

Bank of Scotland plc

Half-Year Management Report

For the half-year to 30 June 2011

Member of the Lloyds Banking Group

FORWARD LOOKING STATEMENTS

This announcement contains forward looking statements with respect to the business, strategy and plans of Bank of Scotland plc, its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the Bank of Scotland Group or the Bank of Scotland Group's management's beliefs and expectations, are forward looking statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. The Bank of Scotland Group's actual future business, strategy, plans and/or results may differ materially from those expressed or implied in these forward looking statements as a result of a variety of risks, uncertainties and other factors, including, without limitation, UK domestic and global economic and business conditions; the ability to derive cost savings and other benefits, as well as the ability to integrate the HBOS Group successfully into the Lloyds Banking Group; the ability to access sufficient funding to meet the Bank of Scotland Group's liquidity needs; changes to Bank of Scotland plc's, Lloyds TSB Bank plc's or the Lloyds Banking Group plc's credit ratings; risks concerning borrower or counterparty credit quality; instability in the global financial markets; changing demographic and market related trends; changes in customer preferences; changes to regulation, accounting standards or taxation, including changes to regulatory capital or liquidity requirements; the policies and actions of governmental or regulatory authorities in the UK, the European Union, or jurisdictions outside the UK, including other European countries and the US; the ability to attract and retain senior management and other employees; requirements or limitations imposed on the Bank of Scotland Group as a result of HM Treasury's investment in Lloyds Banking Group plc; the ability to complete satisfactorily the disposal of certain assets as part of the Lloyds Banking Group's EU state aid obligations; the extent of any future impairment charges or write-downs caused by depressed asset valuations; exposure to regulatory scrutiny, legal proceedings or complaints, actions of competitors and other factors. Please refer to Lloyds Banking Group plc's latest Annual Report on Form 20-F filed with the US Securities and Exchange Commission for a discussion of such factors together with examples of forward looking statements. The forward looking statements contained in this announcement are made as at the date of this announcement, and the Bank of Scotland Group undertakes no obligation to update any of its forward looking statements.

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FINANCIAL REVIEW

Principal activities

Bank of Scotland plc (the Bank) and its subsidiaries (together, the Group) provide a wide range of banking and financial services in the UK and overseas.

During the first half of 2010, the Group earned revenue through interest and fees on a broad range of financial services products including current and savings accounts, personal loans, credit cards and mortgages within the retail market; loans and capital market products to commercial, corporate and asset finance customers; and private banking.

Review of results

The consolidated income statement on page 8 shows a loss before tax of £2,487 million and a loss attributable to equity shareholders of £2,079 million for the half-year ended 30 June 2011. The loss before tax of £2,487 million compares with a loss before tax of £1,458 million for the half-year to 30 June 2010. The increased loss was largely as a result of the £1,155 million provision raised in respect of payment protection insurance (PPI) claims following the publication on 20 April 2011 of the High Court's judgment regarding PPI complaints, and subsequent discussions with the Financial Services Authority.

Net interest income decreased by £283 million from £4,352 million for the half-year to 30 June 2010 to £4,069 million for the half-year to 30 June 2011 reflecting the Group's strategy of running-off assets outside of its risk appetite. This has led to a reduction in interest-earning assets, with loans and advances to customers decreasing by £16,299 million since 31 December 2010, after adjusting for a £15,953 million increase in reverse sale and repurchase agreements (reverse repos), and debt securities held as loans and receivables reducing by £9,522 million since 31 December 2010.

Other income decreased by £1,471 million from £2,196 million for the half-year to 30 June 2010 to £725 million for the half-year to 30 June 2011, mainly due to lower levels of other operating income, reflecting losses on the disposal of treasury assets which were outside of the Group's risk appetite and also partly as a result of the non-recurrence of £419 million of gains on capital transactions which arose in the half-year to 30 June 2010.

Overall total income decreased by £1,754 million from £6,548 million for the half-year to 30 June 2010 to £4,794 million for the half-year to 30 June 2011.

Operating expenses, excluding the PPI provision, decreased by £320 million from £2,354 million for the half-year to 30 June 2010 to £2,034 million for the half-year to 30 June 2011. This was due to a £173 million reduction in staff costs, in part due to the closure of the Group's operations in Ireland in 2010, and a £243 million reduction in depreciation and amortisation following the transfer of operating lease assets to a fellow Lloyds Banking Group subsidiary in 2010.

Impairment losses decreased by £1,492 million from £5,595 million for the half-year to 30 June 2010 to £4,103 million for the half-year to 30 June 2011, reflecting improved credit quality experience in both retail and wholesale lending, partly offset by increased impairments in Ireland and Australia.

The taxation credit of £409 million reflects the expected availability of tax relief on losses incurred and the ability to carry these forward as a deferred tax asset.

FINANCIAL REVIEW (continued)

Total assets have decreased by £5,613 million from £573,794 million at 31 December 2010 to £568,181 million at 30 June 2011 as part of the Group's balance sheet reduction strategy. This has resulted in debt securities held as loans and receivables decreasing by £9,522 million to £14,110 million and available-for-sale financial assets decreasing by £3,977 million to £10,445 million; loans and advances to customers decreased by £16,299 million since 31 December 2010, after adjusting for a £15,953 million increase in reverse repo balances.

Customer deposits increased by £1,958 million to £243,475 million at 30 June 2011 mainly as a result of successful deposit-raising initiatives, including continued strong deposit inflows in the Group's Wealth and International online deposit business, offset by a £7,085 million reduction in funding provided by sale and repurchase agreements (repos).

Shareholders' equity reduced by £994 million from £19,842 million at 31 December 2010 to £18,848 million at 30 June 2011 as a result of the post-tax losses incurred, partly offset by increases in the available-for-sale and cash flow hedging reserves. The Group's total capital ratio was 13.4 per cent (31 December 2010: 13.9 per cent) with a tier 1 capital ratio of 7.9 per cent (31 December 2010: 8.6 per cent) and a core tier 1 capital ratio of 7.7 per cent (31 December 2010: 8.3 per cent), with reduced capital resources, arising from the after-tax losses and the increased excess of expected losses over impairment allowances, being only partly offset by decreases in risk-weighted assets.

