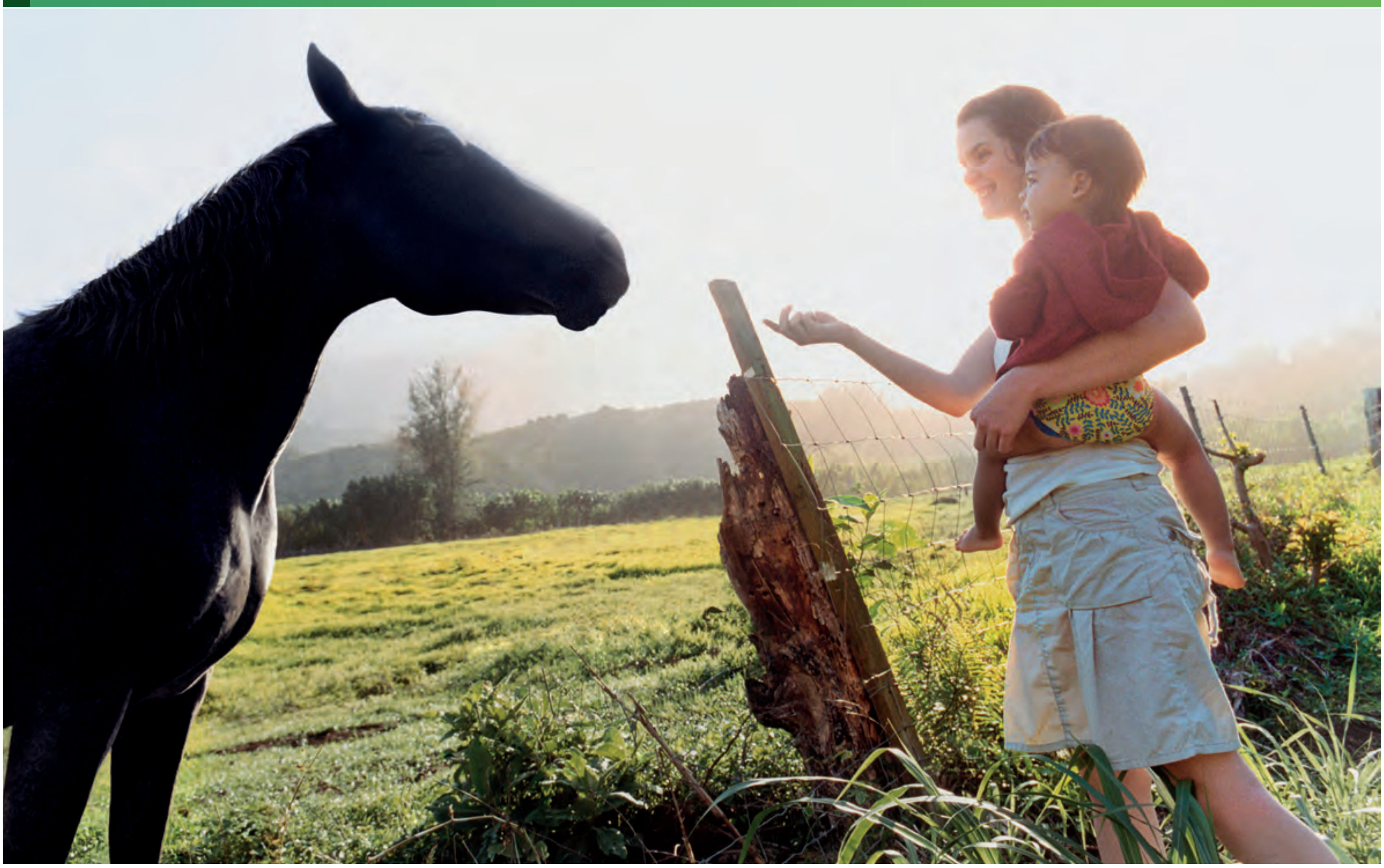
LLOYDS BANKING GROUP

BECOMING THE BEST BANK FOR CUSTOMERS

Lloyds Banking Group
Annual Report and Accounts

2014



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About us

Lloyds Banking Group is a leading provider of financial services to individual and business customers in the UK.

Our main business activities are retail and commercial banking, general insurance, and long-term savings, protection and investment. We provide our services under a number of well recognised brands including Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows and through a range of distribution channels including the largest branch network in the UK and a comprehensive digital proposition.

The Group is quoted on the London Stock Exchange and the New York Stock Exchange and is one of the largest companies in the FTSE 100 index of leading UK companies.

The 2014 Annual Report and Accounts incorporates the Strategic Report and the consolidated financial statements, both of which have been approved by the Board of Directors.

On behalf of the Board
Lord Blackwell
Chairman
Lloyds Banking Group
26 February 2015

This Annual Report and Accounts contains forward looking statements with respect to certain of the Group's plans and its current goals and expectations relating to its future financial condition, performance, results, strategic initiatives and objectives. For further details, reference should be made to the forward looking statements on page 335.

View our Annual Report and Accounts and other information about Lloyds Banking Group at www.lloydsbankinggroup.com

We are meeting our customers' needs by creating a simpler, more responsive organisation and are investing in our digital capability while maintaining a comprehensive branch network.

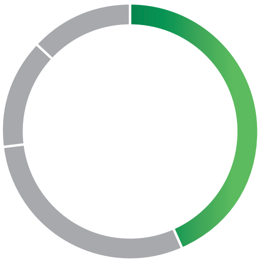
By becoming the best bank for customers we believe we can help Britain prosper and deliver strong and sustainable returns for our shareholders.

Group at a glance

We are a low cost, low risk, customer focused bank operating through four divisions.

UNDERLYING PROFIT

£3,228m



Our Retail division is a leading provider of current accounts, savings, loans and mortgages to personal and small business customers in the UK.

We have an extensive multi-brand, multi-channel offering. With more than 2,200 branches we have the largest branch network and one of the largest fee free ATM networks in the UK and also provide a comprehensive digital, telephony and mobile service. We serve millions of customers through our Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows brands.

1 in 4

First-time buyers helped by us to buy their first home

£286bn

Retail deposit balances

Key brands

LLOYDS BANK

HALIFAX

BANK OF SCOTLAND

SCOTTISH WIDOWS

For more on our Retail division's financial performance go to page 44 or visit www.lloydsbankinggroup.com

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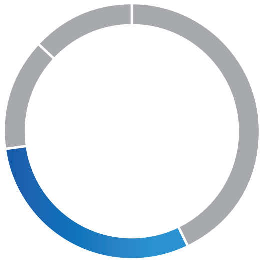
UNDERLYING PROFIT

£2,206m



Our Commercial Banking division has a rich heritage of supporting UK businesses from SMEs to large corporates and financial institutions.

Commercial Banking provides lending, deposits and transaction banking services to corporate clients as well as offering expertise in capital markets (private placements, bonds and syndicated loans), financial markets (foreign exchange, interest rate management, money markets and credit) and private equity.

5%

Growth in SME lending in 2014

17%

Our share of mid-market banking relationships

Key brands

LLOYDS BANK

BANK OF SCOTLAND

SCOTTISH WIDOWS

AMC

LDC

For more on our Commercial Banking division's financial performance go to page 46 or visit www.lloydsbankinggroup.com

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Strategic report
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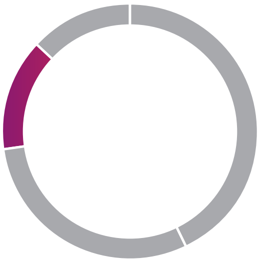
UNDERLYING PROFIT

£1,010m



Our Consumer Finance division provides asset finance solutions and credit cards to consumer and commercial customers.

In Asset Finance, Black Horse provides motor finance loans to over 200,000 customers through more than 5,000 dealers. Lex Autolease is the UK's leading fleet management and fleet funding specialist with close to 300,000 vehicles under management.

We are also one of the UK's leading credit card issuers through our Consumer and Commercial Cards businesses meeting the needs of seven million customers daily through purchasing and flexible short-term borrowing propositions and payment acceptance services for UK merchants.

▲17%

Growth in UK consumer finance lending in 2014

15%

Our share of credit card balances

Key brands

LLOYDS BANK
BANK OF SCOTLAND
HALIFAX
LEX AUTOLEASE
blackhorse

For more on our Consumer Finance division's financial performance go to page 48 or visit www.lloydsbankinggroup.com

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UNDERLYING PROFIT

£922m

Our Insurance division provides customers with long-term savings, investment and protection products and general insurance.

Our long-term savings, investment and protection products are offered under the Scottish Widows brand. Products are available through intermediaries, direct channels and also through our Retail division via Lloyds Bank, Halifax and Bank of Scotland.

The General Insurance business is a leading provider of home insurance in the UK, with products sold through the branch network, direct channels and strategic corporate partners.

3.7m

Home insurance customers

10%

Our share of the life and pensions market

Key brands

LLOYDS BANK
HALIFAX
BANK OF SCOTLAND
SCOTTISH WIDOWS

For more on our Insurance division's financial performance go to page 50 or visit www.lloydsbankinggroup.com

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Financial performance and strategic progress

FINANCIAL PERFORMANCE

SUBSTANTIAL INCREASE IN PROFITABILITY AND RETURNS

3.02%

Return on risk-weighted assets increased 0.88 per cent in the year to 3.02 per cent

Underlying profit

£7.8bn

+26%

Underlying profit increased 26 per cent to £7,756 million

Statutory profit

£1.8bn

Statutory profit before tax of £1,762 million, despite legacy items including £2,200 million of PPI charges

Dividend

0.75p

Delivery of strategy and increased profitability has enabled resumption of dividend

To read more go to page 35
or visit www.lloydsbankinggroup.com

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STRATEGIC PROGRESS

DELIVERY OF 2011 STRATEGIC PRIORITIES HAS TRANSFORMED THE BUSINESS

RESHAPE

£17bn

Run-off portfolio reduced by more than £140 billion to £17 billion

6
Countries

International presence reduced from 30 to six countries

50%

Completed sales totalling approximately 50 per cent of TSB

Successfully reshaped the Group

INVEST

Over **£1bn**

Additional strategic investment over the last three years

Lending growth in key customer segments

STRENGTHEN

12.8%
CET1 ratio

4.9%
Leverage ratio

Strong balance sheet

SIMPLIFY

£9.4bn
Cost base

51%
Cost:income ratio

Cost leadership position attained

To read more go to page 11
or visit www.lloydsbankinggroup.com

Chairman's statement

Our low cost, low risk, customer focused, UK retail and commercial banking strategy is the right one in the current environment.

Lord Blackwell
Chairman

Overview and strategy

My first year as Chairman of Lloyds Banking Group saw the achievement of our 2011 strategic plan. We have delivered on our key strategic priorities over the last three years, reshaping the Group to focus on serving our UK customers and returning the balance sheet to strength, while at the same time generating a significant improvement in underlying profitability and recommencing a dividend payment. I would like to extend my thanks to the Board, the management team and all colleagues across the Group for their determination to see this through.

While we are all proud of these achievements, we recognise that this is a base for the future, not the end of the strategic journey. There are major changes in the environment as well as our own capabilities that we need to address in the next phase of our development to become the best bank for customers and shareholders.

The next phase of our strategy, announced in October, outlined how we will focus on creating the best customer experience, becoming simpler and more efficient and delivering sustainable growth. As a Board, we have spent much time discussing how we could take the business forward, recognising the impact that the evolving regulatory and competitive environment and customers' changing needs are having on our UK retail and commercial banking focused business. We believe that digital transformation in particular will result in more fundamental change occurring in the banking industry over the next decade than we have seen in the last 200 years.

I am confident that our low cost, low risk, customer focused, UK retail and commercial banking strategy is the right one in the current environment. It capitalises on the Group's unique assets, including its franchise and capabilities, and is also consistent with our prudent risk appetite as well as our mission to 'Help Britain Prosper'.

Alongside this strategic challenge, it is essential that we also rebuild trust. This is a major challenge for the UK financial services sector, not just because of the damage caused by the financial crisis but also because of the continuing legacy of past industry misconduct. As well as the continuing impact of issues such as Payment Protection Insurance we also announced settlements on LIBOR and BBA repo rate issues. The Board regards the actions of those individuals responsible for this misconduct as completely unacceptable. Their behaviour involved a gross breach of trust and we condemn it without reservation. Doing the right thing for customers is an integral part of our strategy and I am convinced that these actions are entirely unrepresentative of the vast majority of our staff who are committed to delivering outstanding service, recognising that trust is at the core of our business.

It is clear that regaining this trust, which is a business imperative rather than a 'nice to have', will take time. We are completely committed to achieving this by setting the highest possible standards of integrity to serve our customers and clients.

Regulation

As a result of the financial crisis, there has been a great deal of change in the regulatory environment in recent years. The regulators have made good progress in improving financial stability through prudential regulation and they are now putting greater emphasis on protecting consumers and small business customers through conduct and competition regulation.

Capital requirements, though not yet finalised, are much clearer and the significant progress made in improving our capital position means we are now well placed. During the year, the Group met the capital benchmarks set out by the European Banking Authority (EBA) and the Prudential Regulation Authority (PRA) stress testing exercises, with no additional capital action required; a further demonstration of our robust capital, liquidity and funding position.

The ring-fence perimeter was clearly set in 2014, although final details and implementation of the rules remain undetermined. Our strategy continues to envisage a simple, low risk organisation with a business model focused on traditional retail and commercial banking, that would predominantly sit within the ring-fence.

Regaining trust is a business imperative rather than a 'nice to have'. We are completely committed to achieving this.

Directors

We were delighted to welcome four new Independent Non-Executive Directors to the Board during the year. Dyfrig John joined in January, Nick Prettejohn and Simon Henry in June and Alan Dickinson in September. These appointments bring a good balance of additional skills and experience to our Board. More information can be found in the corporate governance section and on our website.

Our Deputy Chairman, David Roberts, stepped down in May to become Non-Executive Director and Chairman-Elect at Nationwide. I and my colleagues are grateful for the tremendous contribution he made to the Group during his period on the Board. We were pleased to announce the appointment of Anita Frew, a non-Executive Director with the Group since 2010, to this role.

A COMMITMENT TO GOOD GOVERNANCE

One of the principal tasks of the Board is to develop a strategy which can achieve long-term success and generate sustainable returns for shareholders. This needs to be underpinned by the high standards of corporate governance which are critical to the success of any business today and should be driven by the Board (led by the Chairman) and embedded in the thinking and processes of the business. We are confident we have a strong, experienced management team and a commitment to good governance enabling us to build a business that will deliver sustainable success in the future.

Our Board

The Board has seen a number of changes this year, and in line with the provisions of the UK Corporate Governance Code and the interests of good corporate governance, all Directors are required to submit themselves for re-election on an annual basis. We are committed to ensuring we have the right balance of skills and experience within the Board, and we annually review its composition, and the diversity of backgrounds of its members.

Board oversight – key topics

During 2014, the Board continued to review the Group's corporate strategy, the operation of the business and our results within a framework of prudent and effective controls, including the assessment and management of risks. Key topics arising through the year included:

- discussion and oversight of the Group Strategic Update;
- the appointment of four Non-Executive Directors in order to strengthen the Board's experience in the areas of financial services, banking, risk and insurance;
- the initial public offering (IPO) of TSB Banking Group plc in order to meet the Group's commitments to the European Commission;
- the banking stress tests conducted by the EBA and the PRA in order to assess banks' resilience to market downturns;
- the resolution of legacy issues with regulators in the UK and US in respect of the manipulation of the London Interbank Offered Rate (LIBOR) and the Sterling Repo Rate and continued focus on Payment Protection Insurance; and
- the continued creation of a corporate culture that values integrity and best practice standards and that puts customers first.

For more about corporate governance go to page 62 or visit www.lloydsbankinggroup.com

Chairman's statement continued

Community and culture

With a network of more than 2,200 UK branches and a focus on supporting small to medium-sized businesses, we are well positioned to help our local and national communities. Our commitment to invest in the long-term economic future of the UK is highlighted, not just through the significant lending to customers, particularly SMEs and first-time buyers, but also through the many community programmes we run, including our Lloyds Scholars programme, our Social Entrepreneurs programme and our Career Academies.

We remain dedicated to our charitable initiatives and I am thrilled that we raised more than £6 million from our two-year partnership with the Alzheimer's Society and Alzheimer Scotland. The money, which is significantly higher than our 2014 target, will go towards the Dementia Research Leaders Programme, working to improve dementia research and transform our understanding of the condition.

With a network of more than 2,200 UK branches and a focus on supporting small to medium-sized businesses, we are well positioned to help our local and national communities.

I am also delighted to announce that BBC Children in Need will be the Group's Charity of the Year partnership for 2015 and 2016. We chose BBC Children in Need because we share the same goal of supporting communities across the UK and we will be working together to change the lives of disadvantaged children and young people.

A responsible business

Doing business fairly and responsibly is the best way to rebuild trust with Britain's households, businesses and communities. It also rebuilds our colleagues' pride in our Group. Our business model puts customers at the heart; based on traditional attributes such as prudence and a long-term view, whilst making the most of emerging digital channels. The best of the past combined with the best of the present and the future.

I see increasing evidence that we are returning to the qualities that historically made our bank a pillar of local communities, applying these qualities to meet the changing demands of our customers.

This is vitally important. As I noted earlier, trust is not a 'nice to have' – it's a 'must have'. It provides the foundations on which we can build sustainable success as a responsible business dedicated to meeting our customers' needs. It is also, I am convinced, a true reflection of the values and commitment of our hardworking staff, all of whom I would like to thank on behalf of the Board for their dedication to serving our customers.

Remuneration

We continue to believe that remuneration policy at all levels, including for senior executives, needs to motivate staff to deliver strong, sustainable growth whilst supporting the business strategy. We strongly believe in 'rewards for success', properly earned not just paid by default. That means aligning rewards to the longer term, sustainable success of our business and through this the delivery of value to shareholders. It also means holding back or removing performance rewards where managers have failed to meet their objectives.

Despite better results in 2014, the total bonus outcomee for the year has decreased by approximately 3.6 per cent (after adjusting for TSB). This reflects the continuing overhang of past conduct issues. Discretionary bonus awards remain a very small percentage of revenues at approximately 2 per cent, and represent approximately 4.5 per cent of pre-bonus underlying profit before tax, compared to 6 per cent in 2013. Cash bonuses are capped at £2,000 with additional amounts paid in shares and subject to deferral and performance adjustment. Average bonus awards across all our staff are approximately £4,500.

More information on how we ensure our approach to remuneration supports the business strategy can be found in the Directors' remuneration report later in this document.

Outlook

As we enter 2015, a 'milestone' year during which we celebrate the 200th anniversary of Scottish Widows and the 250th anniversary of Lloyds Bank, it is important that we look back with pride but also keep looking forward and adapt to the changing landscape of the future. I believe we are very well placed to make the most of the opportunities that exist.

Lord Blackwell
Chairman

Group Chief Executive's review

We enter the next phase of our strategic journey from a position of strength, having delivered against our key strategic priorities.

António Horta-Osório
Group Chief Executive

Highlights

2014 was a year of continued delivery for the Group, with the achievement of the key objectives set out in our 2011 strategic plan resulting in a significant transformation of the business and improvement in performance. Strategically, we are now a low risk bank, with a strong balance sheet and funding position and industry cost leadership, all of which provide competitive differentiation.

This delivery has, in turn, enabled the UK government to make further progress in returning the Group to full private ownership. In 2014 the UK government reduced its shareholding through the second successful sale of part of its stake in March and the launch of a pre-arranged trading plan in December which provides a means for an orderly sell down that will end no later than June 2015. On 20 February 2015, we were advised that UKFI's interest in the Group had reduced to 23.9 per cent. In the summer, we sold 38.5 per cent of TSB via a well-received Initial Public Offering, with this and the subsequent sale of a further 11.5 per cent stake in September resulting in us being firmly on track to meet our European Commission State Aid commitments.

The Board recognises the importance of sustainable and growing dividends to our shareholders and is today announcing the resumption of dividend payments, with a recommended dividend payment of 0.75 pence per share in respect of 2014. This is a symbolic development that bears testament to our successful transformation and improved risk profile of the business.

Given this strong strategic progress and the improvement in our financial performance and position, we have a firm foundation to deliver the new strategic priorities that we set out in October and we are well placed to continue to support and benefit from the strengthening UK economy and to be the best bank for our customers and shareholders.

Financial performance in 2014

We delivered a significant improvement in financial performance at both an underlying and statutory level. Underlying profit increased by 26 per cent to £7,756 million, with the Group's return on risk-weighted assets (RoRWA) improving by 88 basis points to 3.02 per cent. At a divisional level, all of our banking businesses delivered a robust performance with improvements in underlying profit and RoRWA in our Retail, Commercial Banking and Consumer Finance divisions after increased investment made to deliver growth. Underlying profit was lower in our Insurance division, reflecting the challenging market backdrop and regulatory and legislative changes that have similarly affected the wider industry.

Net interest income increased by 8 per cent, driven by a 33 basis point improvement in the net interest margin to 2.45 per cent and increased lending in our key customer segments. Other income excluding St. James's Place effects was 9 per cent lower, reflecting business disposals and a challenging operating environment. Underlying costs were reduced by 2 per cent, while the effective management of our lending portfolio, coupled with the benign economic and low interest rate environment, resulted in a substantial 60 per cent reduction in the impairment charge to £1,200 million.

On a statutory basis, the Group reported a profit before tax of £1,762 million compared to £415 million in 2013. This was after £2,200 million of charges in respect of PPI (2013: £3,050 million) and other regulatory provisions of £925 million (2013: £405 million).

Group Chief Executive's review continued

Helping Britain prosper and delivering growth in our key customer segments

As a UK centric retail and commercial bank, our future is inextricably linked to the health of the UK economy. In 2014 the UK economy continued to recover, with GDP growing robustly, unemployment falling, and both consumer and business confidence increasing. UK house prices have also continued to recover strongly, with an 8.4 per cent increase in the year. Against this, affordability measures remain good, with the recent calming of house price appreciation in London and the South East a welcome development.

Our strong performance in 2014 marks the culmination of three years of strategic delivery that has transformed the business for the benefit of our customers and shareholders.

We are committed to helping Britain and its communities and in March we launched our Helping Britain Prosper Plan. This initiative comprises a number of public commitments in areas where we can make the biggest difference and create value for our customers across households, businesses and our communities, in turn supporting our goal of being the best bank for customers. Since its launch, all of our divisions have made good progress in implementing this Plan, with the Group exceeding each of its lending commitments in 2014 while also delivering lending growth in our key customer segments.

In our Retail division, we provided £11.9 billion of lending to over 89,000 first-time buyers as well as 1 in 5 of all mortgage loans to customers buying their home in the UK in 2014, with total gross mortgage lending of £40 billion, 13 per cent higher than the prior year. We remain the largest participant in the UK government's Help to Buy mortgage guarantee scheme, lending £1.9 billion through this scheme in the year. In Retail Business Banking, we also supported over 100,000 new business start-ups.

The Commercial Banking division continued to take a leading role in supporting the UK economic recovery, with SME lending growing for the fourth consecutive year against a market that has contracted each year, increasing by 5 per cent in 2014. Lending to Mid Market corporates also increased by 2 per cent in a market that contracted by around 3 per cent. We remain firm supporters of the UK government's Funding for Lending scheme, committing over £15.5 billion of eligible lending and £1 billion to UK manufacturing during 2014.

In Consumer Finance, we achieved UK lending growth of 17 per cent to £16.0 billion, driven by 43 per cent growth in Asset Finance and a return to growth in our cards business following eight years of decline. New business growth was also strong, with a 48 per cent increase in Black Horse new business partly reflecting the launch of the Jaguar Land Rover partnership, and Cards benefiting from a 15 per cent increase in balance transfer volumes from new and existing customers as well as a 4 per cent increase in new consumer credit card accounts opened.

In Insurance, we have seen good momentum in our corporate pensions business where we are a market leader, serving over 11,500 employers and 1.4 million employees who have invested a total of £27 billion of assets with us. In 2014, the number of employees covered by these schemes increased by 40 per cent, principally reflecting our ongoing support for employers through the auto-enrolment process.

Our support for our customers and communities does not just extend to the lending commitments we have made to our key customer groups. It also covers a number of other initiatives through the Helping Britain Prosper Plan. In 2014, we delivered against the majority of these major commitments, donating £16.5 million to the Bank's Foundations to help tackle disadvantage and now having trained over 1,300 colleagues as mentors to SMEs and social entrepreneurs and provided over 940,000 of paid volunteer hours to support community projects.

Read more about our Helping Britain Prosper Plan on page 24 or visit www.lloydsbankinggroup.com

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Delivering the best bank to our key stakeholders

Our strong performance in 2014 marks the culmination of three years of delivery against our strategic plan that has transformed the business for the benefit of our stakeholders.

For our shareholders, we have delivered a significant improvement in financial performance, while improving the risk profile of the bank and strengthening the balance sheet.

We have strengthened underlying performance from a loss of £0.9 billion in 2010 to a profit of £7.8 billion in 2014, driven by a combination of lower impairment charges and a reduction in the Group's cost base. While our statutory result has also increased significantly over this period, our pre-tax profit of £1.8 billion in 2014 continued to be affected by PPI and other regulatory provisions as well as costs associated with TSB, the Simplification programme and the ECN exchange. Looking ahead, while regulatory and conduct risks remain, we believe that the Group's statutory performance will become significantly less impacted by such issues, resulting in a far greater proportion of our underlying financial performance flowing through to shareholder returns over time.

In 2014 we achieved our enhanced target of delivering £2 billion of annual run-rate savings through the first phase of our Simplification programme, resulting in a reduction in our cost base from over £11 billion in 2010 to £9.0 billion (excluding TSB). Our cost:income ratio of 51.2 per cent is now the lowest amongst our major UK banking peers, in turn delivering a cost leadership position as a strategic differentiator and source of competitive advantage.

Being a low risk bank is also central to our strategy and business model, while supporting our aim of being best bank for our shareholders by reducing earnings volatility. This is illustrated by our credit default swap (CDS) spread reducing from over 300 basis points (bps) at the end of 2011 to less than 50 bps at the end of 2014, which is one of the best in the banking sector worldwide. We have significantly reduced risk in our lending business through careful portfolio management, the centralisation of the risk division and the implementation of tighter underwriting standards and controls. As a consequence, non-performing loans have reduced from over 10 per cent of lending balances in 2010 to less than 3 per cent in 2014. Over the same period, we have successfully reshaped the Group, reducing our non-core portfolio from £194 billion, or 25 per cent of customer loans, by £148 billion in a capital accretive way. As of December 2014, we now have a remaining Run-off portfolio of £16.9 billion, with lending assets of £14.4 billion within this total representing 3 per cent of customer loans.

Our balance sheet and funding position have also been transformed, with our post dividend Common Equity Tier 1 (CET1) ratio strengthening to 12.8 per cent through

STRATEGY 2011-2014	KEY ACHIEVEMENTS
RESHAPE our business portfolio to fit our assets, capabilities and risk appetite	– Non-core assets reduced by more than £140 billion to £17 billion – International presence reduced from more than 30 countries to six – Asset quality ratio of 24 basis points, significantly ahead of original guidance of 50-60 basis points
STRENGTHEN the Group's balance sheet and liquidity position	– Capital position improved with a fully loaded common equity tier 1 ratio of 12.8 per cent – Reliance on wholesale funding reduced by more than £180 billion – Loan to deposit ratio improved from 154 per cent to 107 per cent
SIMPLIFY the Group to improve agility and efficiency	– Simplification programme delivered £2 billion per annum of cost savings, £300 million ahead of original target – Cost leadership position created
INVEST to be the best bank for customers	– Over £1 billion of strategic investment in the last three years

Group Chief Executive's review continued

a combination of earnings generation, a reduction in risk-weighted assets as we de-risk the business, and other management actions. Our CET1 ratio is now amongst the strongest within the banking sector worldwide, positioning us well against the backdrop of evolving regulatory requirements for capital and leverage.

Most recently this has been demonstrated by the Group exceeding the minimum thresholds set in the recent stress tests conducted by the EBA and the PRA, despite the heavy weighting of the stress parameters against a UK retail and commercial banking business model such as ours.

Our business has been transformed, with a reshaped, low risk portfolio, a strengthened capital and funding position and a more efficient cost base.

At the same time, we have significantly reduced our reliance on wholesale funding through the careful management of our lending portfolio and the growth in our relationship deposit base, with our loan to deposit ratio strengthening from 154 per cent in 2010 to 107 per cent. Our wholesale funding requirement at the end of 2014 of £116 billion compares to £298 billion at the end of 2010 and is broadly matched by our primary liquid asset portfolio of £109 billion.

Being the best bank for customers is at the heart of our strategy. In support of this, we have continued to invest in our product propositions as well as our branches, digital and telephony channels, with key customer benefits from this investment ranging from reduced processing times, improved ease of access and convenience, and greater efficiency. Digital remains a key area of growth and investment for the business and has now been expanded as a Group-wide division spanning across all business areas, reflecting our customers' evolving preferences in how they interact with us. At the end of 2014, our active online user base was over 10.4 million customers, within which our active mobile users were over 5 million: a 29 per cent increase compared to the end of 2013.

Our success in improving the customer experience has been reflected in net promoter scores (NPS), which have increased by 50 per cent since 2010, and Group reportable banking complaints (excluding PPI), which have reduced significantly over the same period and are now approximately 50 per cent lower than the average of our major banking peers.

Rebuilding customer trust remains a key imperative for the business. In support of this, we have continued to transform the corporate culture and have completely overhauled the performance and reward framework for our customer-facing colleagues, with performance now predominantly assessed on the basis of customer feedback.

We have also strengthened the control environment through changes to our organisational design and the introduction of standardised templates across the Group to assess and monitor our risk appetite. While these improvements have been essential in helping us to rebuild customer trust, we recognise there is more to do and that we still have legacy issues to work through.

Strategic update

In October 2014 we set out the next phase of our strategy, highlighting our key priorities for the next three years and how we intend to deliver value and high quality experiences for customers, alongside strong and sustainable financial performance for our shareholders within a prudent risk and conduct framework.

The first of our three strategic priorities is 'creating the best customer experience'. We will achieve this through our multi-brand, multi-channel approach by combining comprehensive online and mobile capabilities with face-to-face services delivered through our branch and relationship manager network.

We will invest £1 billion over the next three years in digital capability across all business divisions, delivering better service with greater efficiency. This transformation will reflect our customers' changing preferences in how they choose to interact with us, providing seamless access through a secure and resilient digital infrastructure.

Secondly, we will create operational capability by 'becoming simpler and more efficient', enabling us to be more responsive to changing customer expectations and to maintain our cost leadership position amongst UK high street banks as a source of competitive advantage. Through the simplification and increased automation of key processes, the reduction in third party spend and changes to our organisational design, we expect to deliver a further £1 billion of annual run-rate savings by the end of 2017, creating value for customers and improving our long-term competitiveness.

Finally, we expect to 'deliver sustainable growth' by seeking Group-wide growth opportunities while maintaining our prudent risk appetite. We intend to maintain market leadership in our main retail business lines of mortgages and current accounts by growing in line with the market, making the most of our multi-brand, multi-channel strategy to meet customer needs.

We have also identified a number of growth opportunities in segments and areas where we are currently underrepresented and will look to grow above the market, including business banking, financial planning and retirement, and unsecured consumer lending. Consequently, over the next three years we expect to grow net lending in our key customer segments by over £30 billion, comprising growth in line with the market in retail mortgages, coupled with increases in net lending of £3 billion in both our SME and Mid Markets segments, £4 billion growth in customer assets in Asset Finance and £2 billion in credit cards.

We also expect to grow customer assets by over £10 billion in our Insurance division over this timeframe through supporting our retail and corporate customers in making long-term preparations for retirement.

We will invest £1 billion over the next three years in our digital capability across all divisions, delivering better service with greater efficiency.

Over the next three years, we expect the UK financial services industry to undergo an unprecedented rate of change, driven by technology, changing customer behaviour and increasing regulatory requirements at a time when traditional competitors' strategies converge and new entrants compete for customers.

The successful delivery of our strategic priorities over the next three years will ensure that we are well placed to anticipate and react to these changes, in turn enabling us to retain our leading position in the UK market while delivering value to our customers and shareholders.

Outlook

Thanks to the hard work and commitment of our colleagues, we are entering the next three year phase of our strategy from a position of strength. Together, we have delivered the strategic objectives we set out in 2011 resulting in a business that has been transformed, with a reshaped and low risk portfolio focused on our core UK markets, a strengthened capital and funding position, and a more efficient cost base.

In the shorter term, we expect the Group to continue to perform strongly in 2015, with our net interest margin expected to strengthen to around 2.55 per cent, other income to remain broadly stable, and our low risk business model expected to be reflected in an asset quality ratio of around 30 basis points. We also expect our capital generation to remain solid, with our CET1 ratio expected to increase by between 150 and 200 basis points per annum pre-dividend.

While we recognise we still have a lot more to do, these strong foundations give us confidence in our prospects and our ability to achieve our strategic objectives over the next three years, despite uncertainties with regard to the political, regulatory, economic and competitive environment. We are therefore well positioned to continue to progress towards being the best bank for our customers while delivering strong and sustainable returns for our shareholders and supporting the UK economic recovery.

António Horta Osório

António Horta-Osório
Group Chief Executive

Market overview

Given our UK focus, our financial performance is inextricably linked to the performance of the UK economy and its regulatory and competitive environment.

UK ECONOMIC TRENDS

Economic recovery has picked up in 2014

Seven years after the start of the financial crisis, the UK economy is returning to a level of stability. Initial estimates indicate that economic growth rose to 2.6 per cent in 2014 from 1.7 per cent in 2013, the strongest rate of growth since 2006 and above the economy's long-term average growth rate. Unemployment has fallen rapidly – by twice as much in 2014 as across the previous two years combined – and at 5.7 per cent has now reversed the bulk of its rise during the recession. Consumer spending growth and the level of private car registrations have returned to pre-crisis rates. Rising business confidence in response to the upturn in demand has been reflected in a significant increase in business investment, now higher as a share of GDP than before the crisis. The rate of corporate failure has fallen back after its rise in 2009, and is now the lowest on record (since 1984) at 0.5 per cent.

At the root of the economic recovery is the progress that has been made on reducing the high levels of debt that were a key driver of pre-crisis growth. Household debt has fallen back to decade-ago levels relative to incomes, and with interest rates low the burden of debt payments is its lowest since the late 1990s. That has decreased the pace of consumer deleveraging, helping spending growth to recover. The government is broadly half way through its deficit reduction programme, and the pace of fiscal consolidation has also eased markedly, thus reducing its drag on growth. Most of the banking sector, including Lloyds, is on target to meet the new higher capital and liquidity levels mandated by CRD IV and the PRA, so lending supply is able to respond to rising demand.

But as the deleveraging process is not yet complete, some aspects of the economy continue to look abnormal. Most obviously, the Bank of England's Bank Rate (base rate) has remained at 0.5 per cent since 2009. The fiscal deficit remains large at over 5 per cent of GDP, and so requires a continued squeeze on public spending throughout the next Parliament after the May 2015 election. In addition, export growth remains subdued by weak demand in the Eurozone, the result of much less progress on private sector deleveraging and the rapid pace of fiscal tightening. The increasingly robust UK economic recovery has benefited our markets, although balance growth remains substantially lower than pre-crisis rates, as shown in the chart below.

Robust growth expected to continue in 2015

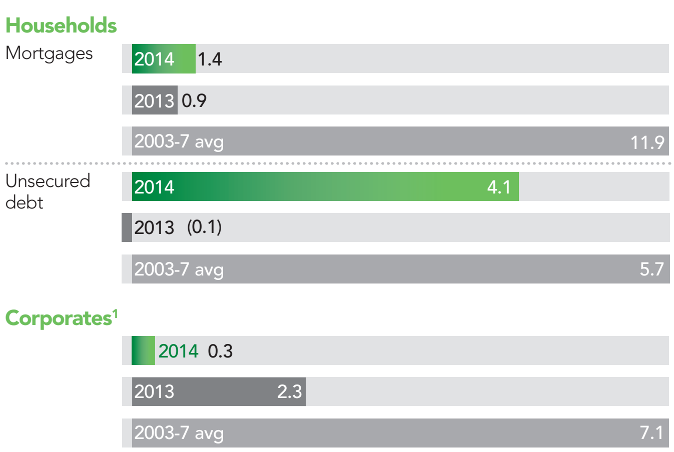
With inflation low and deleveraging progressing at a manageable rate, UK economic growth is expected to continue at a similar rate in 2015 – the current consensus is 2.6 per cent, still above the economy's long-term average growth rate of around 2.2 per cent (see chart below). Domestic demand will remain the driver, with households' real income growth expected to benefit from higher earnings growth, falling unemployment and lower inflation, helped especially by the large fall in oil prices since the middle of 2014. We expect Bank Rate to begin to rise around the end of the year, for the first time in eight years, but the pace of increase is likely to be slow as responsiveness of the economy to interest rates normalises only gradually.

As the economic recovery continues, we expect demand for credit from households and small and medium-sized businesses to rise, but growth is likely to stay well below pre-crisis rates as the appetite to borrow remains constrained by recent experience. With Bank Rate expected to rise only slowly, arrears are expected to remain low.

Risks to the recovery remain

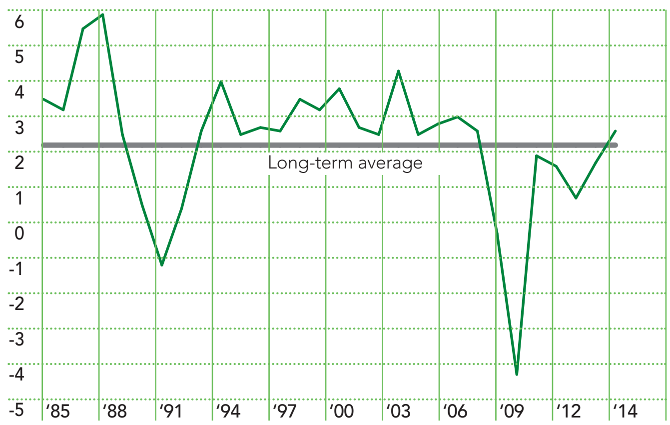
As the recovery continues, and adjustments in debt levels have progressed, the vulnerability of the economy to renewed weakening has reduced. Similarly, the outcome of the Scottish Referendum has removed a key source of near-term uncertainty for the economy and banks. However, with the General Election in May, political uncertainty remains high. The Eurozone remains a risk to the UK, not only because of its potential impact on UK growth, but also because of the financial market turbulence that would ensue if weak growth translates into election of political parties that favour Eurozone exit for some countries. Crystallisation of some of these risks could impact the UK economy significantly, which would in turn have a negative impact on the Group's income, funding costs and impairment charges. Positively, the recent fall in oil prices, if sustained, will be a boost for global growth and could be particularly beneficial for Eurozone growth.

GROWTH IN OUR MARKETS (yearly % change in UK market balances)



[1]Non-financial companies' borrowing from banks, excluding property and construction
Source: Bank of England

GDP GROWTH (% change on year earlier)



REGULATION

The regulatory landscape is continuing to evolve with a greater focus on protecting consumers and small business customers through conduct and competition regulation, and on capital ratios, ring-fencing and resolution models through prudential regulation.

Conduct and competition remains a focus for our regulators who have been carrying out reviews into the savings and credit cards markets alongside reviewing access to and ownership of payment systems. The Competition and Markets Authority (CMA) is also currently reviewing the UK SME and personal current account markets which will focus on competition, in particular barriers to entry and the ease of comparing and switching accounts. We are also continuing to work to ensure provision of appropriate and fair products for customers with clear, simple and relevant terms.

New European Union legislation on capital ratios came into force in the UK on 1 January 2014. The Capital Requirements Directive IV (CRD IV) aims to ensure that firms hold enough financial resources to cover the risk associated with their business. The Basel Committee also continued to review its capital framework, including the consistency of Internal Ratings Based (IRB) models, standardised credit calculations and the capital requirements for operational risk. Other recent related capital regulation includes the UK leverage ratio framework announced by the Bank of England in October 2014. The Group has significantly strengthened its capital position in recent years and is now comfortably in excess of minimum requirements on both its CET1 ratio and its leverage ratio. The resilience of our capital position was demonstrated in 2014 when we exceeded the threshold for both the PRA and EBA stress tests. We will continue to be subject to these annual tests going forward.

Ring-fencing and resolution regulation, through both the Financial Services (Banking Reform) Act 2013 and the European Commission's Recovery and Resolution Directive, continues to be a focus. Banks will be required to ring-fence retail and SME activities from their investment banking activities to ensure consumers are protected. As a UK focused retail and commercial bank, most of our operations are expected to be within the ring-fence and therefore the impact is likely to be less than for many of our peers.

We are assessing and implementing other regulatory changes including the Foreign Account Tax Compliance Act (FATCA), the UK's Fair and Effective Markets Review, the Senior Managers' Regime, and the Solvency II Directive, and will need to consider the legislation for the current EU parliament which is just beginning to be shaped by the new EU Commission.

Overall however, we believe our simple, low risk, UK focused strategy puts us in a strong position to adapt to the ever evolving regulatory landscape.

CUSTOMER DRIVERS AND COMPETITION

In the competitive open markets in which we operate, customers are benefiting from an increasing range of products and services from a growing choice of providers and via a range of channels.

The proportion of the UK population with access to the internet has increased significantly over the past few years, as has the proportion of people accessing the internet via their mobile phone. This has changed customer behaviours and expectations in terms of how they shop for goods and undertake banking and these trends are expected to continue.

An ageing population is expected to affect the products and services that our customers require, with younger people requiring help with planning and providing for retirement, while the older generation is becoming increasingly interested in accessing their equity to support their retirement.

In the current low interest rate environment, many customers are motivated by their desire to achieve better value for money, but security and reputation remain important factors. Customers want clear and transparent products delivered with good service and access to relevant, expert advice when they need it.

We have seen an influx of new entrants to the market, with a variety of business models. These new entrants are likely to have expertise and experience in digital product offerings, with strong funding positions, credible challenger brands, and in some cases pre-existing customer bases and branch networks. In addition, non-banks such as technology firms and supermarkets have the potential to disrupt the banking industry.

As outlined above, there are some clear customer trends emerging, but we recognise that every customer, whether an individual or an organisation, has particular needs and we must engage with them accordingly. Fundamentally, every customer has a choice and will select the provider that can most effectively fulfil their personal needs.

Our new strategy, which focuses on our multi-channel distribution model, simpler processes, broad product reach and expertise across insurance and banking, puts us in a unique position to respond to these market conditions and meet the needs of individual and corporate customers. Above all it recognises that we operate in a competitive market where additional challengers continue to emerge and the only way of ensuring success is by focusing on the ever-changing needs of our customers. Read more about our new strategic priorities on page 20.

MARKET TRENDS

Key opportunities

- Economic environment: significant progress in reducing the Group's risk profile and strengthening the balance sheet along with strategic actions taken in the last couple of years means we are better positioned to benefit as the economy recovers.
- Customer needs: our differentiated customer focused strategy along with our comprehensive multi-channel distribution network, and in particular our evolving digital capability, mean we are well positioned to address changing customer needs.
- Regulatory environment: greater clarity emerging on regulatory requirements and our simple, low risk, UK focused strategy places us in a strong position.
- Low cost position: this enables us to provide competitive differentiation for the benefit of customers and shareholders.

Key challenges

- Economic environment: continuing economic uncertainty in the Eurozone.
- Regulatory environment: uncertainty remains around the implementation of key elements of the proposals on ring-fencing and the form of new legislation, especially that proposed by the new EU Commission.
- Competition: an increasingly competitive market for lending and deposits will potentially impact margins and require us to innovate and evolve more quickly.
- Digital transformation: the pace of change is likely to be significant and we will need to continue to invest to meet evolving customer needs.

Group Key Performance Indicators

Measuring strategic performance

Delivering for shareholders and customers

Our key performance indicators are focused on strategic progress and how we are delivering for our customers and our shareholders.

In 2011 we outlined our strategy which was built upon being the best bank for customers by investing where we could make a real difference, while returning the Group to delivering strong, stable returns for our shareholders. The strategy contained four significant actions to take the Group forward: reshape, strengthen, simplify and invest.

Over the past three years, we have made significant progress in each of these areas, delivered a significant improvement in financial performance and built a strong track record of delivery. It was this strong progress that allowed the UK government to start selling down its stake in the Group, beginning the process of returning the company to full private ownership at a profit for the UK taxpayer.

Our key performance indicators have been considered by the Board and identify the most effective output measures for assessing progress towards becoming the best bank for customers and shareholders.

We also track performance against the commitments of our Helping Britain Prosper Plan, the results of which can be found on page 24.

