870	1,095	1,758	984
Performance bonds and other transaction-related contingencies	2,850	2,429	2,886	2,465
	4,720	3,524	4,644	3,449
	4,769	3,564	4,693	3,491
			The Bank	
			2008 £m	2007 £m
Incurred on behalf of fellow Lloyds Banking Group undertakings			39	42

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

Notes to the accounts

49 Contingent liabilities and commitments continued

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Commitments				
Documentary credits and other short-term trade-related transactions	319	306	323	309
Forward asset purchases and forward deposits placed	613	463	713	590
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	3,056	4,639	2,800	4,083
Other commitments	46,006	52,791	56,192	63,704
	49,062	57,430	58,992	67,787
1 year or over original maturity	31,761	32,165	30,710	28,572
	81,755	90,364	90,738	97,258

	The Bank	
	2008 £m	2007 £m
Incurred on behalf of fellow Lloyds Banking Group undertakings	13,424	13,526

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend £46,890 million (2007: £53,036 million) for the Group and £42,588 million (2007: £46,831 million) for the Bank were irrevocable.

Included in commitments to lend above are not-yet-syndicated leveraged loan underwriting commitments which amounted to £931 million (2007: £1,158 million). All of the underlying assets are performing satisfactorily.

Operating lease commitments

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

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Not later than 1 year	216	212	198	194
Later than 1 year and not later than 5 years	647	677	589	617
Later than 5 years	774	764	694	678
	1,637	1,653	1,481	1,489

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

Capital commitments

Excluding commitments of the Group in respect of investment property (note 21), capital expenditure contracted but not provided for at 31 December 2008 amounted to £92 million for the Group and £6 million for the Bank (2007: £102 million for the Group and £5 million for the Bank). Of the capital commitments of the Group, £85 million (2007: £96 million) relates 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.

50 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: business risk; credit risk; market risk, which includes interest rate risk and foreign exchange risk; insurance risk; operational risk and liquidity risk. Information about the Group's management of these risks is given below.

Business risk*Definition*

Business risk is defined as the risk to economic profit in the Group's budget and over the medium-term plan arising from a sub-optimal business strategy or the sub-optimal implementation of the plan as agreed by the board of directors. 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 subsequently align their plans to the Group's overall business risk appetite.

Notes to the accounts

50 Financial risk management (continued)*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, legal and regulatory, market expectations, reputation and competitive behaviour.

Measurement

An annual business planning process is conducted at Group 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. Over the last few years, the Group has made significant progress with embedding stress testing and scenario analysis into its risk management practice with the dual objectives of adding value to the business whilst also meeting regulatory requirements. The Group assesses a wide array of scenarios including economic recessions, regulatory action scenarios, pandemics and scenarios specific to the operations of each part of the business.

A common approach is applied across the Group to assess the creation of shareholder value. This is measured by economic profit (the profit attributable to shareholders, less a notional charge for the equity invested in the business). The focus on economic profit allows the Group to compare the returns being made on capital employed in each business on a consistent basis.

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, Lloyds Banking Group Risk conducts, where appropriate, an independent risk assessment of the target company.

Monitoring

The Group's strategy is reviewed and approved by the board. Regular reports are provided to the group executive committee and the board on the progress of the Group's key strategies and plans. Lloyds Banking Group Risk conducts oversight to seek to ensure that business plans remain consistent with the Group's strategy.

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 we have contracted to meet its obligations (both on and off balance sheet).

Risk appetite

Credit risk appetite is expressed both in terms of credit risk economic equity and in terms of the impact of credit risk on earnings volatility.

Credit risk appetite is set by the board and is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio model parameters which in turn use the various credit risk rating systems as inputs. These metrics are supplemented by a variety of policies, sector caps and limits to manage concentration risk at an acceptable level.

Exposures

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

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit can be cancelled and the credit-worthiness of customers is monitored frequently. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards, which are also regularly monitored.

Credit risk can also arise from debt securities, derivatives and foreign exchange activities. Note 16 shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2008. 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 the credit risk table on page 87.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers.

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 client or 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 recovery ratio on the defaulted obligations (the 'loss given default').

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. For its retail lending and a growing number of wholesale lending portfolios, exposure at default and loss given default models are also in use. All material rating models are

Notes to the accounts

50 Financial risk management (continued)

authorised by executive management. 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 rigorous validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible.

Each probability of default rating model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between classifications if the assessment of the obligor 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.

The rating systems described above assess probability of default, exposure at default and loss given default, in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment (note 19). 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 model that is used for internal operational management and banking regulation purposes.

The Group's debt securities holdings, which are the subject of external agency ratings, are marked to market and independently checked by the middle office function within the products and markets business. Similarly, debt security investments within Scottish Widows are independently marked to market.

The Group also employs a statistically-based credit portfolio model, which models portfolio credit risk based on defaults and calculates the economic equity employed and credit value at risk for each portfolio.

Mitigation

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

Internal control

- **Credit principles and policy:** Lloyds Banking Group Risk sets out the Group credit principles and policy according to which credit risk is managed, which in turn is the basis for divisional and business unit credit policy. Principles and policy are reviewed regularly and any changes are subject to a review and approval process. Business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. Credit policy also specifies maximum holding period limits for the credit trading portfolios.
- **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 considered and limit breaches are subject to escalation procedures.
- **Individual credit assessment and sanction:** Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting are the same as those for assets intended to be held over the period to maturity.
- **Credit scoring:** In its principal retail portfolios, the Group uses statistically-based decisioning techniques (primarily credit scoring). Divisional risk departments review scorecard effectiveness and approve changes, with material changes to scorecards that form part of a probability of default rating system subject to Lloyds Banking Group Risk approval.
- **Controls over rating systems:** The Group has established a robust and independent process built on a set of common minimum standards designed to challenge the discriminatory power of the systems, accuracy of calibration and ability to rate consistently over time and across obligors. The internal rating systems are developed and implemented by independent risk functions either in the business units or divisions with the business unit managing directors having ownership of the systems. They also take responsibility for ensuring the validation of the respective internal rating systems, supported and challenged by special functions in their respective division.
- **Cross-border and cross-currency exposures:** Country limits are authorised by the Country Limits Panel and managed by a dedicated unit taking into account economic and political factors.
- **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 and more vulnerable sectors. Note 18 to the accounts provides an analysis of loans and advances to customers by industry (for wholesale) and product (for retail). Exposures are monitored to prevent 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 managed 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, for a specific industry sector.
- **Specialist expertise:** Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector-specific expertise; and legal services applicable to the particular market place and product range offered by the business.
- **Daily settlement limits:** Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.
- **Risk assurance and oversight:** Divisional and group level 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. Risk assurance teams are engaged where appropriate to conduct further credit reviews if a need for closer scrutiny is identified.

Notes to the accounts

50 Financial risk management (continued)

Collateral

The principal collateral types for loans and advances are:

- mortgages over residential properties;
- 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.

The Group maintains guidelines on the acceptability of specific classes of collateral.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Collateral or other security is also not usually obtained for credit risk exposures on derivative instruments, except where the Group requires margin deposits from counterparties.

It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of the customer, at the time of borrowing. Collateral is reviewed on a regular basis in accordance with business unit credit policy, which will vary according to the type of lending and collateral involved. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are noticed 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 and reporting

- Portfolio monitoring and reporting: In conjunction with Lloyds Banking Group Risk, businesses and divisions identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Lloyds Banking Group Risk in turn produces an aggregated review of credit risk, throughout the Group, including reports on significant credit exposures, which are presented to the Lloyds Banking Group Business Risk Committee.
- The performance of all rating models is comprehensively monitored on a regular basis, to ensure that models continue to provide optimum risk differentiation capability, the generated ratings remain as accurate and robust as possible and the models assign appropriate risk estimates to grades/pools. All models are monitored against a series of agreed key performance indicators. In the event that monthly monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated.

Market risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, arising from unexpected changes in financial prices, including interest 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 as the quantum and composition of market risk that exists currently in the Group and the direction in which the Group wishes to manage this.

This statement of the Group's overall appetite for market risk is reviewed and approved annually by the board. With the support of the Lloyds Banking Group Asset and Liability Committee the group chief executive allocates this risk appetite across the Group. Individual members of the Lloyds Banking 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.

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

Notes to the accounts

50 Financial risk management continued

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.

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 and equity risk:

- The management of the With Profit Fund within Scottish Widows involves mismatching of assets and liabilities with the aim of generating a higher rate of return on assets to meet policyholders' expectations.
- 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.
- 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 three portfolios: the surplus in the non-profit fund within the long-term fund of Scottish Widows plc, assets in shareholder funds of life assurance companies and an investment portfolio within the general insurance business.

The Group's defined benefit pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 38.

Measurement

The primary market risk measure used within the Group is the Value at Risk (VaR) methodology, which incorporates the volatility of relevant market prices and the correlation of their movements. This is used for determining the Group's overall market risk appetite and for the high level allocation of risk appetite across the Group. Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. The use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures.

During the year the Group introduced Group wide stress testing to measure exposure to credit spread widening across all businesses in response to the market dislocation that has impacted the observable inputs to asset pricing.

Banking – trading and other financial assets at fair value through profit or loss

Based on the commonly used 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 2008 and 2007 based on the Group's global trading positions was as detailed in the table below.

The risk of loss measured by the VaR model is the potential loss in earnings. The total and average trading VaR do not assume any diversification benefit across the four risk types. 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. VaR numbers have increased during 2008 due to the significant rise in volatility reflected in all the Group's VaR models across all markets.