PRINCIPAL RISKS AND UNCERTAINTIES

The principal risks and uncertainties facing the Group in the second half of 2011 are:

Economy

The global economic recovery has slowed in the first half of 2011. Sharp increases in the price of oil and other commodities across the turn of the year, driven by emerging market strength in 2010, have hit consumers' disposable incomes across the world and led to tighter monetary policy in emerging markets. Earlier fiscal stimulus in the US economy has now come to an end, and fiscal tightening is underway across Europe, particularly sharply in the most highly indebted countries. Current data show that the UK economy experienced very little underlying growth over the nine months to the end June 2011. Consumer confidence and spending was hit by the fall in real disposable incomes.

The Group's central scenario is for modest recovery to continue, assuming the recent Eurozone agreement on sovereign debt is enacted quickly and followed up by further measures for Greece. For the UK, the Group's current projection reflected in our outlook, of 1.5 per cent Gross Domestic Product (GDP) growth in 2011 and 2.3 per cent in 2012 is broadly in line with consensus. Households' real spending growth should begin to improve as the squeeze from high inflation begins to reduce towards the end of the year. Further improvements in the corporate failure rate are expected to be only gradual to end 2012, and to be reversed in later years. Both residential and commercial property prices are expected to end this year 2 per cent lower than at the end of 2010, and then rise only very slowly.

The Irish economy, to which the Group has exposure, is expected to be only flat in 2011, and will not return to its pre-recession growth rate.

Downside risks around this scenario remain significant. Further increases in inflation could damage already weak consumer confidence, or result in earlier increases in interest rates if wage growth started to respond. Financial markets may remain unstable and continue to put extra pressure on other Eurozone economies outside Greece. A 'double-dip' scenario – a second shallower recession following closely the one that the economy is just emerging from – would result in further significant increases in corporate failures and unemployment during late 2011 and through 2012. In addition, residential and commercial property would suffer a second period of falling prices, tenant defaults would increase and central banks would have limited ability to cushion the downturn.

Liquidity and funding

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

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

The second quarter of 2011 has seen funding markets' risk appetite reduce as a result of escalating European sovereign concerns. During this period the Lloyds Banking Group has continued to fund successfully with no material change to the Lloyds Banking Group's short-term maturity profile. The Group anticipates that wholesale markets will remain vulnerable to periods of disruption and to mitigate this risk the Lloyds Banking Group has deliberately pre-funded much of the year's term funding requirement during the first half.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

Lloyds Banking Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. These are assumed within the Lloyds Banking Group's funding plan. The requirement to meet this deadline may result in the Lloyds Banking Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

Credit risk

The Group achieved a reduction in its impairment charge due to the stabilisation of the UK economic environment, together with continued low UK interest rates and effective portfolio management. Prudent, 'through the cycle' credit policies and procedures are in place throughout the Group. As a result of this approach, the credit quality of new lending remains strong.

The Group's current level of impairment is being managed successfully in the current challenging economic environment by the wholesale business support units and retail collection and recovery units. The Group's exposure to Ireland is being closely managed. A dedicated UK-based business support team is in place to manage the winding down of the Irish book.

As noted above, the Group continues to forecast a modest UK recovery from recession. In the UK, consumer confidence has been hit by the fall in real disposable incomes and business confidence also remains fragile and the downside risks to a weak UK recovery remain significant. A 'double-dip' scenario remains a key downside risk and could lead to increased impairments across the Group's UK portfolios.

Market risk

Market risk is managed within a Board approved framework using a range of metrics to monitor the Group's profile against its stated appetite and potential market conditions.

The principal market risks are as follows:

- There is a risk to the Group's banking income arising from the level of interest rates and the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Continuing concerns about the fiscal position in peripheral Eurozone countries resulted in increased credit spreads in the areas affected, and fears of contagion affected the Euro and widened spreads between central bank and interbank rates.

Legal and regulatory

Legal and regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which continues to witness high levels of government and regulatory intervention in the banking sector.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

Lloyds Banking Group faces increased political and regulatory scrutiny as a result of its perceived size and systemic importance following the acquisition of HBOS Group. At the time of the acquisition, the Office of Fair Trading (OFT) identified some competition concerns in the UK personal current accounts and mortgages markets and for SME banking in Scotland. The OFT reiterated that it would keep these under review and consider whether to refer any banking markets to the Competition Commission if it identifies any prevention, restriction or distortion of competition.

The UK Government appointed an Independent Commission on Banking (ICB) to review possible structural measures to reform the banking system and promote stability and competition. The ICB has announced that it intends to publish its final report on 12 September 2011. The Government has indicated its support for initial proposals put forward by the ICB that would require capital ring-fencing of the retail activities of banks from their investment banking activities. The Interim Report also referenced a desire to see the state aid required divestment 'substantially enhanced'. The Lloyds Banking Group continues to play a constructive role in the debate and to consult with the ICB. The Treasury Select Committee is also conducting an examination of competition in retail banking. It is too early to quantify the potential impact of these developments on the Group.

In April 2011, the FSA commenced an internal reorganisation as a first step in a process towards the formal transition of regulatory and supervisory powers from the FSA to the new Financial Conduct Authority (FCA) for conduct of business supervision and the Prudential Regulatory Authority (PRA) for capital and liquidity supervision in 2012. Until this time the responsibility for regulating and supervising the activities of the Group will remain with the FSA. In addition, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory approaches across the EU. These could lead to changes in how the Group is regulated and supervised on a day-to-day basis.

Evolving capital and liquidity requirements continue to be a priority for the Group. In September 2010, and further updated in June 2011, the Basel Committee on Banking Supervision put forward proposals for a reform package which changes the regulatory capital and liquidity standards, the definition of 'capital', introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2012 and 2018.

Other notable regulatory initiatives include the Dodd-Frank Act in the US (which affects the financial services industry by addressing, among other issues, systemic risk oversight, bank capital standards, the liquidation of failing systemically significant financial institutions, over-the-counter derivatives, the ability of banking entities to engage in proprietary trading activities and invest in hedge funds and private equity (these restrictions are known as the 'Volcker Rule'), consumer and investor protection, hedge fund registration, securitisation, investment advisors, shareholder 'say on pay', the role of credit-rating agencies, and more) and the Foreign Account Tax Compliance Act (FATCA) which is intended to ensure the US government can determine the ownership of US assets in foreign accounts and which will require non-US financial institutions to enter into disclosure compliance agreements with the US Treasury and all non-financial non-US entities to report and/or certify their ownership or be subject to 30 per cent withholding.

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

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

Customer treatment

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

The FSA also continues to carry out thematic reviews on a variety of issues across the industry as a whole, for example complaints handling. The Lloyds Banking Group actively engages with the regulatory authorities and other stakeholders on these key customer treatment challenges, which includes for example, Payment Protection Insurance (PPI).