Alignment of remuneration with performance

To ensure our employees act in the best interests of customers and shareholders, remuneration at all levels of the organisation is aligned to the strategic development and financial performance of the business and also takes into account specific risk management controls.

Variable remuneration including bonuses for all staff, including our Executive Directors, is based on the performance of the individual, the business area and the Group as a whole. Performance is assessed against a balanced scorecard of objectives and reviewed on a regular basis, across five areas (customer, building the business, risk, people and finance).

Executive management are also eligible to participate in a Long-Term Incentive Plan, which encourages delivery on long-term financial objectives including total shareholder return and the Group's strategic objectives of becoming the best bank for customers and helping Britain prosper.

To read more about how we align remuneration with performance go to pages 27 and 82.

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STRATEGIC PROGRESS

Reshape

BALANCE SHEET REDUCTION (NON-CORE ASSETS)	£bn
2014	17[1]
2013	64
2012	98
2011	141

We have successfully reshaped the business by reducing our non-core assets from £300 billion at the beginning of 2009 to £17 billion in 2014.

[1] Excludes £28 billion of assets previously classed as non-core.

Strengthen

COMMON EQUITY TIER 1 RATIO	%
2014	12.8
2013	10.3
2012	8.1
2011	7.1

Our common equity tier 1 ratio continued to improve, reaching 12.8 per cent in 2014; a strong position in absolute and relative terms compared to our peers.

Simplify

SIMPLIFICATION COST SAVINGS (RUN RATE)	£m
2014	2,042
2013	1,457
2012	847
2011	242

We reached our £2 billion Simplification run-rate cost savings target as outlined in the 2011 strategy.

Invest

STRATEGIC INVESTMENT	£m
2014	465
2013	342
2012	337
2011	167

Following the delivery of simplification benefits, we have increased strategic investment in the business and invested c.£465 million in addition to our business as usual investment performance in 2014.

To read more go to page 11 or visit www.lloydsbankinggroup.com

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DELIVERING FOR SHAREHOLDERS

As a result of the strategic progress made, we reported improvements in underlying and statutory profit as well as a stronger capital position in 2014, despite legacy charges. We were also able to reinstate dividend payments.

UNDERLYING PROFIT BEFORE TAX £m

2014	7,756
2013	6,166
2012	2,565
2011	429

Underlying profit continued to increase in 2014, up 26 per cent.

STATUTORY PROFIT BEFORE TAX £m

2014	1,762
2013	415
2012	(606)
2011	(3,751)

Pre-tax statutory profit continued to recover and reached £1,762 million in 2014, compared to £415 million in 2013.

EARNINGS PER SHARE p

2014	1.7
2013	(1.2)
2012	(2.1)
2011	(4.3)

Earnings per share continued to improve given the increasing profitability of the business.

TOTAL SHAREHOLDER RETURN %

2014	(4)
2013	65
2012	85
2011	(61)

The Lloyds share price fell by 4 per cent in 2014, and this was broadly in line with the FTSE 100 and ahead of the UK banking sector as a whole. Share price performance in the last three years remains significantly ahead of both the sector and the market. Total shareholder return was lower than the FTSE 100 in 2014 as the Group did not pay a dividend.

To read more go to page 35
or visit www.lloydsbankinggroup.com

COST:INCOME RATIO[1] %

2014	51.2
2013	52.9
2012	55.1
2011	51.5

Our cost:income ratio continued to fall in 2014 due to the continued focus on costs and increased income. The resulting cost leadership position provides competitive advantage for the Group.

[1] Excluding St. James's Place

ASSET QUALITY RATIO bp

2014	24
2013	57
2012	102
2011	162

Our asset quality ratio continued to improve and we exceeded our 2014 target of 50 basis points in 2014, demonstrating our lower risk position.

DELIVERING FOR CUSTOMERS

Customer relationships are key to our strategy and are critical for all our businesses. Significant differences across our four divisions mean the financial and non-financial strategic indicators for the development of customer relationships are generally tracked at a divisional level.

To assess progress, we measure customer satisfaction and are publicly committed to reducing complaints.

CUSTOMER SATISFACTION (NET PROMOTER SCORE)

2014	59
2013	55
2012	49
2011	44

Our net promoter score, which is the measure of customer service at key touch points and the likelihood of customers recommending us, improved in the year from 55 to 59.

CUSTOMER COMPLAINTS (FCA BANKING COMPLAINTS[1] PER 1,000 ACCOUNTS)

H1 2014[2]	1.4	H2 2014[2]	1.5
H1 2013	1.0	H2 2013	1.0
H1 2012	1.4	H2 2012	1.1
H1 2011	1.7	H2 2011	1.5

FCA reportable banking complaints increased during the year due to legacy and historic issues, with the increase largely driven by increased activity from claims management companies.

[1] Excluding PPI
[2] Excluding TSB

For more on customer relationships go to page 22 or visit www.lloydsbankinggroup.com

Business model

Unlocking the Group's potential

Our aim is to be the best bank for customers while providing strong and sustainable returns for shareholders.

Customers are at the heart of everything we do, whether that be through our distribution network, our brands or our people. This commitment is supported by our Group values of putting customers first, keeping it simple and making a difference together.

HOW WE CREATE VALUE

CREATING DISTINCTIVE VALUE FOR CUSTOMERS THROUGH…

- A range of iconic and distinctive brands
- Relationship focus
- Superior consumer insight
- Using our cost advantage for the benefit of customers
- Engaged and customer focused colleagues

UNIQUE AND EFFECTIVE SERVICE PROPOSITION THROUGH…

- A broad multi-channel distribution network: branch, telephone and digital
- Efficient systems and processes, providing better customer experience and cost leadership
- Financial strength
- A UK focus

Our business model

We are a leading financial services group with a low cost, low risk, customer focused, UK retail and commercial banking business model. We provide a range of services, primarily in the UK, to individuals and commercial customers and by focusing on the needs of customers and operating sustainably and responsibly, we believe we will help Britain prosper and create value for our shareholders.

We create value for our customers through our distinctive strengths, in particular our range of iconic and distinct brands, our superior customer insight, high quality, committed colleagues and relationship focus.

The foundations for providing effective customer service are: our broad multi-channel distribution network, our financial strength, our efficient systems and processes, and our UK focus. We want to meet our customers' financial needs, help them succeed and create value for them.

We offer simple, tailored products with innovation where it matters most to our customers across all our divisions. Our focus on creating a simpler, more efficient and agile organisation is enabling us to provide better product and service propositions, innovating as appropriate, to address customer needs at a fair price while delivering more efficient processes and improving our cost leadership position.

The UK financial services market remains one of the largest in the world and, although our business model and strategy have been formulated in the context of a cautious outlook for the UK economy, we believe they remain appropriate for all stages of the economic cycle, whilst providing real differentiation and positioning us well for future regulatory reform.

SIMPLE, TAILORED PRODUCTS ADDRESSING CUSTOMER NEEDS...

Lending
mortgages, credit cards, personal and business loans

Deposit taking
current accounts, savings accounts

Insurance
home insurance, motor insurance, protection

Investment
pensions and investment products

Commercial financing
debt capital markets, private equity

Risk management
interest rate hedging, currency, liquidity

...DELIVERED THROUGH OUR FOUR DIVISIONS

ENABLING SUSTAINABLE VALUE CREATION BY HELPING BRITAIN PROSPER.

BECOMING THE BEST BANK FOR CUSTOMERS

TARGETING STRONG, SUSTAINABLE RETURNS FOR OUR SHAREHOLDERS

Our strategy

We have achieved the strategic objectives we set in 2011. Our focus for the next three years builds upon this success with three new strategic priorities.

Our strategy

Our low cost, low risk, customer focused, UK retail and commercial banking business model has driven the development of our new strategy. We have a number of distinct assets and capabilities, including our unique multi-brand, multi-channel model, our customer franchise, our market leading cost position, our proven management team and high quality committed people.

Given the progress made in recent years, we are in a strong financial and operating position as we enter the next phase of our strategy to become the best bank for customers and shareholders.

We intend to deliver value and high quality experiences for customers alongside strong and sustainable financial performance within a prudent risk and conduct framework. We remain committed to supporting the UK economy and the communities in which we operate.

Over the next three years, we need to adapt to the changes in financial services brought about by technology, changing customer behaviour and increasing regulatory requirements, at a time when traditional competitors' strategies converge and new entrants compete for customers. We aim to achieve this through three new strategic priorities which will be consistently applied across all divisions.

1. Creating the best customer experience

Customers remain at the heart of our strategy. We want to create the best customer experience through our multi-brand, multi-channel approach, combining comprehensive online and mobile capabilities with face-to-face services. We are transforming our digital presence, providing customers with simpler, seamless interactions across online, mobile and branches while sustaining extensive customer reach through a branch network focused on delivering high quality service and the right outcomes for customers.

2. Becoming simpler and more efficient

We will create operational capability which is simpler and more efficient than today through further system enhancement and integration and will become more responsive to changing customer expectations while maintaining our cost leadership amongst UK high street banks. This cost leadership enables us to provide increased value to our customers and competitive differentiation.

3. Delivering sustainable growth

As the UK economy continues to recover, we will further develop Group-wide growth opportunities within our prudent risk appetite. We will maintain market leadership in our main retail businesses, making the most of our multi-brand, multi-channel strategy whilst also focusing on areas where we are currently underrepresented.

Colleagues

Our colleagues are fundamental to the achievement of this strategy and engaged and customer focused colleagues will be essential in becoming the best bank for customers and provide further competitive differentiation.

Helping Britain prosper

As the largest retail and commercial bank in the UK, helping Britain prosper remains central to the Group's purpose. We are already the largest lender to first-time buyers, providing 1 in 4 mortgages, and we supported over 107,000 business start-ups in 2014. Over the next three years, we expect to commit over £30 billion of additional net lending to UK personal and commercial customers.

Our commitment to the long-term economic future of the UK is also highlighted through the ongoing investment we make in our community programmes such as Lloyds Scholars, Social Entrepreneurs and Career Academies, as well as our charity of the year which for 2015-2016 is BBC Children in Need.

STRATEGIC FOCUS

OUR BUSINESS MODEL	LOW COST, LOW RISK, CUSTOMER FOCUSED, UK RETAIL AND COMMERCIAL BANK		
OUR AIM	BEST BANK FOR CUSTOMERS	STRONG AND SUSTAINABLE SHAREHOLDER RETURNS	
OUR STRATEGIC PRIORITIES	CREATING THE BEST CUSTOMER EXPERIENCE	BECOMING SIMPLER AND MORE EFFICIENT	DELIVERING SUSTAINABLE GROWTH

CREATING THE BEST CUSTOMER EXPERIENCE

Initiatives
- Seamless multi-channel distribution across branch, online, mobile and telephony
- Tailor product propositions to meet customer needs more effectively
- Commitment to conduct and investment in service

Expected outcomes
- Improved customer experience through enhanced digital offering
- Retain convenience and reach of the leading branch network
- Improvement in customer satisfaction and lower complaints

BECOMING SIMPLER AND MORE EFFICIENT

Initiatives
- Re-engineer and simplify processes to deliver efficiency in a digital world
- Reduce third party spend
- Increase investment in IT efficiency and resilience

Expected outcomes
- Increased automation of end-to-end customer journeys
- More efficient change capability
- Resilient systems and processes
- Continuation of Simplification programme
- Maintain cost leadership position

DELIVERING SUSTAINABLE GROWTH

Initiatives
- Maintain market leading position in key retail business lines
- Leverage Group strengths to capture growth in underrepresented areas

Expected outcomes
- Growth in line with the market in current accounts and mortgages
- Growth above market in underrepresented areas
- Net lending growth of >£1 billion annually in both SME and Mid Markets
- Consumer Finance to increase UK customer assets by over £6 billion from 2015 to 2017
- Support our customers in retirement planning, increasing customer assets by over £10 billion

STRATEGIC TARGETS

COST LEADERSHIP POSITION
- £1 billion of additional run-rate savings per annum
- cost:income ratio to exit 2017 at around 45%; targeting reductions in each year

BEST CUSTOMER EXPERIENCE
- top three for customer satisfaction
- lowest reportable complaints ratio for peer group
- maintain or grow share of branches

LOWER RISK BANK
- asset quality ratio of around 40 basis points through the economic cycle and lower over the next three years

STRONG BALANCE SHEET POSITION
- loan to deposit ratio of 105% - 110%
- steady state CET1 ratio of c.12%
- leverage ratio of at least 4.5%

RETURN ON REQUIRED EQUITY
- 13.5% - 15% by the end of the strategic plan period and through the economic cycle

Relationships and responsibility
Our approach to responsible business

We believe we can make our greatest contribution to society and stakeholders by helping Britain prosper, and that means serving the financial needs of UK households, businesses and communities in a responsible and ethical way.

Our approach
Operating sustainably and responsibly is integral to our business model and strategy. At the heart of our approach are our three Group Values – putting customers first, keeping it simple and making a difference together. Our Codes of Responsibility define the behaviours required to live up to our Values – as a business, as individual colleagues or as suppliers.

Our Values and Codes of Responsibility provide points of reference as we work to become the best bank for customers through our low risk, UK focused retail and commercial business model.

Governance
We have a well-defined, robust Risk Management Framework and a number of Group Policies relating to responsible business. Our Group Ethics and Responsible Business Policy is underpinned by our Codes of Responsibility which outline our adherence to the principles of the United Nations declaration on Human Rights and support for the UN Guiding Principles on Business and Human Rights. We also adhere to the International Labour Organisation Fundamental Conventions.

Our policies and procedures support colleagues working in our relationship management and risk teams in understanding how to approach, assess and manage social, environmental and ethical risks. We are signatories to the Equator Principles, which provide a framework for determining, assessing and managing environmental and social risk in project finance transactions. We recognise the importance of climate change, biodiversity and human rights. We believe that we should avoid the negative impacts on ecosystems, communities and the environment but where impacts are unavoidable they must be appropriately minimised, mitigated or offset.

Our Code of Business Responsibility states that we do not finance any activities prohibited by international conventions supported by the UK government. For example, the Oslo Convention on Cluster Munitions and the Ottawa Treaty on Anti-Personnel Landmines. Consequently, we will not enter into or will exit from credit or investment relationships with businesses believed to be in breach of these conventions. You can read about our approach to managing environmental risk, our credit and investment activity and the Equator Principles in the Responsible Business section of our corporate website.

We have an effective top-to-bottom governance structure, providing an environment in which colleagues are encouraged and supported to do the right thing and work responsibly. This governance structure starts with our Group Board and cascades to every part of our business via our Group Executive Committee, Responsible Business Committee, and colleagues across the Group. All colleagues are accountable for doing business responsibly, which is integral to the way we recruit, develop, assess, promote and reward them – from the Chief Executive to the newest branch trainee.

The Responsible Business Committee is chaired by Non-Executive Director Sara Weller and attended by senior leaders from every part of the business including a number of Group Executive Committee members. The Committee oversees responsible business issues as well as reaching out to external stakeholders to understand their perspective then bringing this understanding back into the Group.

An independent Stakeholder Panel adds extra strength to our governance structure and the quality of our reporting. You can read the Panel's independent statement online.

Our focus on doing business responsibly is recognised by our continued presence in the FTSE4Good socially responsible investment index, our position in the CDP (Carbon Disclosure Project) and our platinum status in the Business in the Community CR Index.

Material issues
As part of our annual Responsible Business reporting we have conducted a comprehensive process to identify and prioritise the material issues that matter most to our stakeholders. More information on this process can be found in our detailed Materiality Report online.

TREATING CUSTOMERS FAIRLY
If we want to rebuild trust in our bank, then we must treat customers fairly, putting their wellbeing at the heart of every decision we make and every action we take

BEING HONEST AND TRANSPARENT
We must do the right thing for customers when it comes to dealing with, and learning from, the mistakes of the past

RESPONSIBLE LENDING FOR ALL CUSTOMERS
We are focused on lending responsibly to all customers, including Britain's homebuyers and businesses

BUILDING A MORE RESPONSIBLE CULTURE
We are continuing to change our culture to make sure that all colleagues are empowered, inspired and incentivised to do the right thing for customers

Read more about material issues on page 26 or see our Responsible Business Review at www.lloydsbankinggroup.com/RB

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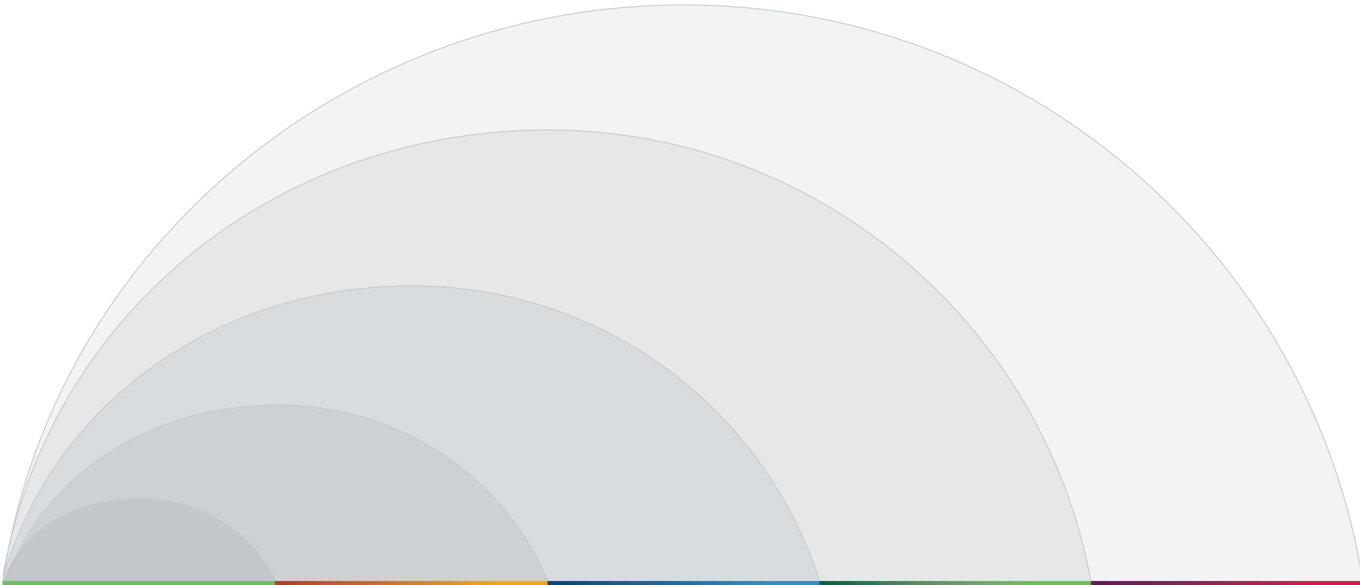
How it all fits together

Operating sustainably and responsibly is integral to our business model and strategy. We aim to make it a day-to-day reality by ensuring that we do business in line with our Group Values, Codes of Responsibility and Group Policies. Together with our 'Boardroom to Branch' governance system, these elements comprise a robust, all-encompassing Responsible Business Framework.

RESPONSIBLE BUSINESS FRAMEWORK



Business Model and Strategy

Our business model positions us as a low cost, low risk, customer focused UK retail and commercial bank, with a distinctive multi-brand, multi-channel offer. By putting customers at the heart of everything we do and operating sustainably and responsibly, we believe we will help Britain prosper and create value for our shareholders.

Our strategy sets out the ways in which we can become the best bank for customers. As described on page 20, it sets three priorities up to 2017: creating the best customer experience; becoming simpler and more efficient; and delivering sustainable growth.

Group Values

Our Group Values underpin everything we do. They guide how we work and define the standards we set everyday. They are:

- Putting customers first
- Making a difference together
- Keeping it simple

Codes and Policies

Our Codes of Responsibility ensure that we operate responsibly as a business and as individuals. Our Policies address the primary areas of risk we face and support a consistent approach to behaviour and decision making. As such, they are an important part of our Group Risk Management Framework.

Our pillars of responsible business:

- Put customers at the heart of our business
- Work responsibly with our external stakeholders
- Aim to be a great company to work for
- Invest in communities to help them prosper and grow
- Work continually to reduce environmental impacts

Governance

Our Governance framework enables strategic, accountable and responsible decision making by all colleagues.

The Group Board, Group Executive Committee and Responsible Business Committee play key roles in ensuring good governance and defining our responsible business objectives. Our Responsible Business team supports colleagues across the Group in fulfilling our responsible business agenda.

Helping Britain Prosper Plan

The Helping Britain Prosper Plan sets out public commitments to help Britain's households, businesses and communities.

It focuses on:

- Helping homebuyers
- Helping people plan for later life
- Championing financial inclusion
- Lending to businesses
- Providing expert training and mentoring for businesses and individuals
- Investing in communities to help them thrive
- Celebrating diversity

Relationships and responsibility continued
Helping Britain Prosper Plan

People in Britain are facing some big issues today. We're using our influence and expertise to help them tackle these issues through our Helping Britain Prosper Plan.

Playing an active role in helping people address some of the big social and economic issues they face today sows the seeds of a better future for us all. We recognise that when the customers and communities we serve prosper, then we do too.

The Helping Britain Prosper Plan complements our ambition to become the best bank for households, businesses and communities. It is fundamental in rebuilding trust with those we serve and also to make Lloyds Banking Group a business that colleagues are proud to work for.

2014 overview

Reviewing the Plan as a whole, it's clear that it has achieved a 'first' for the Group and for the UK banking sector: a framework that we can use to demonstrate to colleagues and external stakeholders the positive impact that our operations have across our seven commitments. We set some challenging targets in the Plan to push ourselves, and we know we need to do more work to meet some commitments in the future. The areas we need to focus on are: supporting colleagues; apprenticeships; and continuing to pay our suppliers on time.

Looking ahead

We've always intended to develop the Plan in line with the next phase of our Group Strategy, announced in 2014, and any relevant market changes. We have updated the Plan for 2015 to keep it relevant to our business and our stakeholders. It now includes 28 metrics (with updated targets for 2015 and beyond) including new metrics focused on: supporting smaller house builders' projects; digital skills; international trade; and infrastructure and investment. You can read more about our 2014 performance and new 2015 metrics in our Helping Britain Prosper Plan Update online.

KEY

ACHIEVED	(green)
PARTIALLY ACHIEVED	(amber)
NOT ACHIEVED	(red)

[1] Through Money for Life's Teach Others and Money Mentors programmes.

[2] Includes Commitment; Know-how; Adjustments; Recruitment; Retention; Products & Services; Suppliers and Partners; Communication; Premises; Information and Communication Technology.

[3] Reporting against this metric will commence in 2015 when the apprenticeship recruitment strategy and measurement approach advised in 2014 are fully embedded.

[4] This % is based on the number of Scholars who are actively seeking employment each year (out of the cumulative 720 who will have been supported by 2017).

[5] Senior roles refers to top 8,000 individuals.

Read more about our Helping Britain Prosper Plan at www.lloydsbankinggroup.com/prosperplan

HELPING BRITAIN PROSPER PLAN 2014

1. We'll help more customers get on the housing ladder – and more customers climb up it
2. We'll help our customers plan and save for later life
3. We'll take a lead in financial inclusion to enable all individuals to access, and benefit from, the products and services they need to make the most of their money
4. We'll help businesses to start up and scale up, and we will procure responsibly
5. We'll help businesses and individuals succeed with expert mentoring and training
6. We'll be the banking Group that brings communities closer together to help them thrive
7. We'll better represent the diversity of our customer base and our communities at all levels of the Group

METRICS	2014 PERFORMANCE	2014 TARGET	INDICATOR
1.1 Number of first-time buyers supported through delivering the most comprehensive mortgage proposition in the UK mortgage market	>89,000	>80,000	
1.2 Share proportion of new-build mortgages provided (for first-time buyers, second steppers and private rented)	1 in 4	1 in 4	
2.1 Number of customers we help to plan for later life through company pension schemes	1.41m (cumulative)	1.1m (cumulative)	
2.2 Number of customers we help post-retirement through providing a continuing annuity income	596,172 (cumulative)	0.55m (cumulative)	
3.1 Amount of additional funding provided to support Credit Unions per year	£1m	£1m	
3.2 Share of social banking accounts we will support	29%	1 in 4	
3.3 Number of community support workers accredited to deliver financial education on the front line[1]	2,035 (cumulative)	1,830 (cumulative)	
3.4 Maintain a category gold award with the Business Disability Forum (BDF) by achieving a high score across the ten areas[2] that lead to a disability confident organisation	98%	>90% score	
4.1 Increased amount of net lending to SMEs on an annual basis (total cumulative)	£1.27bn (>£31bn)	£1bn (>£31bn)	
4.2 Number of start-up businesses we will help to get off the ground	99,133 (107k including TSB)	>100k	
4.3 Increased amount of new lending provided to support UK manufacturing businesses per year	£1bn	£1bn	
4.4 Number of entrepreneurs supported through Lloyds Bank and Bank of Scotland Social Entrepreneurs programmes	756 (cumulative)	>750 (cumulative)	
4.5 % of supplier invoices paid within 30 days	95% (30 days)	95%	
5.1 Number of colleagues trained to mentor SMEs and social entrepreneurs through the Business Finance Taskforce accredited scheme and the Lloyds Bank and Bank of Scotland Social Entrepreneurs programme	1,340 (cumulative)	1,000 (cumulative)	
5.2 Number of new Lloyds Banking Group Apprenticeship positions created with permanent employment	2,210 (cumulative)	2,450 (cumulative)	
5.3 % of Lloyds Banking Group Apprenticeships taken up by external candidates from the UK's most disadvantaged areas[3]	N/A	N/A	N/A
5.4 Undergraduates from low income families supported by the Lloyds Scholars programme	360 (cumulative)	360 (cumulative)	
5.5 % of Lloyds Scholars (from low income families) who have secured a job within six months of graduating from University[4]	100%	90%	
6.1 Number of paid volunteer hours used by colleagues to support community projects	949,600 (cumulative)	800,000 (cumulative)	
6.2 Number of community organisations supported by our volunteers or funding	8,690	6,500	
6.3 £ donated to the Bank's Foundations to help tackle disadvantage	£16.5m	£16.5m	
6.4 £ raised by colleagues for our Charity of the Year (including Matched Giving) to support those in need in our communities	£3.9m	£1.7m	
7.1 % of senior roles[5] to be held by women	29%	29%	
7.2 We will consistently increase the engagement levels of ethnic minority colleagues in all roles	64 (Colleague Survey Score)	66 (Colleague Survey Score)	
7.3 We will consistently increase the engagement levels of disabled colleagues in all roles	52 (Colleague Survey Score)	55 (Colleague Survey Score)	
7.4 We will consistently increase the engagement levels of lesbian, gay, bisexual and transgender colleagues in all roles	52 (Colleague Survey Score)	60 (Colleague Survey Score)	

Strategic report
Financial results
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Financial statements
Other information

Relationships and responsibility continued
Material issues

TREATING CUSTOMERS FAIRLY

Fairer products
We want to do the right thing in every single customer interaction. We're making sure this happens in many different ways, including more than 200 different improvements for customers, including product-specific enhancements, such as better user tools on our digital services and greater flexibility for customers to switch between loan and saving products in search of the best option.

Improving accessibility
We are working hard to make continuous improvements to our evolving multi-channel offer for all customers. We have made several important improvements for customers with disabilities or in ill-health, including those with dementia. We have launched a new branch disability toolkit across all our brands, advising colleagues on best practice and we've installed more talking ATMs in our branches for visually impaired customers.

Developing our digital channels
More than 10 million customers now use our digital banking services. We are the biggest 'mobile bank' in the UK with over 5 million customers using their mobile phone to bank with us. We expect these figures to increase in 2015. We want to make digital banking easier and personal for all our customers. We have also made it possible for digital banking customers to open accounts, swap mortgage products, move saving funds and calculate the benefits of making overpayments on mortgages and loans.

Customer complaints
Providing an excellent service and getting it right for customers first time is the best way to prevent complaints. Excluding legacy complaints relating to PPI, the overall number of customer complaints we receive has fallen by 12 per cent compared with 2013 volumes. We also received fewer banking complaints per 1,000 accounts than our major peers during 2014. We're determined to reduce complaint volumes even further in future by learning from and acting on customers' feedback.

Tackling financial crime, bribery and corruption
We can ensure optimum security levels for customers because we consistently invest in the best technologies, processes and training for colleagues. We've invested £157 million since 2011 to improve IT security, with a focus on state-of-the-art control and protection technologies.

We comply rigorously and consistently with all anti-bribery legislation and regulation wherever we operate, by adopting appropriate procedures and controls to counter the risk of bribery. Our Anti-Bribery Policy applies to all Directors and employees and those acting on the Group's behalf. All colleagues complete annual anti-bribery training and are encouraged to report instances of suspected bribery via the Whistleblowing service. During 2014, the Group was invited to apply, and was subsequently approved, for membership of Transparency International UK's Business Integrity Forum.

DIGITAL INVESTMENT

£750m

Amount invested in digital over the last three years

CUSTOMER COMPLAINTS

1.5

Lloyds Bank	1.9
Halifax	1.1
Bank of Scotland	1.2

Banking complaints per 1,000 accounts, excluding PPI

BEING HONEST AND TRANSPARENT

Tax contributions
We do not interpret tax laws in ways that we believe are contrary to their intention; and we do not promote tax avoidance products to our customers. We comply with the HMRC Code of Practice on Taxation for Banks and the Confederation of British Industry's statement of tax principles. The tax system covering our activities is complex and wide ranging. Because of this, our decisions and actions regarding tax are based on a considered assessment of long-term costs and risks, including their impact on our relationship with stakeholders and our reputation with customers. The Group's approach to tax is governed by a Group Board approved tax policy and strategy, which has been discussed with HMRC.

TAX PAID

£1.7bn

In 2014

£2.1 billion collected on behalf of the government

Addressing and learning from past mistakes
We must do the right thing for customers when it comes to dealing with, and learning from, the mistakes of the past. We must respond fairly, honestly and transparently to any concerns our stakeholders may have about our plans for the future. We have publicly acknowledged our past mistakes, many of which were endemic to our industry, and committed to resolve them. We were the first UK retail bank to offer customers PPI mis-selling compensation.

Branch access
In our strategy update in October 2014 we confirmed that, alongside the digitisation of our business, branches will continue to play an important role in our multi-channel approach to meeting customer needs. To ensure our approach reflects customers' changing behaviours, we stated that we intend to invest £1 billion in digital channels and that we will maintain or grow our share of branches over the next three years.

Read more about these issues in our Responsible Business Review online at www.lloydsbankinggroup.com/RB

RESPONSIBLE LENDING FOR ALL CUSTOMERS

Homebuyers

We made public commitments to lend £10 billion to 80,000 first-time buyers in 2014. We fulfilled both in November 2014, ahead of schedule. In total, we advanced £11.9 billion in new mortgage lending to over 89,000 first-time buyers this year – a 23 per cent and 12 per cent improvement, respectively, on 2013. We provided 1 in 4 of all new first-time buyer mortgage loans completed in the UK in 2014.

Business and SMEs

This year we have increased lending to SMEs by 5 per cent compared with 2013. We have also focused more attention on start-up businesses, with a 2014 Helping Britain Prosper Plan commitment to help 100,000 start-ups this year. We are pleased to say that we beat this target, helping 107,000 start-ups by the end of the year.

Financial inclusion and education

As a bank that is committed to helping Britain prosper, we want to do more to champion financial inclusion, by focusing on five themes: accessible products and services that meet customers' needs; improving people's capability and confidence; working in partnership; investing in financial education; and supporting customers in financial difficulty that might be excluded from financial services.

For many customers, helping them to open a basic bank account is the first step away from financial exclusion and into better money management. In 2014, we provided 269,000 new basic bank accounts and also helped 126,000 customers upgrade from basic to more mainstream products. You can read more about financial inclusion and financial education online.

HOME OWNERSHIP

£11.9bn

New mortgage lending to first-time buyers

BUSINESS START-UPS

107,000

Number of start-ups helped

BUILDING A MORE RESPONSIBLE CULTURE

Embedding responsible business

We are continuing to change our culture to make sure that all colleagues are empowered, inspired and incentivised to do the right thing for customers. In 2012, we launched our Code of Business Responsibility and Code of Personal Responsibility, setting out behaviours consistent with our Group Values. Since then, we've worked hard to embed the Values and Codes across our Group – ensuring that 95 per cent of colleagues completed mandatory training on the Codes in 2014.

Rewarding and remunerating colleagues

From 2015 onwards, we have made the decision to remove the last of the sales targets in our Retail customer-facing roles and focus solely on performance metrics based on customers, risk and people. This will help us to do the right thing for customers and rebuild colleagues' pride in, and sense of commitment to, our Group.

Our Remuneration Policy was approved by shareholders at the AGM in May 2014. The Policy provides a framework to support robust governance in line with the Group's risk appetite and aligned with the Group's business strategy, objectives, values and long-term interests, as well as the consideration of our Codes of Responsibility and the Helping Britain Prosper Plan.

Engaging colleagues

We have regular dialogue with colleagues to get a picture of how they are feeling and keep them informed of changes to our business and our financial performance. We are committed to providing colleagues with comprehensive coverage of the economic and financial issues affecting the Group. Information is provided through various channels and views are represented through regular dialogue and consultation with the Unions. We offer share schemes to colleagues to encourage their financial involvement.

In 2014, our annual Colleague Survey achieved its highest response rate to date, with 85 per cent of colleagues participating compared to 76 per cent in 2013. The Employee Engagement Index (EEI) and the Performance Excellence Index (PEI) measure individual motivation and how strongly colleagues believe we are committed to improving customer service, respectively. The Line Manager Index (LMI) shows how our colleagues feel about their line managers. Key feedback included:

- A 75 per cent PEI score (down 1 percentage point compared with 2013 but 11 percentage points above the UK norm).
- A 60 per cent EEI score (down 4 per cent from 2013 and 2 points below the UK norm).
- An 81 per cent LMI score – the same as 2013 (14 percentage points above the UK norm).

PROFESSIONAL STANDARDS

42,000

Number of colleagues achieving the Foundation Standard for Professional Bankers in 2014

COLLEAGUE ENGAGEMENT SURVEY

85%

Percentage taking part in colleague survey

Relationships and responsibility continued
Doing business responsibly

For us, 'best bank' means doing business honestly and ethically, in ways that benefit our customers, colleagues, communities, other stakeholders and the environment.

COMMUNITY

Through our high street brands, we're an integral part of communities across Britain. We believe we can make our greatest contribution to society by helping Britain's communities to prosper.

Community investment highlights

- £16.5 million donated to the Lloyds Bank and Bank of Scotland Foundations;
- £6.5 million raised since 2013 for our Charity of the year, the Alzheimer's Society and Alzheimer Scotland against our £4 million target;
- 1,632 grants to community groups through our Community Fund;
- 37,847 colleagues volunteered through our Day to Make a Difference programme;
- 4.83 million local people brought together through The Big Lunch, of which Halifax is a partner;
- 2,607 nominations for the Halifax Giving Extra Awards;
- 881 people trained through Money for Life, bringing the total to 2,035 since 2009;
- 120 young people joined our Lloyds Scholars programme;
- 297 social entrepreneurs supported through our Social Entrepreneurs programme; and
- The equivalent of 18 full time colleagues working as Business Connectors helping local businesses, bringing the total to 42 since 2012.

Children in Need

Our new Charity of the Year partnership for 2015 and 2016 is with BBC Children in Need, who share the same goal as the Group in supporting communities across the UK. Our 2015 colleague fundraising target is £2 million.

COLLEAGUES

Our colleagues are at the heart of our business and are critical in ensuring we become the best bank for customers.

Diversity and inclusion

We want our Group to be a genuinely inclusive place to work, with every colleague treated fairly, with dignity and respect. We've made public commitments and set bold targets on diversity and inclusion in our Helping Britain Prosper Plan. These include commitments to: increase the proportion of senior management roles held by women; retain our Gold Standard as a disability-confident organisation; and increase the engagement scores of ethnic minority colleagues, disabled colleagues and lesbian, gay, bisexual and transgender colleagues, measured via our Colleague Survey. We plan to make more diversity and inclusion pledges in the future, as we work to build a culture in which all colleagues can be themselves at work and progress solely on the basis of merit.

We always aim to appoint the best person available into any role, but also to attract talented people from diverse backgrounds and to be unbiased in the way we assess, select, appoint and promote them. We encourage job applications from those with a disability and run a work experience programme with Remploy to support people with disabilities wanting to enter the workplace. We offer a range of programmes to support disabled colleagues including the workplace adjustment programme, which provides physical and non-physical adjustments to support colleagues in their roles. Since 2002, 1,300 colleagues have participated in and benefited from our positive action career development and training programmes for disabled colleagues.

		2014 Number	2013 (Restated) Number
Board members	Male	**10**	8
	Female	**3**	3
Senior managers[1]	Male	**5,644**	6,138
	Female	**2,204**	2,353
Colleagues[1]	Male	**35,255**	39,955
	Female	**47,728**	56,167

[1]Colleague scope of reporting: UK payroll headcount includes established and fixed term contract colleagues. Excludes parental leavers, Non-Executive Directors, contractors, temp, agency and internationals.

	2014 %	2013 (Restated) %
Gender:		
Percentage of colleagues who are female[2]	**58.6%**	58.7%
Female managers[2]	**45.4%**	45.1%
Female senior managers[2]	**29.3%**	28.5%
Disability:		
Percentage of colleagues who disclose they have a disability	**1.3%**	1.4%
Ethnic background:		
Percentage of colleagues from an ethnic minority	**6.8%**	6.4%
Ethnic minority managers	**6.2%**	5.8%
Ethnic minority senior managers	**3.5%**	2.9%
Sexual orientation:		
Percentage of colleagues who disclose they are lesbian, gay, bisexual or transgender	**0.6%**	0.8%

[2]Diversity scope of reporting: UK payroll headcount includes established and fixed term contract colleagues and parental leavers. Excludes Non-Executive Directors, contractors, temp, agency, internationals, TSB, SWIP and Sainsbury's.

Seniors managers: Grades F+

Mangers: Grade D-E

Data source: HR system (HRIS). Apart from gender data, all diversity information is based on colleagues' voluntary self-declaration. As a result this data is not 100 per cent representative; our systems do not record any diversity data for the proportion of colleagues who have not declared this information.

Learning and development

We can only become the best bank for customers if all colleagues are capable of carrying out their roles to the best of their ability. Throughout 2014, we promoted the learning and development opportunities currently available to colleagues by running a series of coordinated campaigns, including road shows at Group locations across the UK, National Learning at Work Week and National Customer Service Week. Increasing digitisation is reflected through our colleagues having access to training in a range of media – how, when and where they need it.

Read more about these issues online at www.lloydsbankinggroup.com/RB

STAKEHOLDERS

We have an active stakeholder engagement plan to ensure, through two-way dialogue, we listen to, and understand our stakeholders' requirements.

Investors and rating agencies

We undertook more than 1,000 meetings with investors in 2014. We regularly engage SRI/ESG investors as well as investment analysts to provide them with information on our performance, strategic plans and how we do business responsibly. In 2014 we held our first responsible business webinar with investors and analysts.

Suppliers

We want to work together with our suppliers and others in our supply chain to ensure we source goods and services in ways that are responsible, sustainable, mutually beneficial and provide best value for our customers and shareholders.

In 2014 we achieved a number of key milestones in our Sourcing Plan, including the launch of our Code of Supplier Responsibility which sets out the minimum standards we expect from all suppliers. These standards are based on the social, ethical and environmental principles that we believe a responsible business should demonstrate. We also introduced our Group-wide Supplier Qualification system, which will help us standardise and manage requests for compliance and assurance data.

Government

We're working directly with the UK government, members of Parliament and other stakeholders to improve ethical and quality standards in the banking industry. To help rebuild trust in banking, we must do, and be seen to be doing, the right thing – helping Britain prosper through our business activities in line with our strategy to become the best bank for customers.

ENVIRONMENT

Our ability to help Britain prosper is inextricably linked to wider environmental issues. Man made climate change and global trends such as resource scarcity, extreme weather and rising energy and commodity prices have an impact on our stakeholders and our own operations.

We recognise the global challenge posed by these wider issues, and our responsibility to reduce the environmental impacts of our business operations. We are committed to managing our direct environmental impacts in a responsible manner and reducing our greenhouse gas emissions. We do this through our Environmental Action Plan, through which we aim to maximise the opportunity to create business value and minimise business risk in relation to our direct environmental impact.

Our approach towards managing our environmental impact is set out in our Environmental Statement, available online.

Greenhouse gas emissions

We have voluntarily reported on our greenhouse gas emissions and environmental performance in our annual Responsible Business Report and Annual Report and Accounts since 2009, but since 2013 we have reported emissions in line with the requirements of the Companies Act 2006. Measuring emissions over time has enabled us to make appropriate investment in targeted reduction activities.

– CO_2e emissions (tonnes)

We report our emissions in terms of CO_2 equivalent tonnes (CO_2e). This year our overall carbon emissions have decreased by 2.2 per cent year-on-year and by 20.9 per cent against our 2009 baseline. The majority of this reduction is attributable to the reduction in consumption of gas and electricity, which constitute the largest proportion of our emissions. This reduction is mainly due to energy management activity, for example continued optimisation of building management systems to ensure that heating and ventilation plant and lighting run times are matched to actual building occupancy times, and investment in 2014 of around £3.8 million in specific energy efficiency measures, such as boiler controls, new lighting and building management upgrades.

The only area where we've seen an increase in CO_2e related to consumption, relates to oil. The main reason is due to the new Horizon data centre becoming operational in the past year and receiving several deliveries of new oil.

CO_2e emissions (tonnes)

	Oct 13-Sep 14	Oct 12-Sep 13
Total CO_2e emissions	**440,835**	450,723
Scope 1 emissions	**54,169**	65,186
Scope 2 emissions	**263,129**	259,253
Scope 3 emissions	**123,537**	126,284

Restated 2012/2013 emissions data to reflect improved reporting processes, using actual data to replace estimations.

All data has been calculated to remove the impact of divestment activity in 2014, both from the current reporting year emissions and prior years.

Emissions in tonnes CO_2e in line with a recognised carbon accounting standard.

A definition of Scope 1,2,3 emissions is provided in the Lloyds Banking Group criteria statement available online at www.lloydsbankinggroup.com

Scope 1 emissions include combustion of fuel and operation of facilities.

Scope 2 emissions have increased despite a reduction in electricity consumption due to a significant increase of global-warming potential of the UK grid mix.

– Methodology

We follow the principles of the Greenhouse Gas (GHG) Protocol Corporate Standard to calculate our Scope 1, 2 and 3 emissions from our worldwide operations.

The reporting period for emissions is October 2013 to September 2014, which is different to that of our Director's Report (January 2014 – December 2014). This is in line with Regulations in that the majority of the emissions reporting year falls within the period of the Directors' Report.

We report emissions based on an operational boundary. The scope of our reporting is in line with GHG Protocol and covers Scope 1, Scope 2 and Scope 3 emissions. Reported Scope 1 emissions cover emissions generated from gas and oil used in Group buildings, emissions from UK company-owned vehicles used for business travel and emissions from the use of air conditioning and chiller/refrigerant plant. Reported Scope 2 emissions cover emissions generated from the use of electricity. Reported Scope 3 emissions relate to business travel undertaken by colleagues and emissions associated with the extraction and distribution of each of our energy sources – electricity, gas and oil. A detailed definition of these emissions can be found in our environmental criteria statement online.

– Intensity ratio

An intensity ratio of GHG gases per £m of underlying income has been selected.

	Oct 13-Sep 14	Oct 12-Sep 13
GHG emissions per unit income	**24.0**	24.9

– Verification

We have retained the services of PricewaterhouseCoopers LLP (PwC) to provide an independent and robust assessment of the Group's Scope 1, 2 and 3 emissions. PwC's limited assurance report is available online.

– Omissions

Emissions associated with joint ventures and investments are not included in the emissions disclosure as they fall outside the scope of our operational boundary. We do not have any emissions associated with heat, steam or cooling. We are not aware of any other material sources of omissions from our emissions reporting.

ENERGY EFFICIENCY

13.1% reduction in energy use compared to 2013

£3.8m invested in energy saving technology in 2014

Risk overview

Effective risk management, governance and control

Managing risk effectively is important for any bank and is fundamental to our strategy. We are now a low cost, low risk, UK focused retail and commercial bank. This has been achieved by maintaining a conservative business model which embodies a risk culture founded on a prudent appetite for risk.

Our approach to risk is founded on an effective control framework and a strong risk management culture which guides how our employees approach their work, the way they behave and the decisions they make. The amount and type of risk that we are prepared to seek, accept or tolerate, otherwise known as risk appetite, works in tandem with our strategy and is approved by the Board. Our risk appetite is then embedded within policies, authorities and limits across the Group.

RISK AS A STRATEGIC DIFFERENTIATOR

The Group strategy and risk appetite were developed together to ensure one informed the other in creating a strategy that delivers on becoming the best bank for our customers whilst helping Britain prosper and creating sustainable growth over time.