	31 December 2008				31 December 2007			
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	6.73	3.36	14.67	0.96	1.63	2.20	4.66	1.27
Foreign exchange risk	2.95	1.22	4.06	0.08	0.08	0.23	0.53	0.04
Equity risk	0.00	0.25	2.67	0.00	0.00	0.29	3.02	0.00
Credit spread risk	7.97	4.94	8.08	4.14	4.21	3.60	8.30	2.06
Total VaR	17.65	9.77	24.95	5.35	5.92	6.32	11.00	4.28

Banking – non-trading

The estimated impacts of an immediate 25 basis point increase (2007: 200 basis point increase) in interest rates on economic value for the years ended 31 December 2008 and 2007 are shown below. Economic value is defined as the present value of the non-trading portfolios concerned. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. No currency breakdown has been provided as most of the exposure is in pounds sterling. These calculations are made monthly using assumptions regarding the maturity of interest rate insensitive assets and liabilities. The portfolio is updated monthly to reflect any changes in the relationship between customer behaviour and the level of interest rates.

This is a risk based disclosure and the amounts below would be amortised in the income statement over the duration of the portfolio. During the year, management reviewed the basis of reporting banking non-trading value at risk to reflect better the internal measurement used to control this exposure. The change in the 25 basis point increase compared to the previous year is due to the impact on retail balances of significant cuts in base rate during the last few months of 2008. In view of the unprecedented low interest rate environment in 2009, the assumptions underlying this particular risk measure are under review and likely to change.

	31 December 2008 £m	31 December 2007 £m
Change in value	(158)	8

Notes to the accounts

50 Financial risk management (continued)

Insurance portfolios

The Group's market risk exposure in respect of insurance activities described above is measured using European Embedded Value (EEV) as a proxy for economic value. The pre-tax sensitivity of EEV to standardised market stresses is shown below for the years ended 31 December 2008 and 2007. Foreign exchange risk arises predominantly from overseas equity holdings. 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 or tracked on a daily basis.

	31 December 2008	31 December 2007
	£m	£m
Equity risk (impact of 10% fall pre-tax)	(236)	(248)
Interest rate risk (impact of 25bp reduction pre-tax)	59	58
Credit spread risk (impact of 25bp increase pre-tax)	(82)	(110)

Mitigation

Various mitigation activities are undertaken across the Group to manage portfolios and 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 liabilities and interest rate sensitive assets, is managed centrally. Matching assets and liabilities are offset against each other and internal interest rate swaps are also used.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled.

Insurance activities

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

Monitoring

The senior asset and liability committee regularly reviews high level market risk exposure including, but not limited to, the data described above. It also makes 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 locally by independent risk functions and at a high level by Lloyds Banking Group Risk. Where appropriate, escalation procedures are in place.

Banking activities

Trading is restricted to a number of specialist centres, the most important centre being the products and markets 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 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 limits set with reference to the Group's overall risk appetite and regularly reviewed by the senior asset and liability committee:

- The With Profit Fund is 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.

Insurance risk*Definition*

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

Risk appetite

Insurance risk appetite is defined as the quantum and composition of insurance risk that exists currently in the Group and the direction in which the Group wishes to manage this.

Notes to the accounts

50 Financial risk management (continued)

Exposures

The major sources of insurance risk within the Group are the insurance businesses and the Group's defined benefit pension schemes. The nature of insurance business involves the accepting of insurance risks which relate primarily to mortality, longevity, morbidity, persistency, expenses, property damage and unemployment. The prime insurance risk carried by the Group's staff pension schemes is related to longevity.

Measurement

Insurance risks are measured using a variety of techniques including stress and scenario testing; and, where appropriate, stochastic modelling.

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate.

Mitigation

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level committees/Boards. For the life assurance businesses the key control body is the board of Scottish Widows Group Limited with the more significant risks also being subject to approval by the Group Executive Committee and/or the Lloyds Banking Group board. For the general insurance businesses the key control body is the Lloyds TSB General Insurance Limited Board with the more significant risks again being subject to Lloyds Banking Group Executive Committee and/or Lloyds Banking Group board approval. All group staff pension scheme issues are covered by the Lloyds Banking Group Asset and Liability Committee and the Lloyds Banking Group Business Risk Committee.

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

Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)
- Pricing-to-risk (new insurance proposals would usually be priced in accordance with the underwriting assessment)
- Claims management
- Product design
- Policy wording
- Product management
- The use of reinsurance or other risk mitigation techniques.

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

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

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 and that risk management is 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.

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:

Legal and regulatory risk

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

Customer treatment risk

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate or poor customer treatment.

Notes to the accounts

50 Financial risk management (continued)*Business process risk*

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from inadequate or failed internal processes and systems, people-related events and deficiencies in the performance of external suppliers/service providers.

Financial crime risk

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related legal and regulatory obligations, these losses may include censure, fines or the cost of litigation.

People risk

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

Change risk

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 or failing to implement change effectively or realise the desired benefits.

Governance risk

The risk of reductions in earnings and/or value, through financial or reputational loss, from poor corporate governance at group, divisional or business unit level. Corporate governance in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

Security risk

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.

Risk appetite

Operational risk appetite is defined as the quantum and composition of operational risk identified in the Group and the direction in which the Group wishes to manage it.

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, including customer service requirements.

For legal and regulatory risk the Group has minimal risk appetite and seeks to operate to high ethical standards. The Group encourages and maintains an appropriately balanced legal and 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.

Exposures

The main sources of operational risk within the Group relate to uncertainties created by the changing business, in particular the legal and regulatory environment in which financial firms operate both in the UK and overseas. As a result the most significant operational risk exposures are legal and regulatory.

Legal and regulatory exposure is driven by the significant volume of current legislation and regulation with which the Group has to comply, along with new 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. Further uncertainties arise where regulations are principles-based without the regulator defining supporting minimum standards either for the benefit of the consumer or firms. This gives rise to both the risk of retrospection from any one regulator and also to the risk of differing interpretation by individual regulators.

For legal and regulatory issues there are significant reputational impacts associated with potential censure which drive the Group's stance on appetites referred to above. There are clear accountabilities and processes in place for reviewing new and changing requirements. Each business has a nominated individual with 'compliance oversight' responsibility under FSA rules. The role of such individuals is to advise and assist management to ensure that each business has a control structure which creates awareness of the rules and regulations, to which the Group is subject, and to monitor and report on adherence to these rules and regulations.

Measurement

Throughout 2008 there has been ongoing development of operational risk appetites and metrics to ensure both current and potential future operational risk exposures are understood in terms of both risk and reward potential.

The Group has a comprehensive and consistent operational risk management framework for the timely identification, measurement, monitoring and control of operational risk.

Integral to this operational risk management framework is a hybrid approach to calculating capital to support unexpected losses. The capital model calculations are driven by internal data which captures past losses, and forward looking scenarios which value potential future risk events. External industry-wide data is collected to help with validating scenarios.

The capital model outputs are used to determine the internal capital charge for the Group which is then allocated to the businesses within the Group. Following review and approval of the operational risk management framework and capital model, the FSA has granted the banking businesses within the Group an Advanced Measurement Approach (AMA) Waiver which recognises the embedding of the operational risk framework across the Group. The waiver allowed the Group to calculate its own regulatory capital charge for operational risk from its capital model with effect from 1 January 2008.

Notes to the accounts

50 Financial risk management (continued)

The intention is to extend the same methodology to the insurance businesses within the Group where regulatory capital is currently determined under the ICA requirements.

Mitigation

The Group's operational risk management framework consists of five key components:

- Identification of the key operational risks facing a business area.
- Evaluation of the effectiveness of the control framework covering each of the key risks to which the business area is exposed.
- Evaluation of the non-financial exposures (e.g. reputational risk) for each of the key risks to which the business area is exposed.
- For material risks identified, an estimate of the exposure to financial losses that could result within the coming financial year, together with an estimate of losses in a stressed environment.
- For material risks identified, an estimate of exposure to high impact, low frequency events through a scenario.

The Group purchases insurance to mitigate certain operational risk events.

Monitoring

Business unit risk exposure is aggregated at divisional level and reported to group risk where a group-wide report is prepared. The report is discussed at the monthly group compliance and operational risk committee. This committee 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.

Liquidity risk

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.

In recent months, the strain in the financial systems has increased substantially, leading to a significant tightening in market liquidity and the threat of a more marked deterioration in the global economic outlook, with a consequent increase in recourse to liquidity schemes provided by central banks. While various governments including the UK Government have taken substantial measures to ease the current crisis in liquidity, such as the measures announced in the UK on 8 October 2008 and 13 October 2008, there can be no assurance that these global measures will succeed in improving the funding and liquidity of the markets in which the major banks operate.

Consistent with regulatory requirements, the Banking and Insurance parts of the Group manage their liquidity independently on a stand-alone basis. Liquidity for all banking business is managed centrally. Liquidity risk taken in insurance business is managed at business unit level and is not considered further in this section.

Risk appetite

Liquidity and funding risk appetite for the banking businesses is set by the board and reviewed on an annual basis. It is reported through various metrics that enable the Group to manage liquidity and funding constraints. The chief executive, assisted by the Lloyds Banking Group Asset and Liability Committee, regularly reviews performance against risk appetite. The board reviews liquidity and funding risk on a quarterly basis.

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 and stress test survival period triggers. Strict criteria and limits are in place to ensure marketable securities are available as part of the portfolio of highly liquid assets.

Mitigation

The Group mitigates the risk of a liquidity mismatch which is outside of its appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term strategic funding. Short-term liquidity management is considered from two perspectives, business as usual and crisis liquidity, 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 an original maturity of more than one year.

The Group's funding and liquidity management is underpinned by its significant retail deposit base, accompanied by appropriate funding from the wholesale markets. 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 provide inter-bank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's short-term money market funding is based on an 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 central banks and corporate customers, to supplement its retail deposit base.

Notes to the accounts

50 Financial risk management (continued)

During 2008, amounts deposited by customers increased by £15,651 million from £156,713 million at 31 December 2007 to £172,364 million at 31 December 2008. These customer deposits were supplemented by short-term wholesale market operations, the use of sale and repurchase agreements and the issue of subordinated loan capital and wholesale funding sources in the capital markets; these comprised Euro Medium-Term Note programmes, of which £15,926 million had been utilised for senior funding at 31 December 2008, and commercial paper programmes, under which £7,882 million had been utilised at 31 December 2008. The Group also raised wholesale funding via the issuance of Residential Mortgage Backed Securities: £9,824 million was outstanding at 31 December 2008.