The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers. The Group regularly reviews its product range to ensure that it meets regulatory requirements and is competitive in the market place. Nonetheless there is a risk that certain aspects of the Group's business may be determined by the authorities or the courts as not being conducted in accordance with applicable laws or regulations, or with what is fair and reasonable in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

People

The people risk profile is being driven principally by the factors outlined below:

- The scale and pace of organisational, legislative, and regulatory change
- Integration and other strategic initiatives
- The implementation of EU state aid requirements
- The Independent Commission on Banking's (ICB) proposals for banking reform.

Failure to manage the related people risks would significantly impact the Group's ability to deliver against its strategic objectives.

Integration

The integration of the two heritage organisations is now in its final stages. Lloyds Banking Group's Integration Execution Board, chaired by the Lloyds Banking Group Operations Director, continues to oversee the integration process and progress is regularly reviewed by the Lloyds Banking Group Executive Committee and Lloyds Banking Group Board. While there continue to be delivery risks to the remaining elements of the programme, the Group has now completed more than two years of integration activity and has a fully functioning governance framework to manage the associated risks. There is a clear understanding of the remaining deliverables to ensure the ongoing consistent provision of good quality service to our customers, together with effective delivery against our integration objectives.

State funding and state aid

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

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

The Lloyds Banking Group is subject to European state aid obligations in line with the restructuring plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of the Lloyds Banking Group and address any competition distortions arising from the benefits of state aid. This has placed a number of requirements on the Lloyds Banking Group including asset reductions in certain parts of its balance sheet by the end of 2014 and the disposal of certain portions of its business by the end of November 2013, including in particular the disposal of some parts of the Group's retail banking business. The Lloyds Banking Group is working closely with the EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission.

CONDENSED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED INCOME STATEMENT

	Note	Half-year to 30 June 2011 £ million	Half-year to 30 June 2010 £ million
Interest and similar income		8,428	9,194
Interest and similar expense		(4,359)	(4,842)
Net interest income		4,069	4,352
Fee and commission income		607	682
Fee and commission expense		(124)	(157)
Net fee and commission income		483	525
Net trading income		47	334
Other operating income		195	1,337
Other income	2	725	2,196
Total income		4,794	6,548
Payment protection insurance provision	14	(1,155)	–
Other operating expenses		(2,034)	(2,354)
Total operating expenses	3	(3,189)	(2,354)
Trading surplus		1,605	4,194
Impairment	4	(4,103)	(5,595)
Share of results of joint ventures and associates		11	(57)
Loss before tax		(2,487)	(1,458)
Taxation	5	409	137
Loss for the period		(2,078)	(1,321)
Profit attributable to non-controlling interests		1	22
Loss attributable to equity shareholders		(2,079)	(1,343)
Loss for the period		(2,078)	(1,321)

CONDENSED INTERIM FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**

	Half-year to 30 June 2011 £ million	Half-year to 30 June 2010 £ million
Loss for the period	(2,078)	(1,321)
Other comprehensive income:		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	151	224
Income statement transfers in respect of disposals	(6)	(112)
Income statement transfers in respect of impairment	509	38
Other income statement transfers	50	–
Taxation	(177)	(44)
	527	106
Movement in cash flow hedging reserve:		
Effective portion of changes in fair value	459	(413)
Net income statement transfers	290	690
Taxation	(207)	(77)
	542	200
Currency translation differences (tax: nil)	16	9
Other comprehensive income for the period, net of tax	1,085	315
Total comprehensive income for the period	(993)	(1,006)
Total comprehensive income attributable to non-controlling interests	1	22
Total comprehensive income attributable to equity shareholders	(994)	(1,028)
Total comprehensive income for the period	(993)	(1,006)

CONDENSED INTERIM FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED BALANCE SHEET**

	Note	As at 30 June 2011 £ million	As at 31 December 2010 £ million
Assets			
Cash and balances at central banks		2,375	2,375
Items in course of collection from banks		266	319
Trading and other financial assets at fair value through profit or loss	6	23,261	24,696
Derivative financial instruments		25,941	29,451
Loans and receivables:			
Loans and advances to banks		73,496	61,349
Loans and advances to customers	7	405,179	405,525
Debt securities		14,110	23,632
		492,785	490,506
Available-for-sale financial assets		10,445	14,422
Investment properties		1,365	789
Investments in joint ventures and associates		397	401
Goodwill		386	376
Other intangible assets		68	58
Tangible fixed assets		2,593	3,433
Current tax recoverable		310	214
Deferred tax assets		4,768	4,826
Other assets		3,221	1,928
Total assets		568,181	573,794

CONDENSED INTERIM FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED BALANCE SHEET**

	Note	As at 30 June 2011 £ million	As at 31 December 2010 £ million
Equity and liabilities			
Liabilities			
Deposits from banks		145,109	143,056
Customer deposits		243,475	241,517
Items in course of transmission to banks		769	251
Trading liabilities		22,584	18,786
Derivative financial instruments		23,324	27,268
Notes in circulation		1,048	1,074
Debt securities in issue	10	92,016	100,721
Other liabilities		4,341	5,013
Current tax liabilities		22	42
Deferred tax liabilities		7	1
Other provisions		1,514	786
Subordinated liabilities	11	15,108	15,236
Total liabilities		549,317	553,751
Equity			
Share capital	12	5,847	5,847
Share premium account	13	27,479	27,479
Other reserves	13	1,700	615
Retained profits	13	(16,178)	(14,099)
Shareholders' equity		18,848	19,842
Non-controlling interests		16	201
Total equity		18,864	20,043
Total equity and liabilities		568,181	573,794

CONDENSED INTERIM FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders			Total £ million	Non- controlling interests £ million	Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million			
Balance at 1 January 2011	33,326	615	(14,099)	19,842	201	20,043
Comprehensive income						
(Loss) profit for the period	–	–	(2,079)	(2,079)	1	(2,078)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	527	–	527	–	527
Movements in cash flow hedging reserve, net of tax	–	542	–	542	–	542
Currency translation differences, net of tax	–	16	–	16	–	16
Total other comprehensive income	–	1,085	–	1,085	–	1,085
Total comprehensive income	–	1,085	(2,079)	(994)	1	(993)
Transactions with owners						
Change in non- controlling interests	–	–	–	–	(186)	(186)
Total transactions with owners	–	–	–	–	(186)	(186)
Balance at 30 June 2011	33,326	1,700	(16,178)	18,848	16	18,864