Risks are identified, managed and mitigated using our Risk Management Framework (see page 31). The principal risks we face, which could significantly impact the delivery of our strategy, are discussed on pages 32 and 33.

We believe effective risk management can be a strategic differentiator, in particular:

Sustainable growth

The role of risk is to provide proactive support and constructive challenge to the business to deliver sustainable growth, which is achieved through informed risk decision making and superior risk and capital management, supported by a consistent risk-focused culture across the Group.

- **Conservative approach to risk**
  We have a fully embedded conservative approach to, and prudent appetite for, risk with risk culture and appetite driven from the top.
- **Strong control framework**
  This framework is the foundation for the delivery of effective risk management and ensures that the business units operate within approved parameters.
- **Effective risk analysis, management and reporting**
  This identifies opportunities as well as risks and ensures risks are managed appropriately and consistent with strategy. Our principal risks and performance against risk appetite are monitored and reported regularly to senior management using quantitative and qualitative analysis and are subject to relevant stress testing. This enables us to understand the risk in the business at both an individual risk type and aggregate portfolio level.
- **Business focus and accountability**
  Managing risk effectively is a key focus and is one of the five criteria within the Group Balanced Scorecard on which business areas and individual performance are judged. Our approach to risk means that businesses remain accountable for risk but a strong and independent risk function also helps ensure adherence to the Group's risk and control frameworks. Continued investment in risk systems and processes help differentiate our risk management approach.

ACHIEVEMENTS IN 2014

The Group strategy laid out in 2011 is now substantially complete. We have reshaped the Group, strengthened the balance sheet and delivered Simplification savings which have enabled reinvestment for growth. The independent Risk Division has played a pivotal role in supporting delivery which includes:

Conduct

Initiatives spanning the entire Group support the conduct agenda from strategy, insight, product, processes, through to sales and service to drive consistently good customer outcomes. Risk Division has played a key role in shaping this strategy and determining conduct risk measures to monitor performance and continue to support the journey to be market leading in complaint management through robust root cause analysis and remediation.

Capital strength

During the year, our common equity tier 1 (CET1) capital position has continued to build to 12.8 per cent, increasing by 2.5 per cent in the year, in line with our capital generative strategy. The Group's EBA and PRA stress testing exercises exceeded the relevant thresholds and the PRA confirmed no requirement to submit a revised capital plan or undertake additional management actions.

Impairment

Through effective risk management our impairment charge improved by 60 per cent to £1,200 million, mainly driven by the reduction in Run-off assets and the sustained improvement in asset quality across the Group.

Operational agility

Risk Division has continued to invest via the Risk Transformation Programme, driving improvements in supporting systems, simplified processes, improved customer experience and improved credit decision engines in order to deliver the most efficient and effective returns for the Group, underpinning the Group's targeted objective of sustainable growth.

State aid commitments

Risk Division continued to support the Group's divestment of TSB, with the Group selling 35 per cent of ordinary shares by way of an Initial Public Offering in June 2014, 3.5 per cent through utilisation of an over allotment option in July 2014 and a further 11.5 per cent of the ordinary shares by way of an Institutional Placing in September 2014, remaining on course to complete the divestment by the end of 2015.

RISK PRIORITIES FOR 2015

- **Enabling and delivering sustainable growth**
  Helping the business make the right decisions through proactive support and constructive challenge to the business areas whilst delivering the right risk and customer outcomes.
- **Creating the best customer experience**
  Putting our customers at the heart of our decisions throughout the Group through continued embedding of the conduct strategy and cultural change.
- **Becoming simpler and more efficient**
  Responding quickly to changing customer, business and regulatory needs.

RISK GOVERNANCE

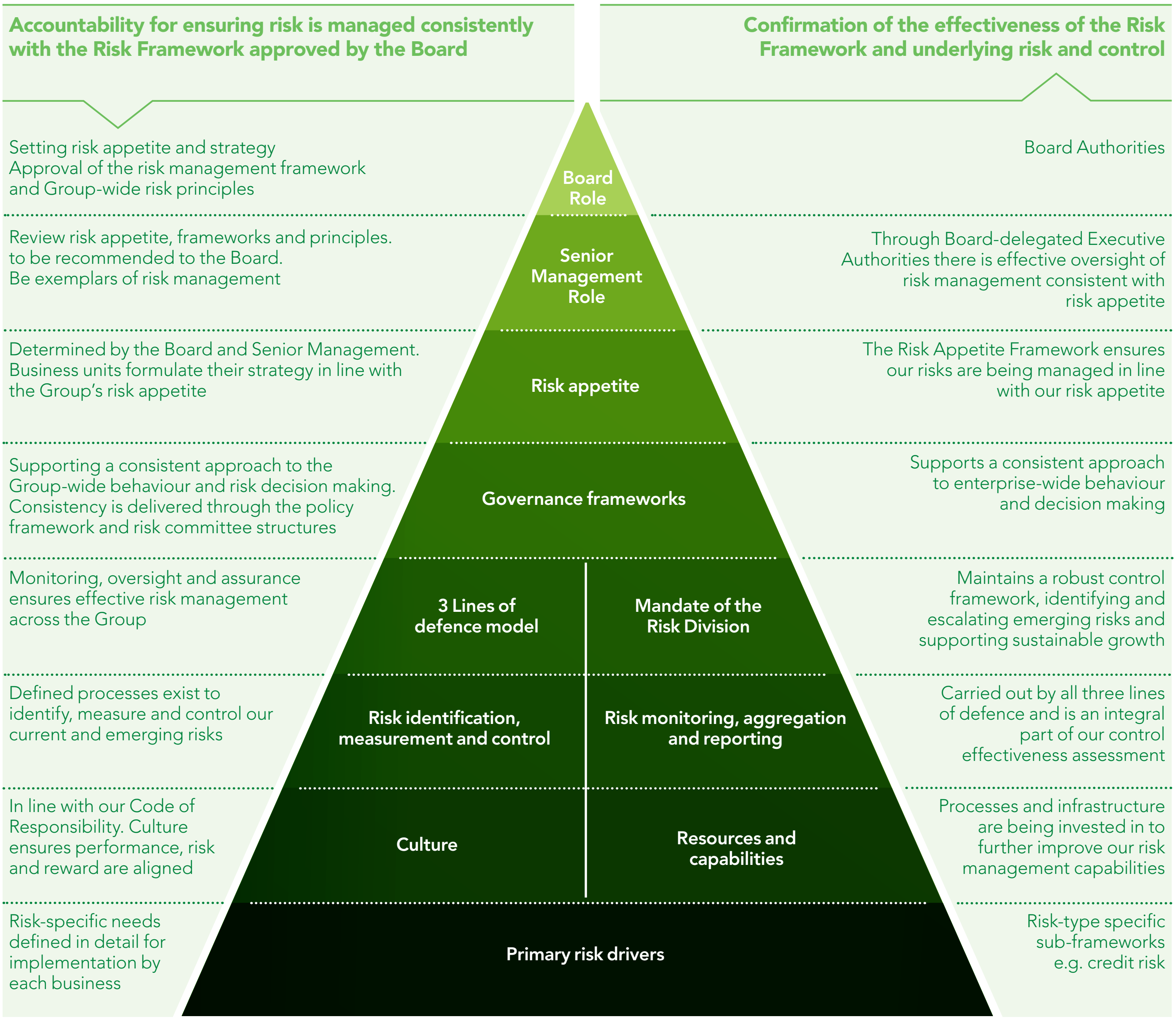
Risk management strategy and risk appetite are developed and reviewed in tandem with Group strategy. The Group uses an enterprise-wide risk management framework to ensure a robust and consistent approach to risk management is applied across all business areas and all risk types in order to drive improvements in its risk profile in line with risk appetite.

The framework articulates individual and collective accountabilities for risk management, risk oversight and risk assurance and supports the discharge of responsibilities to customers, shareholders and regulators. It establishes a common risk language which assigns risks to which the Group is exposed, to categories which are used consistently to support risk aggregation and reporting. The frameworks will evolve and be periodically updated to reflect any changes in the nature of our business and the external environment.

The framework outlines the key risk management activities undertaken consistently across the Group for all types of risk.

Governance is maintained through delegation of authority from the Board, down through the management hierarchy to individuals, and is supported by a committee based structure designed to ensure that our risk appetite, policies, procedures, controls and reporting are fully in line with regulations, law, corporate governance and industry best practice.

Our approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions. Board-level engagement, coupled with the direct involvement of senior management in Group-wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated where required. The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management. A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management. Performance is optimised by allowing business units to operate within approved parameters.



Risk overview continued

The most significant risks faced by the Group which could impact on the success of delivering against the Group's strategic objectives together with key mitigating actions are outlined below.

PRINCIPAL RISKS	KEY MITIGATING ACTIONS
Credit risk Any adverse changes in the economic and market environment we operate in, or the credit quality and/or behaviour of our borrowers and counterparties would reduce the value of our assets and potentially increase our write-downs and allowances for impairment losses, adversely impacting profitability.	– Credit policy incorporating prudent lending criteria aligned with the Board approved risk appetite to effectively manage credit risk. – Clearly defined levels of authority ensure we lend appropriately and responsibly with separation of origination and sanctioning activities. – Robust credit processes and controls including well-established governance to ensure distressed and impaired loans are identified, considered and controlled with independent credit risk assurance.
Conduct risk We face significant potential conduct risk, including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; and exhibiting behaviours which do not meet market or regulatory standards.	– Customer focused conduct strategy implemented to ensure customers are at the heart of everything we do. – Product approval, review processes and outcome testing supported by conduct management information. – Clear customer accountabilities for colleagues, with rewards driven off customer-centric metrics. – Learning from past mistakes, including root cause analysis.
Market risk Key market risks include interest rate risk across the Banking and Insurance businesses. However, our most significant market risk is from the Defined Benefit Pension Schemes (DBPS) where asset and liability movements impact on our capital position.	– A structural hedge programme has been implemented to manage liability margins and margin compression. – Board approved pensions risk appetite covering interest rate, credit spreads and equity risks. Credit assets are being purchased and equity holdings reduced in the pension schemes. – Stress and scenario testing of risk exposures.
Operational risk We face significant operational risks which may result in financial loss, disruption or damage to the reputation of the Group. These include the availability, resilience and security of our core IT systems and the potential for failings in our customer processes.	– Continually review IT system architecture to ensure that our systems are resilient and that the confidentiality, integrity and availability of our critical systems and information assets are protected against cyber attacks. – Continue to implement the actions from the 2013 independent IT Resilience Review to enhance the resilience of systems supporting the processes most critical to our customers.
Funding and liquidity risk Our funding and liquidity position is supported by a significant and stable customer deposit base. A deterioration in either our or the UK's credit rating, or a sudden and significant withdrawal of customer deposits would adversely impact our funding and liquidity position.	– At 31 December 2014 the Group had £109.3 billion of unencumbered primary liquid assets and the Group maintains a further large pool of secondary assets that can be used to access Central Bank liquidity facilities. – Daily monitoring against a number of market and Group specific early warning indicators and regular stress tests. – Contingency funding plan to identify liquidity concerns earlier.
Capital risk Our future capital position is potentially at risk from a worsening macroeconomic environment. This could lead to adverse financial performance for the Group, which could deplete capital resources and/or increase capital requirements due to a deterioration in customers' creditworthiness.	– Close monitoring of capital and leverage ratios to ensure we meet our current and future regulatory requirements. – Comprehensive stress testing analysis to evidence sufficient levels of capital adequacy for the Group under various adverse scenarios. – In addition to accumulating retained profits we can raise additional capital in a variety of ways.
Regulatory risk We are subject to industry wide investigations and reviews into a perceived lack of competition in UK banking and financial services. The outcomes of the UK General Election in May 2015 and the investigations by the CMA and FCA are presently unclear and their impact therefore remains uncertain. Other initiatives under review include the ring-fencing proposals in the Banking Reform Act 2013, the new FCA Consumer Credit regime and CRD IV.	– The Legal, Regulatory and Mandatory Change Committee ensures we develop plans for regulatory changes and tracks their progress. – Continued investment in our people, processes and IT systems is enabling us to meet our regulatory commitments. – Continued engagement with government and regulatory authorities on forthcoming regulatory changes and market investigations and reviews.
People risk Key people risks include the risk that the Group fails to lead responsibly in an increasing competitive marketplace, particularly with the introduction of the Senior Managers' Regime and Certification Regime which will come into force in 2015. This may dissuade capable individuals from taking up senior positions within our Group.	– Work collaboratively with regulators to implement the new Individual Accountability Regime in 2015, ensuring burden of proof and attestation requirements are effectively implemented. – Maintain competitive working practices to attract, retain and engage high quality people. – Create a work environment which listens and acts on colleague feedback, making the Group the best bank for colleagues.

KEY RISK INDICATORS | Commentary | FUTURE FOCUS

IMPAIRMENT CHARGE

2014	£1.2bn
2013	£3bn

ASSET QUALITY RATIO[1]

2014	0.24%
2013	0.57%

[1]This key risk indicator is also a key performance indicator (KPI).

Commentary: The material reduction reflects lower levels of new impairment as a result of effective risk management, improving economic conditions and the continued low interest rate environment, together with Run-off asset reductions.

Future focus:
- Continue to support the UK economy through appropriate lending to Retail and Commercial customers including first-time buyers and SMEs, without compromising on risk appetite.

Read more on page 116

BANKING COMPLAINTS PER 1,000 ACCOUNTS[1] (EXCL. PPI)

2014	1.5
2013	1.0

[1]This key risk indicator is also a key performance indicator (KPI).

Commentary: FCA reportable banking complaints increased during the year due to legacy and historic issues, with the increase largely driven by increased activity from claims management companies.

Future focus:
- Continued reduction in complaint levels through root-cause analysis and improvements in complaints handling.

Read more on page 136

PENSION (DEFICIT)/SURPLUS

2014	SURPLUS £890m
2013	DEFICIT £787m

Commentary: The DBPS are in a surplus of £890 million at 2014 which is an improvement from a £787 million deficit in 2013. Volatility has been reduced due to interest rate and inflation hedging and equity sales.

Future focus:
- Continue to effectively manage the DBPS to secure pensions provision to members and minimise Group impact.

Read more on page 138

AVAILABILITY OF CORE SYSTEMS

2014	99.96%
2013	99.94%

Commentary: IT service availability improved on 2013 with 99.96 per cent availability across our key IT systems. We continue to invest in improving the resilience of our systems to avoid outages and minimise any customer impact.

Future focus:
- Ongoing investment in IT resilience.
- Risk appetite monitoring for critical business processes.

Read more on page 144

PRIMARY LIQUIDITY/<1yr WHOLESALE FUNDING

2014	2.7
2013	2.0

LOAN TO DEPOSIT RATIO[1]

2014	107%
2013	113%

[1]This key risk indicator is also a key performance indicator (KPI).

Commentary: Primary and secondary liquidity assets provide a substantial buffer in the event of an extended market dislocation.

Future focus:
- Continue to meet all current regulatory ratios and ensure we meet all future regulatory ratios.

Read more on page 146

CET1 RATIO[1]

2014	12.8%
2013	10.3%

LEVERAGE RATIO

2014	4.9%
2013	3.8%

[1]This key risk indicator is also a key performance indicator (KPI).

Commentary: Further progress has been made in improving our capital position through a strongly capital generative strategy, including Run-off and disposal of assets, and the issuance of new additional tier 1 and tier 2 securities in April and November 2014 respectively.

Future focus:
- Continue to meet current and future regulatory requirements, whilst optimising value for shareholders.
- We expect to generate between 1.5 per cent and 2.0 per cent of CET1 per annum (pre-dividend).

Read more on page 153

LEGAL, REGULATORY AND MANDATORY INVESTMENT SPEND

2014	£406m
2013	£402m

Commentary: We continue to build constructive relationships with our regulators in order to effectively manage the regulatory change agenda.

Future focus:
- Ongoing constructive engagement with regulators.
- Continued compliance with the regulatory change agenda.

Read more on page 166

BEST BANK FOR CUSTOMERS[2]

2014	72% Favourable

[2]New measure for 2014. No comparison data available for 2013.

Commentary: As part of our Colleague Engagement Survey, the Best Bank for Customers index is designed to help the Group understand the colleague views on progress we are making towards becoming the best bank for customers.

Future focus:
- Continued action to further strengthen performance to become the best bank for customers.

Read more on page 168

FINANCIAL RESULTS

Summary of Group results

Overview: strong underlying profitability and balance sheet

The Group's underlying profit increased by 26 per cent in the year to £7,756 million, with a 2 per cent fall in income more than offset by a 2 per cent reduction in costs and a 60 per cent improvement in impairments. Excluding the effects of St. James's Place, which benefited the 2013 results, total underlying income was up 1 per cent, and expenses were down 2 per cent with underlying profit up 40 per cent.

Statutory profit before tax in 2014 was £1,762 million (2013: £415 million) after provisions for PPI of £2,200 million (2013: £3,050 million) and other regulatory matters of £925 million (2013: £405 million), liability management losses of £1,386 million (2013: £142 million), Simplification and TSB build and dual running costs of £1,524 million (2013: £1,517 million) and a pension credit of £710 million (2013: charge £104 million). The statutory profit after tax in 2014 was £1,499 million compared to a loss after tax of £802 million in 2013. In the 2014 half year results news release we stated that we expected the full year statutory profit to be significantly ahead of the first half. Statutory profit before tax in the year was £1,762 million compared with £863 million in the first half.

Total loans and advances to customers were £477.6 billion at 31 December 2014, 3 per cent lower than at 31 December 2013, with growth in the key customer segments of mortgages, SME lending, Mid Markets and UK Consumer Finance offset by reductions in balances in the Run-off portfolio and lending to Global Corporate customers. Customer deposits were £447.1 billion at 31 December 2014, an increase of £10.6 billion, or 2 per cent, since 31 December 2013 with growth of relationship deposits, partly offset by a reduction in tactical brands.

The Group's risk-weighted assets have fallen by 12 per cent to £239.7 billion reflecting the reduction in Run-off assets, active portfolio management in Commercial Banking, and the improving economic conditions.

The Group's liquidity position continues to improve with increased primary liquidity up £20.0 billion to £109.3 billion. In addition the Group has a further £99.2 billion of secondary liquid assets a proportion of which are expected to be eligible for the Liquidity Coverage Ratio (LCR). Based on the Group's current understanding of the LCR standards due to be implemented in October 2015, the Group believes that it met the upcoming requirements as at 31 December 2014.

The combination of strong underlying profitability and continued reduction in risk-weighted assets resulted in a further improvement in the Group's common equity tier 1 ratio to 12.8 per cent at 31 December 2014 after the 0.2 per cent impact of the recommended dividend (31 December 2013: 10.3 per cent pro forma) and the leverage ratio to 4.9 per cent post dividend (31 December 2013: 3.8 per cent pro forma). The increase in the leverage ratio also reflects the issue of additional tier 1 securities (AT1) in the second quarter.

Total income

	2014 £ million	2013 £ million	Change %
Net interest income	**11,761**	10,884	8
Banking fees and commissions	**2,775**	2,987	(7)
Insurance income	**1,944**	2,234	(13)
Operating lease and other income	**1,437**	1,434	–
Run-off	**451**	604	(25)
Other income	**6,607**	7,259	(9)
Total underlying income	**18,368**	18,143	1
St. James's Place	**–**	662	
Total income	**18,368**	18,805	(2)
Banking net interest margin	**2.45%**	2.12%	33bp
Banking net interest margin excluding TSB	**2.40%**	2.10%	30bp
Average interest-earning banking assets	**£483.7bn**	£510.9bn	(5)
Average interest-earning banking assets excluding TSB	**£461.1bn**	£486.7bn	(5)

Total income of £18,368 million was 2 per cent lower than in 2013, with strong growth in net interest income offset by lower other income. Adjusting for St. James's Place effects, total underlying income increased by 1 per cent.

Net interest income increased 8 per cent to £11,761 million, reflecting the continued improvement in net interest margin and loan growth in our key customer segments, partly offset by the effect of disposals and the reduced Run-off portfolio. Net interest margin increased to 2.45 per cent, up 33 basis points, benefiting from improved deposit pricing and lower funding costs (including approximately 7 basis points from the Enhanced Capital Notes (ECNs) exchange in the first half), partly offset by continued pressure on asset prices. The net interest margin in the fourth quarter was 2.47 per cent, 4 basis points lower than in the previous quarter as a result of a one-off charge to net interest income following the decision to simplify the range of savings products available to customers.

The Group expects the net interest margin for the 2015 full year will be around 2.55 per cent.

Excluding St. James's Place effects, other income in the year was 9 per cent lower at £6,607 million. The reduction was due to lower insurance income which was affected by changes in the pensions and annuities markets, the continued challenging market conditions experienced by the Debt Capital Markets and Financial Markets businesses and lower valuations in the private equity business within Commercial Banking, and the impact of business disposals and the smaller Run-off portfolio. The Group expects other income will be broadly stable in 2015 compared with 2014.

Summary of Group results continued

Total costs

	2014 £ million	2013 £ million	Change %
Total costs	**9,412**	9,635	2
Operating lease depreciation included in costs	**720**	746	3
Cost:income ratio[1]	**51.2%**	52.9%	(1.7)pp
Underlying cost:income ratio[2]	**49.8%**	49.8%	–
Simplification savings annual run-rate	**2,042**	1,457	40

[1] Excluding income of £662 million and costs of £44 million relating to St. James's Place in 2013.

[2] Excluding St. James's Place, operating lease depreciation deducted from income and costs and excluding TSB running costs.

Total costs of £9,412 million were 2 per cent lower than in 2013. The reduction was driven by incremental savings from the Simplification programme of £449 million and business disposals of £392 million, partly offset by pay and inflation of £116 million, and increased investment in the business. Total costs excluding TSB running costs in the year were £9,042 million (2013: £9,072 million). Costs in the fourth quarter included the Bank levy of £254 million (2013: £238 million).

The Simplification programme which began in 2011 is now delivering annual run-rate savings of £2 billion, meeting the increased target announced with the 2013 results. In October the Group announced the next phase of the programme and is targeting a cost:income ratio excluding TSB and adjusting for operating lease depreciation of around 45 per cent by the end of 2017 with annual improvements in the ratio in the intervening years.

Impairment

	2014 £ million	2013 £ million	Change %
Impairment charge excluding Run-off	**997**	1,615	38
Run-off impairment charge	**203**	1,389	85
Total impairment charge	**1,200**	3,004	60
Asset quality ratio	**0.24%**	0.57%	(33)bp
Impaired loans as a % of closing advances	**2.9%**	6.3%	(3.4)pp
Provisions as a % of impaired loans	**56.4%**	50.1%	6.3pp

The impairment charge was £1,200 million, 60 per cent lower than in 2013 as a result of a significant reduction in run-off business and improvements in all divisions. The improvement reflects lower levels of new impairment as a result of effective risk management, improving economic conditions and the continued low interest rate environment. The net charge has also benefited from significant provision releases but at lower levels than seen in 2013. The asset quality ratio in 2014 was 24 basis points. The impairment charge and asset quality ratio in the fourth quarter were £183 million and 15 basis points, respectively.

The Group expects the asset quality ratio for the 2015 full year will be around 30 basis points.

Impaired loans as a percentage of closing advances reduced from 6.3 per cent at the end of December 2013 to 2.9 per cent at the end of December 2014, driven by reductions within both the continuing and the Run-off portfolios. Provisions as a percentage of impaired loans increased from 50.1 per cent to 56.4 per cent.

Statutory profit

Statutory profit before tax was £1,762 million compared to a pre-tax profit of £415 million in 2013. Further information on the reconciliation of underlying to statutory results is included on page 206.

	2014 £ million	2013 £ million
Underlying profit	**7,756**	6,166
Asset sales and other items:		
Asset sales	138	(687)
Sale of government securities	–	787
Liability management	(1,386)	(142)
Own debt volatility	398	(221)
Other volatile items	(112)	(457)
Volatility arising in insurance businesses	(228)	668
Fair value unwind	(529)	(228)
	(1,719)	(280)
Simplification and TSB costs:		
Simplification costs	(966)	(830)
TSB build and dual running costs	(558)	(687)
	(1,524)	(1,517)
Payment Protection Insurance provision	(2,200)	(3,050)
Other regulatory provisions	(925)	(405)
Other items:		
Past service pensions credit (charge)	710	(104)
Amortisation of purchased intangibles	(336)	(395)
	374	(499)
Profit before tax – statutory	**1,762**	415
Taxation	(263)	(1,217)
Profit/(loss) for the year	**1,499**	(802)
Underlying earnings per share	8.1p	6.6p
Earnings per share	1.7p	(1.2)p

Asset sales and other items

The net gain from asset sales of £138 million included a gain of £122 million from the sale of Scottish Widows Investment Partnership. In 2013 there was a net loss from asset sales of £687 million and a £787 million gain on the sale of government securities.

The loss for liability management in 2014 of £1,386 million largely related to the Group's ECN exchange offers completed in the second quarter. This was partly offset by the credit from own debt volatility of £398 million which mainly reflected the change in value of the equity conversion feature of the ECNs.

There was a charge for other volatile items of £112 million (2013: charge of £457 million) relating to the change in fair value of interest rate derivatives and foreign exchange hedges in the banking book not mitigated through hedge accounting.

Negative volatility arising in insurance businesses was £228 million in 2014, principally reflecting lower than expected returns on equity markets and cash investments. This compared to positive insurance volatility of £668 million in 2013 driven by strong equity market performance.

The fair value unwind was a net charge of £529 million compared with a net charge of £228 million in 2013. The charge largely related to the amortisation of fair value adjustments relating to the subordinated debt acquired as part of the HBOS acquisition in 2009.

Simplification and TSB costs

Total Simplification costs in 2014 were £966 million (2013: £830 million). The total spent on Simplification to the end of December 2014 was £2.4 billion with a further £0.2 billion of redundancy costs in 2014 relating to the acceleration of the next phase of the programme. The original programme has delivered annual run-rate savings of £2.0 billion, meeting the increased target announced with the 2013 results. In the next phase of Simplification the Group is targeting a further £1 billion of annual run-rate savings by the end of 2017.

The Group holds 50 per cent of TSB's ordinary shares. TSB build and dual running costs in the year were £232 million and £326 million, respectively. In 2013 TSB build costs were £687 million.

Summary of Group results continued

PPI

The Group increased the provision for expected PPI costs by a further £700 million in the fourth quarter. This brings the amount provided in 2014 to £2,200 million (2013: £3,050 million), and the total amount provided to £12,025 million. Total costs incurred in the fourth quarter were £700 million and as at 31 December 2014, £2,549 million or 21 per cent of the total provision, remained unutilised.

The volume of reactive PPI complaints in 2014 fell by 22 per cent compared with 2013 and by 12 per cent in the fourth quarter. During 2014 there has been a more sustained level of Claims Management Company (CMC) activity and as a result the Group is forecasting a slower decline in future volumes than previously expected. The provision remaining at 31 December 2014 assumes that we will receive a further 0.6 million complaints. This revised forecast of complaint volumes accounts for £1,080 million, approximately half of the additional provision taken in the year and of which £300 million in the fourth quarter. However, the provision remains sensitive to future trends; as an example, were reactive complaint levels in the first two quarters of 2015 to remain broadly in line with the fourth quarter of 2014 then the revised modelled total complaints and associated administration costs would increase the provision by approximately £700 million.

The Group has mailed the original Past Business Review (PBR) scope of 2.7 million policies as at 31 December 2014. During the year response rates to mailings have been slightly higher than expected, and some limited additional mailing has been added to the scope. This covers £300 million of the provision increase in the year and £45 million in the fourth quarter.

The Group has now commenced re-reviewing previously handled cases. During the course of the year the scope of remediation has increased, which combined with higher uphold rates following complaint handling policy changes, has resulted in an additional provision being required of £250 million for the year, of which £140 million was in the fourth quarter.

The Group has also revised its forecast for uphold rates and average redress and increased its estimate for the associated administrative expenses connected with the above which combined have resulted in an increase in the provision of £570 million, of which £215 million was in the fourth quarter.

The total amount provided for PPI represents our best estimate of the likely future costs. The run-rate of spend in the first quarter of 2015 is expected to increase as a result of cash payments for remediation and residual PBR responses. The run-rate of spend in the first half of 2015 overall however, is expected to remain broadly in line with the second half of 2014 as remediation spend reduces. These programmes will be largely complete by mid year, and as a result the Group expects a further reduction in cash outflow in the second half of 2015. However, a number of risks and uncertainties remain in particular in respect of complaint volumes, uphold rates, average redress costs, the cost of proactive mailings and remediation, and the outcome of the FCA Enforcement Team investigation. The cost of these factors could differ materially from our estimates, with the risk that a further provision could be required.

Other regulatory provisions

During 2014 the Group has charged £925 million (2013: £405 million) in respect of other regulatory and conduct related matters of which £425 million was charged in the fourth quarter.

In July 2014, the Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rate) with the UK Financial Conduct Authority (FCA), the United States Commodity Futures Trading Commission and the United States Department of Justice regarding the manipulation several years ago of submissions to the British Bankers' Association London Interbank Offered Rate and Sterling Repo Rate between May 2006 and 2009, as well as the associated systems and control failings. In addition to these regulatory settlements, the Group paid nearly £8 million to the Bank of England to compensate for fees that were underpaid as a direct consequence of the manipulation of the Sterling Repo Rate in 2008 and 2009. These costs were recognised in the first half.

Further provisions of £150 million have been made relating to the past sale of interest rate hedging products (IRHPs) to certain small and medium-sized businesses of which £100 million was recognised in the fourth quarter. The further provision brings the total amount provided for redress and related administration costs for customers in scope of the agreement with the FCA to £680 million of which £109 million was unutilised at 31 December 2014.

Other provisions also included £120 million recognised in the fourth quarter given the emerging experience relative to expectations for claims relating to policies issued by Clerical Medical Investment Group Limited in Germany, bringing the total provision to £520 million of which £199 million was unutilised at 31 December 2014.

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints and claims from customers in connection with its past conduct, and where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. In 2014, the Group made further provisions of £430 million in respect of a number of matters affecting the Retail, Commercial Banking and Consumer Finance divisions, including potential claims and remediation in respect of products sold through the branch network and continuing investigation of matters highlighted through industry wide regulatory reviews, as well as legacy product sales and historical systems and controls such as those governing legacy incentive schemes. Of the additional provision, £205 million was recognised in the fourth quarter. The increase reflected the Group's assessment of a limited number of matters under discussion, none of which are individually considered financially material in the context of the Group.

Other items

The Group made a number of changes to its defined benefit pension scheme arrangements in the first half of the year. These changes and other actions resulted in a £710 million net credit which was recognised in the second quarter.

Taxation

The tax charge for the year to 31 December 2014 was £263 million, representing an effective tax rate of 15 per cent.

The effective tax rate was lower than the UK corporation tax rate largely as a result of tax exempt gains on sales of businesses in the first half and a lower deferred tax liability in respect of the value of in-force assets for the life business partially offset by the effect of non-deductible expenses.

The high tax charge in 2013 was driven by the write down of deferred tax assets following the changes in corporation tax rates and the sale of the Australian business.

In December 2014 the Chancellor of the Exchequer announced proposals to restrict to 50 per cent the amount of banks' profits that can be offset by carried forward tax losses for the purposes of calculating corporation tax liabilities. These proposals are expected to be included in the Finance Bill 2015 and, if passed into law, will take effect in respect of profits arising after 1 April 2015. The Group estimates that these proposals will result in no change to the level of deferred tax recognition although it will increase the period over which it expects to fully utilise its tax losses from 2019 to 2025.

Return on required equity

	At 31 Dec 2014	At 31 Dec 2013	Change %
Underlying return on required equity	**13.6%**	9.7%	3.9pp
Statutory return on required equity	**3.0%**	(1.3)%	4.3pp

Underlying return on equity is calculated as the underlying profit after tax at the standard UK corporation tax rate less the post tax profit attributable to other equity holders divided by the average required equity in the year. Required equity is made up of shareholders' equity and non-controlling interests and is the amount required to achieve a common equity tier 1 ratio of 12.0 per cent after allowing for regulatory adjustments and deductions. An adjustment is also made to reflect the notional earnings on any excess or shortfall in equity.

Statutory return on required equity is calculated as the statutory profit after tax less the post tax profit attributable to other equity holders divided by the average required equity in the year. An adjustment is also made to reflect the notional earnings on any excess or shortfall in equity.

Both return measures have improved significantly in the year reflecting the strong growth in underlying profit and the return to statutory profit. The Group has a target statutory return on required equity of between 13.5 per cent and 15 per cent by the end of 2017.

Capital ratios and risk-weighted assets

	At 31 Dec 2014	At 31 Dec 2013	Change
Common equity tier 1 capital ratio[1,3]	**12.8%**	10.3%	2.5pp
Transitional tier 1 capital ratio[1,3]	**16.5%**	11.7%	4.8pp
Transitional total capital ratio[1,3]	**22.0%**	18.8%	3.2pp
Leverage ratio[2,3]	**4.9%**	3.8%	1.1pp
Risk-weighted assets[1,3]	**£240bn**	£272bn	(12)%
Shareholders' equity	**£43bn**	£39bn	11%

[1] Common equity tier 1 ratio is the same on both fully loaded and transitional bases. 31 December 2013 comparatives reflect CRD IV rules as implemented by the PRA at 1 January 2014.

[2] Calculated in accordance with the January 2014 revised Basel III leverage ratio framework.

[3] 31 December 2013 comparatives are reported on a pro forma basis that includes the benefit of the sales of Heidelberger Leben, Scottish Widows Investment Partnership and the Group's 50 per cent stake in Sainsbury's Bank.

The Group continued to strengthen its capital position, with the common equity tier 1 (CET1) ratio increasing to 12.8 per cent (31 December 2013: 10.3 per cent pro forma). The improvement was driven by a combination of underlying profit, further dividends from the Insurance business, changes to and improved valuations of the Group's defined benefit pension arrangements, and a reduction in risk-weighted assets. The positive effect of these items was partly offset by charges relating to legacy issues which reduced the CET1 ratio by 1.5 per cent, the ECN exchange and tender offers which reduced the ratio by 0.5 per cent and the recommended dividend which reduced the ratio by 0.2 per cent.

The regulatory framework in which the Group operates has continued to evolve following the implementation of the Capital Requirements Directive (CRD IV) on 1 January 2014. The Group's Pillar 2A requirement at 31 December 2014 was 3.8 per cent of risk-weighted assets of which 2.1 per cent must be covered by CET1 capital. This reflects a point in time estimate by the PRA, which may change over time, of the total capital that is needed in relation to risks that are not covered or fully covered by Pillar I. The Group is now assuming a steady state CET1 ratio requirement of around 12 per cent.

Risk-weighted assets reduced by 12 per cent, or £32.2 billion, in the year, to £239.7 billion (31 December 2013: £271.9 billion pro forma), primarily due to asset reductions in the Run-off portfolio, active portfolio management in Commercial Banking and improvements in economic conditions.

The Group's leverage ratio increased to 4.9 per cent from 3.8 per cent (pro forma) in December 2013, with the AT1 issuance in the first half, where the Group repurchased the equivalent of £5 billion nominal (£4 billion regulatory value) of ECNs and issued £5.3 billion of new AT1 securities, accounting for 0.5 per cent of the increase.

The Group's leverage ratio exceeds the aggregate minimum levels proposed by the Financial Policy Committee (FPC) which require major domestic banks to meet a minimum ratio of 3 per cent, a supplementary systemic risk based buffer of up to 1.05 per cent (to apply from 2016 for G-SIBs and from 2019 for major domestic banks) and a time-varying countercyclical leverage buffer of up to 0.9 per cent (currently set at zero per cent).

Stress tests

During the year, the Group was subject to stress testing exercises carried out by both the European Banking Authority (EBA) and the PRA. As announced in October and December respectively, the Group exceeded the capital thresholds set for both these tests and was not required to take any action as a result of these exercises.

The remaining issued ECNs were not taken into account for the purpose of core capital for the PRA stress test. A Capital Disqualification Event (CDE) occurred allowing the Group, under certain conditions, to redeem, with the permission of the PRA, any series of ECNs. The Group has also indicated its intention to redeem those series of ECNs listed in the announcement, resulting in a reduction in tier 2 capital resources of £0.5 billion.

Summary of Group results continued

Funding and liquidity

	At 31 Dec 2014	At 31 Dec 2013	Change %
Loans and advances to customers[1]	**£478bn**	£493bn	(3)
Loans and advances to customers excluding TSB, Run-off and other[1]	**£406bn**	£402bn	1
Run-off assets	**£17bn**	£33bn	(49)
Non-retail run-off assets	**£11bn**	£25bn	(57)
Funded assets	**£493bn**	£508bn	(3)
Customer deposits[2]	**£447bn**	£436bn	2
Wholesale funding	**£116bn**	£137bn	(15)
Wholesale funding <1 year maturity	**£41bn**	£44bn	(7)
Of which money-market funding <1 year maturity[3]	**£19bn**	£21bn	(11)
Loan to deposit ratio	**107%**	113%	(6)pp
Primary liquid assets[4]	**£109bn**	£89bn	22

[1] Excludes reverse repos of £5.1 billion (31 December 2013: £0.1 billion). Loans and advances comparative restated, see note 1, page 188.

[2] Excludes repos of £nil (31 December 2013: £3.0 billion). Deposits comparative restated, see note 1, page 188.

[3] Excludes balances relating to margins of £2.8 billion (31 December 2013: £2.3 billion) and settlement accounts of £1.4 billion (31 December 2013: £1.3 billion).

[4] Includes off-balance sheet liquid assets; includes TSB £4.5 billion (31 December 2013: £nil).

The Group increased its net lending in key customer segments by 1 per cent with growth of 2 per cent in mortgages (excluding books closed to new business), growth of 5 per cent and 2 per cent in SME and Mid Markets respectively and 17 per cent in the UK consumer finance business. Overall, loans and advances to customers have fallen by 3 per cent to £477.6 billion as the growth in key segments has been more than offset by a reduction in Run-off loans and advances. The Group reduced total Run-off assets by 49 per cent to £16.9 billion.

The growth in deposits, together with the reduction in total loans and advances, resulted in the loan to deposit ratio improving to 107 per cent from 113 per cent at the end of 2013, and has reduced the Group's wholesale funding requirement. Wholesale funding at 31 December 2014 was £116.5 billion, with 65 per cent having a maturity of greater than one year.

The Group's liquidity position remains strong, with primary liquid assets of £109.3 billion (31 December 2013: £89.3 billion). Primary liquid assets represent almost six times our money-market funding with a maturity of less than one year, and just under three times our total short-term wholesale funding, in turn providing a substantial buffer in the event of market dislocation. In addition to primary liquid assets, the Group has significant secondary liquidity holdings of £99.2 billion (31 December 2013: £105.4 billion). Total liquid assets represent approximately five times our short-term wholesale funding with primary liquid assets broadly equivalent to total wholesale funding.

Based on the Group's current understanding of the LCR standards due to be implemented in October 2015, the Group believes that it met the upcoming requirements as at 31 December 2014.

Dividend

The Board has recommended a dividend of 0.75 pence per ordinary share in respect of 2014, amounting to £535 million. The Group's aim is to have a progressive dividend policy, with dividends starting at a modest level and increasing over the medium term to a dividend payout ratio of at least 50 per cent of sustainable earnings. The intention is to pay an interim and final dividend for 2015, subject to performance.

Conclusion

The Group has delivered a strong underlying performance and a statutory profit after tax of £1.5 billion in 2014 despite recognising further PPI and other regulatory provisions. At the same time, the Group has continued to reduce balance sheet risk, with significantly improved credit quality supported by a further £16 billion reduction in the Run-off portfolio. These achievements have helped strengthen the Group's funding position, key capital and leverage ratios and enabled the Board to recommend a dividend in respect of 2014.

George Culmer
Chief Financial Officer

Underlying basis – segmental analysis

2014	Retail £m	Commercial Banking £m	Consumer Finance £m	Insurance £m	Run-off and Central items £m	TSB[1] £m	Group £m
Net interest income	7,079	2,480	1,290	(131)	257	786	11,761
Other income	1,212	1,956	1,364	1,725	210	140	6,607
Total income	8,291	4,436	2,654	1,594	467	926	18,368
Total costs	(4,464)	(2,147)	(1,429)	(672)	(330)	(370)	(9,412)
Impairment	(599)	(83)	(215)	–	(205)	(98)	(1,200)
Underlying profit (loss)	3,228	2,206	1,010	922	(68)	458	7,756
Banking net interest margin	2.29%	2.67%	6.49%				2.45%
Asset quality ratio	0.19%	0.08%	1.05%				0.24%
Return on risk-weighted assets	4.60%	1.92%	4.87%				3.02%
Return on assets	1.02%	0.94%	4.02%				0.92%
Key balance sheet items at 31 December 2014	£bn	£bn	£bn		£bn	£bn	£bn
Loans and advances to customers	315.2	100.9	20.9		19.0	21.6	477.6
Customer deposits	285.5	119.9	15.0		2.1	24.6	447.1
Total customer balances[2]	600.7	220.8	39.0		21.1	46.2	927.8
Risk-weighted assets	67.7	106.2	20.9		39.7	5.2	239.7

2013[3]	£m	£m	£m	£m	£m	£m	£m
Net interest income	6,500	2,113	1,333	(107)	431	615	10,885
Other income	1,435	2,259	1,359	1,864	840	163	7,920
Total income	7,935	4,372	2,692	1,757	1,271	778	18,805
Total costs	(4,160)	(2,084)	(1,384)	(669)	(775)	(563)	(9,635)
Impairment	(760)	(398)	(343)	–	(1,394)	(109)	(3,004)
Underlying profit (loss)	3,015	1,890	965	1,088	(898)	106	6,166
Banking net interest margin	2.09%	2.21%	6.94%				2.12%
Asset quality ratio	0.24%	0.37%	1.76%				0.57%
Return on risk-weighted assets	3.81%	1.53%	4.51%				2.14%
Return on assets	0.95%	0.77%	3.90%				0.70%
Key balance sheet items at 31 December 2013	£bn	£bn	£bn		£bn	£bn	£bn
Loans and advances to customers	314.3	105.7	19.1		30.3	23.5	492.9
Customer deposits	283.2	108.7	18.7		2.8	23.1	436.5
Total customer balances[2]	597.5	214.4	40.6		33.1	46.6	932.2
Risk-weighted assets[4]	72.9	124.0	20.1		48.5	5.6	271.1

[1] See page 56.

[2] Total customer balances include loans and advances to customers, customer deposit balances and Consumer Finance operating lease assets.

[3] Segment information has been restated to reflect the changes made to the Group's operating structure that came into effect from 1 January 2014. Loans and advances to customers and customer deposits have been restated, see note 1, page 188.

[4] 31 December 2013 comparatives reflect CRD IV rules on a fully loaded basis as implemented by the PRA at 1 January 2014.

Underlying basis

In order to present a more meaningful view of business performance, the results are presented on an underlying basis excluding items that in management's view would distort the comparison of performance between periods. Based on this principle the following items are excluded from underlying profit: the amortisation of purchased intangible assets and the unwind of acquisition-related fair value adjustments; the effects of certain asset sales, the impact of liability management actions and the volatility relating to the Group's own debt and hedging arrangements as well as that arising in the insurance businesses and insurance gross up; Simplification costs, TSB build and dual running costs; payment protection insurance and other regulatory provisions; and certain past service pensions credits or charges in respect of the Group's defined benefit pension arrangements.