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 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.

The Group is able to raise funds by issuing subordinated liabilities or equity. As at 31 December 2008, the Group had £17,389 million of subordinated debt in issuance. The cost and availability of subordinated liability finance are influenced by credit ratings. A reduction in these ratings could increase the cost and could reduce market access.

Monitoring

Liquidity is actively monitored at business unit and Group level at an appropriate frequency. Routine reporting is in place to senior management and through Lloyds Banking Group's committee structure, in particular the Lloyds Banking Group Asset and Liability Committee and the senior asset and liability committee which meet monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent oversight.

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

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

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

Financial and prudential regulatory reporting, disclosure and tax

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 and the failure to disclose information on a timely basis about the Group.

Risk appetite

The risk appetite is set by the board and reviewed on an annual basis. It includes the avoidance of the need for restatement of published financial and prudential regulatory data, public disclosures about the Groups financial, including tax, performance and its legal constitution.

Exposure

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate books and records to support statutory, prudential and tax reporting, to present and detect financial reporting fraud and to manage the Group's tax exposure.

Mitigation

The Group maintains a system of internal controls, which are designed to be consistently applied, and to provide a reasonable assurance that transactions are recorded and undertaken in accordance with delegated authorities that permit the preparation and disclosure of financial statements, prudential regulatory reporting and tax returns in accordance with IFRS, statutory and regulatory requirements.

Monitoring

The Group has in place a disclosure committee whose responsibility is to review all significant disclosures made by the Group and to assist the group chief executive and group finance director fulfill their responsibilities under the Listing Rules and regulations emanating from the Sarbanes-Oxley Act of 2002. A programme of work is undertaken and designed to support an annual assessment of the effectiveness of internal controls over financial reporting, in accordance with the requirements of section 404 of the US Sarbanes-Oxley Act; it also has in place an assurance mechanism over its prudential regulatory reporting; additionally, monitoring activities are designed to identify and maintain tax liabilities and to assess emerging regulation and legislation.

Lloyds Banking Group undertakes a programme of work designed to support an annual assessment of the effectiveness of internal controls over financial reporting, in accordance with the requirements of s.404 of the US Sarbanes-Oxley Act of 2002; to identify and maintain tax liabilities and to assess emerging regulation and legislation.

Notes to the accounts

50 Financial risk management (continued)

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 tables analyse the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

The Group	At fair value through profit or loss			Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m					
As at 31 December 2008								
Financial assets								
Cash and balances at central banks	-	-	-	-	-	5,008	-	5,008
Items in the course of collection from banks	-	-	-	-	-	946	-	946
Trading and other financial assets at fair value through profit or loss	-	857	44,258	-	-	-	-	45,115
Derivative financial instruments	435	28,449	-	-	-	-	-	28,884
Loans and advances to banks	-	-	-	-	40,758	-	-	40,758
Loans and advances to customers	-	-	-	-	242,735	-	-	242,735
Available-for-sale financial assets	-	-	-	55,707	-	-	-	55,707
Total financial assets	435	29,306	44,258	55,707	283,493	5,954	-	419,153
Financial liabilities								
Deposits from banks	-	-	-	-	-	66,514	-	66,514
Customer accounts	-	-	-	-	-	172,364	-	172,364
Items in course of transmission to banks	-	-	-	-	-	508	-	508
Trading and other financial liabilities at fair value through profit or loss	-	6	6,748	-	-	-	-	6,754
Derivative financial instruments	4,169	24,020	-	-	-	-	-	28,189
Debt securities in issue	-	-	-	-	-	73,066	-	73,066
Liabilities arising from insurance contracts and participating investment contracts	-	-	-	-	-	-	33,827	33,827
Liabilities arising from non-participating investment contracts	-	-	-	-	-	-	14,243	14,243
Unallocated surplus within insurance businesses	-	-	-	-	-	-	270	270
Subordinated liabilities	-	-	-	-	-	17,389	-	17,389
Total financial liabilities	4,169	24,026	6,748	-	-	329,841	48,340	413,124

Notes to the accounts

50 Financial risk management (continued)

The Group	At fair value through profit or loss		Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
	Derivatives designated as hedging instruments £m	Held for trading £m					
As at 31 December 2007							
Financial assets							
Cash and balances at central banks	–	–	–	–	4,330	–	4,330
Items in the course of collection from banks	–	–	–	–	1,242	–	1,242
Trading and other financial assets at fair value through profit or loss	–	4,663	53,433	–	–	–	58,096
Derivative financial instruments	264	8,424	–	–	–	–	8,688
Loans and advances to banks	–	–	–	34,845	–	–	34,845
Loans and advances to customers	–	–	–	209,814	–	–	209,814
Available-for-sale financial assets	–	–	20,196	–	–	–	20,196
Total financial assets	264	13,087	20,196	244,659	5,572	–	337,211
Financial liabilities							
Deposits from banks	–	–	–	–	39,091	–	39,091
Customer accounts	–	–	–	–	156,713	–	156,713
Items in course of transmission to banks	–	–	–	–	668	–	668
Trading and other financial liabilities at fair value through profit or loss	–	99	3,107	–	–	–	3,206
Derivative financial instruments	800	6,951	–	–	–	–	7,751
Debt securities in issue	–	–	–	–	49,828	–	49,828
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	38,192	38,192
Liabilities arising from non-participating investment contracts	–	–	–	–	–	18,197	18,197
Unallocated surplus within insurance businesses	–	–	–	–	–	554	554
Subordinated liabilities	–	–	–	–	12,437	–	12,437
Total financial liabilities	800	7,050	3,107	–	258,737	56,943	326,637

Reclassification of financial assets

In accordance with the amendment to IAS 39 as disclosed in note 2, the Group reviewed the classification of its assets classified as held for trading and available-for-sale financial assets. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, the Group and Bank reclassified £2,993 million of assets classified as held for trading (measured at fair value through profit or loss immediately prior to reclassification) to loans and receivables with effect from 1 July 2008 and £437 million of assets classified as available-for-sale financial assets (measured at fair value through equity) to loans and receivables with effect from 1 November 2008. At the time of these transfers, the Group and Bank had the intention and ability to hold them for the foreseeable future or until maturity.

Held for trading to loans and receivables

In respect of the £2,993 million of assets transferred with effect from 1 July 2008, a loss of £172 million was recognised in the income statement for the six months to 30 June 2008 (year to 31 December 2007: £132 million) while they were classified as held for trading. If the assets had not been transferred, a loss of £347 million would have been recognised in the income statement for the six months to 31 December 2008 within net trading income.

Since the reclassification to loans and receivables, a net credit of £31 million has been recognised in the income statement for the six months to 31 December 2008 within net interest income and a charge of £158 million within impairment. The weighted average effective interest rate of the assets transferred was 6.3 per cent with expected recoverable cash flows of £3,524 million.

Available-for-sale financial assets to loans and receivables

In respect of the £437 million of assets transferred with effect from 1 November 2008, a negative valuation movement of £261 million, including exchange movements, was recognised in the revaluation reserve in respect of available-for-sale financial assets for the ten months to 31 October 2008 while they were classified as available-for-sale financial assets. If the assets had not been transferred and had been kept as available-for-sale financial assets £3 million would have been recognised in interest income and £209 million would have been recognised in impairment in the income statement for the two months to 31 December 2008.

Since the reclassification to loans and receivables, an amount of £3 million has been recognised in the income statement for the two months to 31 December 2008 within interest income and a further £23 million within impairment. The weighted average effective interest rate of the assets transferred was 10.9 per cent with expected recoverable cash flows of £837 million.

For the year ended 31 December 2007, a negative valuation movement of £34 million, including exchange movements, was recognised in the revaluation reserve in respect of available-for-sale financial assets and £32 million was recognised in interest income.

Notes to the accounts

50 Financial risk management (continued)

The Bank	At fair value through profit or loss						Total £m
	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	
As at 31 December 2008							
Financial assets							
Cash and balances at central banks	-	-	-	-	-	4,890	4,890
Items in the course of collection from banks	-	-	-	-	-	909	909
Trading and other financial assets at fair value through profit or loss	-	857	2,822	-	-	-	3,679
Derivative financial instruments	435	26,269	-	-	-	-	26,704
Loans and advances to banks	-	-	-	-	38,993	-	38,993
Loans and advances to customers	-	-	-	-	251,201	-	251,201
Available-for-sale financial assets	-	-	-	58,444	-	-	58,444
Total financial assets	435	27,126	2,822	58,444	290,194	5,799	384,820
Financial liabilities							
Deposits from banks	-	-	-	-	-	80,529	80,529
Customer accounts	-	-	-	-	-	184,041	184,041
Items in course of transmission to banks	-	-	-	-	-	467	467
Trading and other financial liabilities at fair value through profit or loss	-	6	6,748	-	-	-	6,754
Derivative financial instruments	1,963	27,767	-	-	-	-	29,730
Debt securities in issue	-	-	-	-	-	74,559	74,559
Subordinated liabilities	-	-	-	-	-	16,853	16,853
Total financial liabilities	1,963	27,773	6,748	-	-	356,449	392,933

The Bank	At fair value through profit or loss						Total £m
	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	
As at 31 December 2007							
Financial assets							
Cash and balances at central banks	-	-	-	-	-	4,211	4,211
Items in the course of collection from banks	-	-	-	-	-	1,196	1,196
Trading and other financial assets at fair value through profit or loss	-	4,663	4,521	-	-	-	9,184
Derivative financial instruments	271	8,353	-	-	-	-	8,624
Loans and advances to banks	-	-	-	-	28,447	-	28,447
Loans and advances to customers	-	-	-	-	212,738	-	212,738
Available-for-sale financial assets	-	-	-	4,260	-	-	4,260
Total financial assets	271	13,016	4,521	4,260	241,185	5,407	268,660
Financial liabilities							
Deposits from banks	-	-	-	-	-	48,940	48,940
Customer accounts	-	-	-	-	-	163,245	163,245
Items in course of transmission to banks	-	-	-	-	-	613	613
Trading and other financial liabilities at fair value through profit or loss	-	99	3,107	-	-	-	3,206
Derivative financial instruments	457	7,908	-	-	-	-	8,365
Debt securities in issue	-	-	-	-	-	36,647	36,647
Subordinated liabilities	-	-	-	-	-	11,903	11,903
Total financial liabilities	457	8,007	3,107	-	-	261,348	272,919

Interest rate risk

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There are a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

Notes to the accounts

50 Financial risk management (continued)

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However a significant proportion of the Group's lending assets, for example personal loans and mortgages, bear interest rates which are contractually fixed for periods of up to five years or longer.