CONDENSED INTERIM FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY** (continued)

	Attributable to equity shareholders				Non-controlling interests £ million	Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million		
Balance at 1 January 2010	32,531	(517)	(9,867)	22,147	206	22,353
Comprehensive income						
(Loss) profit for the period	–	–	(1,343)	(1,343)	22	(1,321)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	106	–	106	–	106
Movements in cash flow hedging reserve, net of tax	–	200	–	200	–	200
Currency translation differences, net of tax	–	9	–	9	–	9
Total other comprehensive income	–	315	–	315	–	315
Total comprehensive income	–	315	(1,343)	(1,028)	22	(1,006)
Transactions with owners						
Dividends	–	–	–	–	(6)	(6)
Issue of ordinary and preference shares	381	–	–	381	–	381
Capital redemption reserve	–	419	(419)	–	–	–
Change in non-controlling interests	–	–	–	–	(4)	(4)
Total transactions with owners	381	419	(419)	381	(10)	371
Balance at 30 June 2010	32,912	217	(11,629)	21,500	218	21,718
Comprehensive income						
Loss for the period	–	–	(2,470)	(2,470)	(12)	(2,482)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	390	–	390	–	390
Movements in cash flow hedging reserve, net of tax	–	224	–	224	–	224
Currency translation differences, net of tax	–	(216)	–	(216)	–	(216)
Total other comprehensive income	–	398	–	398	–	398
Total comprehensive income	–	398	(2,470)	(2,072)	(12)	(2,084)
Transactions with owners						
Dividends	–	–	–	–	(9)	(9)
Issue of ordinary shares	414	–	–	414	–	414
Change in non-controlling interests	–	–	–	–	4	4
Total transactions with owners	414	–	–	414	(5)	409
Balance at 31 December 2010	33,326	615	(14,099)	19,842	201	20,043

CONDENSED INTERIM FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED CASH FLOW STATEMENT

	Half-year to 30 June 2011 £ million	Half-year to 30 June 2010 ¹ £ million
Loss before tax	(2,487)	(1,458)
Adjustments for:		
Change in operating assets	2,902	36,105
Change in operating liabilities	(5,128)	(40,502)
Non-cash and other items	710	3,509
Tax received (paid)	2	(14)
Net cash used in operating activities	(4,001)	(2,360)
Cash flows from investing activities		
Purchase of financial assets	(3,858)	(563)
Proceeds from sale and maturity of financial assets	8,044	4,413
Purchase of fixed assets	(259)	(447)
Proceeds from sale of fixed assets	692	277
Acquisition of businesses, net of cash acquired	(59)	(39)
Disposal of businesses, net of cash disposed	238	57
Net cash provided by investing activities	4,798	3,698
Cash flows from financing activities		
Dividends paid to non-controlling interests	(1)	(6)
Interest paid on subordinated liabilities	(241)	(206)
Repayment of subordinated liabilities	(92)	–
Net cash used in financing activities	(334)	(212)
Effects of exchange rate changes on cash and cash equivalents	2	36
Change in cash and cash equivalents	465	1,162
Cash and cash equivalents at beginning of period	6,382	6,902
Cash and cash equivalents at end of period	6,847	8,064

¹ The cash flow statement for the half-year to 30 June 2010 has been restated to exclude balances with its parent undertakings and fellow subsidiary undertakings from cash and cash equivalents.

Cash and cash equivalents comprise cash and balances at central banks (excluding mandatory deposits) and amounts due from banks with a maturity of less than three months.

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1. Accounting policies, presentation and estimates

These condensed consolidated interim financial statements as at and for the half-year to 30 June 2011 have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority (FSA) and with International Accounting Standard 34 (IAS 34), *Interim Financial Reporting* as adopted by the European Union. They do not include all of the information required for full annual financial statements and should be read in conjunction with the Group's consolidated financial statements as at and for the year ended 31 December 2010 which were prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. Copies of the 2010 annual report and accounts are available on the Lloyds Banking Group's website and are available upon request from Group Secretariat, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN.

The directors consider that it is appropriate to continue to adopt the going concern basis in preparing the condensed interim financial statements. In reaching this assessment, the directors have considered projections for the Group's capital and funding position and have had regard to the factors set out in Principal risks and uncertainties: Liquidity and funding on pages 3 and 4.

Accounting policies

The accounting policies are consistent with those applied by the Group in its 2010 annual report and accounts.

In accordance with IAS 34, the Group's income tax expense for the half-year to 30 June 2011 is based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. This best estimate takes into account the reduction in the main rate of corporation tax from 28 per cent to 26 per cent that was effective from 1 April 2011 but does not take into account the impact of the further reduction to 25 per cent which was substantively enacted on 5 July 2011 and will be effective from 1 April 2012.

Critical accounting estimates and judgements

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions that impact the application of accounting policies and 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. Save for the estimates detailed below, there have been no significant changes in the basis upon which estimates have been determined, compared to that applied at 31 December 2010.

1. Accounting policies, presentation and estimates (continued)

Payment protection insurance

The Group has recognised a provision of £1,155 million in respect of payment protection insurance (PPI) policies as a result of discussions with the FSA and a judgment handed down by the UK High Court (see note 14 for more information). The provision represents management's best estimate of the anticipated costs of related customer contact and/or redress, including administration expenses. However, there are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties of assessing the impact of detailed implementation of the FSA Policy Statement of 10 August 2010 for all PPI complaints, uncertainties around the ultimate emergence period for complaints, the availability of supporting evidence and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

The provision requires significant judgement by management in determining appropriate assumptions, which include the level of complaints, uphold rates, proactive contact and response rates, Financial Ombudsman Service referral and uphold rates as well as redress costs for each of the many different populations of customers identified by the Group in its analyses used to determine the best estimate of the anticipated costs of redress. If the level of complaints had been one percentage point higher (lower) than estimated for all policies open within the last six years then the provision made in 2011 would have increased (decreased) by approximately £40 million. However, it should be noted that there are a large number of inter-dependent assumptions under-pinning the provision; the above sensitivity assumes that all assumptions, other than the level of complaints, remain constant.

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

New accounting pronouncements

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

- (i) Amendment to IAS 32 *Financial Instruments: Presentation – 'Classification of Rights Issues'*. Requires rights issues denominated in a currency other than the functional currency of the issuer to be classified as equity regardless of the currency in which the exercise price is denominated.
- (ii) IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*. Clarifies that when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor, a gain or loss is recognised in the income statement representing the difference between the carrying value of the financial liability and the fair value of the equity instruments issued; the fair value of the financial liability is used to measure the gain or loss where the fair value of the equity instruments cannot be reliably measured.
- (iii) *Improvements to IFRSs* (issued May 2010). Sets out minor amendments to IFRS standards as part of the annual improvements process.