Summary of Group results continued

Consolidated income statement – underlying basis

	2014 £ million	2013 £ million	Change %
Net interest income	**11,761**	10,885	8
Other income	**6,607**	7,920	(17)
Total income	**18,368**	18,805	(2)
Total costs	**(9,412)**	(9,635)	2
Impairment	**(1,200)**	(3,004)	60
Underlying profit	**7,756**	6,166	26
Asset sales and other items	**(1,719)**	(280)	
Simplification and TSB costs	**(1,524)**	(1,517)	
Payment Protection Insurance provision	**(2,200)**	(3,050)	
Other regulatory provisions	**(925)**	(405)	
Other items	**374**	(499)	
Profit before tax – statutory	**1,762**	415	
Taxation	**(263)**	(1,217)	
Profit (loss) for the year	**1,499**	(802)	
Underlying earnings per share[1]	**8.1p**	6.6p	1.5p
Earnings (loss) per share	**1.7p**	(1.2)p	2.9p
Banking net interest margin	**2.45%**	2.12%	(33)bp
Cost:income ratio[2]	**51.2%**	52.9%	(1.7)pp
Asset quality ratio	**0.24%**	0.57%	(33)bp
Return on risk-weighted assets[3]	**3.02%**	2.14%	88bp
Return on assets[3]	**0.92%**	0.70%	22bp
Underlying return on required equity[4]	**13.6%**	9.7%	3.9pp
Statutory return on required equity[4]	**3.0%**	(1.3)%	4.3pp

Balance sheet and key ratios

	At 31 Dec 2014	At 31 Dec 2013	Change %
Loans and advances to customers[5]	**£478bn**	£493bn	(3)
Loans and advances to customers excluding TSB, Run-off and other[5,6]	**£406bn**	£402bn	1
Customer deposits[7]	**£447bn**	£436bn	2
Loan to deposit ratio	**107%**	113%	(6)pp
Total assets	**£855bn**	£842bn	1
Run-off assets	**£17bn**	£33bn	(49)
Wholesale funding	**£116bn**	£138bn	(15)
Common equity tier 1 ratio[8,9]	**12.8%**	10.3%	2.5pp
Transitional total capital ratio[8,9]	**22.0%**	18.8%	3.2pp
Risk-weighted assets[8,9]	**£240bn**	£272bn	(12)
Leverage ratio[9,10]	**4.9%**	3.8%	1.1pp
Tangible net assets per share	**54.9p**	48.5p	6.4p

[1] In calculating underlying earnings per share, tax has been assumed at the standard UK corporation tax rate for the year.
[2] Excluding impact of St. James's Place.
[3] Underlying profit before tax divided by average quarter end risk-weighted assets and total assets respectively.
[4] See definition on page 39.
[5] Excludes reverse repos of £5.1 billion (31 December 2013: £0.1 billion). Loans and advances comparative restated, see note 1, page 188.
[6] Other includes the specialist mortgage book, Intelligent Finance and Dutch mortgages.
[7] Excludes repos of £nil (31 December 2013: £3.0 billion). Customer deposits comparative restated, see note 1, page 188.
[8] 31 December 2013 comparatives reflect CRD IV rules as implemented by the PRA at 1 January 2014.
[9] 31 December 2013 comparatives are reported on a pro forma basis that includes the benefit of the sales of Heidelberger Leben, Scottish Widows Investment Partnership and the Group's 50 per cent stake in Sainsbury's Bank.
[10] Following PRA guidance, calculated in accordance with the January 2014 revised Basel III leverage ratio framework.

Five year financial summary

The financial statements (statutory basis) for each of the years presented have been audited by PricewaterhouseCoopers LLP, independent auditors.

	2014	2013	2012[2]	2011[2]	2010[2]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	**16,399**	18,478	20,517	20,802	24,868
Operating expenses	**(13,885)**	(15,322)	(15,974)	(16,459)	(13,255)
Trading surplus[1]	**2,514**	3,156	4,543	4,343	11,613
Impairment	**(752)**	(2,741)	(5,149)	(8,094)	(10,952)
Profit (loss) before tax	**1,762**	415	(606)	(3,751)	296
Profit (loss) for the year	**1,499**	(802)	(1,387)	(2,890)	(277)
Profit (loss) for the year attributable to ordinary shareholders	**1,125**	(838)	(1,471)	(2,963)	(339)

	31 December 2014	31 December 2013	31 December 2012[2]	31 December 2011[2]	31 December 2010[2]
Balance sheet data (£m)					
Share capital	**7,146**	7,145	7,042	6,881	6,815
Shareholders' equity	**43,335**	38,989	41,896	45,506	45,354
Other equity instruments	**5,355**	–	–	–	–
Net asset value per ordinary share	**60.7p**	55p	60p	66p	67p
Customer deposits[1]	**447,067**	439,467	426,216	413,906	393,633
Subordinated liabilities	**26,042**	32,312	34,092	35,089	36,232
Loans and advances to customers[1]	**482,704**	492,952	516,764	565,638	592,597
Total assets[1]	**854,896**	842,380	933,064	970,609	991,405

	2014	2013	2012[2]	2011[2]	2010[2]
Share information					
Basic earnings (loss) per ordinary share	**1.7p**	(1.2)p	(2.1)p	(4.3)p	(0.5)p
Diluted earnings (loss) per ordinary share	**1.6p**	(1.2)p	(2.1)p	(4.3)p	(0.5)p
Total dividend per ordinary share[3]	**0.75p**	–	–	–	–
Market price (year end)	**75.8**	78.9p	47.9p	25.9p	65.7p
Number of shareholders (thousands)	**2,626**	2,681	2,733	2,770	2,798
Number of ordinary shares in issue (millions)[4]	**71,374**	71,368	70,343	68,727	68,074

	2014	2013	2012[2]	2011[2]	2010[2]
Financial ratios (%)[5]					
Dividend payout ratio[6]	**45.1**	–	–	–	–
Post-tax return on average shareholders' equity	**2.9**	(2.0)	(3.3)	(6.7)	(0.8)
Cost:income ratio[7]	**84.7**	82.9	77.9	79.1	53.3

	31 December 2014	31 December 2013	31 December 2012	31 December 2011	31 December 2010
Capital ratios (%)[8, 9]					
Total capital	**22.0**	20.8	17.3	15.6	15.2
Tier 1 capital	**16.5**	14.5	13.8	12.5	11.6
Common equity tier 1 capital/Core tier 1 capital	**12.8**	14.0	12.0	10.8	10.2

[1] See note 1 on page 188.

[2] Restated in 2013 for IAS 19 (Revised) and IFRS 10.

[3] Annual dividends comprise both interim and estimated final dividend payments. Under IFRS, the total dividend for the year represents the interim dividend paid during the year and the final dividend which will be paid and accounted for during the following year.

[4] This figure excludes the limited voting ordinary shares owed by the Lloyds Bank Foundations.

[5] Averages are calculated on a monthly basis from the consolidated financial data of Lloyds Banking Group.

[6] Total dividend for the year divided by earnings attributable to ordinary shareholders.

[7] The cost:income ratio is calculated as total operating expenses as a percentage of total income (net of insurance claims).

[8] Capital ratios for 2014 reflect CRD IV transitional rules as implemented by the PRA on 1 January 2014. Capital ratios for 2013 and earlier years have not been restated to reflect the implementation of CRD IV.

[9] Capital ratios for 2012 and earlier years have not been restated to reflect the adoption of IAS 19 (Revised).

Divisional results
Retail

Retail offers a broad range of financial service products, including current accounts, savings, personal loans and mortgages, to UK personal customers, including Wealth and small business customers. It is also a distributor of insurance, protection and credit cards, and a range of long-term savings and investment products. Retail's aim is to be the best bank for customers in the UK, by building deep and enduring relationships that deliver value to customers, and by providing them with greater choice and flexibility. Retail will maintain its multi-brand and multi-channel strategy, and continue to simplify the business and provide more transparent products, helping to improve service levels and reduce conduct risks.

Progress against strategic initiatives

- Continued development of its digital capability, with the launch of its new App and the optimisation of browser sites for mobile users. The online user base has increased to over 10.4 million customers, including more than 5 million active mobile users, an increase of 29 per cent from 2013.
- Increased Net Promoter Scores across all channels in 2014.
- Continued to attract new customers through positive switching activity, particularly through the Halifax challenger brand which has attracted around 250,000 customers in 2014.
- Launch of a number of new products, including the Club Lloyds current account proposition which has attracted over 600,000 customers since launch, and the Club Lloyds Saver and Monthly Saver Accounts.
- Launched two new unsecured lending products, enhancing account flexibility and online functionality.
- Announced the simplification of the existing savings products range, which will lead to the consolidation of 47 accounts into three standard products.
- Achieved £40 billion of gross new mortgage lending in 2014, providing 1 in 5 of all mortgage loans to customers buying their homes in the UK. Exceeded our lending commitment to first-time buyers, lending £11.9 billion to over 89,000 customers, providing 1 in 4 of all mortgages. Retail continues to be a leading supporter of the UK government's Help to Buy scheme, lending £1.9 billion in 2014.
- Improved proposition to small business customers through the launch of a new mobile App, online account opening and online lending and successfully transferred 120,000 customers onto a new multi-channel model in Retail. Exceeded its lending commitment by supporting over 100,000 new business start-ups.

Financial performance

- Underlying profit increased 7 per cent to £3,228 million.
- Net interest income increased 9 per cent. Margin increased 20 basis points to 2.29 per cent, driven by improved deposit mix and margin, more than offsetting reduced lending rates.
- Other income down 16 per cent, with lower protection income partly due to the decision to close the face-to-face advised protection role in branches, and lower wealth related income due to regulatory changes.
- Total costs increased 7 per cent to £4,464 million, reflecting higher indirect overheads previously absorbed in the TSB segment and costs associated with ongoing investment in the business.
- Impairment reduced 21 per cent to £599 million, with unsecured charges decreasing consistent with lower impaired loan and arrears balances. Secured coverage strengthened to 37 per cent, resulting in a 13 per cent increase to the impairment charge.
- Return on risk-weighted assets increased 79 basis points driven by 7 per cent increase in underlying profit and reduced risk-weighted assets.

Balance sheet

- Loans and advances to customers increased slightly to £315.2 billion, with stronger growth of 2 per cent in the open mortgage book (excludes closed specialist book and Intelligent Finance).
- Customer deposits increased 1 per cent to £285.5 billion, with relationship balances (including Lloyds, Halifax and BoS) up 4 per cent year-on-year.
- Risk-weighted assets decreased by £5.2 billion to £67.7 billion driven by an improvement in the credit quality of retail assets and improving house prices.

Performance summary

	2014 £m	2013[1] £m	Change %
Net interest income	7,079	6,500	9
Other income	1,212	1,435	(16)
Total income	**8,291**	7,935	4
Total costs	(4,464)	(4,160)	(7)
Impairment	(599)	(760)	21
Underlying profit	**3,228**	3,015	7
Banking net interest margin	2.29%	2.09%	20bp
Asset quality ratio	0.19%	0.24%	(5)bp
Return on risk-weighted assets	4.60%	3.81%	79bp
Return on assets	1.02%	0.95%	7bp

Key balance sheet items	At 31 Dec 2014 £bn	At 31 Dec 2013 £bn	Change %
Loans and advances excluding closed portfolios	284.7	280.4	2
Closed portfolios	30.5	33.9	(10)
Loans and advances to customers	315.2	314.3	–
Relationship balances	247.9	238.4	4
Tactical balances	37.6	44.8	(16)
Customer deposits	285.5	283.2	1
Total customer balances	**600.7**	597.5	1
Risk-weighted assets[2]	67.7	72.9	(7)

[1] Restated to reflect the changes to the Group operating structure that came into effect from 1 January 2014.

[2] 31 December 2013 comparatives reflect CRD IV rules as implemented by the PRA at 1 January 2014.

Divisional results continued
Commercial Banking

Commercial Banking supports UK businesses from SMEs to large corporates and financial institutions. It has a client led, low risk strategy targeting sustainable returns on risk-weighted assets above 2 per cent by the end of 2015 and 2.4 per cent by the end of 2017, whilst simplifying operating processes, building digital capability and maintaining capital discipline. Commercial Banking aims to be the best bank for clients delivering a through-the-cycle relationship approach that provides affordable, simple and transparent finance, as well as support for complex needs and access to Government funding schemes.

Progress against strategic initiatives

- Continued its support of SMEs, growing lending by 5 per cent in a contracting market. Its network of local and key markets relationship managers enables a quick response to the needs of the significant client base.
- Strengthened the capabilities and increased the number of relationship managers in Mid Markets, resulting in an increase in client numbers particularly in the local authority, business services and education sectors.
- Enhanced returns in Global Corporates as a result of continued capital optimisation and increased profitability due to resilient income performance in challenging market conditions.
- Further developed the Financial Institutions franchise, meeting a broader range of client needs, delivering growth in income and profitability whilst supporting financial services in the UK.
- Continued to invest in digital capability, with CB Online launching in 2015 and the continued development of mobile services to clients.
- Continued to help Britain prosper; committing over £15.5 billion of UK lending through Funding for Lending, over £1 billion of funding support to UK manufacturing. In line with the Group's focus on sustainability and responsible lending Commercial Banking became the first UK bank to issue an Environmental, Social and Governance (ESG) bond. The Debt Capital Markets team also pioneered market leading product innovation with the first green loan and first ESG bond for a housing association.
- Its community based actions include the Enterprise Mentoring scheme, with over 400 Group colleagues now trained as Enterprise Mentors, providing support to over 700 SME businesses to date.

Financial performance

- Underlying profit of £2,206 million, up 17 per cent on 2013, driven by strong income growth in SME, Mid Markets and Financial Institutions and lower impairments.
- Income increased by 1 per cent to £4,436 million as a result of increased net interest income in all client segments offset by declining performance in other income reflecting challenging market conditions and lower income from Lloyds Development Capital.
- Net interest margin increased by 46 basis points to 2.67 per cent as a result of disciplined pricing of new lending, customer repricing in deposits and a reduction in funding costs helped by the increase in Global Transaction Banking deposits.
- Other income decreased 13 per cent driven by lower client income in Debt Capital Markets and Financial Markets due to the continued low interest rate and low volatility environment in 2014 and a lower level of revaluation gains in Lloyds Development Capital.
- Asset quality ratio of 8 basis points improved by 29 basis points reflecting lower gross charges, improved credit quality and progress in executing its strategy of building a low risk commercial bank.
- Return on risk-weighted assets increased by 39 basis points to 1.92 per cent, making good progress towards achieving its 2015 target of 2 per cent by the end of 2015.

Balance sheet

- Lending decreased by 5 per cent as a result of selective participation in Global Corporates partially offset by growth in SME and Financial Institutions.
- Customer deposits increased by 10 per cent with Global Transaction Banking balances growing year-on-year in all client segments.
- Risk-weighted assets decreased by £17.8 billion with reductions in credit and market risk-weighted assets as a result of active portfolio management, including reductions in Global Corporates reflecting the successful progress on improving returns.

Performance summary

	2014 £m	2013[1] £m	Change %
Net interest income	**2,480**	2,113	17
Other income	**1,956**	2,259	(13)
Total income	**4,436**	4,372	1
Total costs	**(2,147)**	(2,084)	(3)
Impairment	**(83)**	(398)	79
Underlying profit	**2,206**	1,890	17
Banking net interest margin	**2.67%**	2.21%	46bp
Asset quality ratio	**0.08%**	0.37%	(29)bp
Return on risk-weighted assets	**1.92%**	1.53%	39bp
Return on assets	**0.94%**	0.77%	17bp

Key balance sheet items	At 31 Dec 2014 £bn	At 31 Dec 2013[1] £bn	Change %
SME	**27.9**	26.6	5
Other	**73.0**	79.1	(8)
Loans and advances to customers	**100.9**	105.7	(5)
Customer deposits	**119.9**	108.7	10
Total customer balances	**220.8**	214.4	3
Risk-weighted assets[2]	**106.2**	124.0	(14)

[1] Restated to reflect the changes to the Group operating structure that came into effect from 1 January 2014. Loans and advances to customers and customer deposits have been restated, see note 1, page 188.

[2] 31 December 2013 comparatives reflect CRD IV rules as implemented by the PRA at 1 January 2014.

Divisional results continued
Consumer Finance

Consumer Finance aims to extend its market leadership in Asset Finance by building its digital capability and creating new propositions in both the Black Horse and Lex Autolease businesses. In Credit Cards, better use will be made of Group customer relationships and insight to seek growth within its current risk profile from both franchise and non-franchise customers.

Progress against strategic initiatives

– UK loan growth of 17 per cent year-on-year, increasing momentum from the first half of 2014.
– New business growth of 48 per cent within Black Horse, supported by the launch of the Jaguar Land Rover partnership in the first quarter of 2014 and strong underlying business performance.
– Growth of 23 per cent in new Lex Autolease fleet deliveries with leads from the franchise more than double 2013.
– Growth in lending balances within Credit Cards for the first time in eight years.
– Growth in new consumer credit cards including a 4 per cent increase in new accounts opened and a 15 per cent increase in balance transfer volumes from new and existing customers.
– Net gainer in balance transfers compared to competitors in Credit Cards new business, leveraging the breadth of product lines, brands, and channels, and making strong progress in building non-franchise capabilities.
– Growth of 45 per cent in transaction volumes within the Cardnet Acquiring Solutions business, driven in part by new partnerships, in addition to increased activity from existing customers.
– Successful implementation of initial regulatory changes following change of regulator from the Office of Fair Trading to the Financial Conduct Authority.

Financial performance

– Underlying profit increased by 5 per cent to £1,010 million driven by significant reductions in impairment charges across the portfolio and income growth in Asset Finance, partially offset by a fall in income in Credit Cards and investing for future growth in the businesses.
– Net interest margin reduced by 45 basis points to 6.49 per cent, resulting in a 3 per cent fall in net interest income to £1,290 million. Strong new business growth and deposit repricing have been offset by a change in mix towards higher quality, lower margin lending to the new vehicle market and the impact of the current year's strategic focus on growing the volume of new credit cards. Consistent with the strategy of acquiring high quality new business, the asset quality ratio improved by 71 basis points.
– Other income increased slightly as a result of the growth strategy.
– Total costs increased by 3 per cent driven by investment in growth initiatives and increased operating lease depreciation as a result of growth in the Lex Autolease fleet, offset by cost savings and increased gains for end of life lease asset sales. In 2014 a further £45 million was invested in improving propositions and customer's digital experience.
– Impairment charges reduced by 37 per cent to £215 million, with a substantial improvement in the asset quality ratio. This has been driven by a continued underlying improvement of portfolio quality supported by the sale of recoveries assets in the Credit Cards and Asset Finance portfolios.
– Return on risk-weighted assets increased to 4.87 per cent. This reflected a 5 per cent improvement in underlying profit, while risk-weighted assets increased by only 4 per cent driven by increased customer assets partially offset by an improved credit risk profile of customers.

Balance sheet

– Net lending increased by 9 per cent to £20.9 billion driven by growth across both the underlying and the Jaguar Land Rover portfolios within UK Asset Finance where net lending increased by 43 per cent, and within Credit Cards following eight years of decline where net lending increased by 2 per cent. Balances in the European businesses were down 9 per cent, driven largely by foreign exchange rate movements.
– Operating lease assets increased by 11 per cent to £3.1 billion reflecting Lex Autolease fleet growth of 7 per cent.
– Customer deposits reduced by 20 per cent within Online Deposits driven by deposit re-pricing activity in response to European Central Bank policy actions and foreign exchange rate movements.
– Risk-weighted assets increased by 4 per cent.

Performance summary

	2014 £m	2013[1] £m	Change %
Net interest income	1,290	1,333	(3)
Other income	1,364	1,359	–
Total income	**2,654**	2,692	(1)
Total costs	(1,429)	(1,384)	(3)
Of which operating lease depreciation	(667)	(653)	(2)
Impairment	(215)	(343)	37
Underlying profit	**1,010**	965	5
Banking net interest margin	6.49%	6.94%	(45)bp
Asset quality ratio	1.05%	1.76%	(71)bp
Impaired loans as % of closing advances	3.4%	4.8%	(140)bp
Return on risk-weighted assets	4.87%	4.51%	36bp
Return on assets	4.02%	3.90%	12bp

Key balance sheet items	At 31 Dec 2014 £bn	At 31 Dec 2013 £bn	Change %
Loans and advances to customers	20.9	19.1	9
Of which UK	16.0	13.7	17
Operating lease assets	3.1	2.8	11
Total customer assets	**24.0**	21.9	10
Of which UK	19.1	16.5	16
Customer deposits	15.0	18.7	(20)
Total customer balances	**39.0**	40.6	(4)
Risk-weighted assets[2]	20.9	20.1	4

[1] Restated to reflect the changes to the Group operating structure that came into effect from 1 January 2014.
[2] 31 December 2013 comparatives reflect CRD IV rules as implemented by the PRA at 1 January 2014.

Divisional results continued
Insurance

The Insurance division is focused on helping customers protect themselves today whilst preparing for a secure financial future. The division provides a range of simple, trusted, value for money insurance, protection and retirement products to Retail and Corporate customers, primarily through the Bank and Intermediary networks.

Progress against strategic initiatives

- Insurance is a market leader in the corporate pensions market serving over 11,500 employers (including 19 per cent of the FTSE 350) and 1.4 million employees with £27 billion of assets invested with us. In 2014 the number of employees covered by these schemes grew by 40 per cent principally reflecting the ongoing support for employers through the auto-enrolment process.
- The roll out of the Pensions Freedoms legislation in 2015 presents a significant opportunity to help customers with their retirement planning needs and a range of products to support this is being developed. With access to 24 million Retail customers, the Group remains very well placed to participate in this market.
- Re-launched the Scottish Widows brand in 2014 and increased investment in strategic initiatives specifically in digital and mobile solutions, demonstrating the Group's commitment to being a leader in the changing market.
- In 2014 the underwriting of the Home insurance direct channel business was brought in-house offering all customers access to the first class claims service we provide. Investment is being made in the Group's direct digital capability with the aim of increasing market share in General Insurance and responding to changes in the way customers buy General Insurance, moving more towards online distribution channels.
- Continued commitment to supporting customer protection needs, with focus now on the sale of our standalone protection products through investment in digital solutions and in the Independent Financial Adviser distribution channel alongside continued in-branch protection advice for mortgage applications. In recognition of the change in consumer focus, the Group withdrew standalone protection advice through Retail branches in November.
- Completion of the sale of Heidelberger Leben and Scottish Widows Investment Partnership helped simplify the Insurance business, allowing increased focus on the remaining core business.

Financial performance

- Resilient performance against a backdrop of significant change throughout the industry in 2014.
- Operating cash generation increased by £55 million, to £737 million, primarily reflecting lower commission paid on corporate pensions and increased returns on shareholder free assets offset by reduced General Insurance premiums.
- Underlying profit down 15 per cent to £922 million impacted by the cost of structural changes in the corporate pensions book, primarily the cap on pension charges and lower life new business and General Insurance premiums offset by improved economics and an increase in yields on assets backing annuity business as a result of the strategy to invest in long-term, low risk, higher yielding assets.
- A 10 per cent increase in corporate pensions funds under management has driven a £3 billion increase in unit linked pension funds under management to £79 billion.
- LP&I sales (PVNBP) reduced by 13 per cent in the year with sales of auto-enrolment corporate pension business higher than expected but more than offset by an overall reduction in sales in 2014 following the Retail Distribution Review.
- General Insurance Gross Written Premiums (GWP) down 8 per cent, reflecting the run off of legacy products and a competitive market during 2014.

Capital

- Remitted £1.0 billion of dividends to the Group in 2014 (2013: £2.2 billion), including the £0.3 billion of Heidelberger Leben sale proceeds, whilst maintaining a strong capital base.
- Estimated capital surplus for Pillar 1 is £2.3 billion (Scottish Widows plc, £2.7 billion in 2013) and for Insurance Groups Directive is £3.0 billion (Insurance Group, £2.9 billion in 2013) with the decrease in Pillar 1 reflecting the dividends paid over the period.

Performance summary

	2014 £m	2013[1] £m	Change %
Net interest income	(131)	(107)	(22)
Other income	2,054	2,220	(7)
Insurance claims	(329)	(356)	8
Total underlying income	1,594	1,757	(9)
Total costs	(672)	(669)	–
Underlying profit	922	1,088	(15)
Operating cash generation	737	682	8
UK LP&I sales (PVNBP)[2]	8,601	9,934	(13)
General Insurance total GWP	1,197	1,307	(8)
General Insurance combined ratio	76%	77%	(1)pp

[1] Restated to reflect changes to the Group operating structure that came into effect from 1 January 2014.

[2] Present value of new business premiums.

Profit by product group

	2014					2013
	Pensions & investments £m	Protection & retirement[1] £m	General Insurance £m	Other[2] £m	Total £m	Total £m
New business income	189	74	–	5	268	423
Existing business income	658	120	–	114	892	807
Assumption changes and experience variances	(219)	277	–	(24)	34	70
General Insurance income net of claims	–	–	400	–	400	457
Total income	628	471	400	95	1,594	1,757
Total costs	(381)	(127)	(144)	(20)	(672)	(669)
Underlying profit 2014	247	344	256	75	922	1,088
Underlying profit 2013[3]	357	445	297	(11)	1,088	

[1] Retirement assumption changes and experience variances include the benefit of acquiring, from Commercial Banking, £1.7 billion of loans during 2014; bringing total social housing, infrastructure and education acquired loans to £3.9 billion.

[2] 'Other' is primarily income from return on free assets, interest expense, certain provisions plus a small element of European business.

[3] Full 2013 comparator tables for the profit and cash disclosures can be found on the Lloyds Banking Group investor site.

The new business income of £268 million includes a reduction in pensions new business income due to lower volumes relative to the spike in 2013 sales as pre-Retail Distribution Review sales completed. In calculating new business income on auto-enrolment schemes, allowance has been made for low initial contribution levels and does not include future automatic increases in contribution levels. These increases will be reported in future years. In addition Protection & retirement new business income has reduced following the 2014 Budget announcement which led to industry wide reductions in annuities volumes following changes to the freedoms consumers have in accessing their pension savings.

Existing business income has increased by £85 million reflecting improved economics benefiting the life and pensions business.

Assumption changes and experience variances include, within Protection and retirement, the benefits arising from the acquisition of attractive higher yielding assets to match long duration annuity liabilities and benefits from assumption changes. This has been offset by assumption changes within the existing Pensions and investments book including actions being taken to prepare for the structural changes arising from the DWP's announcement, which introduced a cap on pension charges. These changes to corporate pensions will ensure that future new business is less capital intensive.

General Insurance profit has fallen by £41 million, due to the continued run-off of legacy books and the impact of storms during the first quarter, offset by good prior year experience. During the year underwriting of the Home Insurance business was brought in-house, ensuring delivery of a first class service to all our customers and continued sustainable growth in the underwritten customer base. Excellent technical capabilities and scale have enabled Insurance to respond to competitive pressures and a number of severe weather events in the early part of 2014, and maintain a strong combined ratio.

Divisional results continued
Insurance continued

Operating cash generation

	2014 Pensions & investments £m	2014 Protection & retirement £m	2014 General Insurance £m	2014 Other[1] £m	2014 Total £m	2013 Total £m
Cash invested in new business	(238)	(38)	–	(12)	(288)	(270)
Cash generated from existing business	452	177	–	140	769	655
Cash generated from General Insurance	–	–	256	–	256	297
Operating cash generation	214	139	256	128	737	682
Intangibles and other adjustments[2]	33	205	–	(53)	185	406
Underlying profit	247	344	256	75	922	1,088
Operating cash generation 2013	224	136	297	25	682	

[1] Derived from IFRS underlying profit by removing the effect of movements in intangible (non-cash) items and assumption changes.

[2] Intangible items include the value of in-force life business, deferred acquisition costs and deferred income reserves.

The Insurance business generated £737 million of operating cash in 2014, £55 million higher than the prior year. The growth in cash generated from existing business resulted from increased yields on assets backing the annuity business and increased returns on shareholder free assets. In Pensions and investments, cash invested in new business has reduced due to lower volumes of corporate and individual pensions and reduced commission costs, partially offset by increased reserves for auto-enrolment business (these reserves are expected to unwind over the next few years as contribution levels increase). In Protection and retirement, cash invested in new business is greater than 2013, reflecting lower profitability of standard annuities.

Divisional results continued
Run-off and Central items

Run-off

	2014 £m	2013[1] £m
Net interest income	(116)	138
Other income	451	1,266
Total income	335	1,404
Total costs	(308)	(726)
Impairment	(203)	(1,389)
Underlying loss	(176)	(711)
Total income excluding St. James's Place	335	742
Underlying loss excluding St. James's Place	(176)	(1,329)

	2014 £bn	2013[1] £bn
Loans and advances to customers	14.4	27.7
Total costs	16.9	33.3
Risk-weighted assets[2]	16.8	30.6

[1] Restated to reflect the changes to the Group's operating structure that came into effect from 1 January 2014.
[2] 31 December 2013 comparatives reflect CRD IV rules as implemented by the PRA at 1 January 2014.

– Run-off includes certain assets previously classified as non-core and the results and gains or losses on sale of businesses sold in 2013 and 2014.
– The reduction in income and costs largely related to the sales of St. James's Place in 2013 and Scottish Widows Investment Partnership in the first quarter of 2014.
– The reduction in the impairment charge reflects continued proactive risk management and the success in managing down the Run-off portfolios.

Central items

	2014 £m	2013[1] £m
Total income (expense)	132	(133)
Total costs	(22)	(49)
Impairment	(2)	(5)
Underlying profit/(loss)	108	(187)

[1] Restated to reflect the changes to the Group's operating structure that came into effect from 1 January 2014.

– Central items include income and expenditure not recharged to divisions, including the costs of certain central and head office functions.
– Underlying income in 2014 included the benefit relating to the reduction in interest payable following the ECN exchange in the second quarter, which has not been passed onto divisions.

Other financial information

Banking net interest margin

Banking net interest margin is calculated by dividing banking net interest income by average interest-earning banking assets. A reconciliation of banking net interest income to Group net interest income showing the items that are excluded in determining banking net interest income follows:

	2014 £m	2013 £m
Banking net interest income – underlying basis	**11,845**	10,841
Insurance division	**(131)**	(107)
Other net interest income (including trading activity)	**47**	151
Group net interest income – underlying basis	**11,761**	10,885
Fair value unwind	**(626)**	(631)
Banking volatility and liability management gains	**7**	14
Insurance gross up	**(482)**	(2,930)
Group net interest income – statutory	**10,660**	7,338

Average interest-earning banking assets are calculated gross of related impairment allowances, and relate solely to customer and product balances in the banking businesses on which interest is earned or paid.

	2014 £bn	2013 £bn
Average loans and advances (gross)	**504.2**	518.7
Non-banking assets	**(11.6)**	(8.8)
Other[1]	**(8.9)**	1.0
Average interest-earning assets	**483.7**	510.9

[1] Other includes adjustments for assets that are netted for interest earning purposes, reverse repos and the timing effects of disposals.

Volatility arising in insurance businesses

The Group's statutory result before tax is affected by insurance volatility caused by movements in financial markets, and policyholder interests volatility, which primarily reflects the gross up of policyholder tax included in the Group tax charge.

In 2014 the Group's statutory result before tax included positive insurance and policyholder interests volatility totalling £228 million compared to positive volatility of £668 million in 2013.

Volatility comprises the following:

	2014 £m	2013 £m
Insurance volatility	**(219)**	218
Policyholder interests volatility[1]	**17**	564
Total volatility	**(202)**	782
Insurance hedging arrangements	**(26)**	(114)
Total	**(228)**	668

[1] Includes volatility relating to the Group's interest in St. James's Place in 2013.

Insurance volatility

The Group's insurance business has policyholder liabilities that are supported by substantial holdings of investments, including equities, property and fixed interest investments, all of which are subject to variations in their value. The value of the liabilities does not move exactly in line with changes in the value of the investments, yet IFRS requires that the changes in both the value of the liabilities and investments be reflected within the income statement. As these investments are substantial and movements in their value can have a significant impact on the profitability of the Group, management believes that it is appropriate to disclose the division's results on the basis of an expected return in addition to results based on the actual return.

The expected gross investment returns used to determine the normalised profit of the business, which are based on prevailing market rates and published research into historical investment return differentials, are set out below.

United Kingdom	2014 %	2013 %
Investments backing annuity liabilities	**4.54**	3.83
Equities and property	**6.48**	5.58
UK government bonds	**3.48**	2.58
Corporate bonds	**4.08**	3.18

A review of investment strategy in the Group's Insurance business has resulted in investment being made in a wider range of assets. Expected investment returns include appropriate returns for these assets.

The impact on the results due to the actual return on these investments differing from the expected return (based upon economic assumptions made at the beginning of the year, adjusted for significant changes in asset mix) is included within insurance volatility. Changes in market variables also affect the realistic valuation of the guarantees and options embedded within the with-profits funds, the value of the in-force business and the value of shareholders' funds.

The negative insurance volatility during 2014 of £219 million primarily reflects an adverse performance on equity and cash investments in the period relative to expected return.

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life, pensions and investments business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group's tax charge rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the normalised approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility.

In 2014, the statutory results before tax included a credit to other income which relates to policyholder interests volatility totalling £17 million (2013: £564 million) relating to offsetting movements in equity, bond and gilt returns.

Insurance hedging arrangements

The Group purchased put option contracts in 2014 to protect against deterioration in equity market conditions and the consequent negative impact on the value of in-force business on the Group balance sheet. These were financed by selling some upside potential from equity market movements. A charge of £26 million was taken on hedging contracts in 2014 (2013: £114 million).

Other financial information continued

TSB

The financial results for TSB are presented on a Lloyds Banking Group basis and differ to those reported by TSB for the reasons shown below. Investors in TSB should only rely on financial information published by TSB.

	2014 £m	2013 £m
Profit before tax:		
On a Lloyds Banking Group reporting basis (underlying profit)	**458**	106
Recognition of product transfers[1]	–	(200)
Cost allocation[2]	–	217
TSB dual running costs[3]	(326)	–
Volatile items[4]	(26)	(46)
Defined benefit pension scheme settlement gain[5]	64	–
FSCS levy adjustment[6]	–	10
Other	–	(2)
Reported in the TSB results announcement	**170**	85

	2014 £bn	2013 £bn
Risk-weighted assets:		
On a Lloyds Banking Group reporting basis	**5.2**	5.6
Risk-weighted assets for operational risk[7]	1.5	0.4
Other[8]	0.2	0.2
Reported in the TSB results announcement	**6.9**	6.2

[1] On the Lloyds Banking Group reporting basis, all product transfers to TSB are assumed to have occurred on 1 January 2013.

[2] In 2013, TSB was allocated costs on the same basis as the other business segments. In 2014, costs have been charged to TSB in accordance with the Transitional Service Agreement and the costs that were previously allocated to TSB have been charged to the other business segments.

[3] This represents corporate head office and similar costs incurred by TSB. The Group has excluded these from underlying profit to provide a more meaningful view of underlying business costs as they represent the duplicated costs of running two corporate head offices. These costs form part of the continuing TSB cost base and are reflected in the Group's statutory profit before tax.

[4] Banking volatility reported below underlying profit in the Lloyds Banking Group results.

[5] Following the transfer of employees from employment with Lloyds Banking Group companies to TSB Bank, the defined benefit scheme assets and liabilities have been derecognised from the TSB Bank balance sheet and settled with nil cash consideration, resulting in a one off gain of £64 million. This is eliminated at Lloyds Banking Group level.

[6] Adjustment to reflect the change in timing of the FSCS charge.

[7] The TSB risk-weighted asset for operational risk is determined by TSB as a standalone organisation.

[8] Other relates mainly to risk-weighted assets that result from TSB's standalone capital calculations, for example threshold adjustments and exposures with other businesses in the Lloyds Banking Group.

GOVERNANCE

Board of Directors

NON-EXECUTIVE DIRECTORS

Lord Blackwell
Chairman

NG Ri Re

Appointed: June 2012 (Board), April 2014 (Chairman)

Skills and experience: Extensive insurance, banking, regulatory and public policy experience gained from senior positions in a wide range of industries. He was appointed a Life Peer in 1997.
External appointments: Chairman of Interserve plc.
Former appointments: Chairman of Scottish Widows Group, Non-Executive Director of Ofcom, Halma plc, Dixons Group and SEGRO. Senior Independent Director of Standard Life and chaired its UK Life and Pensions Board. Member of the Board of the Centre for Policy Studies, Non-Executive Member of the Office of Fair Trading, Partner of McKinsey & Co. and a Director of Group Development at NatWest Group. Head of the Prime Minister's Policy Unit.

Anita Frew
Deputy Chairman and Independent Director

NG A Ri Re

Appointed: December 2010 (Board), May 2014 (Deputy Chairman)

Skills and experience: Extensive board, financial and general management experience across a range of sectors, including banking, asset management, manufacturing and utilities.
External appointments: Senior Independent Director of IMI plc.
Former appointments: Chairman of Victrex plc, Senior Independent Director of Aberdeen Asset Management, Executive Director of Abbott Mead Vickers, Director of Corporate Development at WPP Group and Non-Executive Director of Northumbrian Water. In addition, Anita has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland.

Alan Dickinson
Independent Director

A Ri

Appointed: September 2014

Skills and experience: Highly regarded retail and commercial banker having spent 37 years with the Royal Bank of Scotland.
External appointments: Non-Executive Director of Willis Limited and Chairman of its Risk Committee, Chairman of Brown, Shipley & Co Limited, Senior Independent Director of Urban & Civic plc and a Governor of Motability.
Former appointments: Chief Executive of RBS UK, Non-Executive Director of Nationwide Building Society and Chairman of its Risk Committee, Non-Executive Director of Carpetright plc.

Carolyn Fairbairn
Independent Director

A Re

Appointed: June 2012

Skills and experience: Extensive digital and online, government and regulatory experience gained across a range of sectors including media and financial services. Her career began as an Economist at the World Bank.
External appointments: Non-Executive Director of Capita and The Vitec Group and Chairman of their Remuneration Committees. Trustee of Marie Curie, Non-Executive Director of the Competition and Markets Authority and of the UK Statistics Authority.
Former appointments: Non-Executive Director of the Financial Services Authority and Chair of its Risk Committee. Director of Group Development and Strategy at ITV plc and Director of Strategy and a member of the Executive Board at the BBC. Partner of McKinsey & Co. and a policy adviser in the Prime Minister's Policy Unit.

Simon Henry
Independent Director

A Ri

Appointed: June 2014

Skills and experience: International experience in board level strategy and execution. His extensive knowledge of financial markets, treasury and risk management and his qualification as an Audit Committee Financial Expert is of particular value in our Board Risk and Audit Committees. He was Shell's Chief Financial Officer for Exploration & Production, Head of Group Investor Relations and held various finance posts within Shell prior to these appointments.
External appointments: Chief Financial Officer and an Executive Director of Royal Dutch Shell plc, member of the Main Committee of the 100 Group of UK FTSE CFOs and Chair of the European Round Table CFO Taskforce. Also a member of the Advisory Panel of CIMA, the Multi Practitioner Panel Steering Committee – UK Fair and Effective Markets Review and of the Advisory Board of the Centre for European Reform.

Dyfrig John CBE
Independent Director

Ri Re

Appointed: January 2014

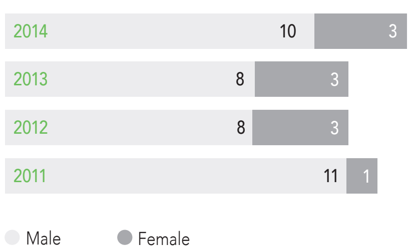
Skills and experience: An international career in banking, principally at HSBC where he worked for 37 years. During that time he held a number of senior management and Board positions in the UK and overseas. He gained a wealth of experience in most areas of the business including the day-to-day running of the bank with specific responsibility for employees, IT, finance and the branch network.
External appointments: Member of the Welsh Rugby Union's Audit Committee.
Former appointments: Chairman of Principality Building Society, Director of HSBC Bank PLC and subsequently, Chief Executive Officer and Deputy Chairman. Prior to this he held a number of senior roles including Group Managing Director and member of the Group Management Board. Board member of the Wales Millennium Centre.

BOARD DIVERSITY

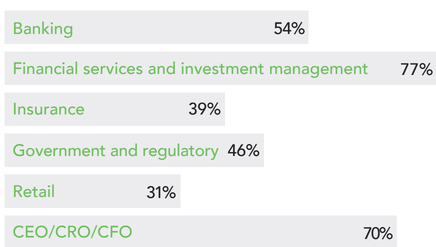
The Board places great emphasis on ensuring that its membership reflects diversity in the broadest sense. The combination of personalities provides a comprehensive range of perspectives and challenge and improves the quality of decision making.

To read more about our Board visit www.lloydsbankinggroup.com

BOARD MEMBERS



BOARD EXPERIENCE



Nick Luff
Independent Director

NG A Ri

Appointed: March 2013

Skills and experience: Significant financial experience in the UK listed environment having served in a number of senior finance positions within a range of sectors. His background and experience enable him to fulfil the role of Audit Committee Chair and, for SEC purposes, the role of Audit Committee Financial Expert.
External appointments: Executive Director and Chief Financial Officer of Reed Elsevier.
Former appointments: Finance Director of Centrica plc, The Peninsular & Oriental Steam Navigation Company and Chief Financial Officer of P&O Princess Cruises plc. Non-Executive Director and Audit Committee Chair of QinetiQ Group.

Nick Prettejohn
Independent Director and Chairman of Scottish Widows Group

A Ri

Appointed: June 2014

Skills and experience: Significant financial services experience, particularly in insurance.
External appointments: Member of the BBC Trust, Chairman of the Britten-Pears Foundation and Chairman of the Royal Northern College of Music.
Former appointments: Non-Executive Director of the Prudential Regulation Authority, Chairman of Brit Insurance, Non-Executive Director of Legal and General Plc, Chief Executive of Prudential UK and Europe, Director of the Prudential plc Board, Chairman of the Financial Services Practitioner Panel, Chief Executive of Lloyd's of London and a member of the Lloyd's Council.

EXECUTIVE DIRECTORS

António Horta-Osório
Executive Director and Group Chief Executive

Appointed: January 2011 (Board), March 2011 (Group Chief Executive)

Skills and experience: Extensive experience in both retail and commercial banking built over a period of more than 25 years, working both internationally and in the UK. In 1993 he joined Grupo Santander having previously worked for Goldman Sachs and for Citibank, and held various senior management positions before becoming Executive Vice President of Grupo Santander and a member of its Management Committee.
External appointments: Non-Executive Director of Fundação Champalimaud and of Sociedade Francisco Manuel dos Santos in Portugal, a member of the Board of Stichting INPAR, a Governor of the London Business School and Chairman of the Wallace Collection.
Former appointments: Non-Executive Director and Chief Executive of Santander UK. Non-Executive Director of the Court of the Bank of England.

Anthony Watson CBE
Senior Independent Director

NG A Ri Re

Appointed: April 2009 (Board), May 2012 (Senior Independent Director)

Skills and experience: Over 40 years of experience in the investment management industry and related sectors.
External appointments: Senior Independent Director of Hammerson and of Witan Investment Trust, Chairman of the Lincoln's Inn Investment Committee and a member of the Norges Bank Investment Management Corporate Governance Advisory Board.
Former appointments: Non-Executive Director of Vodafone Group, Chief Executive of Hermes Pensions Management and Chairman of the Asian Infrastructure Fund, MEPC and of the Strategic Investment Board (Northern Ireland). Member of the Financial Reporting Council and the Marks & Spencer Pension Trustees.

Sara Weller
Independent Director

Ri Re

Appointed: February 2012

Skills and experience: Background in retail and associated sectors, including financial services. Considerable experience of boards at both executive and non-executive level.
External appointments: Non-Executive Director of United Utilities Group and Chair of its Remuneration Committee and a Governing Council Member of Cambridge University. Also Chairman of the Planning Inspectorate, Lead Non-Executive Director at the Department of Communities and Local Government and Board member at the Higher Education Funding Council.
Former appointments: Managing Director of Argos, various senior positions at J Sainsbury including Deputy Managing Director, Non-Executive Director of Mitchells & Butler and senior management roles for Abbey National and Mars Confectionery.

George Culmer
Executive Director and Chief Financial Officer

Appointed: May 2012 (Board)

Skills and experience: Deep operational and financial expertise including strategic and financial planning and control. He has worked in financial services in the UK and overseas for over 20 years. With a strong background in insurance and shareholder advocacy, his skills and experience enhance the Board and strengthen further the senior management team.
External appointments: None.
Former appointments: Executive Director and Chief Financial Officer of RSA Insurance Group and Chief Financial Officer of Zurich Financial Services UK.

KEY

Member of Nomination & Governance Committee	NG
Member of Audit Committee	A
Member of Risk Committee	Ri
Member of Remuneration Committee	Re
Committee Chairman	●

Malcolm Wood
Company Secretary

Appointed: November 2014

Skills and experience: Previously General Counsel and Company Secretary of Standard Life after a career as a corporate lawyer in private practice in London and Edinburgh. He has a wealth of experience in governance, policy and regulation. He is a member of the Advisory Forum of The Institute of Chartered Secretaries and Administrators and in 2014 was made a Fellow of the Institute. He is also a Member of the Company Law Committee of The Law Society of Scotland, the Chartered Institute for Securities and Investment and the GC100.

Juan Colombás
Executive Director and Chief Risk Officer

Appointed: January 2011 (Chief Risk Officer), November 2013 (Board)

Skills and experience: Significant banking and risk management experience, having spent 29 years working in these fields both internationally and in the UK. He held a number of senior risk, control and business management roles across the Corporate, Investment, Retail and Risk Divisions of the Santander Group.
External appointments: Member of the International Financial Risk Institute Executive Committee.
Former appointments: Chief Risk Officer and Executive Director of Santander's UK business.