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate mortgage portfolio. At 31 December 2008 the aggregate notional principal of interest rate swaps designated as fair value hedges was £37,243 million (2007: £50,734 million) for the Group and £38,243 million (2007: £50,209 million) for the Bank with a net fair value liability of £1,231 million (2007: £197 million) for the Group and £1,438 million (2007: £163 million) for the Bank (note 16). The losses recognised by the Group on the hedging instruments were £584 million (2007: losses of £233 million). The Group's gains on the hedged items attributable to the hedged risk were £426 million (2007: gains of £211 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next six years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2008 was £867 million (2007: £630 million) for the Group and the Bank with a net fair value liability of £90 million (2007: £23 million) for the Group and the Bank (note 16). In 2008, there is no ineffectiveness recognised in the Group's income statement that arises from cash flow hedges (2007: £nil). There were no transactions for which cash flow hedge accounting had to be ceased in 2008 or 2007 as a result of the highly probable cash flows no longer being expected to occur.

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 Wholesale and International Banking Market and Liquidity Risk. Associated VaR and the closing, average, maximum and minimum for 2007 and 2008 are disclosed on page 77.

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 investments in certain foreign operations using cross currency swaps. At 31 December 2008 the notional principal of these cross currency swaps was £6,318 million with a net fair value liability of £2,413 million (2007: £5,302 million with a net fair value liability of £316 million) (note 16) and they were designated on an after-tax basis as hedges of net investments in foreign operations. In 2008 ineffectiveness of £14 million before tax and £10 million after tax (2007: £nil) was recognised in the income statement arising from net investment hedges.

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

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Functional currency of Group operations:				
Euro	133	95	82	61
US dollar	(907)	7	90	37
Swiss franc:				
Gross exposure	2,784	1,945	78	51
Net investment hedge	(2,663)	(1,875)	-	-
	121	70	78	51
Japanese yen:				
Gross exposure	3,667	2,148	16	10
Net investment hedge	(3,645)	(2,136)	-	-
	22	12	16	10
Other non-sterling	296	196	258	165
	(335)	380	524	324

Credit risk

The Group's credit risk exposure arises predominantly in the United Kingdom and the European Union.

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

Notes to the accounts

50 Financial risk management (continued)

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Loans and advances to banks	40,916	34,845	39,151	28,447
Loans and advances to customers	246,304	212,222	254,011	214,593
Deposit amounts available for offset ¹	(4,837)	(6,206)	(4,827)	(5,819)
Impairment losses	(3,727)	(2,408)	(2,968)	(1,855)
	278,656	238,453	285,367	235,366
Available-for-sale debt securities and treasury and other bills	55,666	20,167	58,408	4,231
Trading and other financial assets at fair value through profit or loss	21,790	26,165	3,674	9,181
Derivative assets, before netting	28,884	8,688	26,704	8,624
Amounts available for offset under master netting arrangements ¹	(10,598)	(3,287)	(10,598)	(3,287)
	18,286	5,401	16,106	5,337
Assets arising from reinsurance contracts held	385	350	–	–
Financial guarantees	10,382	9,753	10,382	10,056
Irrevocable loan commitments and other credit-related contingencies ²	51,659	56,600	47,281	50,322
	436,824	356,889	421,218	314,493
Maximum credit risk exposure	452,259	366,382	436,643	323,599

¹ Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

² See note 49 – Contingent liabilities and commitments for further information.

A general description of collateral held in respect of financial instruments is disclosed on page 76.

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

Available-for-sale debt securities, treasury and other bills, and trading and other financial assets at fair value through profit or loss – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 15 and a similar analysis for available-for-sale financial assets is included in note 20. The Group's non-participating investment contracts are all unit-linked. Movements in the fair values of trading and other financial assets at fair value through profit or loss which back those investment contracts, including movements arising from credit risk, are borne by the contract holders.

Derivative assets – the Group reduces exposure to credit risk by using master netting agreements and by obtaining cash collateral. An analysis of derivative assets is given in note 16. Of the net derivative assets of £18,286 million for the Group and £16,106 million for the Bank (2007: £5,401 million for the Group and £5,337 million for the Bank), cash collateral of £2,970 million (2007: £2,004 million) was held for both the Group and the Bank, and a further £5,840 million for the Group and £3,574 million for the Bank was due from OECD banks (2007: £1,459 million for the Group and £1,385 million for the Bank).

Assets arising from reinsurance contracts held – of the assets arising from reinsurance contracts held at 31 December 2008 of £385 million (2007: £350 million), £380 million (2007: £341 million) were due from insurers with a credit rating of AA or above.

Financial guarantees – these represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards.

Reverse repo and repo transactions – for reverse repo transactions which are accounted for as collateralised loans, it is the Group's policy to seek collateral which is at least equal to the amount loaned. At 31 December 2008, the fair value of collateral accepted under reverse repo transactions that the Group and the Bank is permitted by contract or custom to sell or repledge was £5,858 million (2007: £10,300 million). Of this, £5,855 million (2007: £10,299 million) for the Group and the Bank was sold or repledged as at 31 December 2008. The fair value of collateral pledged in respect of repo transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to sell or repledge was £5,734 million (2007: £768 million) for the Group and the Bank.

Notes to the accounts

50 Financial risk management (continued)

Loans and advances – The Group

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2008						
Neither past due nor impaired	110,148	33,571	89,208	232,927	608	40,741
Past due but not impaired	3,134	1,146	555	4,835	–	17
Impaired – no provision required	479	150	1,253	1,882	–	–
– provision held	882	4,327	1,451	6,660	–	158
Gross	114,643	39,194	92,467	246,304	608	40,916
Allowance for impairment losses (note 19)	(186)	(2,345)	(1,038)	(3,569)	–	(158)
Net	114,457	36,849	91,429	242,735	608	40,758

No amounts were due from fellow Lloyds Banking Group undertakings at 31 December 2007 or at 31 December 2008.

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2007						
Neither past due nor impaired	99,828	29,850	73,475	203,153	1,189	34,845
Past due but not impaired	2,153	966	639	3,758	–	–
Impaired – no provision required	415	100	293	808	–	–
– provision held	343	3,600	560	4,503	–	–
Gross	102,739	34,516	74,967	212,222	1,189	34,845
Allowance for impairment losses (note 19)	(37)	(2,029)	(342)	(2,408)	–	–
Net	102,702	32,487	74,625	209,814	1,189	34,845

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 which are neither past due nor impaired – The Group

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2008						
Good quality	109,437	21,251	50,718		129	40,295
Satisfactory quality	643	9,305	34,559		411	192
Lower quality	–	900	3,444		56	240
Below standard, but not impaired	68	2,115	487		12	14
Total	110,148	33,571	89,208	232,927	608	40,741
31 December 2007						
Good quality	99,407	18,157	46,240		191	34,647
Satisfactory quality	378	8,964	25,013		670	190
Lower quality	1	665	2,034		327	7
Below standard, but not impaired	42	2,064	188		1	1
Total	99,828	29,850	73,475	203,153	1,189	34,845

Notes to the accounts

50 Financial risk management (continued)

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. Good quality lending includes the lower assessed default probabilities and all loans with low expected losses in the event of default, with other categories reflecting progressively higher risks and lower expected recoveries.

Loans and advances which are past due but not impaired – The Group

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2008						
0-30 days	1,527	853	289	2,669	–	–
30-60 days	633	259	90	982	–	–
60-90 days	424	32	70	526	–	17
90-180 days	549	2	77	628	–	–
Over 180 days	1	–	29	30	–	–
Total	3,134	1,146	555	4,835	–	17
Fair value of collateral held	2,637	n/a	n/a	n/a		
31 December 2007						
0-30 days	1,123	781	266	2,170	–	–
30-60 days	445	155	107	707	–	–
60-90 days	260	29	129	418	–	–
90-180 days	325	1	67	393	–	–
Over 180 days	–	–	70	70	–	–
Total	2,153	966	639	3,758	–	–
Fair value of collateral held	2,111	n/a	n/a	n/a		

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

Collateral held against retail mortgage lending is principally comprised of residential properties; their fair value has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations. The resulting valuation has been limited to the principal amount of the outstanding advance in order to provide a clearer representation of the Group's credit exposure.