1. Accounting policies, presentation and estimates (continued)

- (iv) Amendment to IFRIC 14 *Prepayments of a Minimum Funding Requirement*. Applies when an entity is subject to minimum funding requirements and makes an early payment of contributions to cover those requirements and permits such an entity to treat the benefit of such an early payment as an asset.
- (v) IAS 24 *Related Party Disclosures (Revised)*. Simplifies the definition of a related party and provides a partial exemption from the requirement to disclose transactions and outstanding balances with the government and government-related entities. The Group has taken advantage of this exemption which requires the Group to provide details of only significant transactions with the government and government-related entities. Details of related party transactions are disclosed in note 17.

The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Lloyds Banking Group.

2. Other income

	Half-year to 30 June 2011 £m	Half-year to 30 June 2010 £m
Fee and commission income:		
Current account fees	184	125
Credit and debit card fees	96	112
Other fees and commissions	327	445
	607	682
Fee and commission expense	(124)	(157)
Net fee and commission income	483	525
Net trading income	47	334
Gains on capital transactions ¹	–	419
Other	195	918
Other operating income	195	1,337
Total other income	725	2,196

¹ During 2010, as part of the Lloyds Banking Group's management of capital, the Group exchanged certain existing subordinated debt securities for new subordinated debt securities and ordinary shares. These exchanges resulted in a gain on extinguishment of the existing liabilities of £419 million in the half-year to 30 June 2010, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs.

3. Operating expenses

	Half-year to 30 June 2011 £m	Half-year to 30 June 2010 ¹ £m
Administrative expenses:		
Staff	1,053	1,226
Premises and equipment	242	236
Other expenses	460	383
	<u>1,755</u>	<u>1,845</u>
Depreciation and amortisation	214	457
Impairment of tangible fixed assets	65	52
	<u>2,034</u>	<u>2,354</u>
Total operating expenses, excluding payment protection insurance provision	2,034	2,354
Payment protection insurance provision (note 14)	1,155	–
	<u>3,189</u>	<u>2,354</u>
Total operating expenses	3,189	2,354

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

4. Impairment

	Half-year to 30 June 2011 £m	Half-year to 30 June 2010 £m
Impairment losses on loans and receivables:		
Loans and advances to customers	4,048	5,551
Debt securities classified as loans and receivables	24	1
	<u>4,072</u>	<u>5,552</u>
Impairment losses on loans and receivables (note 8)	4,072	5,552
Impairment of available-for-sale financial assets	32	43
Other credit risk provisions	(1)	–
	<u>4,103</u>	<u>5,595</u>
Total impairment charged to the income statement	4,103	5,595

5. Taxation

A reconciliation of the tax credit that would result from applying the standard UK corporation tax rate to the loss before tax to the actual tax credit is given below:

	Half-year to 30 June 2011 £m	Half-year to 30 June 2010 £m
Loss before tax	<u>(2,487)</u>	<u>(1,458)</u>
Tax credit thereon at UK corporation tax rate of 26.5 per cent (half-year to 30 June 2010: 28 per cent)	659	408
Factors affecting credit:		
UK corporation tax rate change	(163)	–
Disallowed and non-taxable items	(23)	113
Overseas tax rate differences	(1)	(235)
Gains exempted or covered by capital losses	27	7
Tax losses where no deferred tax recognised	(134)	(116)
Adjustments in respect of previous periods	39	(10)
Effect of profit (loss) in joint ventures and associates	3	(16)
Other items	<u>2</u>	<u>(14)</u>
Tax credit	<u>409</u>	<u>137</u>

On 23 March 2011, the Government announced that the corporation tax rate applicable from 1 April 2011 would be 26 per cent. This change passed into legislation on 29 March 2011. The enacted reduction in the main rate of corporation tax from 28 per cent to 27 per cent with effect from 1 April 2011 had been incorporated in the Group's deferred tax calculations as at 31 December 2010. The additional change in the main rate of corporation tax from 27 per cent to 26 per cent has resulted in a further reduction in the Group's net deferred tax asset at 30 June 2011 of £168 million, comprising the £163 million charge included in the income statement and a £5 million charge included in equity.

The proposed further reductions in the rate of corporation tax by 1 per cent per annum to 23 per cent by 1 April 2014 are expected to be enacted separately each year starting in the second half of 2011. The effect of these further changes upon the Group's deferred tax balances and leasing business cannot be reliably quantified at this stage.

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

	As at 30 June 2011 £m	As at 31 December 2010 £m		
Trading assets	22,763	24,274		
Other financial assets at fair value through profit or loss:				
Debt securities	<table border="1" style="display: inline-table;"><tr><td style="text-align: center;">136</td></tr></table>	136	<table border="1" style="display: inline-table;"><tr><td style="text-align: center;">101</td></tr></table>	101
136				
101				
Equity shares	<table border="1" style="display: inline-table;"><tr><td style="text-align: center;">362</td></tr></table>	362	<table border="1" style="display: inline-table;"><tr><td style="text-align: center;">321</td></tr></table>	321
362				
321				
	<u>498</u>	<u>422</u>		
Total trading and other financial assets at fair value through profit or loss	<u>23,261</u>	<u>24,696</u>		

7. Loans and advances to customers

	As at 30 June 2011 £m	As at 31 December 2010 £m
Agriculture, forestry and fishing	709	602
Energy and water supply	1,597	1,145
Manufacturing	3,944	3,881
Construction	7,726	6,983
Transport, distribution and hotels	22,692	23,232
Postal and communications	800	1,032
Property companies	49,466	58,092
Financial, business and other services	43,325	32,029
Personal:		
Mortgages	246,200	246,690
Other	13,834	16,974
Lease financing	4,319	4,458
Hire purchase	1,129	1,358
Due from fellow Group undertakings	34,580	34,365
	<u>430,321</u>	<u>430,841</u>
Allowance for impairment losses on loans and advances (note 8)	<u>(25,142)</u>	<u>(25,316)</u>
Total loans and advances to customers	<u>405,179</u>	<u>405,525</u>

Loans and advances to customers include advances securitised under the Group's securitisation and covered bond programmes. Further details are given in note 9.