Group Executive Committee

Delivering our vision Managing a more agile organisation

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

Biographies of the members of the Group Executive Committee (GEC), and in the case of the Group Audit Director, GEC attendee, are provided opposite.

BOARD MEMBERS

António Horta-Osório
Group Chief Executive

António joined the Board in January 2011 as an Executive Director and became Group Chief Executive in March 2011.

Full biography on page 59.

George Culmer
Executive Director and Chief Financial Officer

George joined the Board as an Executive Director in May 2012.

Full biography on page 59.

NON-BOARD MEMBERS

Andrew Bester
Chief Executive Officer, Commercial Banking

Andrew joined the Group in 2012 from Standard Chartered Bank where he held a variety of senior roles including Global COO and, later, Chief Financial Officer of Consumer Banking. Previously, Andrew worked at Xchanging Plc and Deutsche Bank. He trained as a Chartered Accountant.

Andrew sits on the Board of the Global Financial Markets Association and the Advisory Board of the University of Cambridge Programme for Sustainability Leadership and is a member of The Prince of Wales's UK Corporate Leaders' Group. Andrew is also the Executive Sponsor for the Group's Diversity & Inclusion programme.

Alison Brittain
Group Director, Retail

Alison joined the Group in 2011 from Santander where her last role had been Executive Director for Retail Distribution and a Board Director. She previously worked at Barclays for almost 20 years in various senior roles including Director of Barclays and Woolwich Retail Networks and Managing Director of Barclays Small Business Banking.

Alison is a member of the FCA's Practitioner Panel and a Non-Executive Director for Marks and Spencer Group plc. Alison attended university in Scotland and the USA and has an MBA from Cambridge University's Judge Institute.

Mary Hall
Group Audit Director

Mary joined the Group in 2014 from KPMG where she held various senior roles including Canadian Industry Leader for Financial Services, Canadian National Banking Sector Leader, Canadian Regulatory Risk Management Advisory Leader and Chair of KPMG's Global New Banking Entrants Committee.

Previously, Mary was a senior Financial Services Audit Partner for KPMG Canada where she was a signing audit partner for a number of global financial institutions. She has over 25 years of experience in the financial services industry. Mary has a reporting line to the Chairman of the Audit Committee and the Group Chief Executive.

Antonio Lorenzo
Group Director, Consumer Finance and Group Corporate Development

Antonio joined the Group in 2011 as head of the Wealth and International division and Group Corporate Development. He took on his current role as head of Consumer Finance and Group Corporate Development in 2013. Antonio joined the Group from Santander where he had worked in a number of different finance and business roles since 1998. He was part of the management team that completed the take-over of Abbey National in 2004 and was Chief Financial Officer of Santander UK. Before Santander, Antonio spent over nine years at Arthur Andersen. Antonio has more than 25 years of experience in the financial services industry.

Juan Colombás
Executive Director and Chief Risk Officer

Juan joined the Group as Chief Risk Officer in January 2011 and joined the Board as an Executive Director in November 2013.

Full biography on page 59.

Read more about each member of the Board on our website at www.lloydsbankinggroup.com

Vim Maru
Group Director, Customer Products and Marketing

Vim joined the Group in 2011. He has responsibility for personal products and Group Marketing. Previously, Vim worked at Santander UK and Abbey National. He was appointed to our Group Executive Committee in 2013 and is a Scottish Widows and VISA Europe Board Director.

Vim holds an Economics degree from the London School of Economics and is a member of the Institute of Chartered Accountants.

David Nicholson
Group Director, Halifax Community Bank

David joined the Group in 2008. He has responsibility for the Halifax business, its branch network and 10,500 colleagues.

David has over 30 years' experience in retail financial services. He is Chairman of the 'Your Tomorrow' pension fund trustees and is a member of the Institute of Financial Services School of Finance Board of Governors. He is also community ambassador for Yorkshire and Humberside and chairs the Group Regional Ambassador programme.

David Oldfield
Group Director, Operations

Appointed in 2014, David has responsibility for Group IT, Customer Operations, Customer Services and Global Payments along with Sourcing, Property, Security & Fraud and the Divestment and Development functions. David joined Lloyds Bank in 1984 on the graduate entry scheme. His previous senior leadership roles have included Group IT, SME and Mid Markets Banking, Asset Finance, COO Commercial Banking, Offshore Banking and Group Procurement.

David is a Non-Executive Director for Motability Operations Plc and is also on the Group Insurance Boards and a Fellow of the Chartered Institute of Bankers.

Miguel-Ángel Rodríguez-Sola
Group Director, Digital

Miguel joined the Group in 2011 before which he held a variety of executive positions in the UK, USA and Spain for Santander. Prior to this, Miguel was a Partner at McKinsey where he worked for over 12 years. He assumed his current role in September 2013 having previously held the position of Group Strategy Director and Commercial Director of the Retail Division.

Miguel holds a 'Cum Laude' degree in Business Administration from the University of Barcelona and an MBA from IESE Business School. He is a Board Member of Go-On UK.

Toby Strauss
Group Director, Insurance

Toby joined the Group in 2011 from Aviva where he spent three years, most recently as UK Life CEO and before that, Chief Operating Officer for UK Life.

Before Aviva, Toby worked in a variety of senior positions at McKinsey, where he specialised in financial services and technology; JS & P (now Towry) as Chief Executive and Charcol, as Managing Director. Toby has been a Trustee of Macmillan Cancer Support since April 2013.

Matthew Young
Group Corporate Affairs Director

Matt joined the Group in 2011 and has responsibility for internal and external communications, public policy and government relations, competition and community investment. Prior to this, he was Communications Director at Santander UK and he has also held senior positions with Abbey National and NatWest.

Matt is a member of the Guild of PR Practitioners.

Corporate governance report

Our aim is to be the best bank for our retail and commercial customers, and we are determined to make it a company of the highest integrity and standards.

Dear Shareholders

I am pleased to present our corporate governance report for the 2014 financial year. This report explains how the Group applies the highest principles of corporate governance, in particular those laid down in the 2012 edition of the Financial Reporting Council (FRC)'s UK Corporate Governance Code (the Code). The Code can be accessed at www.frc.org.uk.

2014 has been another significant year for Lloyds Banking Group. The Board has taken a number of important decisions as we work towards the goal of becoming the 'best bank for customers'. I am pleased to report that during the year the Board and its Committees met their key objectives and carried out their responsibilities effectively.

Set out below are some of the principal corporate governance matters considered in 2014.

Group strategy

The Board spent considerable time in 2014 debating the strategic priorities for the business over the next three years. There were several meetings which focused entirely on Group strategy, including a two day off-site. The Group announced in October that, having successfully rebuilt the Group's financial strength, its future focus will remain on continuously improving the customer experience. Through our multi-brand, multi-channel distribution, we will transform our digital capability, continue to simplify our operations and processes, and invest in the business to become the best bank for customers and thereby deliver strong, sustainable returns to shareholders.

TSB

In June and July 2014, as part of the divestment mandated by the European Commission, the Group completed an initial public offering of 38.5 per cent of the ordinary shares in TSB Banking Group plc (TSB). A further 11.5 per cent was placed with institutional investors in September, reducing the Group's interest in TSB to approximately 50 per cent. The significant investor demand for shares in TSB, reflected confidence in the prospects for the business.

The divestment of TSB occupied a considerable amount of the Board's time in 2014. It is an important step for the Group as we act to meet our commitments to the European Commission.

Stress tests

Lloyds Banking Group plc, together with seven other financial institutions in the UK, was subject to the 2014 stress test conducted by the Prudential Regulation Authority (PRA) to assess resilience to adverse market developments and overall systemic risk in the UK financial system. The key assumptions in the stress test included the UK house price index falling 35 per cent and unemployment peaking at 11.8 per cent, resulting in a material impact on those UK banks which are significantly exposed to the UK housing market.

The Group exceeded the capital threshold set out for the purpose of the stress test and was not required to take any action as a result of this test. It will continue to ensure that its robust capital position is maintained.

Similarly, the Group had been subject to the 2014 EU-wide stress test conducted by the European Banking Authority (EBA) to assess overall systemic risk in the EU financial system. Again, the Group met all the capital benchmarks set out for the purpose of the stress test.

Board composition

The Board appointed Alan Dickinson, Simon Henry, Dyfrig John and Nick Prettejohn as directors in 2014. The new directors, whose biographies are set out on pages 58 and 59, possess the necessary technical skills, share our values and have the behavioural characteristics to contribute constructively to our Board, and the self-confidence and analytic capability to form and share independent judgements. More information on the Board's approach to the recruitment of Directors is set out on page 74. In addition, Anita Frew became Deputy Chairman following the resignation of David Roberts and I took over as Chairman from Sir Winfried Bischoff in April last year. All Directors will stand for election/re-election at the 2015 Annual General Meeting.

HM Treasury sell down

In 2014, HM Treasury's interest in the Group was further reduced from approximately 32.7 per cent of the ordinary share capital by way of an accelerated bookbuilding process to institutional investors and a pre-arranged trading plan. On 20 February 2015, the Company was advised that HM Treasury's interest in the Group had reduced to 23.9 per cent.

Legacy issues

We have continued to face legacy issues including Payment Protection Insurance and in July the Group announced that it had reached settlements with UK and US federal authorities in regards to the manipulation of the London Interbank Offered Rate and Sterling Repo Rate. In respect of the latter, the Board regards the actions of those individuals found responsible as completely unacceptable and has taken vigorous action over the last four years to prevent this kind of behaviour from re-occurring.

Our aim is to be the best bank for our retail and commercial customers, and we are determined to make the Group a company of the highest integrity and standards.

Finally I would like to thank the Board and our employees for their support and commitment throughout the year.

Lord Blackwell
Chairman

THE BOARD AND ITS MEMBERS

Purpose and responsibilities

The Group is led by a Board comprising a Non-Executive Chairman, independent Non-Executive Directors and Executive Directors. The Board is collectively responsible for the long-term success of the Company. It achieves this by setting the strategy and overseeing delivery against it, establishing the culture, values and standards of the Group, ensuring that the Group manages risk effectively, monitoring financial performance and reporting and ensuring that appropriate and effective succession planning arrangements and remuneration policies are in place.

The role of the Directors

Set out below are the roles of the Chairman and other Board members. Further details can be found on the website at www.lloydsbankinggroup.com. There is a clear division of responsibility at the head of the Company. The Chairman has overall responsibility for the leadership of the Board while the Group Chief Executive manages and leads the business.

The role of the Company Secretary

The Company Secretary is responsible for advising the Board and providing good information flows and comprehensive practical support to Directors, both as individuals and as a collective, with particular emphasis on supporting the Non-Executive Directors in maintaining the highest standards of probity and corporate governance. The Company Secretary is also responsible for communicating with shareholders as appropriate and ensuring that due regard is paid to their interests. All Directors, including Non-Executive Directors, have access to the services of the Company Secretary in relation to the discharge of their duties.

Both the appointment and removal of the Company Secretary is a matter for the Board as a whole. Malcolm Wood was appointed as Company Secretary in November 2014.

Access to advice

The Group also provides access, at its expense, to the services of independent professional advisers in order to assist Directors in their role. Board Committees are also provided with sufficient resources to undertake their duties.

Overview of the roles of the Directors

Chairman

Lord Blackwell was appointed Chairman on 3 April 2014, following the retirement of Sir Winfried Bischoff. The Chairman:

- has overall responsibility for the leadership of the Board and the promotion of the highest standards of corporate governance;
- sets the Board meeting agendas to ensure that the Board devotes its time and attention to the right matters;
- builds an effective and complementary Board;
- plans succession in Board appointments in conjunction with the Nomination & Governance Committee;
- ensures the Directors receive timely and relevant information and are kept advised of key developments; and
- ensures effective communication with shareholders.

Senior Independent Director

Anthony Watson was appointed Senior Independent Director on 17 May 2012. The Senior Independent Director:

- helps resolve shareholders' concerns;
- acts as a sounding board for the Chairman and Group Chief Executive on Board and shareholder matters;
- is a conduit, as required, for the views of other Non-Executive Directors on the performance of the Chairman;
- is available to shareholders if they have concerns which contact through the normal channels has failed to resolve or for which such contact is inappropriate;
- attends sufficient meetings with major shareholders and financial analysts to understand issues and concerns; and
- conducts the Chairman's annual performance appraisal.

Group Chief Executive

António Horta-Osório was appointed Group Chief Executive on 1 March 2011. The Group Chief Executive:

- manages the Group on a day to day basis, and in accordance with the strategy and long-term objectives approved by the Board;
- with the exception of those matters reserved to the Board, the Group Chief Executive makes decisions on matters affecting the operations, performance and strategy of the Group's businesses;
- provides leadership and direction to senior management; and
- coordinates all activities to implement the strategy and for managing the business in accordance with the Group's risk appetite and business plan set by the Board.

Deputy Chairman

Anita Frew was appointed Deputy Chairman on 14 May 2014 following the retirement of David Roberts. The Deputy Chairman:

- ensures continuity of effective Board Chairmanship during any change of chairmanship;
- supports the Chairman in representing the Board and acting as spokesperson;
- deputises for the Chairman in the discharge of his duties;
- is available to the Board for consultation and advice; and
- represents the Group's interests to official enquiries and review bodies.

Non-Executive Directors

The Non-Executive Directors are listed on pages 58 and 59. Non-Executive Directors:

- challenge constructively;
- help develop and set the Group's strategy;
- participate actively in the decision-making process of the Board;
- scrutinise the performance of management in meeting agreed goals and objectives;
- provide entrepreneurial leadership of the Group within a framework of prudent effective controls;
- satisfy themselves on the integrity of financial information; and
- determine appropriate levels of remuneration of Executive Directors via the Remuneration Committee.

Executive Directors

The Executive Directors are listed on page 59. Executive Directors:

- under the leadership of the Group Chief Executive, make and implement decisions in all matters affecting the operation, performance and strategy of the Group's business.
- provide specialist knowledge and experience to the Board;
- are responsible for the successful leadership and management of the Risk and Finance divisions;
- design, develop and implement strategic plans; and
- deal with day-to-day operations of the Group.

Corporate governance report continued

AUTHORITY AND DELEGATION

Corporate governance framework

The Group's corporate governance framework, which is reviewed annually by the Board, comprises the board authority and the delegated executive authority.

Board authority

The board authority sets out the matters reserved to the Board. These include decisions concerning the strategy and long-term objectives of the Group, the Group's capital, medium-term plan and financial budgets, significant contracts and transactions and various statutory and regulatory approvals.

The approval of the remuneration policy, risk appetite and risk management framework is also reserved to the Board. The board authority delegates responsibility for day-to-day management of the business to the Group Chief Executive and sets out the basis for delegation of authorities from the Board to Board Committees.

Delegated executive authority

The Group Chief Executive, through the delegated executive authority, delegates aspects of his own authority, as permitted, to members of the Group Executive Committee (GEC). The GEC meets weekly to scrutinise items of key business.

The Group Audit Director, Group HR Director and the Company Secretary attend the weekly GEC meetings to ensure that there is appropriate internal audit oversight, that employee interests and people strategy matters are considered and that the highest standards of corporate governance are maintained, including the escalation of matters to the Board and its Committees.

A full schedule of all matters reserved to the Board can be found on our website at www.lloydsbankinggroup.com

The following table provides an overview of the key matters considered by the Board in 2014.

Strategy and customer focus

The Board:

- approved an update to the Group's strategy and long-term objectives;
- approved an update to the 5 Year Operating Plan and the 2014 annual budget and reviewed delivery against plan;
- conducted deep dives into the Retail, Commercial Banking, Consumer Finance, Insurance, Group Operations and Digital divisions;
- noted the brand revitalisation of the Scottish Widows Group; and
- developed customer dashboard and monitored key metrics.

Governance

The Board:

- carried out an annual review of the corporate governance framework, Board Committee terms of reference and key Group policies;
- determined Board and Committee structure, size and composition;
- analysed the Group's performance against the 34 'Salz' recommendations, embedding changes to the Group's governance arrangements where necessary;
- considered the findings of an annual review of the Board's effectiveness, implementing action plans where necessary and tracking performance;
- monitored the Group's performance against EU State Aid Commitments;
- appointed a new Deputy Chairman and four new Non-Executive Directors to the Board; and
- appointed a new Chairman to the Scottish Widows Group.

Risk management

The Board:

- approved the Group's risk appetite and risk management framework;
- monitored the Group's aggregate risk exposures, risk/return and emerging risks;
- scrutinised the results and approved the submission of the Group's stress tests conducted by the PRA and EBA;
- reviewed the effectiveness of the Group's risk management and internal control systems;
- considered the findings of the annual control effectiveness review;
- received reports on risk compliance and risk appetite dashboard performance; and
- conducted a cyber-risk assessment and approved the implementation of measures to address cyber-risk.

Transactions and contingency planning

The Board:

- approved strategic proposals, including the IPO of TSB Bank; and
- considered the impact of a 'yes' vote in Scotland on the Group's operations.

Structure and capital

The Board:

- approved material changes to the capital structure of HBOS and Bank of Scotland;
- considered the basis for allocation of capital, investments, acquisitions, mergers or disposals; and
- approved large transactions, including the sale of portfolios of UK and European real estate loans and tender offers for Enhanced Capital Notes (ECNs).

Finance, statutory and regulatory requirements

The Board:

- considered regulatory changes to be introduced by the Banking Reform Act including retail ring-fencing;
- approved the annual report and accounts and significant accounting changes; and
- approved the shareholder notice of annual general meeting.

BOARD

LLOYDS BANKING GROUP PLC

BOARD COMMITTEES

Nomination & Governance Committee

Reviews the Board's governance arrangements to ensure that they are consistent with best practice, assists the Chairman in reviewing the composition of the Board and leads the appointments process for nominations to the Board

Audit Committee

Monitors and reviews the Group's financial reporting arrangements, the effectiveness of the internal controls and the risk management framework, and the internal and external audit process; manages all aspects of the relationship with the external auditor

Risk Committee

Monitors the Group's compliance with the Board's approved risk appetite, risk management framework and risk culture

Remuneration Committee

Recommends an overall remuneration policy and philosophy that is aligned with the long-term interests of the Group, business objectives, risk appetite and values

GROUP CHIEF EXECUTIVE

ANTÓNIO HORTA-OSÓRIO

Responsible for managing the business of the Group, in accordance with the strategy and long-term objectives approved by the Board.

GROUP EXECUTIVE MEMBERS' COMMITTEES

These include the Group Executive Committee
Please see pages 114 and 115 for a list of the Executive Committees and their purpose

The role of the Board Committees

The Board is supported by its Committees which make recommendations to the Board on matters delegated to them, in particular in relation to internal control, risk, financial reporting, governance and remuneration matters. This enables the Board to spend a greater proportion of its time on strategic, forward looking agenda items. Each Committee comprises Non-Executive Directors only and is chaired by an experienced Chairman. The Committee Chairs report to the Board on the activities of the Committee at each Board meeting. Information on the membership, role and activities of the Nomination & Governance, the Audit and the Risk Committees can be found on pages 73 to 81. Information on the Remuneration Committee can be found in the Directors' remuneration report on pages 82 to 103. Terms of Reference for each of the Board Committees can be found on the website at www.lloydsbankinggroup.com

Subsidiary governance

The Group conducts the majority of its business through a number of subsidiary entities. The Boards of the four main companies, Lloyds Banking Group plc, Lloyds Bank plc, HBOS plc and Bank of Scotland plc, comprise the same Directors. The Board meetings for these companies are held concurrently with the agenda split between the companies to allow decisions to be taken and scrutinised by the appropriate Board.

In addition the Group has an insurance subsidiary, Scottish Widows Group Limited, which itself also has a number of separate operating subsidiaries. The Board of Scottish Widows Group Limited, which also sits as the Board of its major subsidiaries, is chaired by a non-executive member of the Lloyds Banking Group Board and contains a balance of independent non-executive directors, Group executives and Insurance Division executives. This composition supports its legal and regulatory requirements for independent decision making within the overall framework of Group policies and controls.

To help manage the legal, regulatory and reputational risks associated with the Group's subsidiary entities, the Group requires that subsidiary boards and their directors meet minimum governance standards, as laid down in the legal entity management standards and directors' handbook.

Board strategy review

During the year, the Board spent considerable time in a number of meetings, including two days off-site, to debate and devise its strategy for the next three years, building on the Group's strong foundations of having become a low cost, low risk, UK focused retail and commercial bank.

Discussions linked in with those for the five-year operating plan and included economic trends, the competitive and regulatory environment, Group culture and values, the need to rebuild trust with customers, digital transformation, the future of distribution, financial planning and retirement, organisational capability, simplification, IT delivery and risk oversight.

Discussions within other committees were also fed through to the Board for consideration, such as those of the Group Executive Committee and its Strategy Working Group, a forum which oversees development of the Group strategy, delivery of the Group Strategic Review and which gives consideration to strategic priorities and opportunities across the Group.

Corporate governance report continued

BOARD COMPOSITION

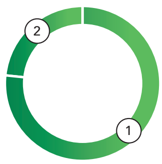
Board size and composition

The Board should be of sufficient size to reflect a broad range of views and perspectives whilst allowing all Directors to participate effectively in meetings. The Board currently comprises three Executive Directors, nine independent Non-Executive Directors and the Chairman who was independent on appointment. The size of the Board is within the optimal range set by the Nomination & Governance Committee. Further details on the composition of the Board and independence of the Non-Executive Directors are provided in the Nomination & Governance Committee report.

Board appointments

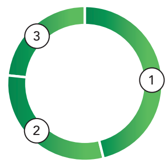
The chart opposite sets out the changes to Board membership in 2014. The appointment of new directors to the Board follows a formal, rigorous and transparent procedure. More information on Board and Committee composition and the appointment process is set out in the Nomination & Governance Committee report. The Directors' biographies are set out on pages 58 and 59.

BOARD COMPOSITION



1. Non-Executive Directors 10
2. Executive Directors 3

BOARD TENURE



1. 0 - 2 years 6
2. 2 - 4 years 4
3. 4 - 6 years 3

BOARD CHANGES IN 2014

		Total number of Directors
Jan	Dyfrig John appointed	12
Apr	Sir Winfried Bischoff retired	11
May	David Roberts retired	10
June	Nick Prettejohn and Simon Henry appointed	12
Sept	Alan Dickinson appointed	13

Manipulation of LIBOR and Sterling Repo Rate

Background

Since 2010 the Group has been engaged with a number of government agencies in the UK, US and elsewhere, who are conducting investigations into the manipulation several years ago of submissions made by panel members to the bodies that set various interbank offered rates, including the London Interbank Offered Rate (LIBOR) and Sterling Repo Rate, along with other reference rates.

Board response

Over the last four years, the Group has fundamentally overhauled systems and controls across the bank including the separation of key control functions such as Risk, Finance and Compliance from the business divisions in order to remove potential conflicts and provide clear independence. The Audit function has been strengthened and given an expanded remit through oversight of financial risks and controls and greater prominence with the Group Audit Director attending the Group Executive Committee meetings. The Group's culture and values have changed; systems and processes were improved and more effective controls were implemented.

In 2014 settlement negotiations commenced with UK and US federal authorities. To manage this process, first the Board Risk Committee and then a specifically established Market Practices Sub-Committee of the Board Risk Committee investigated the issues, which were restricted to a specific area of the business and during a limited time period. The Market Practices Sub-Committee met five times during 2014, reporting to the Board Risk Committee with updates to the Board. The Chairman of the Risk Committee acted as the Chairman of the Sub-Committee.

The Board regards the actions of these individuals between 2006 and 2009 as completely unacceptable. Their behaviour involved a gross breach of trust and we condemn it without reservation.

Lord Blackwell
Chairman

Outcome

In July 2014 the Group announced the payment of £217 million in settlements to UK and US federal authorities in connection with its manipulation several years ago of LIBOR and Sterling Repo Rate between May 2006 and 2009.

The individuals involved have either left the Group, been dismissed, been suspended or are subject to disciplinary proceedings. Bonuses totalling £3 million have been clawed back from those involved.

Executive Director service contracts and Non-Executive Director terms of appointment

The Chairman and Non-Executive Directors are appointed for a specified term. All Directors are subject to annual re-election by shareholders. Non-Executive Directors may have their appointment terminated, in accordance with statute and the articles of association, at any time with immediate effect and without compensation. Executive Directors have service contracts with the Group. The Chairman, Group Chief Executive, Chief Financial Officer and Chief Risk Officer are each obliged to give six months' notice of their intention to retire from their respective roles. The terms and conditions of appointment of Non-Executive Directors and Executive Director service agreements are available for inspection at the registered office address.

Election and re-election

All Directors appointed to the Board since the Annual General Meeting (AGM) in 2014 will stand for election at the 2015 AGM. All other Directors will retire and those wishing to serve again will submit themselves for re-election at the AGM. Biographies of current Directors are set out on pages 58 and 59. Details of the Directors seeking election or re-election at the AGM are set out in the Notice of Meeting.

Directors' and Officers' liability insurance

Throughout 2014 the Group had appropriate insurance cover in place to protect Directors, including former Directors who retired during the year, from liabilities that may arise against them personally in connection with the performance of their role. As well as insurance cover, the Group agrees to indemnify the Directors to the maximum extent permitted by law. Further information on the Group's indemnity arrangements is provided on page 104.

Diversity policy

The Board places great emphasis on ensuring that its membership reflects diversity in the broadest sense. The combination of personalities and experience on the Board provides a comprehensive range of perspectives and challenge and improves the quality of decision making.

At the end of 2013 and during the year, the Board recruited four directors with the assistance of a number of executive search firms, as described in more detail on page 74. Each of the firms was briefed on the Group's diversity policy, diversity being one important aspect of the search for the right mix of directors. The Board has adopted the recommendations of Lord Davies of 25 per cent female representation by 2015.

After diligent processes, the persons selected with the best 'fit' and the most relevant skills and experience were Alan Dickinson, Simon Henry, Dyfrig John and Nick Prettejohn. Following these appointments, female representation on the Board has dropped from 27 per cent last year to 23 per cent – although the actual number of women on the Board remains the same at three.

The following table details the percentage of women employed at various levels of seniority within the Group as at 31 December 2013 and 2014 at all levels of the organisation:

Female Board members		Female senior managers		Female managers		All staff	
2013	**2014**	2013	**2014**	2013	**2014**	2013	**2014**
27.3%	**23.0%**	28.5%	**29.3%**	45.1%	**45.4%**	58.7%	**58.6%**

Developing diversity

The Board recognises that senior management is a group from which future directors may be selected. To promote diversity across the whole Group, a variety of networks have been implemented which include:

– Breakthrough, a women's network committed to encouraging the development of female colleagues and to leverage this talent pool;
– The Group Ethnic Minority network which focuses on career development and supports the aspirations of its members;
– The Access Network which aims to provide support for colleagues with disabilities via initiatives such as mentoring, advice and social events; and
– Rainbow, an inclusive Group-wide network for lesbian, gay, bisexual and transgender colleagues aiming to promote a positive and inclusive working environment.

More information on the Group's diversity programmes, including details of the Group's commitment to raise the percentage of women employed in senior management roles to 40 per cent by 2020, is provided in the Responsible Business section of our website at www.lloydsbankinggroup.com.

Conflicts of interest

All Directors of the Company and its subsidiaries must avoid any situation which might give rise to a conflict between their personal interests and those of the Group. Prior to appointment, potential conflicts of interest are disclosed and assessed to ensure that there are no matters which would prevent that person from taking on the role.

Directors are responsible for notifying the Chairman and Company Secretary as soon as they become aware of actual or potential conflict situations. In addition, conflicts are monitored as follows:

– the Directors are required to complete a conflicts questionnaire on appointment and annually thereafter;
– changes to the commitments of all Directors are reported to the Nomination & Governance Committee and the Board; and
– a register of potential conflicts and time commitments is regularly reviewed and authorised by the Board to ensure the authorisation status remains appropriate.

If any potential conflict arises, the articles of association permit the Board to authorise the conflict, subject to such conditions or limitations as the Board may determine.

Carolyn Fairbairn is a Non-Executive Director of the Competition and Markets Authority (CMA). She recuses herself from all discussions at the CMA on their investigation into banking competition.

Time commitments

Non-Executive Directors are required to devote such time as is necessary for the effective discharge of their duties. On average, this equates to at least 35 to 40 days per annum (including attendance at Committee meetings). For Committee Chairs, this increases to at least 45 to 50 days with the Senior Independent Director and Deputy Chairman spending considerably more than 50 days on the Group's business. Non-Executive Directors may be expected to relinquish other appointments to ensure that they can meet the time commitments of their role.

Fees paid to Non-Executive Directors reflect the time commitment and responsibilities of the role. Non-Executive Directors do not receive share options or other performance related pay. Executive Directors are restricted to taking on no more than one non-executive director role in a FTSE 100 company. The Chairman is required to commit to this being his primary role, limiting his other commitments to ensure he can spend as much time as the role requires. Since the announcement of his appointment to the role of Chairman in December 2013, Lord Blackwell has taken steps to ensure that he can adequately meet the time commitments of the role and has resigned from his positions at Halma plc and Ofcom, in March and July 2014 respectively. The Chairman's biography can be found on page 58.

Corporate governance report continued

TRAINING

Board induction

All Directors are expected to make an informed contribution based on an understanding of the Group's business model and the key challenges facing the Group and its businesses. The Chairman ensures that all Directors receive a full, formal and tailored induction on joining the Board, facilitated by the Company Secretary and comprising:

- a corporate induction, including an introduction to the Board and a detailed overview of the Group, its strategy, operational structures and main business activities. Non-Executive Directors are also afforded opportunities to meet with major shareholders in order to develop an understanding of their views about the Company;
- the roles and responsibilities of a Director, including statutory duties and responsibilities of an FCA approved person;
- a bespoke induction programme tailored by the Chairman to the individual needs of the Director with regard to their specific role and their skills and experience to date. This takes the form of reading materials and meetings with senior executives across the Group and sessions with the Group's business divisions; and
- a detailed induction programme across Risk, focusing on: risk appetite and the Group's risk profile; compliance and conduct risk; capital, stress testing, analytics and modelling; liquidity risk; Retail and Wealth credit risk; Commercial Banking credit risk; operational risk and financial crime; EU State aid, risk transformation, ring-fence banking, recovery and resolution planning; global non-core; and the separation of TSB Bank.

On being appointed Deputy Chairman and interim Risk Committee Chairman, Anita Frew attended numerous meetings with the relevant business executives, including the Chief Risk Officer, and shadowed the previous incumbent closely in the handover period. In particular, Ms Frew received dedicated training from business executives on stress testing to support her role as Chairman of the Stress Testing Sub-Committee of the Board Risk Committee.

Professional development

The Board receives regular refresher training and information sessions throughout the year to address current business or emerging issues. This is done under the leadership of the Chairman who will also regularly review and agree with each Director their training and development needs. Information sessions are delivered through a variety of business updates, including sessions on:

- capital and liquidity (including stress testing requirements);
- the Senior Persons' Regime;
- accounting developments;
- the structural hedge; and
- credit rating agency developments.

These sessions also allow the Executive Directors an opportunity to consider business areas outside their direct responsibilities.

In addition, the Board hosted a series of 'deep dives' in 2014 to which all Directors were invited, and which provided an in-depth review of the operations of each of the business divisions and of the latest accounting standards and operating methodologies. The Board Risk Committee also received reviews from each division. All of the Directors attend the Board Risk Committee meetings.

Directors are also invited to attend courses, management meetings and one-to-one meetings with key executives.

BOARD AGENDA AND ATTENDANCE

Setting the Board agenda

The Chairman is responsible for setting the Board agenda, assisted by the Group Chief Executive and Company Secretary. A yearly planner is prepared by the Company Secretary to map out the flow of key items of business to the Board and to ensure that sufficient time is being set aside for strategic discussions.

Prior to each Board meeting the Chairman reviews the agenda and time allocation with the Group Chief Executive, the Company Secretary and the Chief Financial Officer. The Group Chief Executive holds a separate Board paper review meeting to review the individual papers. That meeting is held with the Chief Financial Officer, the Chief Risk Officer, the Company Secretary and authors of the main papers, as required.

Effective use of the Board's time

To ensure that there is sufficient time for the Board to discuss matters of a material nature, Board dinners and/or breakfast meetings are held prior to each scheduled Board meeting. This allows the Directors greater time to discuss their views and, where relevant, form a consensus ahead of the meeting. These pre-meetings are normally attended by all members of the Board but often the pre-meetings are held without the Executive Directors present and separately, at least once a year, without the Chairman in attendance.

The Non-Executive Directors also receive regular updates from the Group Chief Executive's office and hold regular one-to-one meetings with the Group Chief Executive in the form of a weekly email or briefing call.

Attendance at meetings

The attendance of Directors at Board and Committee meetings is shown in the table overleaf. Whilst all Non-Executive Directors are invited to, and regularly attend, other Committee meetings, only their attendance at Committees of which they are members is recorded.

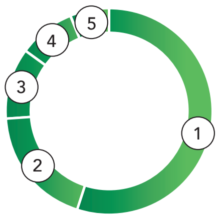
In 2014, a total of 15 Board meetings were held, eight of which were scheduled and seven of which were ad hoc meetings. Ad hoc Board meetings are called at short notice to discuss a matter that cannot wait until the next scheduled Board meeting. Where a Director is unable to attend a meeting, the Chairman discusses the matter with the Director and seeks their support for the proposed recommendation. He also represents their views at the meeting. Also, any Director unable to attend a meeting has the opportunity to review any papers and provide comments to the Chairman.

The Directors attended a number of other Board Committee and Sub-Committee meetings during the year, including meetings in relation to the Initial Public Offering and disposal of a further holding in TSB, the regulatory par call of Enhanced Capital Notes, the Market Practices Committee which provided oversight in relation to the Group's settlement negotiations on LIBOR and the Sterling Repo Rate, and the oversight of PPI.

Group strategy

In addition to routine strategic discussion at Board meetings throughout the year, the Directors spent two days off site in 2014 focusing entirely on the Group's strategic priorities.

2014 BOARD ALLOCATION OF TIME
(including deep dives and away days)



1. Strategy and customer focus	55%
2. Statutory and regulatory requirements	19%
3. Finance and budget	11%
4. Risk and governance	9%
5. Other, including remuneration oversight	6%

Current Directors who served during 2014[1]	Lloyds Banking Group Board Scheduled meetings Attended/Held	Lloyds Banking Group Board Ad hoc meetings Attended/Held	Nomination & Governance Committee Attended/Held	Audit Committee Attended/Held	Board Risk Committee[2] Attended/Held	Remuneration Committee[2] Attended/Held
António Horta-Osório	8/8	7/7	-/-	-/-	-/-	-/-
Lord Blackwell	8/8	7/7	6/6	4/4	7/7	5/5
Juan Colombás	8/8	7/7	-/-	-/-	-/-	-/-
George Culmer	8/8	7/7	-/-	-/-	-/-	-/-
Alan Dickinson	2/2	4/4	-/-	2/2	3/3	-/-
Carolyn Fairbairn	7/8[4]	6/7[5]	-/-	8/8	-/-	11/11
Anita Frew	8/8	7/7	6/6	8/8	7/7	5/5
Simon Henry	3/3	4/5[5]	-/-	2/3[3]	3/4[3]	-/-
Dyfrig John	8/8	7/7	-/-	5/5	7/7	4/4
Nick Luff	8/8	7/7	1/1	8/8	7/7	-/-
Nick Prettejohn	4/4	5/5	-/-	4/4	4/4	-/-
Anthony Watson	8/8	6/7[5]	6/6	6/8[3,4]	6/7[3]	11/11
Sara Weller	8/8	7/7	-/-	-/-	7/7	10/11[5]
Former Directors who served during 2014						
Sir Winfried Bischoff	3/3	2/2	3/3	-/-	2/2	6/6
David Roberts	4/4	2/2	3/4[4]	4/4	3/3	6/6

[1] Number of meetings held during the period the member held office.
[2] The number of Committee meetings includes ad hoc meetings.
[3] Conflict with external appointments.
[4] Prior engagement.
[5] Meeting arranged at short notice.

EFFECTIVENESS

Board effectiveness

The Chairman of the Board leads the rolling review of the Board's effectiveness and that of its committees and individual directors with the support of the Nomination & Governance Committee, which he also chairs.

The annual evaluation provides an opportunity to consider ways of identifying greater efficiencies, maximising strengths and highlighting areas for further development.

Following the comments captured in the 2013 Board effectiveness review and upon becoming Chairman, Lord Blackwell introduced a number of actions to improve the effectiveness of the Board. Actions included:

- meeting times extended to include regular deep dives on specific business issues;
- additional deep dive sessions on business areas to be held between Board meetings;
- all Non-Executive Directors encouraged to attend risk, audit and remuneration committee meetings;
- abbreviated routine performance reporting;
- self-standing timely papers supporting proposed Board decisions;
- informal discussion opportunities to be included in Board sessions;
- guest speakers to be invited for informal lunches; and
- frequent informal dinners.

2014 evaluation of the Board's performance

Evaluation of the Board is externally facilitated at least every three years. The last externally facilitated evaluation was in 2012. This year's evaluation was conducted internally between December 2014 and January 2015 by the Company Secretary, led by the Chairman and overseen by the Nomination & Governance Committee. The 2014 review considered the following areas: strategy; risk and control; planning and performance; Board composition and size; culture and dynamics; balance of skills and experience; diversity; relationships between management and independent directors; governance; the Board's calendar and agenda; the quality and timeliness of information and support for Directors and Committees. The process for the review consisted of:

- a detailed questionnaire, prepared by the Company Secretary in conjunction with the Chairman, to assess the effectiveness of the Board, its Committees and individual Directors;
- follow up interviews by the Company Secretary with each Director;
- feedback to the Nomination & Governance Committee; and
- a recommended action plan.

At the time of the 2015 AGM Anthony Watson will have been on the Board for more than six years. Therefore, in compliance with the Code, his review was particularly rigorous.

The evaluation of the Chairman by the Non-Executive Directors was led by the Senior Independent Director through questionnaires and interviews for those who wanted to discuss anything further. The views of the Executive Directors were also taken into account.

The reviews concluded that the performance of the Board, its Committees, the Chairman and each of the Directors continues to be effective. All Directors demonstrated commitment to their roles.

The outcome of the effectiveness review has been discussed by the Board and each of the Committees. The outcome of the evaluation of the Chairman was discussed by the Non-Executive Directors in the absence of the Chairman. If Directors have concerns about the Company or a proposed action which cannot be resolved, it is recorded in the Board minutes. Also on resignation, Non-Executive Directors are encouraged to provide a written statement of any concerns to the Chairman, for circulation to the Board. No such concerns were raised in 2014.

Corporate governance report continued

A summary of the Board's progress against the actions arising from the 2014 and 2013 effectiveness reviews are set out below:

Themes	Observations	Actions taken/to be taken	Progress/comments
2014 Board Effectiveness Review (internal)			
The timeliness and content of Board and Committee papers	Despite some improvement, timeliness and clarity of papers remains an issue.	Further targeted training for authors is needed to ensure papers are delivered in a timely manner, present a balanced view of all issues and are concise.	To be reported on in 2016.
The process for escalation of matters to the Board and its Committees	The mechanisms to ensure appropriate escalation of issues to the Board (outside the matters reserved for the Board or risk appetite) can be improved.	Current escalation mechanisms to be reviewed and amended where appropriate.	To be reported on in 2016.
The creation of a new Board Committee	Board oversight for matters of the kind currently covered by the executive Responsible Business Committee would be welcome.	The formation of a Responsible Business Board Committee is being considered.	To be reported on in 2016.
2013 Board Effectiveness Review (internal)			
Quality and timeliness of Board papers	Actions taken previously had reduced volume, but more was required to improve quality and timeliness of papers.	Targeted training was rolled out to senior managers to ensure papers focus on the areas that are most likely to lead to discussion.	The quality and timeliness of Board and Committee papers continues to challenge the business. Further improvement is required.
The mix of skills and experience on the Board	Additional banking, finance and risk experience needed.	Dyfrig John, Nick Prettejohn, Simon Henry and Alan Dickinson were appointed in 2014.	Completed – In 2014 the Board gained significant banking, finance, risk and insurance experience with the appointment of four directors.
Refocusing the Board agenda	Devote more time to strategic and customer issues.	More time was allocated to customer dashboards and peer analysis, as well as deep dive sessions.	Completed – In 2014 the Board was able to devote significant time on the Group's strategy and customers.

Audit Committee case study – external audit tender

Background

The Audit Committee confirmed in the Group's 2013 Annual Report and Accounts that it was considering conducting an audit tender during 2014 with a view to reappointing a new firm, or PricewaterhouseCoopers (PwC), with effect from 1 January 2016. A final decision was to be made once there was further clarity on the likely requirements of the proposed EU Directive concerning the mandatory change of auditors.

The EU Directive was approved by the European Parliament on 3 April 2014 and introduced a requirement for Public Interest Entities to retender their audits at least every 10 years and to change the auditor at least every 20 years. The Directive contained transitional rules which, given PwC's length of service in its role as auditors to the Group, meant that the Group would not be able to reappoint PwC after the 2020 year end audit.

The Audit Committee took the decision in April 2014 to invite three firms to tender for the audit of the Group with effect from the 2016 year end. It was the Audit Committee's intention to complete this process during the first half of 2014.

The decision to commence a tender process was taken having given due consideration to the new EU legislation. Whilst the Audit Committee noted that the Group was not obliged to change its auditor for a number of years, it was still felt that it would be appropriate to undertake a tender process at this juncture. The Audit Committee's decision as to the timing of the tender was also influenced by the understanding that at least two other UK banks were likely to put their audits out to tender in the near future and potentially as early as the second half of 2014.

In light of this, it was felt that by undertaking a tender process in the first half of the year the Group could avoid overlapping their tender process with other UK banks, which might be of benefit to the Group as it would ensure that the participating firms could put forward their strongest available team.

Governance

The proposal to tender for the audit work of the Group was overseen by the Audit Committee Chairman. The tender process involved three stages, these are summarised below.

- **Interview phase.** Each firm was invited to an extensive series of interviews with members of the Audit Committee, members of the Board and a number of the Group's senior management team. These interviews formed part of a formal assessment process whereby each firm was scored against key criteria, including matters such as the strength and experience of senior team members and their firm's ability to serve effectively the Group's diverse and sizeable operations.
- **Submission of a written proposal document.** Each firm was asked to provide detailed information in writing on certain matters in support of their proposal which were key to the Audit Committee's assessment of each bid. This included matters such as: any independence issues faced by the firm in connection with their ability to serve the Group as auditors; the outcome of recent internal or external reviews to assess the quality of their firm's audits; details on their audit methodology and areas of audit focus with regards to the Group; and an analysis of their expected level of audit effort (by grade of staff and hours) per year.
- **Tender presentations.** All three of the firms were invited to present their audit proposition to a Selection Committee. The Selection Committee was comprised of Mr Luff, Ms Fairbairn and Ms Frew. A number of the Board members were also in attendance for these presentations.

Following the presentations the Selection Committee submitted a summary of the proposals and a recommendation for consideration by the Audit Committee. The Audit Committee in turn provided a recommendation to the Board for consideration and approval.

Outcome

As was confirmed in the Group's 2014 half-year results news release, after careful consideration of the strength of each proposal, the Board accepted the recommendation from the Audit Committee to retain the services of PwC. Accordingly, subject to shareholders' approval, PwC will be reappointed as auditor. There will be a mandatory rotation for the 2021 year-end audit.

SHAREHOLDER RELATIONSHIPS

The Board recognises the need for a programme of engagement which offers all shareholders opportunities to receive information directly and to enable them to share their views with the Board.

Key facts at 31 December 2014:

- The Group has the largest number of registered ordinary shareholders in the UK
- Retail shareholders represent approximately 98.3 per cent of the total number of shareholders
- Institutional shareholders held approximately 95.5 per cent of the issued share capital on the share register, including approximately 7 per cent held on behalf of retail shareholders

Investor Relations

Investor Relations has primary responsibility for managing and developing the Group's external relationships with existing and potential institutional equity investors. Supported by the Group Chief Executive, Chief Financial Officer, and other members of the senior management team, and the Senior Independent Director where appropriate, they achieve this through a combination of briefings to analysts and institutional investors (both at results briefings and throughout the year), as well as individual discussions with institutional investors.

Further, the team ensures that the Group's Board and Group Executive Committee are informed of key messages, market developments and perception of the Group in the market. The primary responsibility for managing and developing relationships with existing and potential debt investors rests with the Group Corporate Treasury team with support from Investor Relations.

Investor Relations is also responsible for delivering the Group's financial results which includes presentations to the market and publication of formal results and announcements, as well as hosting regular national and international roadshows and meetings for current and potential institutional equity and debt investors in the Company.