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

Notes to the accounts

50 Financial risk management (continued)

Loans and advances – The Bank

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2008						
Neither past due nor impaired	97,016	25,299	70,058	192,373	608	27,654
Past due but not impaired	2,850	860	526	4,236	–	17
Impaired – no provision required	345	125	1,232	1,702	–	–
– provision held	714	3,331	1,368	5,413	–	158
Gross	100,925	29,615	73,184	203,724	608	27,829
Allowance for impairment losses (note 19)	(175)	(1,692)	(943)	(2,810)	–	(158)
Net	100,750	27,923	72,241	200,914	608	27,671
Due from fellow Lloyds Banking Group undertakings				50,287	–	11,322
Total				251,201	608	38,993

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2007						
Neither past due nor impaired	87,689	22,048	54,639	164,376	1,189	21,872
Past due but not impaired	1,943	723	596	3,262	–	–
Impaired – no provision required	391	81	302	774	–	–
– provision held	194	2,804	523	3,521	–	–
Gross	90,217	25,656	56,060	171,933	1,189	21,872
Allowance for impairment losses (note 19)	(32)	(1,521)	(302)	(1,855)	–	–
Net	90,185	24,135	55,758	170,078	1,189	21,872
Due from fellow Lloyds Banking Group undertakings				42,660	–	6,575
Total				212,738	1,189	28,447

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

Loans and advances which are neither past due nor impaired – The Bank

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2008						
Good quality	96,749	14,805	40,273		129	27,420
Satisfactory quality	267	7,897	27,769		411	185
Lower quality	–	867	1,771		56	35
Below standard, but not impaired	–	1,730	245		12	14
Total	97,016	25,299	70,058	192,373	608	27,654
31 December 2007						
Good quality	87,593	12,280	33,998		191	21,680
Satisfactory quality	96	7,515	19,545		670	184
Lower quality	–	641	1,065		327	7
Below standard, but not impaired	–	1,612	31		1	1
Total	87,689	22,048	54,639	164,376	1,189	21,872

Notes to the accounts

50 Financial risk management (continued)

Loans and advances which are past due but not impaired – The Bank

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
31 December 2008						
0-30 days	1,332	578	261	2,171	–	–
30-60 days	583	248	90	921	–	–
60-90 days	404	32	69	505	–	17
90-180 days	530	2	77	609	–	–
Over 180 days	1	–	29	30	–	–
Total	2,850	860	526	4,236	–	17
Fair value of collateral held	2,422	n/a	n/a	n/a		
31 December 2007						
0-30 days	982	544	241	1,767	–	–
30-60 days	407	150	99	656	–	–
60-90 days	244	28	119	391	–	–
90-180 days	310	1	67	378	–	–
Over 180 days	–	–	70	70	–	–
Total	1,943	723	596	3,262	–	–
Fair value of collateral held	1,926	n/a	n/a	n/a		

Renegotiated loans and advances

Loans and advances that were renegotiated during the year and that would otherwise have been past due or impaired at 31 December 2008 totalled £144 million (2007: £579 million) for the Group and £133 million (2007: £251 million) for the Bank.

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Repossessed collateral				
Residential property	221	73	210	54
Other	26	9	–	–
Total	247	82	210	54

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.

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Loan to value ratio of mortgage lending				
Analysis by loan to value ratio of residential mortgage lending which is neither past due nor impaired:				
Less than 70 per cent	55,040	66,716	49,092	59,624
70 per cent to 80 per cent	15,812	15,690	14,079	13,860
80 per cent to 90 per cent	15,954	12,102	14,186	10,270
Greater than 90 per cent	23,342	5,320	19,665	3,935
Total	110,148	99,828	97,022	87,689

Notes to the accounts

50 Financial risk management (continued)

Debt securities, treasury and other bills – analysis by credit rating

The Group

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2008							
Debt securities held at fair value through profit or loss							
<i>Trading assets</i>							
Debt securities:							
Government securities	38	–	–	–	–	–	38
Corporate and other debt securities	76	187	38	68	87	80	536
Total held as trading assets	114	187	38	68	87	80	574
<i>Other assets held at fair value through profit or loss</i>							
Debt securities:							
Government securities	7,025	45	138	1	–	117	7,326
Other public sector securities	–	–	–	–	–	18	18
Bank and building society certificates of deposit	96	337	–	–	–	–	433
Mortgage backed securities	207	108	23	16	–	15	369
Other asset backed securities	206	362	391	277	105	1	1,342
Corporate and other debt securities	3,194	864	2,911	2,142	599	1,410	11,120
Total held at fair value through profit or loss	10,842	1,903	3,501	2,504	791	1,641	21,182
Available-for-sale financial assets							
Debt securities:							
Government securities	851	–	1	–	–	16	868
Other public sector securities	–	–	–	–	–	12	12
Bank and building society certificates of deposit	–	9,418	166	–	18	–	9,602
Mortgage backed securities	4,388	6	21	–	14	–	4,429
Other asset backed securities	4,604	121	60	20	98	53	4,956
Corporate and other debt securities	4,111	1,424	304	71	113	567	6,590
Total debt securities	13,954	10,969	552	91	243	648	26,457
Treasury bills and other bills	26,858	2,351	–	–	–	–	29,209
Total held as available-for-sale assets	40,812	13,320	552	91	243	648	55,666
As at 31 December 2007							
Debt securities held at fair value through profit or loss							
<i>Trading assets</i>							
Debt securities:							
Government securities	62	–	–	–	–	–	62
Mortgage backed securities	–	28	51	8	–	–	87
Other asset backed securities	–	15	61	38	3	5	122
Corporate and other debt securities	268	1,268	1,390	103	59	519	3,607
Total held as trading assets	330	1,311	1,502	149	62	524	3,878
<i>Other assets held at fair value through profit or loss</i>							
Debt securities:							
Government securities	4,808	6	15	1	–	18	4,848
Bank and building society certificates of deposit	42	548	53	–	–	168	811
Mortgage backed securities	61	–	–	–	–	9	70
Other asset backed securities	1,367	214	153	71	–	–	1,805
Corporate and other debt securities	5,118	1,606	2,868	2,528	340	1,104	13,564
Total held at fair value through profit or loss	11,726	3,685	4,591	2,749	402	1,823	24,976

Notes to the accounts

50 Financial risk management (continued)

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
Available-for-sale financial assets							
Debt securities:							
Government securities	310	–	–	–	–	9	319
Other public sector securities	–	–	–	–	–	5	5
Bank and building society certificates of deposit	–	1,683	125	–	15	2	1,825
Mortgage backed securities	5,880	14	10	–	–	146	6,050
Other asset backed securities	3,895	37	27	–	–	112	4,071
Corporate and other debt securities	3,822	1,170	186	–	–	1,092	6,270
Total debt securities	13,907	2,904	348	–	15	1,366	18,540
Treasury bills and other bills	31	1,596	–	–	–	–	1,627
Total held as available-for-sale assets	13,938	4,500	348	–	15	1,366	20,167

There are no material amounts for debt securities, treasury and other bills which are past due but not impaired.

Debt securities, treasury and other bills – analysis by credit rating

The Bank

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2008							
Debt securities held at fair value through profit or loss							
<i>Trading assets</i>							
Government securities	38	–	–	–	–	–	38
Corporate and other debt securities	76	187	38	68	87	80	536
Total held as trading assets	114	187	38	68	87	80	574
<i>Other assets held at fair value through profit or loss</i>							
Other asset backed securities	–	–	–	–	105	–	105
Corporate and other debt securities	41	77	286	1,089	553	341	2,387
Total held at fair value through profit or loss	155	264	324	1,157	745	421	3,066
Available-for-sale financial assets							
Debt securities:							
Government securities	501	–	1	–	–	8	510
Other public sector securities	–	–	–	–	–	12	12
Bank and building society certificates of deposit	–	7,484	166	–	13	–	7,663
Mortgage backed securities	914	6	3	–	5	–	928
Other asset backed securities	960	33	24	20	98	52	1,187
Corporate and other debt securities	1,987	348	–	55	127	159	2,676
Total debt securities	4,362	7,871	194	75	243	231	12,976
Treasury bills and other bills	26,857	–	–	–	–	–	26,857
Total held as available-for-sale assets	31,219	7,871	194	75	243	231	39,833
Due from fellow Group undertakings							
– mortgage backed securities							17,830
– other asset backed securities							745
							58,408

Notes to the accounts

50 Financial risk management (continued)

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2007							
Debt securities held at fair value through profit or loss							
<i>Trading assets</i>							
Government securities	62	–	–	–	–	–	62
Mortgage backed securities	–	28	51	8	–	–	87
Other asset backed securities	–	15	61	38	3	5	122
Corporate and other debt securities	268	1,268	1,390	103	59	519	3,607
Total held as trading assets	330	1,311	1,502	149	62	524	3,878
<i>Other assets held at fair value through profit or loss</i>							
Government securities	1	–	–	–	–	–	1
Mortgage backed securities	–	–	–	–	–	8	8
Other asset backed securities	282	–	–	–	–	–	282
Corporate and other debt securities	1,471	12	362	1,357	276	345	3,823
Total held at fair value through profit or loss	2,084	1,323	1,864	1,506	338	877	7,992
Available-for-sale financial assets							
Debt securities:							
Other public sector securities	–	–	–	–	–	5	5
Bank and building society certificates of deposit	–	1,146	125	–	10	2	1,283
Mortgage backed securities	1,424	14	10	–	–	16	1,464
Other asset backed securities	238	37	26	–	–	112	413
Corporate and other debt securities	729	272	1	–	–	25	1,027
Total debt securities	2,391	1,469	162	–	10	160	4,192
Treasury bills and other bills	30	9	–	–	–	–	39
Total held as available-for-sale assets	2,421	1,478	162	–	10	160	4,231

Liquidity risk

The tables below analyse financial instrument liabilities of the Group and the Bank, 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.