8. Allowance for impairment losses on loans and receivables

	Half-year to 30 June 2011 £m	Year to 31 December 2010 £m
Balance at 1 January	26,607	23,187
Exchange and other adjustments	380	412
Advances written off	(4,619)	(7,351)
Recoveries of advances written off in previous years	12	57
Unwinding of discount	(98)	(375)
Charge for the half-year to 30 June (note 4)	4,072	5,552
Charge for the half-year to 31 December	–	5,274
Charge to the income statement	4,072	10,826
Disposal of subsidiary undertakings	–	(149)
Balance at end of period	<u>26,354</u>	<u>26,607</u>
In respect of:		
Loans and advances to customers (note 7)	25,142	25,316
Debt securities	1,212	1,291
Balance at end of period	<u>26,354</u>	<u>26,607</u>

9. Securitisations and covered bonds

The Group's principal securitisation and covered bond programmes, together with the balances of the loans subject to these arrangements and the carrying value of the notes in issue, are listed in the table below.

	As at 30 June 2011		As at 31 December 2010	
	Gross assets securitised £m	Notes in issue £m	Gross assets securitised £m	Notes in issue £m
<i>Securitisation programmes</i>				
UK residential mortgages	97,635	77,653	102,801	83,367
US residential mortgage-backed securities	6,543	6,553	7,197	7,221
Irish residential mortgages	6,154	6,348	6,061	6,191
Credit card receivables	6,747	4,931	7,372	3,856
Dutch residential mortgages	4,411	4,310	4,551	4,415
Personal loans	–	–	3,012	2,011
Commercial loans	664	632	667	633
Motor vehicle loans	1,081	1,140	926	975
	<u>123,235</u>	<u>101,567</u>	<u>132,587</u>	<u>108,669</u>
Less held by the Group		<u>(71,194)</u>		<u>(78,686)</u>
Total securitisation programmes (note 10)		<u>30,373</u>		<u>29,983</u>
<i>Covered bond programmes</i>				
Residential mortgage-backed	47,292	38,190	55,032	44,271
Social housing loan-backed	3,331	2,400	3,377	2,400
	<u>50,623</u>	<u>40,590</u>	<u>58,409</u>	<u>46,671</u>
Less held by the Group		<u>(10,500)</u>		<u>(17,239)</u>
Total covered bond programmes (note 10)		<u>30,090</u>		<u>29,432</u>
Total securitisation and covered bond programmes		<u>60,463</u>		<u>59,415</u>

Securitisation programmes

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the SPEs are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue. In addition to the SPEs detailed above, the Group sponsors two conduit programmes, Grampian and Landale.

Covered bond programmes

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

Cash deposits of £30,060 million (31 December 2010: £25,139 million) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs, the term advances relating to covered bonds and other legal obligations.

10. Debt securities in issue

	As at 30 June 2011 £m	As at 31 December 2010 £m
Medium-term notes issued	19,193	24,430
Covered bonds (note 9)	30,090	29,432
Certificates of deposit	1,020	3,061
Securitisation notes (note 9)	30,373	29,983
Commercial paper	9,836	11,317
	<u>90,512</u>	<u>98,223</u>
Amounts due to fellow Group undertakings	1,504	2,498
Total debt securities in issue	<u>92,016</u>	<u>100,721</u>

11. Subordinated liabilities

The movement in subordinated liabilities during the period was as follows:

	£m
At 1 January 2011	15,236
Repurchases and redemptions during the period	(92)
Foreign exchange and other movements	(36)
At 30 June 2011	<u>15,108</u>

12. Share capital

Ordinary share capital in issue is as follows:

	Number of shares (millions)	£m
Ordinary shares of 25 pence each		
At 1 January and 30 June 2011	<u>23,388</u>	<u>5,847</u>

13. Reserves

	Share premium £m	Other reserves			Total £m	Retained profits £m
		Available- for-sale £m	Cash flow hedging £m	Merger and other £m		
At 1 January 2011	27,479	(899)	(415)	1,929	615	(14,099)
Loss for the period	-	-	-	-	-	(2,079)
Change in fair value of available-for-sale assets (net of tax)	-	148	-	-	148	-
Change in fair value of hedging derivatives (net of tax)	-	-	325	-	325	-
Transfers to income statement (net of tax)	-	379	217	-	596	-
Exchange and other adjustments	-	-	-	16	16	-
At 30 June 2011	<u>27,479</u>	<u>(372)</u>	<u>127</u>	<u>1,945</u>	<u>1,700</u>	<u>(16,178)</u>

14. Payment protection insurance

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

In October 2010, the UK Competition Commission confirmed its decision to prohibit the active sale of PPI by a distributor to a customer within seven days of a sale of credit. This followed the completion of its formal investigation into the supply of PPI services (other than store card PPI) to non-business customers in the UK in January 2009 and a referral of the proposed prohibition to the Competition Appeal Tribunal. The Competition Commission consulted on the wording of a draft Order to implement its findings from October 2010, and published the final Order on 24 March 2011 which became effective on 6 April 2011. Following an earlier decision to stop selling single premium PPI products, the Group ceased to offer PPI products to its customers in July 2010.

On 29 September 2009 the FSA announced that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. Lloyds Banking Group agreed in principle that it would undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. That review will now form part of the ongoing PPI work referred to below.

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

On 8 October 2010, the British Bankers' Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008.

The Judicial Review hearing was held in late January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA's application. On 9 May 2011, the BBA confirmed that the banks and the BBA did not intend to appeal the judgment.

Since publication of the judgment, the Group has been in discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group has conducted of compliance with applicable sales standards, which is continuing, the Group has concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group has made a provision in its income statement for the half-year to 30 June 2011 of £1,155 million in respect of the anticipated costs of such contact and/or redress, including administration expenses. There are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties of assessing the impact of detailed implementation of the Policy Statement for all PPI complaints, uncertainties around the ultimate emergence period for complaints, the availability of supporting evidence and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

15. Contingent liabilities and commitments

Interchange fees

The European Commission has adopted a formal decision finding that an infringement of European Commission competition laws has arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the fee be reduced to zero for relevant cross-border transactions within the European Economic Area. This decision has been appealed to the General Court of the European Union (the General Court). Lloyds TSB Bank plc and Bank of Scotland plc (along with certain other MasterCard issuers) have successfully applied to intervene in the appeal in support of MasterCard's position that the arrangements for the charging of a uniform fallback interchange fee are compatible with European Union competition laws. The OFT has also intervened in the General Court appeal supporting the European Commission position. An oral hearing took place on 8 July 2011 but judgment is not expected for six to twelve months. MasterCard has reached an understanding with the European Commission on a new methodology for calculating intra-European Economic Area multi-lateral interchange fees on an interim basis pending the outcome of the appeal.