Investor contact

During 2014, the Group held over 1,000 meetings with institutional equity and debt investors in the UK and overseas. Typical discussion points for institutional investors during the year included the Group's financial performance; the Group's strategy as outlined within the Strategic Update announced in October 2014; performance against strategy; progress in meeting regulatory requirements; as well as a number of issues that were pertinent at different times in the year such as the Initial Public Offering of TSB and the Scottish Referendum.

Governance and executive remuneration

Both the Chairman and Anthony Watson, the Group's Senior Independent Director and Chairman of the Remuneration Committee, have participated in discussions with investors regarding governance and the strategic direction of the Group. Anthony Watson, supported by Investor Relations and the Human Resources Reward team, has engaged extensively with proxy advisors and the Group's larger shareholders to consult on issues relating to executive remuneration.

Company Secretary and retail shareholders

Group Secretariat has a dedicated team responsible for managing services and communications for and with retail shareholders.

The Group's registrar, Equiniti Limited, provides a dedicated shareholder telephone and dealing service to assist shareholders in managing their investments. Investors can also manage their shareholdings online.

The Group engages directly with retail shareholders to respond to enquiries that are specific to the Group covering topics such as legacy matters, results, resumption of dividends and strategic progress.

Group Secretariat runs a programme of asset reunification through ProSearch, a subsidiary of the registrar. This is tailored to specific sections of former and current shareholders and since its inception in 2011 in excess of £13 million has been successfully reunited with more than 185,000 shareholders.

The Annual General Meeting (AGM)

The AGM is the principal opportunity for shareholders to engage directly with the Board. It is more commonly used by retail shareholders as an opportunity to share views and raise questions during the meeting, but afterwards there is the opportunity to meet the Directors and members of the Group Executive Committee. All Board members attended the AGM held in Edinburgh in 2014 and will also attend the AGM in 2015.

In accordance with the articles of association, the AGM is held in Scotland, usually in May, with attendance of between 350 to 500 shareholders, members of the media and other guests and observers. For those unable to attend, the AGM is broadcast live through the internet with a recording being made available on our website.

Usually, in excess of 70 per cent of total voting rights is voted by shareholders. The results are a key indicator of how shareholders support the Board. At the AGM in 2014, the 'in favour' vote range across all resolutions was 87.25 per cent to 99.98 per cent.

INTERNAL CONTROL

The Board is responsible for the Group's risk management systems and internal controls, which are designed to facilitate effective and efficient operations and to ensure the quality of internal and external reporting and compliance with applicable laws and regulations. The Directors and senior management are committed to maintaining a robust control framework as the foundation for the delivery of effective risk management. The Directors acknowledge their responsibilities in relation to the Group's systems of risk management and internal control and for reviewing their effectiveness.

In establishing and reviewing the systems of risk management and internal control, the Directors consider the nature and extent of the risks facing the Group, the likelihood of a risk event occurring and the costs of control. A system of internal control is designed to manage, rather than eliminate, the risk of failure to achieve business objectives, and can therefore only provide reasonable but not absolute assurance against the risk of material misstatement or loss. The process for identification, evaluation, escalation and management of the principal risks faced by the Group is integrated into the Group's overall framework for risk governance. The Group is forward-looking in its risk identification processes to ensure emerging risks are identified. The risk identification, evaluation and management process also identifies whether the controls in place result in an acceptable level of risk.

Corporate governance report continued

At Group level, a consolidated risk report and risk appetite dashboard are reviewed and regularly debated by the Group Risk Committee, Board Risk Committee and the Board to ensure they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The report and dashboard provide a monthly view of the Group's overall risk profile, key risks and management actions, together with performance against risk appetite and an assessment of emerging risks which could affect the Group's performance over the life of the operating plan. Information regarding the main features of the internal control and risk management systems in relation to the financial reporting process is provided in the risk management report on pages 107 to 170.

An annual control effectiveness review (CER) is undertaken to evaluate the effectiveness of the Group's control framework with regard to its material risks, and to ensure management actions are in place to address key gaps or weaknesses in the control framework. Business areas and head office functions assess the controls in place to address all material risk exposures across all risk types. The CER considers all material controls, including financial, operational and compliance controls. Members of senior management complete an attestation to confirm the CER findings which are reviewed and independently challenged by the Risk Division and Group Audit and reported to the Board. Action plans are implemented to address any control deficiencies.

The effectiveness of the risk management and internal control systems is reviewed regularly by the Board and the Audit Committee, which also receives reports of reviews undertaken by the Risk Division and Group Audit. The Audit Committee receives reports from the Company's auditor, PricewaterhouseCoopers LLP (which include details of significant internal control matters that they have identified), and has a discussion with the auditor at least once a year without executives present, to ensure that there are no unresolved issues of concern.

The Group's risk management and internal control systems are regularly reviewed by the Board and are consistent with the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting issued by the Financial Reporting Council and compliant with the requirements of the Capital Requirements Directive IV (CRD IV). They have been in place for the year under review and up to the date of the approval of the annual report.

The 2014 CER found that, overall, the Group is well controlled and that the control environment has improved year-on-year, with no significant failings or weaknesses identified. This conclusion is consistent with the delivery of previously initiated action plans and an improvement in the operational risk profile of the Group. The Audit Committee, in conjunction with the Board Risk Committee, concluded that the Group's risk management systems and internal controls were effective and adequate having regard to the Group's risk profile and strategy, and recommended that the Board approve them accordingly.

STATEMENT OF COMPLIANCE

UK Corporate Governance Code

The UK Corporate Governance Code 2012 (the Code) applied to the 2014 financial year. The Group confirms that it applied the main principles and complied with all provisions of the 2012 Code throughout the year, as required by the Listing Rules of the Financial Conduct Authority (FCA).

In September 2014 the Financial Reporting Council published an updated version of the UK Corporate Governance Code. This applies to the 2015 financial year and the Group will report on its application of the 2014 Code in the 2015 annual report.

The British Bankers' Association Code for Financial Reporting Disclosure

The Group has adopted the British Bankers' Association's Code for Financial Reporting Disclosure and its 2014 financial statements have been prepared in compliance with its principles.

COMMITTEE REPORTS

The following pages contain reports from the Nomination & Governance Committee, the Audit Committee and the Board Risk Committee.

Further information about the work of the Remuneration Committee is included in the Directors' remuneration report on pages 82 to 103.

In 2014 the Board was strengthened through the appointment of four Non-Executive Directors, each of whom share our values, have the behavioural characteristics to contribute constructively to our Board, and the self-confidence and analytic capability to form and share independent judgements.

Lord Blackwell
Chairman, Nomination & Governance Committee

Nomination & Governance Committee members	Appointed/resigned
Committee chairman	
Lord Blackwell	03/04/2014
Committee members	
Anita Frew	25/04/2013
Nick Luff	26/06/2014
Anthony Watson	01/03/2010
Former Committee members	
Sir Winfried Bischoff	03/04/2014
David Roberts	14/05/2014

Nomination & Governance Committee report

Chairman's overview

During 2014, the Committee continued to keep under review the Group's governance arrangements, succession planning and the effectiveness of the Board and its Committees.

The Committee recommended that the Board appoint a number of new directors. More on the appointments of Dyfrig John, Nicholas Prettejohn, Simon Henry and Alan Dickinson can be found on the next page.

During the year the Committee also recommended the appointment of Anita Frew (a director since 2010) as Deputy Chairman and interim Risk Committee Chairman, following the retirement of David Roberts and the appointment of Alan Dickinson as Risk Committee Chairman in place of Anita Frew from January 2015.

The Committee considered progress against the action plan to address the issues identified out of the 2013 Board effectiveness review and oversaw an internal review for 2014, led by the Chairman and conducted by the Company Secretary. Details of the effectiveness review can be found on pages 69 and 70.

The Committee monitored changes in regulation, most notably regulation brought about by the implementation of the Capital Requirements Directive IV which covers prudential rules for banks, building societies and investment firms.

Committee purpose and responsibilities

The purpose of the Nomination & Governance Committee is to keep the Board's governance, composition, skills, experience, knowledge, independence and succession arrangements under review and to make appropriate recommendations to the Board to ensure the Company's arrangements are consistent with the highest corporate governance standards. A full list of the Committee's responsibilities is detailed in its terms of reference, which can be found on our website at www.lloydsbankinggroup.com.

A description of the Group's diversity policy can be found on page 67.

To ensure a broad representation of experienced and independent Directors, membership of the Nomination & Governance Committee comprises the Chairman, the Deputy Chairman, the Senior Independent Director (also the Chairman of the Remuneration Committee) and the Chairman of the Audit Committee. The Group Chief Executive attends meetings as appropriate.

During the year the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

Corporate governance report continued

Board composition and skills

Background

Following his appointment as Chairman in April 2014, Lord Blackwell undertook an assessment of the collective technical and governance skills that he sought from the Non-Executive Directors, together with an assessment of how the existing Board members met those desired characteristics. This exercise allowed the creation of a framework which helped determine the desired profile of Board members, now and in the future.

The assessment of individuals' skills and experience in a skills matrix revealed good coverage amongst the existing Non-Executive Directors, but a high dependency on a limited number of individuals with core retail and commercial banking experience and experience in IT operations.

The Board response

To address this situation, the Board sought to recruit new Non-Executive Directors to strengthen coverage in these critical areas.

The Nomination & Governance Committee oversees the Board's arrangements for the longer-term succession of Board and Committee members. The recruitment of new or replacement directors is organised with the assistance of executive search firms.

JCA Group assisted with the search in respect of the appointments of Dyfrig John and Nick Prettejohn. Egon Zehnder facilitated the search for Simon Henry and Odgers Berndtson supported the search which resulted in the appointment of Alan Dickinson. None of the executive search firms have any other connection with the Group.

In each case, a short list was prepared and the candidates were interviewed by the Chairman, the Group Chief Executive and individual members of the Committee. The Chairman, in conjunction with the Committee, then recommended the preferred candidate to the full Board for appointment, subject to regulatory approval, as Directors must seek and maintain 'Approved Person' status and comply with the Statements of Principle issued by the FCA and the Code of Practice for Approved Persons.

The outcome

The Board appointed four new directors in 2014, all of whom share our values, have the behavioural characteristics to contribute constructively to our Board, and the capability to form and share independent judgements.

Dyfrig John and Alan Dickinson brought deep understanding of retail and corporate banking as well as risk management. Furthermore, Dyfrig John has a wealth of IT experience.

Nick Prettejohn has significant financial services experience, particularly in insurance. He replaced Lord Blackwell as chair of the Group's insurance business, Scottish Widows.

Simon Henry has extensive financial expertise and international experience in board level strategy and execution.

For further information on the Directors' experience, please see their biographies on pages 58 and 59 or on the website at www.lloydsbankinggroup.com

HOW THE NOMINATION & GOVERNANCE COMMITTEE SPENT ITS TIME IN 2014

Corporate governance

The Committee:

- oversaw the Board's governance arrangements to ensure that they paid due regard to best practice principles and remain appropriate;
- received regular corporate governance updates from the Company Secretary;
- monitored developing trends, initiatives or proposals in relation to board governance issues in the UK and elsewhere;
- considered the impact of emerging regulation on the Board and its corporate governance practices;
- reviewed and approved the annual corporate governance report;
- monitored Board governance issues including the establishment of appropriate policies and practices to enable the Board to operate effectively and efficiently; and
- reviewed the Group's corporate governance framework, comprising the board authority and the delegated executive authority.

Effectiveness and succession planning

The Committee:

- oversaw the annual evaluation of the performance of the Board and its Committees, and recommended actions to address the findings. Full details of this action plan, and the 2014 effectiveness review and outcomes are set out on pages 69 and 70;
- recommended the appointment of Anita Frew as Deputy Chairman in place of David Roberts. Ms Frew was also appointed as interim Board Risk Committee Chairman until 1 January 2015 when she was succeeded by Alan Dickinson;
- oversaw the Board's arrangements for the longer-term succession of Board and Committee members. Non-Executive succession planning is addressed as part of the ongoing review of Board composition and takes account of the need to regularly refresh the intake of Non-Executives to bring new, diverse perspectives to the Board and its deliberations, to ensure appropriate representation on each of the Board's Committees and to plan for longer-term succession; and
- considered the adequacy of succession arrangements for Executive Directors, members of the Group Executive Committee and their direct reports. The Chairman is responsible for developing and maintaining a succession plan in relation to the Group Chief Executive who is in turn, primarily responsible for developing and maintaining a succession plan for key leadership positions in the senior executive team.

Composition, skills and independence

The Committee:

- reviewed the appropriate structure, size and composition of the Board, having regard to the balance of skills, experience, independence, knowledge and leadership needs of the Group;
- reviewed the independence of Non-Executive Directors, the re-appointment or re-election of Directors and their suitability to continue in office. In assessing independence, the Committee did not rely solely on the Code criteria but considered whether, in fact, the Non-Executive Director was demonstrably independent and free of relationships and other circumstances that could affect their judgement. It did this with reference to the individual performance and conduct in reaching decisions. It also took account of any relationships that had been disclosed and authorised by the Board. Based on its assessment for 2014, the Committee is satisfied that, throughout the year, all Non-Executive Directors remained independent as to both character and judgement; and
- reviewed the role, including capabilities and time commitment, of the Chairman, Deputy Chairman, Senior Independent Director, Non-Executive Directors, the Group Chief Executive and Executive Directors. In particular, the Committee considered the impact of new limits placed on the number of directorships that can be held by each of the Directors.

High quality internal and external audit are key to the Group. This year, the Audit Committee has overseen a tender for the external audit and the appointment of a new head of internal audit.

Nick Luff
Chairman, Audit Committee

Audit Committee members	Appointed/resigned
Committee chairman	
Nick Luff	01/04/2013
Committee members	
Alan Dickinson	08/09/2014
Carolyn Fairbairn	01/06/2012
Anita Frew	01/12/2010
Simon Henry	26/06/2014
Nick Luff	05/03/2013
Nick Prettejohn	23/06/2014
Anthony Watson	06/05/2009
Former Committee members	
Lord Blackwell	02/04/2014
Dyfrig John	25/06/2014
David Roberts	14/05/2014

Audit Committee report

Chairman's overview

The Committee has met its key objectives and has carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

Following the publication of the new EU Directive in April 2014, the Committee invited three professional services firms, including the incumbent firm (PwC), to tender for the external audit with effect from the 2016 year end. The tender process involved an extensive and robust assessment of the three firms, details of which are set out on page 70. The assessment process was overseen by the Audit Committee Chairman.

After careful consideration of the strength of each proposal, the Board accepted the recommendation from the Audit Committee to retain the services of PwC. Accordingly, subject to shareholders' approval, PwC will be reappointed as Auditor. There will be a mandatory rotation for the 2021 year-end audit.

In recognition of the ongoing level of uncertainty of the ultimate level of redress payments and other costs relating to Payment Protection Insurance (PPI), the Committee continued to spend considerable time each quarter reviewing the assumptions on which the cost provisions are based. In addition, given the scale of the residential mortgage book for the Group, the Committee focused on impairment provisions for mortgages.

The Committee also looked at other areas of significant judgement or complexity that are relevant to the financial statements. These include other conduct provisions, other loan impairments, deferred tax assets, hedging, actuarial assumptions for insurance and pension accounting, and the accounting for one-off transactions such as the sell down of TSB.

The Committee continues to be satisfied with the activity, role and effectiveness of the internal audit function. The Committee oversaw the process for the recruitment of the new Group Audit Director, Mary Hall.

Committee purpose and responsibilities

The purpose of the Committee is to monitor and review the Group's financial and narrative reporting arrangements, the effectiveness of the internal controls and the risk management framework, whistleblowing arrangements and each of the internal and external audit processes. The Audit Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board, all of which have been accepted during the year. A full list of responsibilities is detailed in the Committee's terms of reference, which can be found on our website at www.lloydsbankinggroup.com.

Committee composition, skills and experience

The Committee acts independently of the executive to ensure that the interests of the shareholders are properly protected in relation to financial reporting and internal control.

All members of the Committee are independent Non-Executive Directors, the majority with recent and relevant experience in finance and/or banking. Nick Luff is a chartered accountant and has significant financial experience in the UK listed environment enabling him to fulfil the role of Audit Committee Chair and for SEC purposes the role of Audit Committee Financial Expert. Simon Henry joined the Board in June 2014 as a member of the Audit Committee and the Risk Committee. Simon has extensive knowledge of financial markets, treasury and risk management and also qualifies as an Audit Committee Financial Expert under SEC rules.

Corporate governance report continued

HOW THE AUDIT COMMITTEE SPENT ITS TIME IN 2014

Financial reporting

As might be expected a key responsibility of the Committee is to review the content of the Annual Report and Accounts, half yearly report and interim management statements. In doing so the Committee:

– reviewed the Annual Report and Accounts to ensure that taken as a whole, based on the information supplied to and challenged by the Committee and on their judgement it is fair, balanced and understandable and advised the Board to that effect;

– reviewed and challenged the going concern assessment undertaken by management;

– reviewed and challenged, where necessary, the actions, estimates and judgements of management, in relation to the interim and annual financial statements. This was undertaken through regular reporting on ongoing litigation, conduct and regulatory matters affecting the Group, detailed portfolio impairment reviews and a review of the approach to PPI; and

– monitored, on an ongoing basis, the integrity of the financial statements of the Group and reviewed the critical accounting policies, receiving regular reports on the detailed disclosure obligations and changes in accounting requirements.

Internal control and risk management

Full details of the internal control and risk management systems in relation to the financial reporting process are given within the risk management report on pages 107 to 170. Specific matters that the Committee considered during the year included:

– the effectiveness of systems for internal control, financial reporting and risk management;

– the extent of the work undertaken by the Finance teams across the Group and considering the resources to ensure that the control environment continued to operate effectively; and

– the major findings of any internal investigations into control weaknesses, fraud or misconduct and management's response along with any control deficiencies identified through the assessment of the effectiveness of the internal controls over financial reporting under the US Sarbanes-Oxley Act.

The Audit Committee was satisfied that internal controls over financial reporting were appropriately designed and operating effectively.

Group Audit

In monitoring the activity, role and effectiveness of the internal audit function and their audit programme the Committee:

– monitored the effectiveness of Group Audit and their audit programme through quarterly reports on the activities undertaken in the period;

– approved the annual audit plan and budget and reviewed progress against the plan in detail at the half year including consideration of the audits that had been undertaken and in relation to the adequacy of resources within Group Audit and the standing of Group Audit in the Group;

– considered the major findings of significant internal audits, and management's response;

– oversaw the process for recruitment of a new Group Audit Director, and approved the appointment of Mary Hall to the role;

– received the views of Group Audit on the reports submitted to the Committee to act as a check and balance on the information provided to the Committee; and

– reviewed thematic audits completed during the period – e.g. embedding risk appetite, integrity of the Risk Management Framework, customer outcomes, corporate culture, business application and strategic risks.

Whistleblowing

The Committee received and considered reports from management on the Group's whistleblowing arrangements including the line activity, summaries of cases and ongoing reviews of the Whistleblowing Governance Structure.

External audit

The Committee oversaw the relationship with the external auditor and considered the terms of engagement (including remuneration), their effectiveness, their continued independence and their objectivity.

In particular the Committee:

– approved the annual audit plan including methodology and risk identification processes;

– reviewed the findings of the external audit including key judgements such as impairment and conduct provisions and the level of challenge provided by the external auditor;

– considered management's responsiveness to the auditor's findings and recommendations;

– considered the continued effectiveness of the audit process; and

– considered the external auditors' performance, including technical competence, strategic knowledge, quality control, capabilities, communication and reporting through the recent tender process (see case study) and an internal effectiveness questionnaire.

Auditor tenure

PwC has been the auditor of Lloyds Banking Group since 1995 and prior to that PwC and its predecessor firms were also auditors to certain of the Group's predecessor companies. After careful consideration the Committee undertook a full tender exercise for the external audit of the Group during the year and, in doing so, reviewed the qualifications, expertise and resources of the tendering firms – further details of the tender are set out as a case study on page 70. The process culminated in a recommendation to reappoint PwC. In accordance with regulations the lead audit partner is subject to rotation with the next rotation due in 2016.

Auditor independence and remuneration

Both the Board and the external auditor have safeguards in place to protect the independence and objectivity of the external auditor. The Audit Committee has a comprehensive policy to regulate the use of the auditor for non-audit services. This policy sets out the nature of work that the external auditor may not undertake and guidance on the hiring of former external audit staff.

In some cases, PwC are selected over another service provider due to their detailed knowledge and understanding of the business. Any allowable non-audit services with a value above a defined fee limit require prior approval from the Audit Committee Chairman. The total amount paid to the auditor in 2014 is shown in note 11 to the financial statements on pages 212 to 214. The increase against the prior year largely relates to assurance services provided by PwC ahead of the Initial Public Offering of TSB in June 2014.

Financial reporting

During the year, the Committee considered the following significant financial issues/judgements in relation to the Group's financial statements and disclosures, with input from management, Group Audit and the external auditor:

KEY ISSUES/JUDGEMENTS IN FINANCIAL REPORTING	AUDIT COMMITTEE REVIEW AND CONCLUSIONS
Payment Protection Insurance (PPI) Determining the adequacy of the provision for redress payments in connection with mis-selling of PPI is highly judgemental and requires the Group to make a number of assumptions, including the number of complaints that will be received in the future, response rates to proactive mailings, uphold rates for complaints received, average redress payments and related administrative costs. In the 2014 full year results, an additional provision of £2,200 million was reflected for expected PPI costs. The provision brought the total amount set aside by the Group to cover PPI costs to £12,025 million.	– The Audit Committee spent considerable time in 2014 challenging the assumptions made by management in determining the provision for PPI redress. – The key assumption that the Audit Committee focused on was future complaints volumes and associated operational costs. Management used a combination of analyses to forecast future complaint volumes, including statistical modelling and customer surveys. The Audit Committee challenged the appropriateness of these methods for forecasting complaint volumes, giving consideration to the total PPI policies sold by the Group. – Group Audit provided assurance to the Audit Committee that the process was undertaken in a controlled manner using reasonable, consistent and supportable assumptions and inputs. In 2014, the Audit Committee concluded that the processes followed by management in determining the provision for PPI redress were appropriate, although they will continue to monitor periodically as experience emerges. – The Audit Committee considered the appropriateness of disclosures in the News Release and the Annual Report and Accounts. The Audit Committee oversaw enhancements made to the PPI disclosure to include the total number of PPI policies remediated since 2000 and continued use of sensitivities reflecting the uncertainty that remains around the ultimate cost of PPI. – The Audit Committee was satisfied that the PPI provision and disclosures were appropriate. The disclosures relating to PPI are set out in note 40: 'Other provisions' on page 248 of the financial statements.
Other conduct provisions The Group has a number of other provisions for conduct related matters, all of which are judgemental and require the Group to make a number of assumptions. In the 2014 full year results, further provisions were made for derivatives mis-sold to small and medium-sized enterprises (SMEs), the Group's insurance branch business in Germany, and a number of other smaller provisions across the divisions in relation to other conduct and compliance matters.	– The Audit Committee spent time understanding and assessing the adequacy of provision for other conduct related matters. – For derivatives mis-sold to SMEs, the Audit Committee understood the basis for determining forecast average redress payments based on experience to date, and the adequacy of provisions made for operational costs for the expected duration of the programme. – More broadly, the Audit Committee challenged management on their processes and controls for ensuring that all conduct related matters were identified and that exposures and associated provisions were appropriately quantified where necessary. – Group Audit independently reviewed and challenged the key estimates and assumptions of the Management in respect of the conduct provisions and confirmed that the methodology adopted for each provision and the individual processes were reasonable. – The Audit Committee was satisfied that the provisions for other conduct matters were appropriate. The disclosures relating to other conduct provisions are set out in note 40: 'Other provisions' on page 248 of the financial statements.
Allowance for impairment losses on loans and receivables Determining the appropriateness of impairment losses is judgemental and requires the Group to make a number of assumptions.	– The Audit Committee received regular reports in relation to impairment provisioning from management during 2014, presented by the division's Credit Risk Officers. – Key assumptions challenged by the Audit Committee included the criteria for determining when a loan was impaired and whether any previous provisions were appropriate when these subsequently changed. – Group Audit performed work to assess the effectiveness of impairment governance and processes and reported their findings to the Audit Committee. The audits considered whether management oversight, review processes and key judgements were adequately supported by quantitative analysis and detailed management information. The work carried out by Group Audit considered the basis for adjustments and calibrations to model output results and found these to be reasonable and supported by observed performance. – The Audit Committee was satisfied that the impairment provisions were appropriate. The disclosures relating to impairment provisions are set out in note 54: 'Financial risk management' on page 293 of the financial statements.

Corporate governance report continued

Recoverability of the deferred tax asset The recoverability of the deferred tax asset in respect of carry forward losses requires the consideration of the future levels of taxable profit in the Group.	– The Audit Committee considered the recognition of deferred tax assets, in particular the forecast taxable profits based on the Group's five year operating plan and the split of these forecasts by legal entity and the likely impact of the Chancellor of the Exchequer's December 2014 statement concerning the restriction on banks' ability to use their carry forward losses. – The Audit Committee agreed with management's judgement that the deferred tax assets were appropriately supported by forecast taxable profits, taking into account the Group's long-term financial and strategic plans. The disclosures relating to deferred tax are set out in note 3: Critical accounting estimates and judgements on page 199 and note 39: 'Deferred tax' on page 247 of the financial statements.
Uncertain tax positions The Group has a number of open tax matters which requires the Group to make judgements as to the likely outturn for the purposes of calculating its tax position.	– The Audit Committee understood the uncertain tax positions of the Group, including the respective views of the Group and the relevant tax authorities. The Audit Committee also understood the external advice obtained by management to support the views taken by the Group. – The Audit Committee was satisfied that the disclosures made in respect of uncertain tax positions were appropriate. The relevant disclosures are set out in note 50: 'Contingent liabilities and commitments' on page 271 of the financial statements.
Retirement benefit obligations Determining the value of the defined benefit obligation is judgemental and requires the Group to determine a number of economic and non-economic actuarial assumptions.	– In the first half of 2014, the Group recognised a curtailment gain following the implementation of a freeze on pensionable pay for the Group's principal defined benefit pension schemes. The gain was dependent on a number of assumptions, including an estimate of the proportion of then current members who opt out of these schemes as a result of the freeze. The Audit Committee was satisfied that the gain and Annual Report and Accounts disclosures associated with the freeze on pensionable pay are appropriate. – As in previous years, the Audit Committee considered the assumptions underlying the calculation of the defined benefit assets and liabilities, in particular the discount rate applied to future cash flows. The Audit Committee was satisfied that the value and disclosures made in respect of retirement benefit obligations are appropriate. The relevant disclosures are set out in note 38: 'Retirement benefit obligations' on page 240 of the financial statements.
Value-In-Force (VIF) asset and insurance liabilities Determining the value of the VIF asset and insurance liabilities is judgemental and requires the Group to determine a number of economic and non-economic actuarial assumptions, including longevity, persistency, expenses, credit risk and illiquidity premiums.	– The Audit Committee considered and challenged the calculation of the value of expected future net cash flows from currently in-force insurance contracts and the liabilities arising from those contracts. – The Audit Committee was satisfied that the value of the VIF asset and insurance liabilities were appropriate. The disclosures are set out in note 25: 'Value of in-force business' on page 227 and note 35: 'Liabilities arising from insurance contracts and participating investment contracts' on page 239 of the financial statements.
Adjustment to derivative valuations Determining the credit, debit and funding valuation adjustments for uncollateralised derivative transactions is judgemental and requires management to assess whether model inputs, such as the creditworthiness of the derivative counterparty, are appropriate.	– The Audit Committee has discussed this matter previously and is satisfied that the disclosures set out in note 51(3)(C) to the financial statements on page 283 are appropriate.
One-off transactions Determining the appropriate accounting for certain one-off transactions is judgemental and requires management to assess the facts and circumstances specific to each transaction.	– Two examples of one-off transactions considered by the Audit Committee during 2014 were the sales of TSB shares and the exchange of enhanced capital notes for additional tier 1 securities. – The Audit Committee is satisfied that it remains appropriate for the Group to consolidate TSB. Further information on liability management is set out below.
Liability management Determining the loss recognised on exchanging a proportion of the Group's enhanced capital notes for additional tier 1 securities.	– In the first half of 2014, the Group exchanged a proportion of its enhanced capital notes (ECN) for new additional tier 1 (AT1) securities. The Group recognised a loss of £1,362 million on the transaction. The AT1 securities are classified as equity. – The Audit Committee considered the accounting loss arising on the exchange and the classification of the AT1 securities as equity and was satisfied that the disclosure set out in note 46: 'Other equity instruments' on page 260 to the financial statements is appropriate.

I am pleased to report that the Group's strategy and strong risk discipline continues to build a safer, low risk bank.

Anita Frew
Chairman, Risk Committee
14 May – 31 December 2014

Risk Committee members	Appointed/resigned
Committee chairman	
Alan Dickinson	01/01/2015
Anita Frew	14/05/2014 – 31/12/2014
Committee members	
Lord Blackwell	01/06/2012
Alan Dickinson	08/09/2014
Anita Frew	01/12/2010
Simon Henry	26/06/2014
Dyfrig John	01/01/2014
Nick Luff	05/03/2013
Nick Prettejohn	23/06/2014
Anthony Watson	01/12/2012
Sara Weller	01/02/2012
Former committee members	
Sir Winfried Bischoff	03/04/2014
David Roberts	14/05/2014

Risk Committee report

Chairman's overview

I am pleased to report the Board Risk Committee fulfilled its responsibilities and met its key objectives, whilst the annual Board effectiveness review concluded the Committee continued to operate effectively. The Committee maintains an appropriate balance of its scheduled review of key risks, whilst maintaining a dynamic approach so that emerging risks are appropriately escalated and considered and management actions and plans are constructively challenged. For example, through 2014 the Committee reviewed the Group's conduct strategy and reviewed the oversight and governance of the Group's approach to the capital and stress testing work.

The continued embedding of a suitable 'risk culture' is a critical component of effective risk management and the Committee will continue to oversee management's efforts in this regard.

Whilst the UK economy continued to recover in 2014, there remain continued external challenges, for example lack of economic growth in the Eurozone and volatility such as oil prices.

Notwithstanding these external challenges, I am pleased to report the Group's strategy and risk discipline has led to a safer, low risk bank.

Committee purpose, responsibilities and composition

The purpose of the Board Risk Committee is to monitor: the Group's compliance with the Group risk appetite as approved by the Board covering the extent and categories of risk which the Board regards as acceptable for the company to bear; the Group's risk management framework embracing principles, policies, methodologies, systems, processes, procedures and people; and the Group's risk culture to ensure that it supports the Group's risk appetite. Full details of the Committee's responsibilities are set out in its terms of reference, which can be found on our website at www.lloydsbankinggroup.com.

Committee composition, skills and experience

The Chair of the Board Risk Committee, Anita Frew took over interim responsibility as Chairman of the Board Risk Committee from David Roberts on 14 May 2014. Anita has extensive board, financial and general management experience across a number of sectors, including banking. Anita was supported on the Committee by Non-Executive Directors members who have a variety of industry backgrounds, including banking, financial services and retail, who bring scrutiny and fresh perspective to the risk management framework of the Group. The Chief Risk Officer has full access to the Committee and attends the meeting.

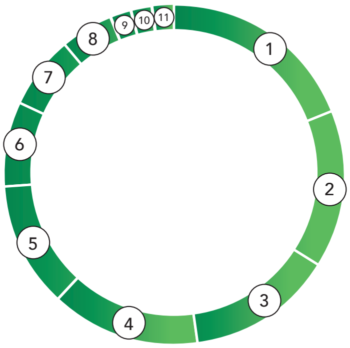
On 1 January 2015, Anita handed over the chair of the Board Risk Committee to Alan Dickinson. Alan is a highly regarded retail and commercial banker having spent 37 years with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK.

The Committee composition includes core banking and risk knowledge, together with the breadth that brings wider knowledge from other sectors and a clear awareness of customer needs. As a matter of practice and as a reflection of the importance attached to risk in the Group, all Directors regularly attend the Board Risk Committee meetings, including those Directors who are not members. The Group Audit Director and the external auditor also attend Board Risk Committee meetings.

Corporate governance report continued

Matters considered by the Board Risk Committee

Over the course of the year the Board Risk Committee considers a wide variety of aspects of risk across the Group. Set out below is a summary of the key matters that the Board Risk Committee considered in 2014, followed by an outline of the principal risks that were considered by the Committee.



1. Conduct risk	19%
2. Consolidated risk report	15%
3. IT and cyber	14%
4. Stress testing	14%
5. Divisional risk profiles	12%
6. Risk appetite	8%
7. AML/Group money laundering report	7%
8. Risk culture	5%
9. Macroeconomic update	2%
10. Risk management framework	2%
11. Other (including regulatory update, credit risk and risk adjustments of performance)	2%

HOW THE BOARD RISK COMMITTEE SPENT ITS TIME IN 2014

Risk management

The Committee considered the Group's approach to risk management, including the overall framework review and regulatory developments. In particular the Committee:

- considered the annual review of the Group's governance and internal control framework – the Risk Management Framework – which includes the arrangements for the cascade of authority from the Board to its Committees and the Group Chief Executive, and the status of the Group's risk governance and the Group policy frameworks. The review concluded that the Group's Risk Management Framework is effective in design and the Group's corporate governance arrangements and the policy framework are stable;
- considered the approach and key findings of the annual control effectiveness review (see pages 69 and 70), before referring it to the Audit Committee to review in conjunction with Group Audit's control framework assessment;
- received reports and monitored the Group's approach to regulatory developments including the Banking Reform Act; and
- oversaw the Group's approach to managing culture with particular reference to risk culture within the context of the Risk Management Framework.

Risk appetite

The Committee considered the Group's risk appetite. In particular, the Committee:

- carried out the annual review of the Group's risk appetite. The review considered the statements and risk appetite metrics under each category of identified risk;
- received regular detailed consolidated risk reports, analysis of the Group's performance against risk appetite and divisional risk profiles;
- monitored the embedding of risk appetite across the Group; and
- considered the Group's approach to Structural Hedging to ensure that the approach remained within risk appetite.

Further details on the Group's risk appetite can be found in the risk management section on pages 107 to 170.

Risk Division

In overseeing the risk function within the Group the Committee:

- reviewed the adequacy of the Risk Division's resources, its authorities and standing within the Company. The review scrutinised the Risk Division's annual plan, which sets out how the Risk Division will achieve clear outcomes from individual teams in a structured and measurable manner; and
- concluded that the Risk Division is adequately resourced and continues to have sufficient authority and standing within the Group. This outcome further reflects the importance of risk management in the Group.

More information on the Group's approach to risk management can be found on pages 108 and 109.

Risk principles and policy

The Committee has a key role in relation to the Group's Risk Principles and Policy Framework and in so doing:

- reviewed new and material amendments to the risk principles and policy framework, recommended by the Group Chief Executive and Chief Risk Officer; and
- oversaw adherence to Group risk principles, policies and standards and monitored any action taken resulting from material policy breaches.

Consolidated risk report

The Committee reviewed this report at each meeting. It provides the Committee with a monthly summary of the main risks measure within the business, providing supporting quantitative data and additional commentary to inform the Committee in considering and challenging management's assessment and future projected status of key risks against appetite.

Divisional risk profiles

The Committee considered the risk profiles of the divisions of the Group and in doing so:

- reviewed the divisional risk enterprise wide risk management reviews across the principle business areas; and
- considered the Insurance Divisional risk appetite to ensure that it was specifically relevant to the Insurance Division, its separate prudential needs, and the separate categories of risks that are relevant to the insurance business.

The insurance business has its own separate board and risk committee.

Significant risks considered by the Committee

Set out below are some of the significant risks facing the company that were considered by the Committee in 2014.

Significant risks considered by the Committee	Board Risk Committee review
Conduct risk	The Committee spent considerable time in 2014 reviewing reports at every meeting from management on conduct risk including reviews of prior conduct issues and regulatory investigations. The Committee also reviewed the Group's conduct strategy and its embedded status including reports from Group Audit. It received reports on sales processes and product governance, including the progress of annual product risk assessments, the results of outcome testing including mystery shopping results and complaint metrics, rewards and incentives.
Operational risk	The Committee received regular updates across operational risk from both the business and the Risk Division, including incident management, advanced measurement, change, records management, and IT Resilience including cyber risk and financial crime. In regards to IT resilience/cyber risk, the Committee set the framework for, and oversaw, the response to an external review of IT resilience carried out in 2013 and considered the Group's exposure to cyber risk. The Committee also discussed investment in incremental improvements in IT resilience and our cyber controls. The Committee received two reports in the year from the Group's Money Laundering Reporting Officer along with detailed updates from the businesses on compliance with the Anti Money Laundering requirements.
Financial and market risk	The Committee considered the controls in place for financial markets and reviewed the structural hedge risk appetite. The Committee reviewed the liquidity and funding position including the stress testing analysis undertaken, and the Group's stress testing reports against internal and regulator driven economic scenarios, and their impact on the Group's plans. The Committee was also heavily involved in the oversight and governance of the Group's approach to the capital and stress testing required by both the PRA and the EBA. The Committee monitored the macro economic conditions as they affect the Group. The Committee received regular updates on the macro economic conditions and risks from the Chief Economist, and considered these in its risk appetite and strategies.
Remuneration	The Committee reviewed, ahead of the Remuneration Committee, the internal independent control function's risk assessments of the Group and its divisions, to ensure that the remuneration awards proposed clearly consider the observance of risk appetite and demonstration of appropriate risk management.
Regulatory developments	The Committee received regular updates from management on regulatory developments and assessed the impact of those developments on the Group's risk profile and actions proposed by management.
Credit	The Committee received regular updates through the consolidated risk report and divisional updates. The Committee considered the Group's exposure to credit markets and the structural quality of new lending. In addition, the Committee considered more detailed reports on focussed areas, including the Mortgage and Commercial portfolios.
Risk culture	The Committee reviewed and debated a range of metrics and insights into risk culture within the firm, with the clear linkage to the conduct strategy, remuneration policies and wider Group strategy.

Risk Committee case study – capital and stress testing

Background

Stress testing is conducted to assess the Group's risk profile against risk appetite and acts as a basis for discussion with the regulator for the setting of the capital planning buffer. The Board ensures that there is continued direct Board level oversight of the Group's assumptions and results of the principal internal and regulatory stress testing exercises.

What the Risk Committee did

By way of example for the PRA and EBA stress testing exercises:

Given the complexity and timescales for finalisation of each of the stress test exercises, the Board Risk Committee set up a Sub-Committee to oversee, on behalf of itself and the Board, the Group's detailed assumptions and results for each exercise. The Sub-Committee reported the stress test outcomes to the Board Risk Committee and the full Board.

The Sub-Committee also commissioned an independent external review of the Group's approach to stress testing to identify enhancements. Recommendations for the short and medium term have been appropriately actioned or incorporated into future plans.

The Sub-Committee met regularly to review and challenge the stress testing exercises and the recommendations of the independent review. In turn the Board Risk Committee received detailed reports to consider the process and preliminary results in advance of the finalisation of each of the stress testing submissions.

Controls

Group Audit's review of the process and controls used in the PRA and EBA stress test exercises did not identify any material control weaknesses.

Outcome

The Committee was satisfied with the results and recommended the detailed submissions to each of the PRA and EBA to the Board.

Directors' remuneration report

STATEMENT BY THE CHAIRMAN OF THE REMUNERATION COMMITTEE

Dear Shareholders

On behalf of the Board and as Chairman of the Group's Remuneration Committee, I am pleased to present the Directors' remuneration report for the year ended 31 December 2014, which is split into two parts:

– A summary of the Directors' Remuneration Policy. This section contains a summary of the remuneration policy approved at the 2014 Annual General Meeting (AGM) and is for information only. No changes have been made to the policy this year.
– The Directors' Remuneration Implementation Report, which outlines how policy was implemented in 2014 and how the Directors' Remuneration Policy is intended to apply in 2015.

This statement and Implementation Report will be subject to an advisory vote at the 2015 AGM.

Linking remuneration to business strategy

The Committee continues to place great importance on ensuring that there is a clear link between remuneration and the Group's business strategy.

We therefore reviewed our variable pay plans during 2014 to ensure that they are designed to motivate the delivery of our key strategic objectives, including the Helping Britain Prosper Plan and our responsible business goals. In this way, they support a performance-orientated culture and reward long-term sustainable performance, as well as building an environment in which colleague conduct and trust from customers are paramount.

– Our annual bonus plan will continue to reward the delivery of financial targets and balanced scorecard objectives in line with our operating plan. During 2014, we reviewed our performance adjustment framework and made enhancements in line with current regulatory expectations. Further details on this are provided below. Performance adjustment is the process by which variable remuneration is adjusted to take into account matters that fall outside the Board's specified risk appetite. Individual and collective performance adjustment is now based on new guidelines and principles, ensuring adjustments reflect accountability and are sufficient to change colleague behaviours. Collective performance adjustment is intended to encourage positive risk behaviour across the Group by adjusting all bonuses for material risk failings.
– Our long-term incentive plan continues to support value creation for shareholders with appropriate focus on the customer, financial health and the achievement of long-term strategic aims.

In order to support the Group's journey to become the Best Bank for Customers, the Committee has adjusted the performance targets for the 2015 long-term incentive plan (LTIP) so that they are closely aligned with the areas of focus under the Group Strategic Review (GSR):

– Creating the best customer experience
– Becoming simpler and more efficient
– Delivering sustainable growth
– Building the best team

The core financial measures (economic profit, absolute TSR and cost:income ratio) will remain the same, representing 65 per cent of the total award. For the remaining 35 per cent of the award, quantitative strategic measures relating to customers and digitisation will be used to reflect key areas of strategic focus under the GSR.

With regard to the economic profit measure, which remains a core financial measure, the Group is currently reviewing the calculation methodology for financial reporting purposes in order to better align with current expectations of the Group's forward-looking plan, including the Group's capital requirements and asset quality ratio. We are seeking to complete this review as soon as possible and will consult with shareholders in respect of any proposed changes in the first half of 2015.

End-to-end review of annual bonus process and performance adjustment

During 2014, the Committee undertook an extensive end-to-end review of our bonus process resulting in a revised methodology for calculating the risk-adjusted bonus outcome being implemented for 2014. As part of this, our approach to performance adjustment was reviewed to ensure that we have clear principles for collective and/or individual adjustments when taking account of material, adverse risk events.

As a result of this review, we have enhanced our governance relating to performance adjustment through the formation of the Independent Performance Adjustment Committee which supports the Remuneration Committee in its decision making relating to adjustments and through greater alignment between the Board Risk Committee and Remuneration Committee in assessing risk matters.

In addition, the Group has now incorporated clawback provisions for all Material Risk Takers in line with Prudential Regulation Authority (PRA) requirements from 1 January 2015. Variable remuneration can now be recovered from employees up to seven years after the date of award in the case of a material or severe risk event.

All of the above actions will ensure that there is full alignment between risk, reward and the performance of the Bank when determining variable pay outcomes.

Remuneration outcomes for 2014

We have performed strongly in 2014, delivering substantial improvements in profitability while at the same time continuing to address historical legacy issues

As outlined elsewhere in the annual report, in terms of financial performance, our underlying profit increased by 26 per cent, driven by an increase in net interest income, further reduced costs and lower impairments. We have also delivered strongly against many of our key strategic goals, with continued delivery of simplification cost savings, reduction in risk and the successful completion of the TSB IPO during the year.

In determining 2014 bonus outcomes for Lloyds Banking Group (excluding TSB), the Remuneration Committee has balanced the need to remunerate appropriately for the Bank's strong performance in 2014, and ensure that appropriate adjustments are made for legacy issues. The Committee has applied collective adjustments to the bonus outcome and individual adjustments to bonus awards where necessary.

Having implemented the new process, it is critical that our colleagues understand how variable remuneration is determined and adjusted for risk matters. We have therefore made significant enhancements to communications and training to support the embedding of the performance adjustment approach.

The collective adjustment reflects the level of provisions for legacy conduct-related matters, principally relating to PPI, legacy retail issues and SME derivatives. These have declined significantly from the previous year, but still have a material impact on our statutory profit. The risk failure which led to regulatory settlement on LIBOR and Repo rate setting was also a significant element in determining the level of the collective adjustment.

The overall assessment of collective adjustment also takes into account certain positive factors that are not otherwise captured in the bonus calculation, but which benefited the Group's shareholders or improved the Group's reputation. These include progress with non-core disposals, the SWIP sale, the TSB separation/IPO and the reduction in the Government shareholding.

Taking all of the above into account, the Committee determined that a bonus outcome for 2014 of £369.5 million was appropriate, incorporating a reduction for collective performance adjustment of approximately 25 per cent. This is a 3.6 per cent reduction in the bonus outcome from 2013 (after adjusting for TSB).