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
As at 31 December 2008						
Deposits from banks	49,620	13,617	1,480	1,986	5	66,708
Customer accounts	158,607	8,482	9,788	2,322	830	180,029
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	30,776	1,077	5,295	7,203	3,818	48,169
Debt securities in issue	24,306	26,932	6,591	13,643	3,489	74,961
Liabilities arising from non-participating investment contracts	14,243	–	–	–	–	14,243
Subordinated liabilities	20	102	438	4,593	17,987	23,140
Total	277,572	50,210	23,592	29,747	26,129	407,250
As at 31 December 2007						
Deposits from banks	35,466	2,218	1,480	26	–	39,190
Customer accounts	144,406	4,800	7,578	2,002	537	159,323
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	10,454	2,176	3,607	1,589	1,851	19,677
Debt securities in issue	20,299	6,032	7,789	13,152	6,197	53,469
Liabilities arising from non-participating investment contracts	18,197	–	–	–	–	18,197
Subordinated liabilities	16	188	970	5,854	11,098	18,126
Total	228,838	15,414	21,424	22,623	19,683	307,982

Trading derivatives (other than those in the insurance companies) and trading liabilities are included in the up to 1 month column at their fair value. Liquidity risk on these items is not managed on the basis of contractual maturity as they are frequently settled on demand at fair value and therefore this is considered a better presentation of the Group's liquidity risk. Derivatives used in a hedging relationship are included according to their contractual maturity.

Cash flows for undated subordinated liabilities whose terms give the Group the option to redeem at a future date are included within the table on the basis that the Group will exercise its option to redeem.

Notes to the accounts

50 Financial risk management (continued)

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £300 million (2007: £126 million) per annum for the Group and approximately £272 million (2007: £126 million) per annum for the Bank which is payable in respect of those instruments for as long as they remain in issue (i.e. in perpetuity) is not included beyond 5 years.

Further information on the Group's liquidity exposures is provided on page 81.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
The Bank						
As at 31 December 2008						
Deposits from banks	61,342	14,675	2,203	2,579	–	80,799
Customer accounts	146,168	9,689	19,758	8,498	2,122	186,235
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	27,912	425	1,210	7,051	3,573	40,171
Debt securities in issue	16,100	22,206	10,561	23,605	3,263	75,735
Subordinated liabilities	21	102	409	4,479	17,432	22,443
Total	251,543	47,097	34,141	46,212	26,390	405,383
As at 31 December 2007						
Deposits from banks	43,854	2,632	2,067	652	63	49,268
Customer accounts	137,530	5,862	10,545	13,416	1,295	168,648
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	10,641	185	3,509	1,485	1,271	17,091
Debt securities in issue	7,959	5,678	7,605	13,050	5,701	39,993
Subordinated liabilities	–	181	941	5,760	10,451	17,333
Total	199,984	14,538	24,667	34,363	18,781	292,333

Liabilities of the Group 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	1-2 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
As at 31 December 2008	340	927	2,626	7,030	22,904	33,827
As at 31 December 2007	238	651	1,570	9,548	26,185	38,192

The following tables set out the amounts and residual maturities of 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
The Group					
31 December 2008					
Acceptances	49	–	–	–	49
Other contingent liabilities	1,722	1,525	402	1,071	4,720
Total contingent liabilities	1,771	1,525	402	1,071	4,769
Lending commitments	54,155	15,029	8,014	3,625	80,823
Other commitments	572	181	80	99	932
Total commitments	54,727	15,210	8,094	3,724	81,755
Total contingents and commitments	56,498	16,735	8,496	4,795	86,524
31 December 2007					
Acceptances	39	1	–	–	40
Other contingent liabilities	1,441	1,032	255	796	3,524
Total contingent liabilities	1,480	1,033	255	796	3,564
Lending commitments	60,981	13,759	10,634	4,221	89,595
Other commitments	466	78	108	117	769
Total commitments	61,447	13,837	10,742	4,338	90,364
Total contingents and commitments	62,927	14,870	10,997	5,134	93,928

Notes to the accounts

50 Financial risk management (continued)

The Bank	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2008					
Acceptances	49	–	–	–	49
Other contingent liabilities	1,631	1,522	402	1,089	4,644
Total contingent liabilities	1,680	1,522	402	1,089	4,693
Lending commitments	64,095	14,613	7,704	3,290	89,702
Other commitments	673	182	81	100	1,036
Total commitments	64,768	14,795	7,785	3,390	90,738
Total contingents and commitments	66,448	16,317	8,187	4,479	95,431
31 December 2007					
Acceptances	41	1	–	–	42
Other contingent liabilities	1,370	1,028	255	796	3,449
Total contingent liabilities	1,411	1,029	255	796	3,491
Lending commitments	71,781	11,780	8,928	3,870	96,359
Other commitments	597	77	108	117	899
Total commitments	72,378	11,857	9,036	3,987	97,258
Total contingents and commitments	73,789	12,886	9,291	4,783	100,749

Fair values of financial assets and liabilities

Financial instruments include financial assets, financial liabilities and derivatives. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Wherever possible, fair values have been estimated using market prices for instruments held by the Group. Where market prices are not available or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics either identical or similar to those of the instruments held by the Group. These estimation techniques are necessarily subjective in nature and involve several assumptions.

The fair values presented in the following 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.

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.

The valuation technique for each major category of financial instrument and, where valuation models are used, significant inputs into valuation models, are discussed below.

Where referred to within the major categories listed, the Group's use of lead manager quotes and market standard consensus pricing services are as described below:

Lead manager quotes for illiquid assets in the current markets do not represent binding levels and are validated for consistency across the same asset class and by reference to discounted cash flow models that use expected loss and discount assumptions.

Market standard consensus pricing services aggregate price and other market data inputs from leading participants in the relevant markets and provide average mid-level outputs adjusted to exclude prices that are clearly out of line with other prices observed; these levels do not represent binding quotes.

Trading and other financial assets at fair value through profit or loss

The fair values of financial instruments quoted in active markets are based on quoted prices. The fair values of financial instruments that are not quoted in active markets are determined using valuation techniques including cash flow models which, to the extent practicable, use observable market inputs such as interest rate yield curves, equities and commodities prices, option volatilities and currency rates that are either directly observable or are implied from instrument prices. The fair values of bonds classified as trading assets are determined predominantly from lead manager quotes and, where these are not available, by reference to market standard consensus pricing services, broker quotes and other research data. Certain corporate bonds were valued using credit default swap (CDS) spreads and assumptions around the bond/CDS spread. The fair values of the Group's venture capital investments are determined using techniques which follow British Venture Capital Association (BVCA) guidelines.

The fair value movement on assets and liabilities held at fair value through profit or loss and gains in respect of instruments held for trading are disclosed in note 7.

At 31 December 2008, the Group had a portfolio of corporate bonds hedged by CDS. Prior to October 2008, the markets for both corporate bonds and CDS were relatively liquid and both sides of the above position were valued using market observable inputs. During October 2008 bid/offer spreads widened severely and, consequently, the cash market for corporate bonds became inactive. The above position is valued in part using assumptions around the bonds/CDS spread. The effect of using reasonably possible alternative adverse assumptions for this valuation would reduce net trading income by up to £105 million.

Notes to the accounts

50 Financial risk management (continued)

Derivative financial instruments

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 options 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.

Interest rate swaps 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 are priced using rates available from publicly quoted sources. Credit derivatives, except for the items noted below, are valued using publicly available yield and CDS curves; the Group uses standard models with observable inputs. Less complex interest rate and foreign exchange option products 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.

An analysis of derivatives including fair values by contract type is given in note 16.

At 31 December 2008, the Group had a senior synthetic position in a structured corporate collateralised debt obligation (CDO) that is valued in part using assumptions around recovery levels. The effect of using reasonably possible alternative favourable or adverse assumptions for recovery levels would increase or reduce net trading income by up to £80 million respectively.

At 31 December 2008, the Group had a credit valuation reserve on its derivative positions that is valued in part using assumptions around credit spreads and recovery risks. The effect of using reasonably possible alternative adverse combinations of assumptions for these risks would reduce net trading income by up to £70 million.

Loans and advances to banks and customers

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair values of asset backed securities (ABS) and secondary loans, which were previously within assets held for trading and were reclassified to loans and receivables (see page 84), 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.

Available-for-sale financial assets

Listed securities are valued at current bid prices. Unlisted securities and other financial assets are valued based on discounted cash flows, market prices of similar instruments and other appropriate valuation techniques. The fair values of bonds classified as available-for-sale financial assets, including those within asset backed securities (ABS), 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.

At 31 December 2008, the Group's available-for-sale financial assets included ABS of £13,938 million. In respect of these assets, the effects of a 100 basis point shift in credit spreads would result in a pre-tax movement of £590 million which would be recognised, net of tax, in the revaluation reserve in respect of available-for-sale assets.

Deposits from banks and customer accounts

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

Debt securities in issue and subordinated liabilities

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

Trading and other financial liabilities at fair value through profit or loss

The fair values of financial instruments quoted in active markets are based on quoted prices. The fair values of financial instruments that are not quoted in active markets are determined using valuation techniques including cash flow models which, to the extent practicable, use observable market inputs such as interest rate yield curves, equities and commodities prices, option volatilities and currency rates that are either directly observable or are implied from instrument prices.

Liabilities arising from non-participating investment contracts

The value of the Group's non-participating investment contracts, all of which are unit-linked, is contractually linked to the fair values of financial assets within the Group's unitised investment funds and 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.

Notes to the accounts

50 Financial risk management (continued)*Financial commitments and contingent liabilities*

Financial guarantees are valued on the basis of cash premiums receivable. The Group considers that it is not meaningful or practical to provide an estimate of the fair value of other contingent liabilities and financial commitments, given the lack of an established market, the diversity of fee structures and the difficulty of separating the value of the instruments from the value of the overall transaction. Therefore only financial guarantees are included in the following table.