Meanwhile, the European Commission is pursuing an investigation with a view to deciding whether arrangements adopted by Visa for the levying of uniform fallback interchange fees in respect of cross-border payment transactions also infringe European Union competition laws. In this regard Visa reached an agreement with the European Commission to reduce the level of interchange for cross-border debit card transactions to the interim levels agreed by MasterCard. The UK's OFT has also commenced similar investigations relating to the interchange fees in respect of domestic transactions in relation to both the MasterCard and Visa payment schemes. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

Interbank offered rate setting investigations

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

Financial Services Compensation Scheme (FSCS)

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

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. The borrowings with HM Treasury, which total circa £20 billion, are on an interest-only basis until 31 March 2012 and the FSCS and HM Treasury are currently discussing the terms for refinancing these borrowings to take effect from 1 April 2012.

15. Contingent liabilities and commitments (continued)

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

FSA investigation into Bank of Scotland

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

Other legal actions and regulatory matters

In the course of its business, the Group is engaged in discussions with the FSA in relation to a range of conduct of business matters, including complaints handling, packaged bank accounts, product terms and sales processes. The Group is keen to ensure that any regulatory concerns regarding the Group's processes, product governance, sales processes or contract terms are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

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

15. Contingent liabilities and commitments (continued)**Contingent liabilities and commitments arising from the banking business**

	As at 30 June 2011 £m	As at 31 December 2010 £m
Contingent liabilities		
Acceptances and endorsements	3	1
Other:		
Other items serving as direct credit substitutes	124	103
Performance bonds and other transaction-related contingencies	619	575
	743	678
Total contingent liabilities	746	679
Commitments		
Documentary credits and other short-term trade-related transactions	14	2
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	7,971	6,875
Other commitments	30,727	32,130
	38,698	39,005
1 year or over original maturity	10,107	12,617
Total commitments	48,819	51,624

16. Capital ratios

	As at 30 June 2011 £m	As at 31 December 2010 £m
Capital resources		
Core tier 1		
Shareholders' equity	18,848	19,842
Regulatory adjustments:		
Non-controlling interests	29	230
Available-for-sale revaluation reserve	372	899
Cash flow hedging reserve	(127)	415
Other items	(61)	–
	<u>19,061</u>	<u>21,386</u>
Less: deductions from core tier 1		
Goodwill and other intangible assets	(486)	(459)
Excess of expected losses over impairment allowances at 50 per cent	(576)	–
Securitisation positions at 50 per cent	(117)	(132)
Core tier 1 capital	<u>17,882</u>	<u>20,795</u>
Preferred securities	700	700
Less: deductions from tier 1		
Material holdings in financial companies at 50 per cent	(154)	(25)
Total tier 1 capital	<u>18,428</u>	<u>21,470</u>
Tier 2		
Available-for-sale revaluation reserve in respect of equities	345	346
Undated subordinated debt	4,830	4,819
Eligible provisions	1,473	1,750
Dated subordinated debt	8,011	8,244
Less: deductions from tier 2		
Excess of expected losses over impairment allowances at 50 per cent	(576)	–
Securitisation positions at 50 per cent	(117)	(132)
Material holdings in financial companies at 50 per cent	(154)	(25)
Total tier 2 capital	<u>13,812</u>	<u>15,002</u>
Supervisory deductions		
Unconsolidated investments	(956)	(1,672)
Total supervisory deductions	<u>(956)</u>	<u>(1,672)</u>
Total capital resources	<u>31,284</u>	<u>34,800</u>
Risk-weighted assets	<u>233,620</u>	<u>250,598</u>
Core tier 1 capital ratio	7.7%	8.3%
Tier 1 capital ratio	7.9%	8.6%
Total capital ratio	13.4%	13.9%

17. Related party transactions**Balances and transactions with Lloyds Banking Group plc and fellow Group undertakings**

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

	As at 30 June 2011 £m	As at 31 December 2010 £m
Assets		
Derivative financial instruments	2,004	1,497
Loans and advances to banks	67,898	55,053
Loans and advances to customers	34,580	34,365
Debt securities classified as loans and receivables	394	544
Other	5,676	6,650
Liabilities		
Deposits from banks	138,916	131,138
Customer deposits	41,812	40,949
Trading liabilities	7,740	3,294
Derivative financial instruments	4,658	4,196
Debt securities in issue	1,504	2,498
Other	–	145
Subordinated liabilities	11,217	11,266

During the half-year to 30 June 2011 the Group earned £543 million of interest income and incurred £1,498 million of interest expense on balances and transactions with Lloyds Banking Group plc and fellow Group undertakings.

UK Government

In January 2009, the UK Government through HM Treasury became a related party of Lloyds Banking Group plc, the Bank's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 30 June 2011, HM Treasury held a 40.2 per cent (31 December 2010: 40.6 per cent) interest in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of Lloyds Banking Group plc, and therefore of the Group, during the half-year to 30 June 2011.

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

17. Related party transactions (continued)

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

Government and central bank facilities

During the half-year to 30 June 2011, the Lloyds Banking Group has participated in HM Treasury's Credit Guarantee Scheme and the Bank of England's UK Special Liquidity Scheme. HM Treasury's Credit Guarantee Scheme charges a commercial fee for the guarantee of new short and medium-term debt issuance; the fee payable to HM Treasury on guaranteed issues is based on a per annum rate of 50 basis points plus the median five-year credit default swap spread. Further details of the UK Special Liquidity Scheme, including the fees payable to the Bank of England by participants, are available on the Bank of England's website.

At 30 June 2011 the Lloyds Banking Group had £37,096 million of debt issued under the aforementioned schemes (31 December 2010: £94,925 million). The facilities have various maturity dates, the last of which is in the fourth quarter of 2012. During the half-year to 30 June 2011, the Lloyds Banking Group repaid £57,829 million under the aforementioned schemes.

Lending commitments

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

Business Growth Fund

In May 2011 the Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to subscribe for shares in the Business Growth Fund plc which is the company created to fulfil the role of the Business Growth Fund as set out in the British Bankers' Association's Business Taskforce Report of October 2010.

Other government-related entities

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

Other related party transactions

Except as noted above, other related party transactions for the half-year to 30 June 2011 are similar in nature to those for the year ended 31 December 2010.