At this level, the bonus outcome reflects the achievement of the plan for the year set by the Board. The total outcome is less than was paid in 2013 and is less than 5 per cent of the underlying profit from which it is derived, which is a considerably lower figure than other UK banks. Average bonus payments across all our staff are approximately £4,500, with fewer than 3 per cent of our staff receiving a bonus in excess of £25,000, of which £2,000 is paid in cash, the balance being deferred in shares and released periodically over subsequent months and years.

For the Executive Directors, performance against the financial measures of the annual bonus significantly exceeded the maximum targets, and performance against balanced scorecard objectives was also strong. However, taking into account the legacy issues noted above, the Committee determined that bonus awards of between 54 per cent and 69 per cent of maximum opportunity should be made to Executive Directors.

In respect of LTIP awards made in 2012, the Bank's performance to the end of 2014 was very strong. The proposed vesting level of 96.6 per cent reflects strong financial performance, and significant shareholder value created over the period as the Bank's market capitalisation increased from c.£18 billion to c.£54 billion. This has justifiably led to significant payouts to participants, due not only to the delivery of targets but also the increase in share price. Awards were granted in shares at 34.786 pence and the significant increase over the period has more than doubled the value for recipients, in line with the increase realised by shareholders.

Consideration of stakeholders' views

We remain committed to maintaining regular dialogue with our key stakeholders and take careful consideration of their views when making our decisions.

During the year, we consulted with UK Financial Investments (UKFI) and a number of our other major shareholders to gather their views and feedback on remuneration, and in particular the changes to the 2015 LTIP. We also consulted with our main regulators, the Financial Conduct Authority (FCA) and the PRA throughout the year. We are grateful for the supportive feedback we have received from all parties.

The Committee reviews annually a report from the Group HR Director on the operation of the remuneration policy and its effectiveness. In 2014, the report concluded that effective systems and controls are in place for all requirements of the policy and that it delivers outcomes in line with the Group's values, reward principles and the PRA Remuneration Code.

We continue to believe that our remuneration policies and practices fairly reward our directors, and support the delivery of the Group's strategy and the creation of shareholder value. I therefore hope you will support the resolution relating to remuneration at the 2015 AGM.

Anthony Watson, CBE
Chairman, Remuneration Committee

Directors' remuneration report continued

DIRECTORS' REMUNERATION POLICY

The policy set out in the 2013 Directors' remuneration report was formally approved by shareholders at the AGM on 15 May 2014.

It is intended that approval of the remuneration policy will be sought at three year intervals, unless amendments to the policy are required in which case further shareholder approval will be sought. There are no amendments required to the current policy for 2015 and therefore shareholders will not be asked to vote on the Remuneration Policy at the AGM this year.

The remuneration policy tables for Executive and Non-Executive Directors are included below for ease of reference. They have been reproduced as approved with the exception of minor, inconsequential deletions. In particular, where 2014 examples were provided in the 2013 Annual Report, these have been removed. Information on how the Policy will be implemented in 2015 is included in the Directors' remuneration report. The full policy is available at www.lloydsbankinggroup.com/investors/shareholder-info/shareholder-meetings.

As outlined in the 2013 Directors' remuneration report, our policy is intended to ensure that our remuneration proposition is both cost effective and enables us to attract and retain executives of the highest calibre. Our objective is to align individual reward with the Group's performance, the interests of its shareholders and a prudent approach to risk management. In this way, we balance the requirements of our major stakeholders: our customers, shareholders, employees, and regulators.

The policy is based on principles which are applicable to all employees within the Group and in particular the principle that the reward package should support the delivery of our strategic goal to be the 'Best Bank for Customers'. It embeds a performance-driven and meritocratic culture, encourages effective risk disciplines and is in line with relevant regulations and codes of best practice. There is no significant difference between the policy for Executive Directors and that for other senior employees. If a significant difference for any individual were proposed, this would be subject to approval by the Remuneration Committee (within regulatory requirements).

REMUNERATION POLICY TABLE FOR EXECUTIVE DIRECTORS

Base salary	
– Purpose and link to strategy	Base salary reflects the role of the individual taking account of responsibilities and experience, and pay in the Group as a whole. It helps to recruit and retain Directors and forms the basis of a competitive remuneration package.
– Operation	Base salaries are typically reviewed annually with any increases normally taking effect from 1 January. When determining and reviewing base salary levels, the Committee ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies. – Pay for comparable roles in comparable publicly listed financial services groups, of a similar size. The Committee also takes into account base salary increases for employees throughout the Group. As disclosed in previous reports, since his appointment, the Group Chief Executive (GCE) has a reference salary of £1.22 million which is used to calculate certain elements of long-term remuneration and the pension allowance.
– Maximum potential	The Committee will make no increase which it believes is inconsistent with the two parameters above. Increases will normally be in line with the increase awarded to the overall employee population. However, a greater salary increase may be appropriate in certain circumstances, such as a new appointment made on a salary below a market competitive level, where phased increases are planned, or where there has been an increase in the responsibilities of an individual.
– Performance measures	N/A
Fixed share award	
– Purpose and link to strategy	To ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for Executive Directors with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements.
– Operation	The Fixed Share Award will be delivered in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award.
– Maximum potential	The maximum award is 100 per cent of base salary.
– Performance measures	N/A

Pension	
– Purpose and link to strategy	Our pension policy aims to support Executive Directors in building long-term retirement savings.
– Operation	Executive Directors are entitled to participate in the Group's defined contribution scheme with company contributions set as a percentage of salary. An individual may elect to receive some or all of their pension contribution as a cash allowance.
– Maximum potential	The maximum allowance for the GCE is 50 per cent of reference salary less any flexible benefit allowance. The maximum allowance for other Executive Directors is 25 per cent of base salary.
– Performance measures	N/A

Benefits	
– Purpose and link to strategy	To provide suitable benefits as part of a competitive package.
– Operation	Benefits may include those currently provided and disclosed in the Implementation Report. Core benefits include a company car or car allowance, private medical insurance, life insurance and other benefits that may be selected through the Group's flexible benefits plan. Additional benefits may be provided to individuals in certain circumstances such as relocation. This may include benefits such as accommodation, relocation, and travel. The Committee retains the right to provide additional benefits depending on individual circumstances. When determining and reviewing the level of benefits provided, the Committee ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies. – Benefits for comparable roles in comparable publicly listed financial services groups of a similar size.
– Maximum potential	The Committee will make no increase in the benefits currently provided which it believes is inconsistent with the two parameters above. The Group's flexible benefits allowance is capped at 4 per cent of base salary.
– Performance measures	N/A

All-employee plans	
– Purpose and link to strategy	Executive Directors are eligible to participate in HMRC approved all-employee schemes which encourage share ownership.
– Operation	Executive Directors may participate in these plans in line with HMRC guidelines currently prevailing (where relevant), on the same basis as other eligible employees.
– Maximum potential	Participation levels may be increased up to HMRC limits as amended from time to time. With effect from April 2014, the monthly savings limits for Save As You Earn (SAYE) is £500. The maximum value of shares that may be purchased under the Share Incentive Plan (SIP) in any year is £1,800 with a two for one match (although currently a one for one match is operated) and the maximum value of free shares that may be awarded in any year is £3,600.
– Performance measures	N/A, following HMRC rules.

Directors' remuneration report continued

Annual bonus

– Purpose and link to strategy	Incentivise and reward the achievement of the Group's annual financial and strategic targets.
– Operation	Measures and targets are set annually and awards are determined by the Committee after the year end based on performance against the targets set. The annual bonus may be delivered partly in cash and partly deferred into cash, shares, notes or other debt instruments including contingent convertible bonds. Deferral levels are set at the time of award and in compliance with regulatory requirements (which currently require that at least 60 per cent of variable pay is deferred and at least 50 per cent of variable pay is paid in shares or other instruments). Deferred awards normally vest after three years and the Committee may adjust awards in the event of any variation of share capital, demerger, special dividend or distribution or amend the terms of the plan in accordance with the plan rules. At the time of the release, Executive Directors receive an amount (in cash or shares) equal to the interest that would have accrued on the deferred component, if deferral is made in notes or debt instruments, or dividends paid or payable if deferred in shares, between the date of grant and the vesting of the award on the number of shares which have vested. The Committee applies its judgement to determine the payout level commensurate with business and/or individual performance. The Committee may reduce the level of deferred award (including to zero), apply additional conditions to the vesting, or delay the vesting of deferred awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of an event occurring before vesting.
– Maximum potential	The maximum annual bonus opportunities are 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors.
– Performance measures	Measures and targets are set annually by the Committee in line with the Group's strategic business plan and further details are set out in the Implementation Report for the relevant year. At least 50 per cent of the awards are weighted towards financial measures, with the balance on strategic objectives. All assessments of performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance is not met for financial measures and the individual is rated 'Developing performer' or below. The expected value of the bonus is 30 per cent of maximum opportunity. The Committee retains the right to change the measures and weighting of those measures, including following feedback from regulators, shareholders and/or other stakeholders. The Committee is, however, committed to providing transparency in its decision making in respect of bonus awards and will disclose historic target and measure information together with information relating to how the Group has performed against those targets in the Implementation Report for the relevant year unless this information is deemed to be commercially sensitive.

Long-term incentive plan

– Purpose and link to strategy	Incentivise and reward the achievement of the Group's longer-term objectives, to align executive interests with those of shareholders and to retain key individuals.
– Operation	Awards are made in the form of conditional shares or nil cost options. Award levels are set at the time of grant, in compliance with regulatory requirements, and may be subject to a discount in determining total variable remuneration under the rules set by the European Banking Authority (EBA). Vesting will be subject to the achievement of performance conditions measured over a period of three years, or such longer period, as determined by the Committee. On vesting, Executive Directors receive an amount (in cash or shares) equal to the dividends which would have been paid during the vesting period on shares vesting. The Committee retains full discretion to amend the payout levels should the award not reflect business and/or individual performance. The Committee may reduce (including to zero) the level of the award, apply additional conditions to the vesting, or delay the vesting of awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of an event occurring before vesting. Executive Directors are required to hold the shares which vest for a further two years.
– Maximum potential	The maximum annual award for Executive Directors will normally be 300 per cent of salary excluding dividend equivalents (this being the reference salary in the case of the GCE). Under the plan rules, awards can be made up to 400 per cent of salary in exceptional circumstances excluding dividend equivalents.

– Performance measures	Measures and targets are set by the Committee annually and are set out in the Implementation Report each year. At least 60 per cent of awards are weighted towards typical market (e.g. Total Shareholder Return (TSR)) and/or financial measures (e.g. economic profit), with the balance on strategic measures. 25 per cent will vest for threshold performance and 50 per cent for on-target performance. The measures are chosen to support the 'Best Bank for Customers' strategy and to align management and shareholder interests. Targets are set by the Committee to be stretching within the context of the strategic business plan. Measures are selected to balance profitability, achievement of strategic goals and to ensure the incentive does not encourage inappropriate risk taking. Measures and targets are set annually by the Committee and limited details can therefore be provided in the remuneration policy. For future awards, the Committee will disclose in the Implementation Report for the relevant year historic measure and target information, together with how the Group has performed against those targets, unless this information is deemed to be commercially sensitive.
– Shareholding guidelines	Executive Directors are required to build up a holding of a value of 200 per cent of base salary and fixed share award for the GCE and 150 per cent for other Executive Directors. Details of holding are shown in the Implementation Report.

REMUNERATION POLICY TABLE FOR CHAIRMAN AND NON-EXECUTIVE DIRECTORS

The table below sets out the remuneration policy that has been applied to Non-Executive Directors (NEDs) from the date of the AGM in 2014.

Chairman and Non-Executive Director fees

– Purpose and link to strategy	To provide an appropriate reward to attract and retain a high-calibre individual with the relevant skills, knowledge and experience.
– Operation	The Committee is responsible for evaluating and making recommendations to the Board with regards to the Chairman's fees. The Chairman does not participate in these discussions. The GCE and the Chairman are responsible for evaluating and making recommendations to the Board in relation to the fees of the NEDs. When determining fee levels, the following are considered: – The individual's skills and experience. – Comparable fees at FTSE companies of a similar size to Lloyds Banking Group, including the major UK banks. The Chairman receives an all inclusive fee, which is reviewed periodically plus benefits including life insurance, car allowance, medical insurance and transportation. The Committee retains the right to provide additional benefits depending on individual circumstances. NEDs are paid a basic fee plus additional fees for the chairmanship/membership of committees and for membership of Group companies/boards/non-board level committees. Additional fees are also paid to the senior independent director and to the deputy chairman to reflect additional responsibilities. Any increases normally take effect from 1 January of a given year. When determining and reviewing fee and benefit levels, the Committee ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective sizing methodologies. – Pay for comparable roles in comparable publicly listed financial services groups, of a similar size. The Chairman and the NEDs are not entitled to receive any payment for loss of office (other than in the case of the Chairman's fees for the six month notice period) and are not entitled to participate in the Group's bonus, share plan or pension arrangements. NEDs are reimbursed for expenses and any tax arising from these expenses. Where appropriate, the Group will also meet the costs and any tax arising from travel for business purposes.
– Maximum potential	The Committee will make no increase in fees or benefits currently provided which it believes is inconsistent with the two parameters above.
– Performance metrics	N/A

SERVICE AGREEMENTS

The service contracts of all current Executive Directors are terminable on 12 months' notice from the Group and six months' notice from the individual. The Chairman also has a service agreement. His engagement may be terminated on six months' notice by either the Group or the individual.

Directors' remuneration report continued

DIRECTORS' REMUNERATION IMPLEMENTATION REPORT

CONSIDERATION OF MATTERS RELATING TO DIRECTORS' REMUNERATION

The Remuneration Committee has responsibility for setting remuneration for all Executive Directors and the Chairman, including pension rights and any compensation payments. The Committee also recommends and monitors the level and structure of remuneration for senior management and material risk takers.

The Committee's purpose is to consider, agree and recommend to the Board an overall remuneration policy and philosophy for the Group that is aligned with its long-term business strategy, its business objectives, its risk appetite, values and the long-term interests of the Group that recognises the interests of relevant stakeholders. A full list of the Committee's responsibilities is detailed in its terms of reference, which can be found on our website at www.lloydsbankinggroup.com

The Committee is comprised of Non-Executive Directors from a wide background to provide a balanced and independent view on remuneration matters.

The members of the Committee during 2014 were:

– Anthony Watson (chairman)
– Lord Blackwell
– Sir Winfried Bischoff (retired April 2014)
– Carolyn Fairbairn
– Anita Frew (also chairman of the Board Risk Committee from May 2014) (from May 2014)
– Dyfrig John (from June 2014)
– David Roberts (also chairman of the Board Risk Committee until May 2014) (retired May 2014)
– Sara Weller

During 2014, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review. The Committee met 11 times and considered the following principal matters:

– Review of remuneration arrangements for senior executives
– Determination of the appropriate remuneration packages for a number of senior new hires
– Determination of bonus pools based on Group performance and adjustment for risk
– Performance conditions for the Long-Term Incentive Plan
– Bonus and salary awards for Executive Directors and key senior managers
– Approval of remuneration and terms of service that fall within the Committee's terms of reference, including new hires
– Feedback from the Committee Chairman on his meetings with the PRA and shareholders
– Oversight and approval of revised bonus and performance adjustment methodology and process
– Consideration of remuneration governance in light of regulatory changes

Committee members are thanked for their commitment during the last year and attendance at meetings.

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. During the year, Deloitte LLP advised the Committee. Deloitte was appointed as remuneration consultants by the Committee following a competitive tendering process. Deloitte has voluntarily signed up to the Remuneration Consultants' Code of Conduct. The Committee has evaluated Deloitte during 2014 and concluded that it was effective in providing objective and independent advice to the Committee. In particular, it was recognised that Deloitte had the requisite knowledge and provided relevant external updates which enabled the Committee to fulfil its responsibilities. Deloitte is not connected with the Group.

Deloitte's fees for services to the Committee in 2014 were on a time and materials basis and amounted to £526,000. In addition, Deloitte LLP provided the Group with advice on taxation and other consulting services, and assurance services.

António Horta-Osório (Group Chief Executive), Rupert McNeil (Group HR Director), Paul Hucknall (HR Director, Performance & Reward) and Chris Evans (Director, Performance and Reward Governance) provided guidance to the Committee (other than for their own remuneration). Juan Colombás (Chief Risk Officer) and George Culmer (Chief Financial Officer) also attended the Committee to advise as and when necessary on risk and financial matters.

The Committee is satisfied that its processes are robust and diligent and that the Group's remuneration and incentive plans conform to best practice standards.

STATEMENT OF VOTING AT ANNUAL GENERAL MEETING

The proposals on the Group's remuneration policy and the remuneration offered to our Executive Directors in 2014 were detailed within the Directors' remuneration report for 2013 and were voted on at the 2014 AGM. The shareholder votes submitted at the meeting, either directly, by mail or by proxy, were as follows:

	Votes cast in favour		Votes cast against		Votes withheld
	Number of shares (millions)	Percentage of votes cast	Number of shares (millions)	Percentage of votes cast	Number of shares (millions)
Remuneration policy	**48,261**	**97.97%**	**999**	**2.03%**	**1,391**
Remuneration implementation report	**43,788**	**87.26%**	**6,395**	**12.74%**	**468**

As mentioned in the Chairman's statement, we are committed to an ongoing dialogue with our shareholders. Shareholders have different views, notably on incentive scheme design and whilst we do take all comments into consideration, there will inevitably be some diverging views.

One of the observations was that the introduction of Fixed Share Awards for Executive Directors in 2014 was not accompanied by a sufficient reduction in total remuneration to reflect increased certainty of rewards. The Committee considered this point and ensured that the expected value of bonus awards was reduced so that total remuneration remained consistent for equivalent levels of performance. It also maintained the value of long-term incentives and instead made significant reductions to short-term bonus opportunity, thereby further weighting reward towards long-term performance. The Committee is satisfied that its approach, and the revised maximum remuneration opportunity, is positioned conservatively against peers and will provide a fair and competitive level of remuneration for outstanding performance.

The Committee believes that the structure of the Group's remuneration is appropriate, given the regulatory requirements. We have consulted extensively with our major shareholders but we also welcome feedback from all of our shareholders on our remuneration arrangements and on this report.

In line with the Group's drive for providing greater transparency where appropriate, this report provides as much detail as possible unless deemed to be commercially sensitive.

IMPLEMENTATION OF THE POLICY IN 2015

It is proposed to operate our policy in the following way in 2015:

Base salary

In line with our policy, when determining and reviewing base salary levels, the Committee ensures that decisions are made within the following two parameters:

– An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies.
– Pay for comparable roles in comparable publicly listed financial services groups, of a similar size.

The Committee also takes into account base salary increases for employees throughout the Group. We are proposing a 2.5 per cent overall salary budget increase for the general population differentiated by performance and market position (increases generally range from 0 per cent to 6.5 per cent).

The three Executive Directors have made significant contributions to the Group's success, as reflected in their risk-adjusted performance ratings in 2014, but there is no increase proposed for the Group Chief Executive. Salary increases of 2 per cent are, however, proposed for the Chief Financial Officer and the Chief Risk Officer. Salaries with effect from 1 January 2015 will therefore be as follows:

Group Chief Executive (GCE): £1,061,000

Chief Financial Officer (CFO): £734,400

Chief Risk Officer (CRO): £724,200

As disclosed in previous reports, since his appointment, the Group Chief Executive has a reference salary of £1.22 million which is used to calculate certain elements of long-term remuneration and the pension allowance.

Fixed share award

Fixed Share Awards were introduced in 2014 in order to ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for Executive Directors, with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements.

The actual levels of award set for 2015 are as follows (which will be released in shares over a five year period):

GCE: £900,000

CFO: £504,000

CRO: £497,000

Shares will be released in equal tranches over a five year period.

Pension

In line with the remuneration policy, Executive Directors are entitled to a cash allowance in lieu of pension contributions. The level of allowances has not been increased for 2015.

GCE: 50 per cent of reference salary less flexible benefit allowance

CFO: 25 per cent of base salary

CRO: 25 per cent of base salary

The GCE is also entitled to the provision of an unfunded unapproved retirement benefit scheme (UURBS), subject to performance conditions, as described further in the Implementation Report.

Benefits

For 2015, the benefits provided to Executive Directors include a car allowance, transportation, private medical insurance, life assurance and other benefits selected through the flexible benefit allowance which is capped at 4 per cent of base salary.

The CRO's benefits in respect of relocation ended in January 2014.

Directors' remuneration report continued

All employee plans	Executive Directors are eligible to participate in the Sharesave and Sharematch scheme on the same basis as other employees.
Annual bonus	
– Opportunity	The maximum annual bonus opportunity is 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors. All assessments of performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance for the financial measure is not met and the individual is rated 'Developing performer' or below. The expected value of the bonus is 30 per cent of the maximum opportunity.
– Performance measures and targets	For 2015 the annual bonus will be based on: – Financial underlying profit – 50 per cent – Balanced scorecard (BSC) objectives comprising five categories (finance, building the business, customer, risk and people) – 50 per cent The Committee considers the targets that apply to these measures to be commercially sensitive but will provide information on the level of payout relative to the performance achieved in next year's Implementation Report. The Committee applies its judgement to determine the payout level commensurate with business and/or individual performance in determining the final BSC rating. A revised performance adjustment policy has been fully implemented. Performance adjustment is determined by the Remuneration Committee and Board Risk Committee and may result in a reduction of up to 100 per cent of the bonus opportunity. The Independent Performance Adjustment Committee (IPAC) reviews the balanced scorecard outcomes and submits a report to the Remuneration Committee and Board Risk Committee to assist in this process. The application of performance adjustment will generally be considered when: – there is reasonable evidence of employee misbehaviour, misconduct or material error or that they participated in conduct which resulted in losses for the Group or failed to meet appropriate standards of fitness and propriety; – material failure of risk management at a Group, business area, division and/or business unit level; – the financial results at a Group, division or business unit level are re-stated or consideration is given to restatement; – the Committee determines that the financial results for a given year do not support the level of variable remuneration awarded; and/or – any other circumstances where the Committee consider adjustments should be made. Individual performance adjustment is informed using a matrix-based approach taking into account the severity of the issue, the individual's proximity to the issue and the individual's behaviour in relation to the issue. In addition, the annual bonus may be subject to clawback up to seven years after the date of award.
Long-term incentive plan	
– Opportunity	The maximum annual long-term incentive award for Executive Directors is 300 per cent of salary. Awards in 2015 will be made as follows: GCE: 300 per cent of reference salary CFO: 275 per cent of base salary CRO: 275 per cent of base salary
– Performance measures and targets	2015 awards will be subject to a three-year performance period, and a two-year holding period following vesting. During 2014 and early 2015, the Committee consulted widely with various shareholders on appropriate performance measures and, in particular, on how management can be incentivised through the long-term incentive plan to successfully deliver the objectives set out in the Group Strategic Review. The awards made in 2015 will vest based on Lloyds Banking Group's performance against the following key measures: – Economic profit (25 per cent) – Absolute Total Shareholder Return (30 per cent) – Cost:income ratio (10 per cent) – Strategic measures (35 per cent) The following table provides a breakdown of these measures and the targets applicable. We believe these measures capture risk management and profit growth and appropriately align management and shareholder interests. LTIP awards may be subject to clawback up to seven years after the date of award. The scenarios in which the Committee may consider performance adjustment/clawback are outlined in the annual bonus section above.

Strategic focus	Measure	Basis of payout range	Metric	Weighting
Delivering sustainable growth	Absolute Total Shareholder Return (TSR)	Growth in share price including dividends over 3 year period	Threshold: 8% pa Maximum: 16% pa	30%
Becoming simpler and more efficient	Economic profit	Set relative to 2017 targets	Threshold: £2,870m Maximum: £3,587m	25%
	Cost:income ratio	Set relative to 2017 targets	Threshold: 45.6% Maximum: 44.5%	10%
Creating the best customer experience	Customer complaint handling (total FCA reportable complaints per 1,000 accounts)[1] and Financial Ombudsman Service (FOS) uphold rate	Average performance over 3 year period	Threshold: 1.15 complaints per 1,000 accounts and 32% FOS uphold rate Maximum: 1.05 complaints per 1,000 accounts and 28% FOS uphold rate	10%
	Net promoter score	Major Group average ranking over 2017	Threshold: 3rd Maximum: 1st	10%
	Digital active customer growth	Set relative to 2017 targets	Threshold: 12.7m active users Maximum: 13.3m active users	7.5%
	Colleague engagement score	Set relative to 2017 targets	Threshold: 62% Maximum: 70%	7.5%

[1] Measure excludes PPI complaints and any complaints received via Claims Management Companies, but includes Banking, Home Finance, General Insurance, Life, Pensions and Investment complaints.

With regard to the economic profit measure, which remains a core financial measure, the Group is currently reviewing the calculation methodology for financial reporting purposes in order to better align with current expectations of the Group's forward-looking plan, including the Group's capital requirement and asset quality ratio. We are seeking to complete this review as soon as possible and will consult with shareholders in respect of any proposed changes during 2015.

CHAIRMAN AND NON-EXECUTIVE DIRECTOR FEES IN 2015

The annual fee for the Chairman is unchanged at £700,000.

The annual Non-Executive Director fees were last reviewed in 2013 and have remained unchanged since 1 July 2013:

	2014	2015
Basic fee	£65,000	£65,000
Deputy Chairman	£100,000	£100,000
Senior Independent Director	£60,000	£60,000
Audit Committee Chairmanship	£50,000	£50,000
Remuneration Committee Chairmanship	£50,000	£50,000
Board Risk Committee Chairmanship	£50,000	£50,000
Audit Committee membership	£20,000	£20,000
Remuneration Committee membership	£20,000	£20,000
Board Risk Committee membership	£20,000	£20,000
Nomination & Governance Committee membership[1]	£5,000	£5,000

[1] Where individual is not already Chairman of another Committee.

Non-Executive Directors may receive more than one of the above fees.

For 2015, the benefits provided to the Chairman include a car allowance, medical insurance, life insurance and transportation.

The following pages contain information that is required to be audited in compliance with the Directors' remuneration requirements of the Companies Act 2006. All narrative and quantitative tables are unaudited unless otherwise stated.

Directors' remuneration report continued

REMUNERATION OUTCOME FOR 2014

Executive directors (audited)

The following table summarises the total remuneration delivered during 2014 in relation to service as an Executive Director.

	António Horta-Osório		George Culmer		Juan Colombás[6]		Totals	
£000	2014	2013	2014	2013	2014	2013	2014	2013
Base salary	**1,061**	1,061	**720**	720	**710**	58	**2,491**	1,839
Fixed Share Award	**900**	–	**504**	–	**497**	–	**1,901**	–
Benefits	**119**	113	**40**	37	**60**	15	**219**	165
Pension allowance[1]	**568**	568	**180**	286	**173**	14	**921**	868
Other remuneration[2]	**1**	173	**301**	301	**–**	2	**302**	476
Annual bonus[3]	**800**	1,700	**496**	910	**468**	78	**1,764**	2,688
Long-term incentive[4]	**7,383**	3,128	**3,565**	–	**3,174**	41	**14,122**	3,169
Conditional pension buy-out[5]	**712**	732	**–**	–	**–**	–	**712**	732
Total remuneration	**11,544**	7,475	**5,806**	2,254	**5,082**	208	**22,432**	9,937
Less: Buy-out amounts	**(712)**	(904)	**(300)**	(300)	**–**	(2)	**(1,012)**	(1,206)
Total remuneration less buy-outs	**10,832**	6,571	**5,506**	1,954	**5,082**	206	**21,420**	8,731

[1] Following changes to the amount of tax relief available on pension contributions in each year, Directors may elect to receive some or all of their allowances as cash. The breakdown of payments made in cash and contributions into the pension scheme are shown below. Note that the amount for 2013 in respect of George Culmer includes £106,000 carried over from 2012 and delivered in 2013.

[2] Other remuneration payments comprise contractual cash payments to George Culmer as part of the buyout of benefits from his previous employer and income from all employee share plans, which arises through employer matching or discounting of employee purchases up to a maximum of £960 per annum.

[3] In addition to deferral and performance adjustment, the GCE's bonus will only vest if the Group's share price remains above 75.5 pence on average for any 126 consecutive trading days in the five years following grant or the UK government sells 100 per cent of its shareholding in the Group at any time during the three years following grant. If either condition is met earlier than the third anniversary of grant, vesting will still only occur on the third anniversary. In this event, the award will be subject to a further two year holding period following vesting up to a maximum of five years in total.

[4] The long-term incentive vesting was confirmed by the Remuneration Committee at its meeting on 25 February 2015. The closing share price on that date of 79.24 pence has been used to calculate the value. The shares were awarded in 2012 based on a share price of 34.786 pence.

[5] The GCE has a conditional unfunded pension commitment, subject to share price performance. This was a partial buyout of a pension forfeited on joining from Santander. It is an unfunded unapproved retirement benefit scheme (UURBS). The UURBS provides benefits on a defined benefit basis at a normal retirement date of 65. The UURBS applies for a maximum of six years following the commencement of employment and the maximum allowance over that period is 26.5 per cent of the higher of the GCE's base salary and reference salary in the 12 months before retirement or leaving, subject to performance conditions. No additional benefit is due in the event of early retirement. The rate of pension accrual in each year depends on share price conditions being met. An annual pension entitlement of £35,610 was accrued in 2014.

[6] Amounts shown for 2013 reflect the period from 29 November 2013 when Juan Colombás was appointed as an Executive Director. Total remuneration for 2013 was £3,193,000. Under terms agreed when joining the Group, the CRO is entitled to a conditional lump sum benefit of £718,996 either (i) on reaching normal retirement age unless the CRO voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long term sickness or health.

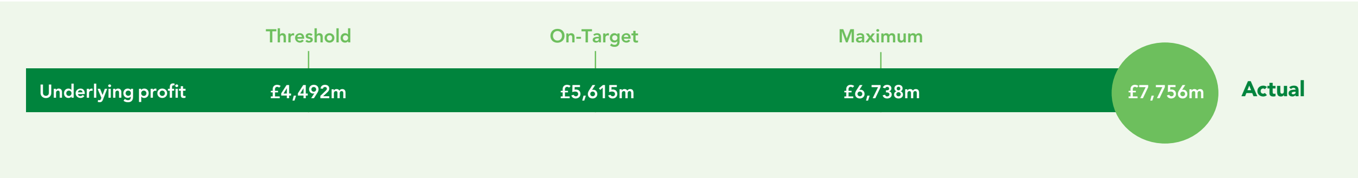
Pension and benefits (audited)

Pension/Benefit £	António Horta-Osório	George Culmer	Juan Colombás
Employer contribution to pension scheme	**10,670**	**20,900**	**21,717**
Cash allowance in lieu of pension contribution	**556,890**	**159,100**	**151,470**
Car or car allowance	**12,000**	**10,660**	**12,000**
Flexible benefits payments	**42,440**	**28,800**	**25,640**
Private medical insurance	**27,293**	**760**	**12,406**
Transportation	**37,280**	**–**	**1,634**
Relocation	**–**	**–**	**8,333**

ANNUAL BONUS

The 2014 annual bonus outcome for Lloyds Banking Group (excluding TSB) was determined by adjusting the Group's target outcome (£400 million in 2014) according to:

– Group underlying profit performance: a target of £5,615 million was approved by the Board in advance of the performance year, with threshold and maximum set at 20 per cent above and below target. The outcome for 2014 was as follows:

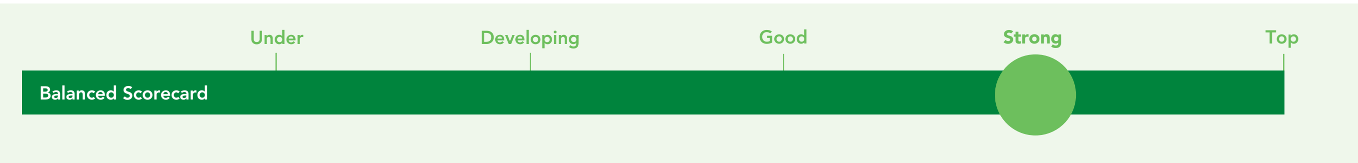


– Balanced Scorecard performance: stretching objectives for each division were approved by the Remuneration Committee around the start of the performance year. The objectives were aligned to the Group's strategy and split across five categories:

  – Financial
  – Building the business
  – Customer service
  – Risk
  – People development

  Balanced Scorecard ratings are based on a scale ranging from 'Under' (at the lowest level), through 'Developing', 'Good', 'Strong' and up to 'Top' which is the highest rating. Each of these ratings may be further differentiated by the addition of 'minus' or 'plus'.

  The Remuneration Committee reviewed performance in depth to determine ratings for the Group and each division, including consideration of risk matters arising in 2014. The overall rating for the Group was 'Strong':



– Collective performance adjustment: consideration was given to items not factored into the Group underlying profit or divisional balanced scorecards. These included the provisions for legacy conduct-related matters and regulatory settlements on LIBOR and Repo rate setting. It also considered positive factors, such as non-core disposals, the SWIP sale, the TSB separation/IPO and the reduction in government shareholding.

  As a result of these items, the Remuneration Committee applied an overall adjustment of approximately 25 per cent, resulting in a final bonus outcome of £369.5 million (a reduction of 3.6 per cent from the total outcome in 2013 (after adjusting for TSB).

To ensure fairness for our shareholders, the total bonus outcome is subject to a limit of 10 per cent of pre-bonus underlying profit. For 2014, the bonus outcome of £369.5 million is significantly below the limit of £813 million.

Individual outcomes for Executive Directors

The individual bonus awards for Executive Directors are determined in the same way as for colleagues across the Group, with outcomes based on:

– Group underlying profit performance
– Balanced Scorecard performance
– Collective performance adjustment
– Individual performance
– On-target award

Awards are approved by the Remuneration Committee, which has discretion to adjust outcomes for any reason.

Directors’ remuneration report continued

António Horta-Osório

The Group Chief Executive’s individual performance assessment for 2014, as confirmed by the Committee, reflected a number of considerations including:

- Strong financial performance: underlying profit increased by 26 per cent to £7,756 million in 2014 and statutory profit increased from £415 million to £1,762 million.
- Successful completion of the TSB IPO in June 2014 and further successful sell down of the government’s holding to below 25 per cent.
- Successful development of new 2015-2017 strategic plan for the Group.
- Customer dashboards implemented across the Group and improvements in Net Promoter Scores (our measure of the customer experience), although there has been an increase in FCA reportable complaints.
- Continued progress in conduct strategy, although further work is required to continue to drive cultural improvements.
- Completion of simplification programme (cost savings of £449 million realised in 2014).
- Continued improvement in strengthening the balance sheet and reducing risk: pro forma fully loaded common equity tier 1 ratio increasing by 2.5 percentage points to 12.8 per cent.
- Exceeded PRA stress testing threshold measure of 4.5 per cent.
- Over £39 billion of gross new lending to British customers was committed during 2014 under the Funding for Lending Scheme (FLS).

Based on a full assessment of performance, the Committee agreed an individual rating for 2014 of ‘Strong’ for the Group Chief Executive.

The introduction of the Fixed Share Awards in 2014 resulted in a reduction in the annual bonus opportunity for the Group Chief Executive (the maximum award reduced from 225 per cent to 140 per cent of base salary). Expected outcomes are based on individual performance before taking into account a modifier based on underlying profit and the Group balanced scorecard, as follows:

Rating	Under	Developing	Good	Strong	Top
Expected outcome as % of salary	0%	0%	42%	91%	140%

Following the Committee’s assessment of performance against the underlying profit target and Group balanced scorecard objectives, and taking into account the collective performance adjustment of 24.9 per cent and the individual rating of ‘Strong’, the Committee determined a 2014 bonus award to the Group Chief Executive of £800,000 (75 per cent of base salary). In arriving at this award, the Committee exercised its discretion to apply a reduction to reflect the external environment.

George Culmer

The Chief Financial Officer’s personal performance assessment for 2014, as confirmed by the Committee, reflected a number of considerations including:

- Effective management and contribution to underlying income and profit to ensure they were significantly ahead of target.
- Ensuring Core Tier 1 and cost:income ratios were strong (ratios at end of 2014 were 12.8 per cent and 51.2 per cent respectively).
- Excellent management and delivery of the Group Strategic Review.
- Positive performance in Risk Appetite status, material regulatory breaches and audit actions, although delivery of regulatory change programmes has been challenging.
- Stress testing within appetite.
- Excellent execution of AT1 transaction.

Based on a full assessment of performance, the Committee agreed an individual rating for 2014 of ‘Strong’ for the Chief Financial Officer.

The introduction of the Fixed Share Awards in 2014 resulted in a reduction in the annual bonus opportunity for the Chief Financial Officer (the maximum award reduced from 200 per cent to 100 per cent). Expected outcomes are based on individual performance before taking into account a modifier based on underlying profit and the Group balanced scorecard, as follows:

Rating	Under	Developing	Good	Strong	Top
Expected outcome as % of salary	0%	0%	30%	65%	100%

Following the Committee’s assessment of performance against the underlying profit target and the Finance function’s balanced scorecard objectives, and taking into account the collective performance adjustment of 24.9 per cent and the individual rating of ‘Strong’, the Committee determined a 2014 bonus award to the Chief Financial Officer of £496,000 (69 per cent of base salary).

Juan Colombás

The Chief Risk Officer's personal performance assessment for 2014, as confirmed by the Committee, reflected a number of considerations including:

- Good progress across the Board Risk Appetite, although legacy issues continue to present challenges.
- Maintaining high level of responsiveness to our regulators with whom we strive for a strong working relationship.
- Improvements in mitigating operational risks and regulatory breaches.
- Driving progress in conduct strategy.
- Leading remediation of legacy issues.
- Positive achievements in impairment charge, reduction in non-core assets, RWAs and leverage ratio.

Based on a full assessment of performance, the Committee agreed an individual rating for 2014 of 'Strong' for the Chief Risk Officer.

The introduction of the Fixed Share Awards in 2014 resulted in a reduction in the annual bonus opportunity for the Chief Risk Officer (the maximum award reduced from 200 per cent to 100 per cent of base salary). Expected outcomes are based on individual performance, before taking into account a modifier based on underlying profit and the Risk division's balanced scorecard, as follows:

Rating	Under	Developing	Good	Strong	Top
Expected outcome as % of salary	0%	0%	30%	65%	100%

Following the Committee's assessment of performance against the underlying profit target and the Risk division's balanced scorecard objectives, and taking into account the collective performance adjustment of 24.9 per cent and the individual rating of 'Strong', the Committee determined a 2014 bonus award to the Chief Risk Officer of £467,892 (66 per cent of base salary).

Application of the Committee's judgement

As described above, the Committee used its judgement to apply a collective adjustment to reflect the level of provisions for legacy conduct related matters.

As with the bonus outcome determination for the wider Group, the Committee retains the discretion to adjust for other factors when determining individual awards, such as market relativity, year-on-year performance, stakeholder views, the statutory profit and the Group's capital position. For 2014, the Committee exercised discretion by applying a reduction to the award for the Group Chief Executive.

The bonuses awarded are summarised in the table below:

Name	António Horta-Osório	George Culmer	Juan Colombás
Maximum opportunity (% of base salary)	140%	100%	100%
% awarded for 2014 (as % of maximum)	54%	69%	66%
Bonus awarded for 2014	£800,000	£496,000	£467,892

Deferral

The Group Chief Executive's award is deferred into shares for five years and subject to performance adjustment and clawback. The award is subject to an additional condition that the share price must remain above 75.5 pence on average for any 126 consecutive trading days in the five years following grant or the UK government sells 100 per cent of its shareholding during the three years following grant.

If either condition is met earlier than the third anniversary of grant, vesting will still only occur on the third anniversary. The award will be subject to a further holding period following vesting such that, in any event, the award will release no earlier than five years after grant. If neither of the conditions has been met by the fifth anniversary of the award, the award will lapse entirely.

Consistent with the aim of ensuring that short-term financial results are only rewarded if they promote sustainable growth, the 2014 annual bonus is subject to deferral in shares until at least 2018. This deferred amount is subject to performance adjustment (malus).

Bonus awards for other Executive Directors are deferred into shares until at least March 2017 and subject to performance adjustment and clawback. They are also subject to remaining in the Group's employment, as set out in the approved policy from the 2013 Directors' Remuneration Report.

The Group has implemented clawback, covering all Remuneration Code Staff, in line with PRA requirements. Vested variable remuneration can be recovered from employees up to seven years after the date of award in the case of a material or severe risk event. Clawback will be used alongside other performance adjustment processes and applies to variable remuneration awarded from 1 January 2015.

The Committee reserves the right to exercise its discretion in reducing any payment that otherwise would have been earned, if it deems appropriate.

Directors' remuneration report continued

Long-term awards made in March 2012 vesting for the period ended on December 2014

The Group's financial performance over the three year performance period was very strong, with significant shareholder value created as the Group's market capitalisation trebled from c.£18 billion to c.£54 billion. This has justifiably led to significant payouts to participants, due not only to the delivery of targets but also the increase in share price. Awards were granted in shares at 34.786 pence so the increase over the period has more than doubled the value for recipients in line with the increase realised by shareholders.

At the end of the performance period, it has been assessed that awards will vest at 96.6 per cent of maximum.

	Threshold	Maximum	Vesting at threshold	Vesting at maximum	Actual performance	Vesting % of maximum
Economic profit[1] 30% of award	£225m	£2,330m	25%	100%	£2,094m	26.6%
Absolute total shareholder return 30% of award	12% per annum	30% per annum	25%	100%	30.2%	30.0%
Short-term funding as a percentage of total funding 10% of award	20%	15%	25%	100%	7.0%	10.0%
Non-core assets at end of 2014 10% of award	<=£95bn	<=£80bn	25%	100%	£47.1bn	10.0%
Net simplification benefits 10% of award	£1.5bn	£1.8bn	25%	100%	£2.0bn	10.0%
Customer satisfaction[2] 10% of award	1.5	1.3	25%	100%	1.2	10.0%

[1] Economic profit threshold and maximum targets were initially set at £160 million and £1,653 million respectively. These were subsequently increased by the Committee.

[2] Customer satisfaction target is based on the average reportable complaints per 1,000 customers over the three year period.

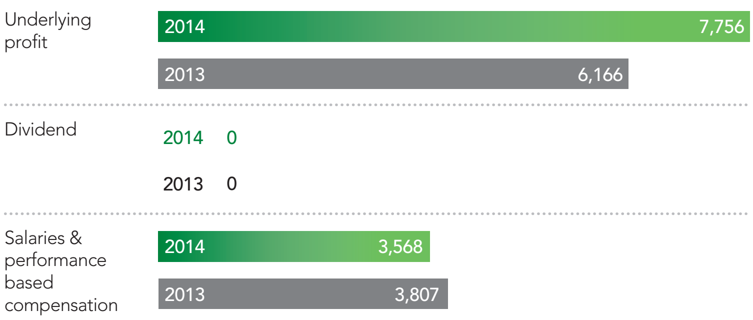
Percentage change in remuneration of GCE versus the wider employee population

Figures for 'All Employees' are calculated using figures for UK-based colleagues subject to the Group Annual Bonus Plan. This population is considered to be the most appropriate group of employees for these purposes because its remuneration structure is consistent with that of the Group Chief Executive.

	% change in base salary (2013 – 2014)	% change in bonus (2013 – 2014)	% change in benefits (2013 – 2014)
Group Chief Executive	0%	(52.9)%	5.3%
All Employees	2.5%[1]	4.8%[1]	2.5%[1]

[1] Adjusted for movements in staff numbers and other impacts to ensure a like-for-like comparison.

Relative spend on pay (£m)



Underlying profit has been used for comparison on the basis that it reflects performance, excluding legacy issues and one-off events.

Payments within the reporting year to past directors (audited)

As part of arrangements on leaving the Group, deferred bonus was released to Tim Tookey (£135,879).

Loss of office payments (audited)

There were no payments for the loss of office made to former Directors during 2014.

Chairman and Non-Executive Directors (audited)

	Fees £000		Taxable benefits £000		Total £000	
Current Non-Executive Directors	**2014**	2013	**2014**	2013	**2014**	2013
Lord Blackwell	**580**	233	**9**[1]	–	**589**	233
Alan Dickinson (appointed September 2014)	**33**	–	**–**	–	**33**	–
Carolyn Fairbairn	**105**	103	**–**	–	**105**	103
Anita Frew	**202**	105	**–**	–	**202**	105
Simon Henry (appointed June 2014)	**53**	–	**–**	–	**53**	–
Dyfrig John (appointed January 2014)	**105**	–	**–**	–	**105**	–
Nick Luff	**135**	108	**–**	–	**135**	108
Nick Prettejohn (appointed June 2014)	**182**	–	**–**	–	**182**	–
Anthony Watson	**215**	204	**–**	–	**215**	204
Sara Weller	**123**	103	**–**	–	**123**	103
Former Non-Executive Directors						
Sir Winfried Bischoff (retired April 2014)	**183**	700	**10**[2]	17[3]	**193**	717
David Roberts (retired May 2014)	**95**	248	**–**	–	**95**	248
Total	**2,011**	1,804	**19**	17	**2,030**	1,821

[1] 2014 taxable benefits are made up of car allowance of £8,909.
[2] 2014 taxable benefits are made up of car allowance of £3,136, private medical benefit of £608, and transportation of £6,693.
[3] 2013 taxable benefits are made up of car allowance of £12,000, private medical benefit of £566, and transportation of £4,864.