	The Group				The Bank			
	Carrying value		Fair value		Carrying value		Fair value	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
<i>Financial assets</i>								
Trading and other financial assets at fair value through profit or loss	45,115	58,096	45,115	58,096	3,679	9,184	3,679	9,184
Derivative financial instruments	28,884	8,688	28,884	8,688	26,704	8,624	26,704	8,624
Loans and advances to banks	40,758	34,845	40,425	34,832	38,993	28,447	38,659	28,434
Loans and advances to customers	242,735	209,814	237,079	209,066	251,201	212,738	245,386	212,015
Available-for-sale financial assets	55,707	20,196	55,707	20,196	58,444	4,260	58,444	4,260
<i>Financial liabilities</i>								
Deposits from banks	66,514	39,091	66,504	39,063	80,529	48,940	80,520	48,912
Customer accounts	172,364	156,713	172,545	156,766	184,041	163,245	184,236	163,293
Trading and other financial liabilities at fair value through profit or loss	6,754	3,206	6,754	3,206	6,754	3,206	6,754	3,206
Derivative financial instruments	28,189	7,751	28,189	7,751	29,730	8,365	29,730	8,365
Debt securities in issue	73,066	49,828	73,646	49,567	74,559	36,647	74,254	36,387
Liabilities arising from non-participating investment contracts	14,243	18,197	14,243	18,197	–	–	–	–
Financial guarantees	35	26	35	26	35	26	35	26
Subordinated liabilities	17,389	12,437	11,788	12,674	16,853	11,903	11,649	12,162

51 Capital

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

	2008 £m	2007 £m
Tier 1 capital	13,574	13,449
Tier 2 capital	10,437	8,603
	24,011	22,052
Supervisory deductions	(4,758)	(4,864)
Total capital	19,253	17,188

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

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

The life assurance and general insurance businesses are subject to separate regulatory rules. Further disclosure relating to the life assurance business, as required by FRS 27, is set out below.

Life assurance businesses

At 31 December 2008 the principal subsidiary involved in the Group's life assurance operations was Scottish Widows plc (Scottish Widows), which holds the only large With Profit Fund managed by Lloyds Banking Group.

Notes to the accounts

51 Capital (continued)**Basis of determining regulatory capital of the life assurance 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. Different rules apply depending on the nature of the fund, as detailed below.

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. 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.

'Realistic' basis. The FSA requires each life assurance company which contains a with-profits fund in excess of £500 million, including Scottish Widows, to carry out a 'realistic' valuation of that fund. The word 'realistic' in this context reflects the terminology used for reporting to the FSA and is an assessment of the financial position of a with-profits fund calculated under a prescribed methodology.

The valuation of with-profits assets in a with-profits fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profits business written in a with-profits fund (a relatively small amount of business in the case of Scottish Widows), it includes the present value of the anticipated future release of the prudent margins for adverse deviation. The realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above.

The realistic valuation of liabilities is carried out using a stochastic simulation model which values 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 below in the section entitled 'Options and guarantees'.

Regulatory capital requirements

Each life assurance 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, 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 regulatory capital requirement is deducted from the available capital resources to give 'statutory excess capital'.

For Scottish Widows, no amount is required to cover the impact of stress tests on the actuarial reserves. However, a further test is required in respect of the With Profit Fund, which compares the level of 'realistic excess capital' to the 'statutory excess capital' of the With Profit Fund. In circumstances where the 'realistic excess capital' position is less than 'statutory excess capital', the Company is required to hold additional capital to cover the shortfall, but only to the extent it exceeds the value, calculated in a prescribed way, of internal transfers from the With Profit Fund. Any additional capital requirement under this test is referred to as the With-Profits Insurance Capital Component. 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 determination of realistic liabilities of the With Profit Fund in respect of Scottish Widows includes the value of internal transfers expected to be made from the With Profit Fund to the Non-Participating Fund of Scottish Widows. These internal transfers include charges on policies where the associated costs are borne by the Non-Participating Fund. The With-Profits Insurance Capital Component is 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 Non-Participating Fund.

Capital statement

The following table provides more detail regarding the sources of capital in the life assurance business. The figures quoted are based on management's current expectations pending completion of the annual financial return to the FSA. The figures allow for an anticipated transfer of £110 million from the Long Term Fund to the Shareholder Fund as at 31 December 2008.

	With Profit Fund £m	Non- Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2008					
Assets attributable to the shareholder held outside the long-term funds	–	–	–	862	862
Assets attributable to the shareholder held within the long-term funds	–	2,562	2,562	–	2,562
Total shareholders' funds	–	2,562	2,562	862	3,424
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	293	–	293	–	293
Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities	–	(708)	(708)	(581)	(1,289)
Adjustment to include estimated 'realistic' liabilities payable to the shareholder	(406)	–	(406)	–	(406)
Adjustment to replace 'realistic' liabilities with statutory liabilities	811	–	811	–	811
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	(49)	–	(49)	–	(49)
Qualifying loan capital	–	–	–	604	604
Available capital resources	649	1,854	2,503	885	3,388

Notes to the accounts

51 Capital (continued)

The figures shown above for available capital resources within the insurance business relate to Scottish Widows plc only. The estimated total additional resources relating to the other life assurance subsidiaries within the Group on 31 December 2008 are £310 million.

The comparative position as at 31 December 2007 was as follows (again, relating to Scottish Widows plc only):

	With Profit Fund £m	Non- Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2007					
Assets attributable to the shareholder held outside the long-term funds	–	–	–	956	956
Assets attributable to the shareholder held within the long-term funds	–	2,343	2,343	–	2,343
Total shareholders' funds	–	2,343	2,343	956	3,299
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	569	–	569	–	569
Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities	–	(435)	(435)	(602)	(1,037)
Adjustment to include estimated 'realistic' liabilities payable to the shareholder	(634)	–	(634)	–	(634)
Adjustment to replace 'realistic' liabilities with statutory liabilities	3,695	–	3,695	–	3,695
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	(23)	–	(23)	–	(23)
Qualifying loan capital	–	–	–	541	541
Available capital resources	<u>3,607</u>	<u>1,908</u>	<u>5,515</u>	<u>895</u>	<u>6,410</u>

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.

Constraints over available capital resources

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 and must be maintained until the value of these assets reaches a minimum level. 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 in assessing the realistic value of assets available to the With Profit Fund. At 31 December 2008, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,854 million (31 December 2007: £1,908 million) and the estimated value of the Support Account was £200 million (31 December 2007: £827 million).

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 2008, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £3,603 million (31 December 2007: £4,026 million) and the estimated combined value of the Support Account and Further Support Account was £2,584 million (31 December 2007: £2,834 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 2008 is £162 million (31 December 2007: £183 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.

Notes to the accounts

51 Capital (continued)*Movements in regulatory capital*

The movements in Scottish Widows plc's available capital resources can be analysed as follows:

	With Profit Fund £m	Non-Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2007	3,607	1,908	5,515	895	6,410
Changes in estimations and in assumptions used to measure life assurance liabilities	15	(29)	(14)	–	(14)
Dividends and capital transfers	–	(110)	(110)	(110)	(220)
Changes in regulatory requirements	–	–	–	–	–
New business and other factors	(2,973)	85	(2,888)	100	(2,788)
As at 31 December 2008	649	1,854	2,503	885	3,388

The primary reasons for the movement in total available capital resources during the year are as follows:

With Profit Fund:

Available capital in the With Profit Fund has decreased from £3,607 million at 31 December 2007 to an estimated £649 million at 31 December 2008. The key driver is investment market performance.

Non-Participating Fund:

Available capital in the Non-Participating Fund has decreased from £1,908 million at 31 December 2007 to an estimated £1,854 million at 31 December 2008. This is primarily a result of the anticipated transfer from the Non-Participating Fund to the Shareholder Fund at the year end of £110 million and market movements, offset by the return generated from the business.

Shareholder Fund:

During 2008, dividends of £220 million were paid.

Financial information calculated on a 'realistic' basis

The estimated financial position of the With Profit Fund of Scottish Widows at 31 December 2008, calculated on a 'realistic' basis, is given in the following table, in the form reported to the FSA. As a result of the capital support arrangements, it is considered appropriate to also disclose the estimated 'realistic' financial position of the Long Term Fund of Scottish Widows as a whole, which consists of both the With Profit Fund and the Non-Participating Fund.

	31 December 2008		31 December 2007	
	With Profit Fund £m	Long Term Fund £m	With Profit Fund £m	Long Term Fund £m
Realistic value of assets of fund	13,155	16,665	16,793	21,005
Support arrangement assets	362	–	1,010	–
Realistic value of assets available to the fund	13,517	16,665	17,803	21,005
Realistic value of liabilities of fund	(13,268)	(13,062)	(16,858)	(16,979)
Working capital for fund	249	3,603	945	4,026
Working capital ratio for fund	1.8%	21.6%	5.3%	19.2%

The financial information calculated on a 'realistic' basis reconciles to the Capital statement as follows:

	31 December 2008		31 December 2007	
	With Profit Fund £m	Long Term Fund £m	With Profit Fund £m	Long Term Fund £m
Available regulatory capital	649	2,503	3,607	5,515
Support arrangement assets	362	–	1,010	–
Adjustments to replace statutory liabilities with 'realistic' liabilities	(811)	(779)	(3,695)	(3,575)
Adjustments to include the value of future profits recognised in respect of Non-Participating business written in the With Profit Fund	49	49	23	23
Recognition of future profits allowable for 'realistic' capital purposes	–	1,830	–	2,063
	249	3,603	945	4,026

Notes to the accounts

51 Capital (continued)

Analysis of policyholder liabilities in respect of the Group's life assurance business:

	Scottish Widows plc With Profit Fund (in accordance with FRS 27) £m	Other long-term funds £m	Total life business £m
As at 31 December 2008			
With Profit Fund liabilities	13,328	–	13,328
Unit-linked business (excluding that accounted for as investment contracts)	–	11,480	11,480
Other life assurance business	–	8,364	8,364
Insurance and participating investment contract liabilities	13,328	19,844	33,172
Non-participating investment contract liabilities	–	14,243	14,243
Total policyholder liabilities	13,328	34,087	47,415
As at 31 December 2007			
With Profit Fund liabilities	16,533	–	16,533
Unit-linked business (excluding that accounted for as investment contracts)	–	14,282	14,282
Other life assurance business	–	6,714	6,714
Insurance and participating investment contract liabilities	16,533	20,996	37,529
Non-participating investment contract liabilities	–	18,197	18,197
Total policyholder liabilities	16,533	39,193	55,726

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 Fund

The with-profits realistic liabilities and the available capital for the With Profit Fund 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.