18. Future accounting developments

The following pronouncements will be relevant to the Group but are not applicable for the year ending 31 December 2011 and have not been applied in preparing these condensed interim financial statements. The full impact of these accounting changes is currently being assessed by the Group.

Effective for the Group for the year ending 31 December 2012

- (i) Amendments to IFRS 7 *Financial Instruments Disclosures – Transfers of Financial Assets*. Requires additional disclosures in respect of risk exposures arising from transferred financial assets.
- (ii) Amendments to IAS 12 *Income Taxes – Deferred Tax: Recovery of Underlying Assets*. Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property is recognised on that basis.

Effective for the Group for the year ending 31 December 2013

- (i) IFRS 9 *Financial Instruments*. Replaces those parts of IAS 39 *Financial Instruments: Recognition and Measurement* relating to the classification, measurement and derecognition of financial assets and liabilities. Requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instrument. The available-for-sale financial asset and held-to-maturity investment categories in the existing IAS 39 will be eliminated. The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39.

IFRS 9 is the initial stage of the project to replace IAS 39. Future stages are expected to result in amendments to IFRS 9 to deal with changes to impairment of financial assets measured at amortised cost and hedge accounting. Although the effective date of IFRS 9 is currently annual periods beginning on or after 1 January 2013, the IASB has not yet finalised the replacement of IAS 39 and is expected to propose changing the effective date of IFRS 9 to annual periods beginning on or after 1 January 2015 to facilitate the adoption of the entire replacement of IAS 39. Until all stages of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39.

- (ii) Amendments to IAS 1 *Presentation of Financial Statements – Presentation of Items of Other Comprehensive Income*. Requires entities to group items presented in other comprehensive income on the basis of whether they are potentially reclassified to profit or loss subsequently.
- (iii) IFRS 10 *Consolidated Financial Statements*. Supersedes IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities* and establishes principles for the preparation of consolidated financial statements when an entity controls one or more entities.
- (iv) IFRS 11 *Joint Arrangements*. Supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* and establishes principles for financial reporting by parties to a joint arrangement.
- (v) IFRS 12 *Disclosure of Interests in Other Entities*. Requires an entity to disclose information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.
- (vi) IFRS 13 *Fair Value Measurement*. The standard defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements and applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements.

18. Future accounting developments (continued)

- (vii) Amendment to IAS 27 *Separate Financial Statements*. Contains accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity presents separate financial statements. The standard no longer deals with consolidated financial statements which are dealt with in IFRS 10.
- (viii) Amendment to IAS 28 *Investments in Associates and Joint Ventures*. Prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.
- (ix) IAS 19 *Employee Benefits (Revised)*. Prescribes the accounting and disclosure by employers for employee benefits. Actuarial gains and losses (remeasurements) in respect of defined benefit pension schemes are no longer deferred using the corridor approach and are recognised immediately in other comprehensive income.

As at 3 August 2011, all of these pronouncements were awaiting EU endorsement.

19. Events after the balance sheet date

The Finance (No. 3) Bill 2011, which included the legislation in respect of the Bank Levy, received Royal Assent on 19 July 2011. Under the legislation, the Lloyds Banking Group will only become liable to pay the Bank Levy at 31 December 2011 and, as a result, the Lloyds Banking Group has not accrued for this cost during the first half of 2011. The Lloyds Banking Group expects that the cost of the Bank Levy for 2011 will be approximately £260 million.

20. Ultimate parent undertaking

Bank of Scotland plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Lloyds Banking Group plc has published consolidated accounts for the year to 31 December 2010, and copies may be obtained from Group Secretariat, Lloyds Banking Group, 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com

21. Other information

The financial information included in these condensed interim financial statements does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006. Statutory accounts for the year ended 31 December 2010 were approved by the directors on 24 February 2011 and were delivered to the Registrar of Companies following publication on 30 March 2011. The auditors' report on those accounts was unqualified and did not include a statement under sections 498(2) (accounting records or returns inadequate or accounts not agreeing with records and returns) or 498(3) (failure to obtain necessary information and explanations) of the Companies Act 2006.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The directors listed below (being all the directors of Bank of Scotland plc) confirm that to the best of their knowledge these condensed consolidated interim financial statements have been prepared in accordance with International Accounting Standard 34, Interim Financial Reporting, as adopted by the European Union, and that the interim management report herein includes a fair review of the information required by DTR 4.2.7R and DTR 4.2.8R, namely:

- an indication of important events that have occurred during the six months ended 30 June 2011 and their impact on the condensed interim financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year; and
- material related party transactions in the six months ended 30 June 2011 and any material changes in the related party transactions described in the last annual report.

Signed on behalf of the board by

António Horta-Osório
Group Chief Executive
3 August 2011

Bank of Scotland plc board of directors:

Sir Winfried Bischoff (Chairman)
António Horta-Osório (Chief Executive)
Tim J W Tookey (Finance Director)
Sir Julian Horn-Smith
Anita Frew
Lord Leitch
Glen R Moreno
David L Roberts
T Timothy Ryan, Jr
Martin A Scicluna
G Truett Tate
Anthony Watson

INDEPENDENT REVIEW REPORT TO BANK OF SCOTLAND PLC

Introduction

We have been engaged by the Bank to review the condensed consolidated interim financial statements in the half-year management report for the six months ended 30 June 2011, which comprises the consolidated income statement, consolidated statement of comprehensive income, consolidated balance sheet, consolidated statement of changes in equity, consolidated cash flow statement and related notes. We have read the other information contained in the half-year management report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed consolidated interim financial statements.

Directors' responsibilities

The half-year management report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-year management report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

As disclosed in note 1, the annual financial statements of the Group are prepared in accordance with International Financial Reporting Standards as adopted by the European Union. The condensed consolidated interim financial statements included in the half-year management report have been prepared in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union.

Our responsibility

Our responsibility is to express to the Bank a conclusion on the condensed consolidated interim financial statements in the half-year management report based on our review. This report, including the conclusion, has been prepared for and only for the Bank for the purpose of the Disclosure and Transparency Rules of the Financial Services Authority and for no other purpose. We do not, in producing this report, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity' issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

INDEPENDENT REVIEW REPORT TO BANK OF SCOTLAND PLC (continued)

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed consolidated interim financial statements in the half-year management report for the six months ended 30 June 2011 are not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

PricewaterhouseCoopers LLP
Chartered Accountants
London
3 August 2011

Notes:

- a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the Group directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
- b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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For further information please contact:

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