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 Fund is partly mitigated by the actions that can be taken by management.

Other long-term funds

Outside the With Profit Fund, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower mortality rates are more onerous). Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of life assurance contracts. In addition, poor cost control would gradually depreciate 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 actuarial reserves are invested across a range of investment categories including fixed interest securities, equities, properties and cash. The mix of investments is determined in line with the policy of Lloyds Banking Group to minimise 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 Fund and in other funds.

Options and guarantees within the With Profit Fund

The most significant options and guarantees provided from within the With Profit Fund 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 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 2008 of £2.0 billion (2007: £1.7 billion). The eventual cost of providing benefits on policies written both pre

Notes to the accounts

51 Capital (continued)

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 the With Profit Fund 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 the 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 2008, the 10 year equity-implied at-the-money assumption was set at 34.6 per cent (31 December 2007: 25.5 per cent). The assumption for property volatility was 15 per cent (31 December 2007: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 16 per cent (31 December 2007: 11 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 Fund of Scottish Widows

Certain personal pension policyholders, 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 £65 million (31 December 2007: £65 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 £3 million. If yields were 0.5 per cent lower than assumed, the liability would increase by some £11 million.

52 Cash flow statements**a Change in operating assets**

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Change in loans and advances to banks	(3,360)	8,673	(10,522)	8,831
Change in loans and advances to customers	(30,357)	(18,946)	(36,327)	(18,989)
Change in trading assets	(8,827)	(4,329)	(15,191)	(3,352)
Change in other operating assets	(298)	(511)	(264)	(38)
Change in operating assets	(42,842)	(15,113)	(62,304)	(13,548)

b Change in operating liabilities

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Change in deposits from banks	25,279	2,136	29,445	4,321
Change in customer accounts	14,356	15,905	19,501	20,359
Change in debt securities in issue	21,501	(4,194)	36,175	(9,241)
Change in trading liabilities	23,693	3,895	24,620	3,978
Change in investment contract liabilities	(3,061)	(58)	–	–
Change in other operating liabilities	681	923	659	26
Change in operating liabilities	82,449	18,607	110,400	19,443

Notes to the accounts

52 Cash flow statements (continued)**c Non-cash and other items**

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Depreciation and amortisation	686	630	317	299
Revaluation of investment property	1,058	321	–	–
Allowance for loan losses	2,876	1,721	2,472	1,405
Write-off of allowance for loan losses	(1,498)	(1,405)	(1,294)	(1,171)
Impairment of available-for-sale securities	130	70	130	70
Impairment of goodwill	100	–	–	–
Permanent diminution in value of subsidiaries	–	–	20	–
Change in insurance contract liabilities	(4,649)	825	–	–
Customer remediation paid	(9)	(54)	(8)	(48)
Other provision movements	16	2	45	5
Net charge in respect of defined benefit schemes	164	175	127	126
Contributions to defined benefit schemes	(547)	(452)	(406)	(348)
Other non-cash items	(3,743)	789	2,262	140
Total non-cash items	(5,416)	2,622	3,665	478
Interest expense on subordinated liabilities	901	755	822	704
Profit on disposal of businesses	–	(657)	–	(407)
Other	(10)	(31)	(14)	(18)
Total other items	891	67	808	279
Non-cash and other items	(4,525)	2,689	4,473	757

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

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Cash and balances with central banks	5,008	4,330	4,890	4,211
Less: mandatory reserve deposits ¹	(545)	(338)	(530)	(319)
	4,463	3,992	4,360	3,892
Loans and advances to banks	40,758	34,845	38,993	28,447
Less: amounts with a maturity of three months or more and balances due from subsidiary undertakings	(12,461)	(6,946)	(20,929)	(8,312)
	28,297	27,899	18,064	20,135
	32,760	31,891	22,424	24,027

¹Mandatory 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 of the Group at 31 December 2008 is £8,255 million (2007: £7,426 million) held within the Group's life funds, which is not immediately available for use in the business.

e Analysis of changes in financing during the year

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Share capital (including share premium account): At 1 January and 31 December	4,502	4,502	4,502	4,502
Minority interests:				
At 1 January	284	352		
Exchange and other adjustments	28	(1)		
Repayment of capital to minority shareholders	(3)	(80)		
Minority share of profit after tax	26	32		
Dividends paid to minority shareholders	(29)	(19)		
At 31 December	306	284		

Notes to the accounts

52 Cash flow statements (continued)

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Subordinated liabilities				
At 1 January	12,437	11,506	11,903	10,281
Exchange and other adjustments	2,312	133	2,310	124
Issue of subordinated liabilities	3,021	1,098	3,021	1,098
Repayments of subordinated liabilities	(381)	(300)	(381)	(300)
Transfer of C&G business (note 27)	–	–	–	700
At 31 December	17,389	12,437	16,853	11,903

f Acquisition of group undertakings and businesses

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Net cash outflow from acquisitions in the year – investments in subsidiaries	–	–	817	18
Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000	19	8	–	–
Net cash outflow from acquisitions	19	8	817	18

g Disposal of group undertakings and businesses

	The Group		The Bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Cash and balances at central banks	–	37	–	–
Trading and other financial assets at fair value through profit or loss	–	10,999	–	–
Loans and advances to banks	–	1,150	–	–
Value of in-force business	–	412	–	–
Liabilities arising from insurance contracts and participating investment contracts	–	(4,349)	–	–
Liabilities arising from non-participating investment contracts	–	(7,283)	–	–
Unallocated surplus within insurance businesses	–	(15)	–	–
Other net assets and liabilities	–	(95)	187	111
	–	856	187	111
Profit on sale of businesses	–	657	–	407
Cash and cash equivalents disposed of	–	(37)	–	–
Net cash inflow from disposals	–	1,476	187	518

Notes to the accounts

53 Future developments

The following pronouncements will be relevant to the Group but were not effective at 31 December 2008 and have not been applied in preparing these financial statements. The full impact of these accounting changes is being assessed by the Group, however, the initial view is that none of these pronouncements are expected to cause any material adjustments to reported numbers in the financial statements.

Pronouncement	Nature of change	Effective date
IFRIC 13 Customer Loyalty Programmes	Addresses accounting by entities who grant customer loyalty award credits to customers as part of sales transactions and which can be redeemed in the future for free or discounted goods or services.	Annual periods beginning on or after 1 July 2008.
IFRIC 16 Hedges of a Net Investment in a Foreign Operation ¹	Provides guidance on accounting for hedges of net investments in foreign operations in an entity's consolidated financial statements.	Annual periods beginning on or after 1 October 2008.
IAS 1 Presentation of Financial Statements	Revises the overall requirements for the presentation of financial statements, guidance for their structure and minimum content requirements. The revised standard requires the presentation of all non-owner changes in equity within a statement of comprehensive income.	Annual periods beginning on or after 1 January 2009.
IAS 23 Borrowing Costs	Requires interest and other costs incurred in connection with the borrowing of funds to be recognised as an expense except for those which are directly attributable to the acquisition, construction or production of assets that take a substantial period of time to get ready for their intended use or sale which must be capitalised as part of the cost of those assets.	Annual periods beginning on or after 1 January 2009.
IFRS 8 Operating Segments	Replaces IAS 14 Segment Reporting and requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally.	Annual periods beginning on or after 1 January 2009.
IFRS 2 Share-based Payment – Vesting Conditions and Cancellations	The amendment restricts the definition of vesting conditions to include only service conditions and performance conditions and deals with the accounting consequences of a failure to meet a condition other than a vesting condition including how to deal with cancellations by the counterparty and circumstances where neither the entity nor the counterparty is in a position to choose whether or not to meet a vesting condition.	Annual periods beginning on or after 1 January 2009.
Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation	The amendment requires some puttable financial instruments (being those which give the holder the right to put the instrument back to the issuer for cash or another financial asset) and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation to be classified as equity.	Annual periods beginning on or after 1 January 2009.
Improvements to IFRSs	Sets out minor amendments to IFRS standards as part of annual improvements process.	Dealt with on a standard by standard basis but not earlier than annual periods beginning on or after 1 January 2009.
Amendment to IAS 27 Consolidated and Separate Financial Statements – Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate	Removes the definition of the cost method and requires the presentation of dividends as income in the separate financial statements of the investor.	Annual periods beginning on or after 1 January 2009.
IFRS 3 Business Combinations ^{1,2}	The revised standard continues to apply the acquisition method to business combinations, however, all payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the minority interest, and all transaction costs are expensed.	Annual periods beginning on or after 1 July 2009.
IAS 27 Consolidated and Separate Financial Statements ^{1,2}	Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is re-measured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.	Annual periods beginning on or after 1 July 2009.
IFRIC 17 Distributions of Non-cash Assets to Owners ^{1,2}	Provides accounting guidance for non-reciprocal distributions of non-cash assets to owners (and those in which owners may elect to receive a cash alternative).	Annual periods beginning on or after 1 July 2009.
Amendment to IAS 39 Financial Instruments: Recognition and Measurement – Eligible Hedged Items ^{1,2}	Clarifies how the principles underlying hedge accounting should be applied in particular situations.	Annual periods beginning on or after 1 July 2009.

¹ At the date of this report, these pronouncements are awaiting EU endorsement.

² Subject to any EU endorsement, the Group has not yet made a final decision as to whether it will apply these pronouncements in the 2009 financial statements.

Notes to the accounts

54 Approval of the financial statements and other information

The financial statements were approved by the directors of Lloyds TSB Bank plc on 26 February 2009.

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

Printed in the UK by Royle Print, a Carbon Neutral printing company, on a material which contains a minimum of 50% post consumer waste, using soya based inks and water based sealants; the printer and paper manufacturing mill are both accredited with ISO 14001 Environmental Management systems standard and both are Forest Stewardship Council certified. When you have finished with this report, please dispose of it in your recycled waste stream.