Breakdown of Non-Executive Directors' fees (£000s)

	Board fee	Deputy Chairman	Senior Independent Director	Audit committee	Remuneration committee	Board Risk committee	SWG board fees[1]	Other fees	2014 Total
Lord Blackwell	**16**			**5**		**5**	**33**		**59**[4]
Alan Dickinson	**21**			**6**		**6**			**33**
Carolyn Fairbairn	**65**			**20**	**20**				**105**
Anita Frew	**65**	**63**		**20**	**13**	**39**		**2**[2]	**202**
Simon Henry	**33**			**10**		**10**			**53**
Dyfrig John	**65**			**20**	**20**				**105**
Nick Luff	**65**			**50**		**20**			**135**
Nick Prettejohn	**34**			**10**		**10**	**128**		**182**
Anthony Watson	**65**		**60**	**20**	**50**	**20**			**215**
Sara Weller	**65**				**20**	**20**		**18**[3]	**123**

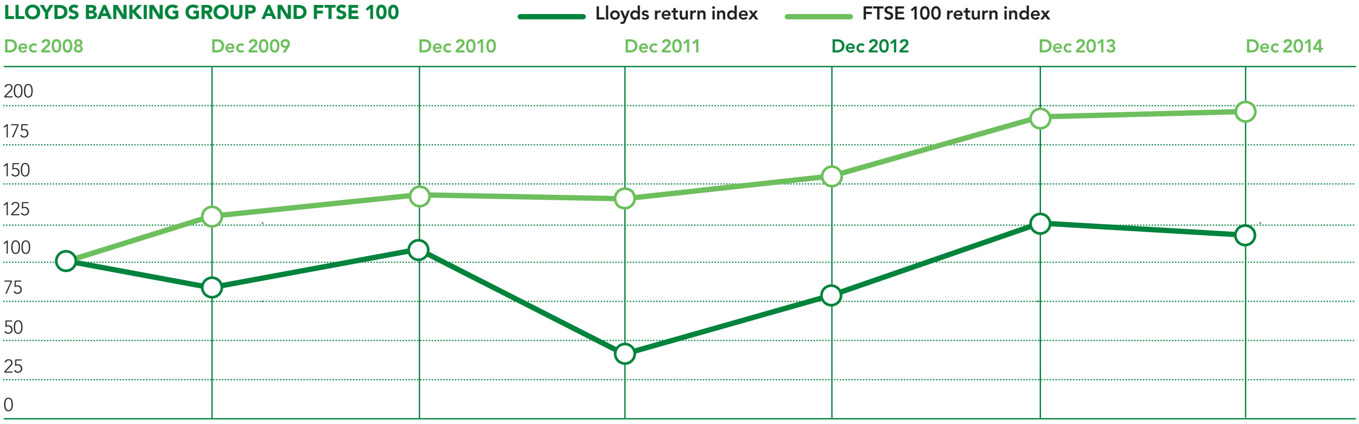
[1] Scottish Widows Group Ltd.
[2] Fees for membership of Nomination & Governance Committee.
[3] Fees for chairing the Responsible Business Steering Group and the Finance Inclusion Committee (non-Board level committees).
[4] The fees shown in the table above reflect the period of service prior to becoming Chairman of the Board.

Directors' remuneration report continued

HISTORICAL TOTAL SHAREHOLDER RETURN (TSR) PERFORMANCE

The chart below shows the historical TSR of Lloyds Banking Group plc compared with the FTSE 100 as required by the regulations, rebased as at 31 December 2008. The FTSE 100 index has been chosen as it is a widely recognised equity index of which Lloyds Banking Group plc has been a constituent throughout this period.

TOTAL SHAREHOLDER RETURN INDICES
LLOYDS BANKING GROUP AND FTSE 100



Rebased to 100 on 31 December 2008. Source: Deloitte

HISTORICAL GROUP CHIEF EXECUTIVE (GCE) REMUNERATION OUTCOMES

	GCE	2009	2010	2011	2012	2013	2014
GCE single figure of remuneration £000	J E Daniels	1,121	2,572	855	–	–	**–**
	António Horta-Osório	–	–	1,765	3,398	7,475	**11,544**
Annual bonus payout (% of maximum opportunity)	J E Daniels	Waived	62%	0%	–	–	**–**
	António Horta-Osório	–	–	Waived	62%	71%	**54%**
Long-term incentive vesting (% of maximum opportunity)	J E Daniels	0%	0%	0%	–	–	**–**
	António Horta-Osório	–	–	0%	0%	54%	**97%**

Notes: J E Daniels served as GCE until 28 February 2011; António Horta-Osório was appointed GCE from 1 March 2011. J E Daniels declined to take a bonus in 2009 and António Horta-Osório declined to take a bonus in 2011.

OUTSTANDING SHARE AWARDS

Directors' interests (audited)

– Shareholding guidelines

Executive Directors are required to build up a holding in Lloyds Banking Group plc shares of value equal to 150 per cent of base salary and fixed share award (200 per cent for the GCE) and are expected to achieve these targets within three years from the later of 1 January 2012 and their date of joining the Board. They are required to retain any shares vesting from LTIP awards granted from 2012 onwards for a further two years post vesting (although vested shares would count towards the shareholding requirement). Members of the Executive Committee are required to build up a shareholding of 100 per cent of their gross salary. As at 31 December 2014, all Executive Directors significantly exceeded the requirements.

	Number of shares			Number of options		Total shareholding[4]		Value
	Owned outright	Unvested subject to continued employment	Unvested subject to performance	Unvested subject to continued employment	Vested unexercised	Totals at 31 December 2014	Totals at 26 February 2015	Expected value at 31 December 2014 (£000s)[2]
Executive Directors								
António Horta-Osório[1]	6,204,884	5,168,008	21,710,202	37,151	–	33,120,245	33,120,660[3]	16,881[1]
George Culmer	1,232,436	2,573,846	11,184,291	37,151	4,460,003	19,487,727	19,488,142[3]	10,536
Juan Colombás	3,101,794	2,205,384	9,957,127	29,990	535,231	15,829,526	15,829,940[3]	8,227
Non-Executive Directors								
Lord Blackwell	50,000	–	–	–	–	50,000	n/a	n/a
Alan Dickinson	50,000	–	–	–	–	50,000	n/a	n/a
Carolyn Fairbairn	40,000	–	–	–	–	40,000	n/a	n/a
Anita Frew	300,000	–	–	–	–	300,000	n/a	n/a
Simon Henry	–	–	–	–	–	–	n/a	n/a
Dyfrig John	27,385	–	–	–	–	27,385	n/a	n/a
Nick Luff	200,000	–	–	–	–	200,000	n/a	n/a
Nick Prettejohn	–	–	–	–	–	–	n/a	n/a
Anthony Watson	476,357	–	–	–	–	476,357	n/a	n/a
Sara Weller	200,000	–	–	–	–	200,000	n/a	n/a

[1] Shareholdings held by António Horta-Osório are either wholly or partially in the form of ADRs.

[2] Awards subject to performance under the Long-Term Incentive Plan had an expected value of 50 per cent of face value at grant (using current accounting assumptions). Values are based on the 31 December 2014 closing price of 75.82 pence. Full face value of awards are £25,111,769 for António Horta-Osório, £14,775,594 for George Culmer and £12,001,946 for Juan Colombás.

[3] The changes in beneficial interests for António Horta-Osório (415 shares), George Culmer (415 shares) and Juan Colombás (414 shares) relate to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2014 and 26 February 2015. There have been no other changes up to 26 February 2015.

[4] Including holdings of connected persons.

A summary of transactions undertaken in the year, including share plan awards vested plus open market purchases and sales made by Directors, is shown on page 103.

As a result of the above shareholdings, the position for each Executive Director is as follows:

		Shareholding requirement		Current shareholding		
	Base salary plus fixed share award (£000s)	% of base salary plus fixed share award	Number of shares[1]	% of base salary plus fixed share award[1]	Number of shares as at 31/12/14[2]	Requirement met
Executive Directors						
António Horta-Osório	1,961	200%	5,172,778	240%	6,204,884	Yes
George Culmer	1,224	150%	2,421,525	353%	5,692,439	Yes
Juan Colombás	1,207	150%	2,387,892	228%	3,637,025	Yes

[1] Number of shares required and current shareholding percentage of base salary figures are calculated using the 31/12/14 closing price of 75.82 pence.

[2] Shares owned outright plus vested but unexercised options have been used to calculate current shareholding figures.

None of those who were Directors at the end of the year had any other interest in the capital of Lloyds Banking Group plc or its subsidiaries.

Directors' remuneration report continued

Breakdown of shares interests (audited)

– Long-term incentive plan awarded in 2014

Awards (in the form of conditional rights to free shares) in 2014 were made over shares with a value of 300 per cent of reference salary for the GCE (4,640,077 shares with a face value of £3,660,000); 275 per cent for the CFO (2,510,205 shares with a face value of £1,980,000); and 275 per cent for the CRO (2,234,780 shares with a face value of £1,762,750). The share price used to calculate face value is the average price over the five days prior to grant (17 March to 21 March 2014), which was 78.878 pence. This was the average share price used to determine the number of shares awarded.

The performance conditions attached to these awards are set out in the table below. The performance period ends on 31 December 2016.

Category	Measure	Basis of payout range	Metric	Weighting
Financial	Economic profit	Set relative to 2016 targets	Threshold: £2,154m Maximum: £3,231m	30%
	Absolute TSR	Growth in share price including dividends over 3 year period	Threshold: 8% pa Maximum: 16% pa	30%
	Cost:income ratio	Set relative to 2016 targets	Threshold: 48.9% Maximum: 46.5%	10%
Customer	Customer satisfaction (total FCA reportable complaints per 1,000 accounts)[1]	Set relative to 2016 targets	Threshold: 1.15 Maximum: 1.05	10%
	Net promoter score	Major Group average ranking over 2016	Threshold: 3rd Maximum: 1st	10%
Helping Britain Prosper	SME lending	Set relative to targets for SME lending growth over 3 year period	Threshold: 14% Maximum: 18%	5%
	Share of first-time buyer market	Set relative to targets for market share over 3 year period	Threshold: 20% Maximum: 25%	5%

[1] Measure excludes PPI complaints, but includes Banking, Home Finance, General Insurance, Life, Pensions and Investment complaints.

The targets referred to in the table relate to the Group's strategic plan, as approved by the Board. Further details have not been provided for reasons of commercial sensitivity, but will be disclosed after vesting.

For each measure, 25 per cent will vest for threshold performance, 50 per cent for on-target performance and 100 per cent for maximum performance.

– SAYE interests awarded in 2014

The Executive Directors are eligible to participate in the Group's 'sharesave' and 'sharematch' plans. In 2014, the GCE and CFO were each granted SAYE options over 14,995 shares and the CRO was granted SAYE options over 29,990 shares (with an exercise price of 60.02 pence per share and a face value of £11,276 and £22,552 respectively). The share price used to calculate the face value is the price on grant (2 October 2014), which was 75.2 pence.

– Deferred bonus awarded in 2014

Bonus is deferred into shares. The face value of the share awards in respect of bonuses granted in March 2014 was £1.7 million (2,155,227 shares) for the GCE; £910,000 (1,153,680 shares) for the CFO; and £860,000 (1,090,290 shares) for the CRO. The share price used to calculate face value is the average price over the five days prior to grant (17 March to 21 March 2014), which was 78.878 pence.

Interests in share options (audited)

	At 1 January 2014	Granted during the year	Exercised during the year	Lapsed during the year	At 31 December 2014	Exercise price	Exercise periods From	Exercise periods To	Notes
António Horta-Osório	1,452,401	–	1,452,401	–	–	–	–	–	1,4
	662,116	–	662,116	–	–	–	–	–	1,4
	1,452,401	–	1,452,401	–	–	–	–	–	1,4
	438,846	–	438,846	–	–	–	–	–	1,4
	22,156	–	–	–	22,156	40.62p	1/6/2016	30/11/2016	3
		14,995	–	–	14,995	60.02p	1/1/2018	30/6/2018	3
George Culmer	2,216,187	–	–	–	2,216,187	–	1/4/2013	31/3/2018	2
	2,243,816	–	–	–	2,243,816	–	1/4/2014	31/3/2019	2
	22,156	–	–	–	22,156	40.62p	1/6/2016	30/11/2016	3
		14,995	–	–	14,995	60.02p	1/1/2018	30/6/2018	3
Juan Colombás	235,499	–	–	–	235,499	–	15/6/2011	30/3/2021	1
	299,732	–	–	–	299,732	–	15/6/2012	30/3/2021	1
		29,990	–	–	29,990	60.02p	1/1/2018	30/6/2018	3
Former Directors who served during 2014									
None									

[1] Share buy-out award granted on 30 March 2011 for the loss of deferred share awards forfeited on leaving the Santander Group. Awards are consistent with those forfeited and have a nil option price.
[2] Executive share award granted on 6 August 2012 for the loss of deferred share awards forfeited on leaving RSA Insurance Group plc.
[3] Sharesave.
[4] Options exercised on 28 March 2014. The closing market price of the Group's ordinary shares on that date was 74.34 pence.

None of the other directors at 31 December 2014 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

The market price for a share in the Group at 1 January 2014 and 31 December 2014 was 79.12 pence and 75.82 pence, respectively. The range of prices between 1 January 2014 and 31 December 2014 was 70.94 pence to 86.3 pence.

Lloyds Banking Group long-term incentive plan (audited)

The following table shows conditional shares awarded under the plan. Further information regarding this plan can be found on pages 90 and 100.

	At 1 January 2014	Awarded during the year	Vested during the year	Lapsed during the year	At 31 December 2014	End of performance period	Expected value (£000s)	Notes
António Horta-Osório	7,154,187	–	3,856,106	3,298,081	–	31/12/2013	–	1
	9,644,684	–	–	–	9,644,684	31/12/2014	7,313	
	7,425,441	–	–	–	7,425,441	31/12/2015	5,630	
	–	4,640,077	–	–	4,640,077	31/12/2016	3,518	2
George Culmer	4,657,045	–	–	–	4,657,045	31/12/2014	3,531	
	4,017,041	–	–	–	4,017,041	31/12/2015	3,046	
	–	2,510,205	–	–	2,510,205	31/12/2016	1,903	2
Juan Colombás	3,087,272	–	1,664,039	1,423,233	–	31/12/2013	–	1
	4,146,064	–	–	–	4,146,064	31/12/2014	3,144	
	3,576,283	–	–	–	3,576,283	31/12/2015	2,712	
	–	2,234,780	–	–	2,234,780	31/12/2016	1,694	2

[1] The shares awarded in March 2011 vested on 7 March 2014. The closing market price of the Group's ordinary shares on that date was 81.35 pence.
[2] Award price 78.878 pence.

Values are based on the 31 December 2014 closing price of 75.82 pence.

Directors' remuneration report continued

Additional disclosures
– Emoluments of the eight highest paid senior executives[1]

The following table sets out the emoluments of the eight highest paid senior executives (excluding Executive Directors) in respect of the 2014 performance year.

	Executive							
	8 £000	7 £000	6 £000	5 £000	4 £000	3 £000	2 £000	1 £000
Fixed								
Cash based	400	400	766	500	919	664	754	700
Share based	200	280	410	350	406	459	218	490
Total fixed	600	680	1,176	850	1,325	1,123	972	1,190
Variable								
Upfront cash	2	2	2	2	2	2	2	2
Deferred cash	–	–	–	–	–	–	–	–
Upfront shares	238	46	167	142	55	171	56	183
Deferred shares	360	72	253	216	85	259	39	277
Long-term incentive plan	880	1,980	1,458	1,980	2,599	3,248	3,733	3,466
Total variable pay	1,480	2,100	1,880	2,340	2,741	3,680	3,830	3,928
Pension cost	100	100	151	125	142	164	188	245
Total remuneration	2,180	2,880	3,207	3,315	4,208	4,967	4,990	5,363

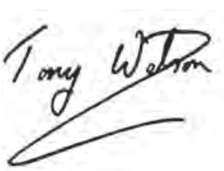
[1] Includes members of the Group Executive Committee and Senior Executive level colleagues.

Variable pay in respect of performance year 2014. LTIP values shown reflect awards for which the performance period ended on 31 December 2014. Pension costs based on a percentage of salary according to level.

Directors' interests – summary of awards vested, purchases and sales made by directors in 2014 (unaudited)

	Holding at 1 January 2014 (or appointment Date)	Transactions during the year	Number of shares	Notes	Holding at 31 December 2014
Executive Directors					
António Horta-Osório	1,411,685	07/03/14	2,043,736	Release of 2011 LTIP	
		28/03/14	2,118,332	Exercise of Share Buy Out award	
		27/06/14	315,330	Fixed Share Award	
		25/09/14	156,416	Fixed Share Award	
		19/12/14	156,990	Fixed Share Award	
		Monthly	2,395	Share Incentive Plan purchase and matching shares	**6,204,884**
George Culmer	877,951	27/06/14	176,584	Fixed Share Award	
		25/09/14	87,592	Fixed Share Award	
		19/12/14	87,914	Fixed Share Award	
		Monthly	2,395	Share Incentive Plan purchase and matching shares	**1,232,436**
Juan Colombás	1,409,048	07/03/14	231,604	Release of 2010, 2011 and 2012 Deferred Bonus	
		07/03/14	881,940	Release of 2011 LTIP	
		27/06/14	174,132	Fixed Share Award	
		03/09/14	231,604	Release of 2010, 2011 and 2012 Deferred Bonus	
		25/09/14	86,376	Fixed Share Award	
		19/12/14	86,693	Fixed Share Award	
		Monthly	397	Share Incentive Plan purchase and matching shares	**3,101,794**
Non-Executive Directors					
Lord Blackwell	50,000				**50,000**
Alan Dickinson	50,000				**50,000**
Carolyn Fairbairn	–	21/05/14	40,000	Purchase	**40,000**
Anita Frew	300,000				**300,000**
Simon Henry	–				**–**
Dyfrig John	27,385				**27,385**
Nick Luff	80,000	16/05/14	120,000	Purchase	**200,000**
Nick Prettejohn	–				**–**
Anthony Watson	476,357				**476,357**
Sara Weller	150,000	11/03/14	50,000	Purchase	**200,000**

On behalf of the Board



Anthony Watson, CBE
Chairman, Remuneration Committee

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Directors' report

Corporate governance statement
The corporate governance report found on pages 58 to 81 and, together with this report of which it forms part, fulfils the requirements of the Corporate Governance Statement for the purpose of the Financial Conduct Authority's Disclosure and Transparency Rules (DTR).

Results
The consolidated income statement shows a statutory profit before tax for the year ended 31 December 2014 of £1,762 million. A summary of the Group's results can be found on pages 35 to 43 and is incorporated into this report by reference.

Dividends
The Directors recommend to shareholders a dividend of 0.75 pence per ordinary share in respect of the full financial year ended 31 December 2014, which will be paid on 19 May 2015. Further information on ordinary dividends is shown in note 47 on page 261 and is incorporated into this report by reference.

Post balance sheet events
There have been no material post balance sheet events.

Going concern
The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of key dependencies which are set out in the risk management section under principal risks and uncertainties: funding and liquidity on page 32 and pages 146 to 152 and capital position on pages 153 to 165 and additionally have considered projections for the Group's capital and funding position. Having consulted on these, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Directors
The names and biographical details of the current Directors are shown on pages 58 to 59. Particulars of their emoluments and interests in shares in the Company are given on pages 82 to 103. Changes to the composition of the Board since 1 January 2014 up to the date of this report are shown in the table below:

	Joined the Board	Retired from the Board
Dyfrig John	1 January 2014	
Sir Winfried Bischoff		3 April 2014
David Roberts		14 May 2014
Nick Prettejohn	23 June 2014	
Simon Henry	26 June 2014	
Alan Dickinson	8 September 2014	

Lord Blackwell, who has served on the Board since 1 June 2012, was appointed Chairman in place of Sir Winfried Bischoff on 3 April 2014.

Appointment and retirement of Directors
The appointment of Directors is governed by the Company's articles of association, the UK Corporate Governance Code and the Companies Act 2006. The Company's articles of association may only be amended by a special resolution of the shareholders in a general meeting.

Alan Dickinson, Simon Henry and Nick Prettejohn have been appointed to the Board since the 2014 annual general meeting and will therefore stand for election at the forthcoming annual general meeting. In the interests of good governance and in accordance with the provisions of the UK Corporate Governance Code, all of the other Directors will retire and those wishing to serve again will submit themselves for re-election at the forthcoming annual general meeting.

Directors' indemnities
The Directors of the Company, including the former Directors who retired during the year have entered into individual deeds of indemnity with the Company which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006. The deeds indemnify the Directors to the maximum extent permitted by law and remain in force for the duration of a Director's period of office. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Directors appointed in 2014. Deeds for existing Directors are available for inspection at the Company's registered office. In addition, the Group had appropriate Directors and Officers liability Insurance cover in place throughout 2014.

The Company has also granted a deed of indemnity through deed poll which constituted 'qualifying third party indemnity provisions' to the Directors of the Group's subsidiary companies, including to former Directors who retired during the year and since the year end. Qualifying pension scheme indemnities were also granted to the Trustees of the Group's Pension Schemes.

Branches and financial risk management objectives and policies

The Group provides a wide range of banking and financial services through branches and offices in the UK and overseas. Information about internal control and financial risk management systems in relation to financial reporting and financial risk management objectives and policies in relation to the use of financial instruments can be found in the following sections of the annual report, which are incorporated into this report by reference:

	Pages
Internal control and financial risk management systems in relation to financial reporting	107 to 170 and 71 to 72
Financial risk management objectives and policies in relation to the use of financial instruments	107 to 170 (and in note 54 on pages 293 to 317)

Information included in the strategic report

The following information that would otherwise be required to be disclosed in the directors' report and which is incorporated into this report by reference can be found on the following pages in the strategic report:

	Pages
Future developments	2 to 33
Diversity and inclusion	28
Colleague engagement	27
Disclosures concerning greenhouse gases	29

Disclosures required under Listing Rule 9.8.4R

Additional information required to be disclosed by Listing Rule 9.8.4, where applicable to the Group, can be found in the following sections of the annual report:

	Pages
Publication of unaudited financial information	35
Allotment of equity securities	257
Significant contracts	268 to 271
Dividend waivers	261

Share capital and control

Information about share capital, restrictions on the transfer of shares or voting rights and special rights with regard to control of the Company is shown in note 42 on pages 257 and 258 and is incorporated into this report by reference.

The powers of the Directors, including in relation to the issue or buy back of the Company's shares, are set out in the Companies Act 2006 and the Company's articles of association. The Directors were granted authorities to issue and allot shares and to repurchase shares at the 2014 annual general meeting. Shareholders will be asked to renew the authorities at the 2015 annual general meeting.

The Company did not repurchase any of its shares during the year (2013: none).

Substantial shareholders

Information provided to the Company by substantial shareholders pursuant to the DTR is published via a Regulatory Information Service.

As at 31 December 2014, the Company was notified under Rule 5 of the DTR that The Solicitor for the Affairs of Her Majesty's Treasury had a direct interest in 17,771,118,604 ordinary shares, representing 24.9 per cent in the issued share capital with rights to vote in all circumstances at general meetings. On 20 February 2015, the Company was notified that the interest of The Solicitor for the Affairs of Her Majesty's Treasury had reduced to 17,093,553,260 ordinary shares, representing 23.9 per cent in the issued share capital. No other notification has been received under Rule 5 of the DTR.

Change of control

The Company is not party to any significant contracts that are subject to change of control provisions in the event of a takeover bid. There are no agreements between the Company and its Directors or employees providing compensation for loss of office or employment that occurs because of a takeover bid.

The Company is party to a deed of covenant with each of the four Lloyds Foundations (the Foundations) which hold limited voting shares in the Company (the limited voting shares are further described in note 42 on pages 257 and 258). Under the terms of the deeds of covenant, the Company makes an annual payment to each of the Foundations. In the event of a successful offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting share would convert to an ordinary share under the terms of the Company's articles of association. The payment obligation under the deeds of covenant would come to an end one year following the conversion of the limited voting shares.

Research and development activities

During the ordinary course of business the Group develops new products and services within the business units.

Directors' report continued

Statement of directors' responsibilities

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

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements and the Directors' remuneration report comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the financial statements is placed on our website at www.lloydsbankinggroup.com. The Directors are responsible for the maintenance and integrity of the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors, who are in office and whose names and functions are listed on pages 58 and 59 of this annual report, confirm that, to the best of his or her knowledge:

– the Group financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and Group; and
– the management report contained in the strategic report and the directors' report includes a fair review of the development and performance of the business and the position of the Company and Group, together with a description of the principal risks and uncertainties that they face.

The Directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy. The Directors have also separately reviewed and approved the Strategic Report.

Independent auditor and audit information

Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware and each Director has taken all the steps that he or she ought to have taken as a Director to make himself or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

Resolutions concerning the re-appointment of PricewaterhouseCoopers LLP as auditor and authorising the Audit Committee to set its remuneration will be proposed at the annual general meeting.

On behalf of the Board

Malcolm Wood
Company Secretary
26 February 2015

Lloyds Banking Group plc
Registered in Scotland

Company number SC95000

RISK MANAGEMENT

All narrative and quantitative tables are unaudited unless otherwise stated. The audited information is required to comply with the requirements of relevant International Financial Reporting Standards.

Further information on risk management can be found:

Risk management

Risk management is at the heart of our strategy to become the best bank for customers.

Our mission is to support the business in delivering sustainable growth. This is achieved through informed risk decision making and superior risk and capital management, supported by a consistent risk-focused culture across the Group.

The risk overview (pages 30 to 33) provides a summary of risk management within the Group. It highlights the important role of risk as a strategic differentiator, risk achievements in 2014 and priorities for 2015 along with a brief overview of the Group's risk governance structure and the principal risks faced by the Group and key mitigating actions.

This full risk management section provides a more in-depth picture of how risk is managed within the Group, detailing the Group's emerging risks, approach to stress testing, risk governance and committee structure and the Group's appetite for risk (pages 110 to 115) and a full analysis of the primary risk drivers (pages 116 to 170) – the framework by which risks are identified, managed, mitigated and monitored.

Each risk driver is described and managed using the following standard headings: definition, appetite, exposures, measurement, mitigation and monitoring.

See risk overview on page 30

THE GROUP'S APPROACH TO RISK

The Group operates a prudent approach to risk with rigorous management controls to keep the Group safe, support sustainable business growth and minimise losses within risk appetite. The Group has a strong and independent risk function (Risk Division) with a mission to maintain a robust control framework, identify and escalate emerging risks and support sustainable business growth within risk appetite through good risk reward decisioning.

RISK CULTURE

The Board ensures that senior management implements risk policies and risk appetites that either limit or, where appropriate, prohibit activities, relationships and situations that could be detrimental to the Group's risk profile.

The Group has a conservative business model embodied by a risk culture founded on a prudent approach to managing risk. The Group refreshed its Codes of Business and Personal Responsibility in 2014 reinforcing its approach where colleagues are accountable for the risks they take and the needs of customers are paramount.

The focus remains on building and sustaining long-term relationships with customers whatever the economic climate.

RISK APPETITE

- The Group defines risk appetite as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate.'
- The Group's strategy operates in tandem with its high level risk appetite which is supported by more detailed metrics and limits. An updated Risk Appetite Statement was approved by the Board in 2014. This incorporated recommendations from the Non-Executive Directors and is fully aligned with Group strategy.
- Risk appetite is embedded within principles, policies, authorities and limits across the Group.
- Risk appetite will continue to evolve to reflect external market developments and the composition of the Group.
- The Group optimises performance by allowing business units to operate within approved risk appetite and limits.

GOVERNANCE AND CONTROL

- Governance is maintained through delegation of authority from the Board down through the management hierarchy, supported by a committee-based structure designed to ensure open challenge and that the Group's risk appetite, principles, policies, procedures, controls and reporting are fully in line with regulations, law, corporate governance and industry good-practice.
- Board-level engagement, coupled with the direct involvement of senior management in Group-wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated where required.
- The Group's approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions.
- The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.
- A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management.

RISK DECISION MAKING AND REPORTING

- Taking risks which are well understood, consistent with strategy and with appropriate margin is a key driver of shareholder value.
- Risk analysis and reporting supports the identification of opportunities as well as risks.
- An aggregate view of the Group's overall risk profile, key risks and management actions, and performance against risk appetite, is reported to and discussed monthly at the Group Risk Committee (and a subset at the Group Asset and Liability Committee), with regular reporting to the Board Risk Committee and the Board.
- Rigorous stress testing exercises are carried out to assess the impact of a range of adverse scenarios with different probabilities and severities to inform strategic planning.
- The Chief Risk Officer regularly informs the Board Risk Committee (BRC) of the aggregate risk profile and has direct access to the Chairman and members of the Board Risk Committee. The Chief Risk Officer was appointed to the Board on 29 November 2013.

Table 1.1: **Exposure to risk arising from the business activities of the Group**

The table below provides a high level guide to the how the Group's business activities are reflected in its risk measures and balance sheet.

	LLOYDS BANKING GROUP PLC						
DIVISION	**Retail**	**Commercial Banking**	**Consumer Finance**	**Run-off**	**Central Items**	**TSB**[1]	**Insurance**[2]
BUSINESS ACTIVITIES	The Retail division is a leading provider of financial service products, including current accounts, savings, personal loans and mortgages to UK personal customers, including Wealth and small business customers	The Commercial Banking division supports business clients from small businesses to large corporates to financial institutions, with a range of propositions fully segmented according to client needs	The Consumer Finance division comprises the Group's consumer and corporate credit card businesses, along with Black Horse motor financing and Lex Autolease car leasing businesses in Asset Finance	Run-off includes assets that are outside of the Group's risk appetite, and were previously classified as non-core	Central Items include assets held outside the main operating divisions, including exposures relating to Group Corporate Treasury which holds the Group's liquidity portfolio and Group Operations.	TSB is a standalone multi-channel retail banking business. It serves retail and small business customers; providing a full range of retail banking products	The Insurance division is one of the UK's largest insurers and provides long-term savings, protection and investment products and general insurance products to customers in the UK and Europe
Risk-weighted assets (RWAs)							
– Credit risk[3]	£53.4bn	£83.4bn	£17.4bn	£15.4bn	£11.8bn	£5.2bn	–
– Counterparty credit risk[3]	–	£11.0bn	–	–	£0.3bn	–	–
– Operational risk	£14.3bn	£7.1bn	£3.5bn	£1.4bn	–	–	–
– Market risk	–	£4.7bn	–	–	–	–	–
Total (excluding threshold)	£67.7bn	£106.2bn	£20.9bn	£16.8bn	£12.1bn	£5.2bn	–
– Threshold	–	–	–	–	£10.8bn[2]	–	–
Total	**£67.7bn**	**£106.2bn**	**£20.9bn**	**£16.8bn**	**£22.9bn**	**£5.2bn**	**–**

[1] TSB risk-weighted assets are on a Lloyds Banking Group reporting basis and differ to those reported by TSB as a standalone regulated entity.

[2] As a separate regulated business, Insurance maintains its own regulatory solvency requirements, including appropriate management buffers, and reports directly to Insurance Board. Insurance does not hold any RWAs, as its assets are removed from the Banking Group's regulatory capital calculations. However, part of the Group's investment in Insurance is included in the calculation of Threshold RWAs, subject to the CRD IV rules, while the remainder is taken as a capital deduction.

[3] Exposures relating to the default fund of a central counterparty and credit valuation adjustments are included in Credit Risk and Counterparty Credit Risk respectively for the purposes of this table.

Principal risks

The Group's principal risks are shown in the risk overview (pages 30 to 33). The Group's emerging risks are shown overleaf. Full analysis of the Group's risk drivers are on pages 116 to 170.

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EMERGING RISKS

The Group considers the following to be risks that have the potential to increase in significance and affect the performance of the Group.

These risks are considered alongside the Group's five year operating plan.

Risk	Key mitigating actions
Compliance and Competition Regulation There is a material volume of regulatory change including market studies undertaken by the FCA and Competition and Markets Authority, overhaul of the Senior Managers' Regime and evolving regulatory oversight on the Payments agenda. All of these could impact on the Group's direction, structure and returns.	– Close working with the FCA and other regulatory bodies to support positive customer outcomes and compliance. – Rigorous implementation of a well defined and embedded Conduct Strategy and customer redress actions. – Embedding appropriate policies in the Risk Management Framework. – Full participation in all industry wide initiatives and IT investment to support new and secure payment product delivery channels. – Embedding competition risk within key policies.
Leveraging data Increasing regulatory scrutiny under EU Data Protection Regulation could have material commercial impact on the Group's strategy as currently proposed.	– Assessment of the possible impacts of this legislation is ongoing and the Group expects to deliver enhanced systems to fulfil related regulatory requirements.
Digital Internet and mobile technologies are changing the way the Group interfaces with its customers. The evolution of these technologies will require us to assess these services in respect of our conduct approach, multi-channel distribution, operational and legal developments and back office digitalisation.	– A full review of digital offering and related business plans to ensure the Group is fully able to respond. – Addressing the Group's digital solutions in all relevant policies, standards, governance and control models.
Data integrity and systems infrastructure The Group must continue to invest to maintain robust data integrity, security to ensure the quality, flow and consistency of data to meet regulatory and internal standards including the EU Data Protection Regulation requirements.	– Group investments will continue to address data integrity and security. – Assessment of the possible impacts of EU Data Protection Regulation legislation is ongoing and the Group expects to deliver enhanced systems to fulfil related regulatory requirements.
Ring Fencing and Resolution planning UK Ring Fencing legislation and Resolution planning continue to influence the Group's business and operating model and could impact the ability to, and cost of, servicing customers effectively.	– Continued progress following close and detailed liaison and engagement with Prudential Regulation Authority (PRA), Bank of England and all relevant regulatory bodies to deliver required Resolution and Ring Fencing obligations. – Extensive resources mobilised to deliver on requirements.
Evolving capital requirements The regulatory capital framework continues to be developed and there is a risk that this will give rise to higher regulatory capital requirements than the Group has anticipated within its strategic plans. Developments are being made at a global level through the FSB and Basel Committee, at a European level mainly through the issuance of CRD IV technical standards and guidelines and within the UK by the PRA and through directions from the FPC.	– The Group has made significant progress and continues to deliver on its strategy of strengthening the balance sheet, including its capital position, to improve the resilience of the Group. – The Group continues to work closely with regulatory authorities and industry associations to ensure that it is able to identify and respond to proposed regulatory changes. – The Group has strong governance, processes and controls which, combined with the Group's proactive management of risk, result in an appropriate level of capital.
Impact of accounting standards New reporting requirements under IFRS 9 introduce forward looking credit loss models which could lead to changes in the timing of reporting of impairments and therefore the Group's capital position.	– Impact assessments will continue to be undertaken and subsequent plans put in place to ensure the Group is compliant with this new 2018 reporting standard which will be deployed in a controlled and effective manner.
UK political uncertainty and risk of United Kingdom leaving the European Union The outcome of the 2015 General Election, and the likelihood of a referendum on British membership of the EU, remain unclear.	– The Group will continue to monitor and assess potential impacts while managing all exposures according to current risk policies.
Geopolitical shocks Geopolitical uncertainties could impact the current gradual global recovery, market risk pricing, asset price valuations and oil prices leading to tighter financial conditions, higher funding costs and therefore potentially reducing returns.	– Risk appetite criteria limits single counterparty bank and non bank exposures, supported by country limits commitments accordingly and a strategy that is UK focused. – The Group has continued to limit the reliance on short-term wholesale funding within the funding structure, favouring customer deposits and long-term wholesale funding coupled with a substantial portfolio of liquid assets.

STRESS TESTING

OVERVIEW

Stress testing is recognised as an essential risk management tool within the Group by the Board, senior management, the businesses and the risk and finance functions. Stress testing is embedded in the planning process of the Group as a key activity in medium term planning. This allows senior management and Board to assess the base case plan in adverse circumstances and to adjust strategies/propose mitigating actions if the plan does not meet risk appetite in a stressed scenario. A rigorous review and challenge process ensures that senior management is actively involved in the stress testing process.

The Group uses scenario stress testing to:

- Provide an assessment of strategic plans under adverse circumstances, against Board risk appetite to ensure the Group is managed within risk appetite.
- Drive the development of potential actions and contingency plans to mitigate the impacts of adverse scenarios. Stress testing also links directly to the Group's Recovery Planning process.
- Support the Internal Capital Adequacy Assessment Process (ICAAP) and setting of Individual Capital Guidance (ICG).
- Meet the standards required and information needs of internal and external stakeholders, including regulators.

At least on an annual basis, the Group conducts a detailed macroeconomic stress testing exercise based on the five-year operating plan, which is supplemented with higher-level refreshes of the stress testing exercise if necessary. The exercise aims to highlight the key vulnerabilities of the Group to adverse changes in the economic environment and to ensure that there are adequate financial resources in the event of a downturn. The exercise includes a range of economic scenarios, including a severe stress scenario modelled on the UK-wide PRA stress scenario. Ad hoc stress testing exercises are also undertaken to assess emerging risks, as well as in response to regulatory requirements.

During 2014, the Group was subject to stress testing exercises carried out by the European Banking Authority (EBA) and the PRA. As announced in October and December, the Group exceeded the capital thresholds set for both these tests and was not required to take any action as a result of these exercises.

The Group's stress testing programme also involves undertaking assessment of operational risk scenarios, liquidity scenarios, market risk sensitivities, business specific scenarios (see relevant risk section for further information on risk specific level stress testing) and reverse stress testing. This provides a comprehensive view of the potential impacts arising from the risks to which the Group is exposed and reflects the nature, scale and complexity of the Group.

METHODOLOGY

The Chief Economist's Office develops the macroeconomic scenarios to be used by the Group. Internal scenarios are developed based on key uncertainties for the economic outlook. A wide set of economic parameter assumptions is constructed, with over 150 metrics provided such as Gross Domestic Product, Base Rate, unemployment, Property Indices, Insolvencies and Corporate Failures to facilitate modelling of scenarios across the Group. Where an external scenario is provided as was the case with the EBA and the UK-wide PRA stress exercises, the Chief Economist's Office broadens the externally supplied parameters to the level of detail required by the Group. These are then sent back to the regulator who ensures consistent application of assumptions across banks.

The stress tests at all levels must comply with all regulatory requirements, and are put through a rigorous review and challenge process. This is supported by analysis and insight into impacts on customers and business drivers. The engagement of all required risk and control areas is built into the preparation process, so that the appropriate analysis of each risk drivers' impact upon the business plans are understood and documented.

The methodologies and modelling approach used for stress testing ensures that a clear link is shown between the macroeconomic scenarios, the business drivers for each area and the resultant stress testing outputs. All material assumptions used in modelling are documented and justified, with a clearly communicated review and sign off process. Modelling is supported by expert judgement and is subject to the Group Model Risk Governance Policy.

Below is an overview of the principal output responsibilities by team.

- Finance teams in the business prepare and review finance related stress testing results including, but not limited to, income, margins, costs, lending and deposit volumes.
- Credit risk and market risk teams prepare and review risk-related stress outputs, including, but not limited to, impairment charges, risk-weighted assets, expected loss and trading losses.
- The Group Financial Risk team provides objective oversight of the finance and risk stress submissions as well as the consolidated Group position and capital ratios and produces analysis packs for the Group's senior committees.
- The Group Corporate Treasury team reviews the stress outputs and evaluates the impact upon the Group's Capital and Funding Plan.

REVERSE STRESS TESTING

Reverse stress testing is used to explore the vulnerabilities of the Group's strategies and plans to extreme adverse events, and to help improve contingency planning. The scenarios used in such a stress test are those that would cause a failure in the business model. Where reverse stress testing reveals plausible scenarios with an unacceptably high risk when considered against the Group's risk appetite, the Group will undertake measures to prevent or mitigate that risk, which are then reflected in strategic plans.

GOVERNANCE

Clear accountabilities and responsibilities for stress testing are assigned to senior management and the risk and finance functions throughout the Group. This is formalised through the Business Planning and Stress Testing Policy and Procedures, which are reviewed at least annually.

The Group Financial Risk Committee (GFRC), chaired by the Chief Risk Officer, is the Committee that has primary responsibility for oversight of the development and execution of the Group's stress tests.

The main economic assumptions developed by the Chief Economist's Office are reviewed and challenged at Group Risk Committee (GRC)/ Group Executive Committee (GEC) and Board Risk Committee (BRC), and approved by the Board before being cascaded across the Group.

The stress test outputs go through a rigorous review and challenge process at divisional level, including sign-off by the divisional Finance Directors and Risk Directors. The outputs are then presented to GFRC, GRC and BRC for review and challenge, before being approved by the Board.

The review and challenge process includes the detailed stress forecasts, the key assumptions behind these, and the methodology used to translate the economic assumptions into stressed outputs.

Risk management continued

HOW RISK IS MANAGED IN LLOYDS BANKING GROUP

The following section describes how Lloyds Banking Group manages risk. As a separate standalone entity, TSB Banking Group independently manages its own risks.

Risk management in the business

Line management is directly accountable for identifying and managing any risks inherent or consequential in their individual businesses. A key objective is to ensure that business decisions strike an appropriate balance between risk and reward, consistent with the Group's risk appetite.

All business areas complete a Control Effectiveness Review (CER) annually, reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Executives from each business area and each GEC member challenge and certify the accuracy of their assessment. This key process is overseen and independently challenged by Policy Owners, Risk Division and Group Audit.

This approach provides the Group with an effective mechanism for developing and embedding risk policies and risk management strategies which are aligned with the risks faced by its businesses. It also seeks to facilitate effective communication on these matters across the Group.

Risk Management Framework (RMF)

The RMF (see risk overview, page 30) is structured around nine components which meet and align with the industry-accepted internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO).

Role of the Board and senior management – key responsibilities of the Board and senior management include:

- setting risk appetite and approval of the RMF;
- approval of Group-wide risk principles and policies;
- the cascade of delegated authority (e.g. to Board sub-committees and the Group Chief Executive); and
- effective oversight over risk management consistent with the risk appetite.

Risk appetite – the business plan is aligned to the Risk Appetite Statement so that the Group's short and medium-term business objectives match its risk tolerances which are translated into relevant risk limits for business units.

Risk appetite is defined within the Group as the amount and type of risk that the Group is prepared to seek, accept or tolerate. Risk appetite is documented in a Risk Appetite Statement reviewed and approved annually by the Board. The Board risk appetite is aligned to the Risk Appetite Framework, and in turn the Risk Management Framework and Group Risk Principles.

As a separate regulated entity with its own Board, the Insurance business maintains its own Risk Appetite Framework, aligned to the Group risk appetite. Where deemed material and relevant, Insurance business metrics are included in the Group Board Risk Appetite Statement.

The Group's strategy operates in tandem with the Board risk appetite and business planning is undertaken with a view to meeting the requirements of the Board risk appetite.

Role of the Board and GEC members

Board:

- Approves the type and level of risk the Group is prepared to accept and the boundaries within which management must operate when setting strategy and executing the business plan.
- Holds the Group Chief Executive and other Senior Executives accountable for the integrity of the Board Risk Appetite Statement.
- Reviews and approves reporting, against the Board risk appetite Statement.
- Ensures executive remuneration is aligned with risk appetite adherence.

Group Chief Executive and GEC members:

- Ensure that the Board Risk Appetite Statement is developed in collaboration with the Chief Risk Officer and is fully embedded in the business.
- Ensure resources and processes are in place to support the Board Risk Appetite framework.
- Are accountable for the integrity of the Board Risk Appetite Statement, including the timely identification and escalation of breaches and for developing mitigating actions.
- Ensures risk appetite is fully embedded including/across strategy, planning, decision making processes and remuneration.
- Monitor compliance with Board risk appetite.

Group Chief Risk Officer:

- Develops the Board Risk Appetite Statement in collaboration with the Group Chief Executive and other GEC members.
- Obtains the Board's support and approval of the Board Risk Appetite Statement.
- Oversees that the metrics are fully embedded by the business and reported on a monthly basis.
- Ensures breaches are identified, escalated and appropriate mitigating action is taken by the business.

Risk appetite is embedded across the Group in the following ways:

- Communication – Board Risk Appetite Metrics developed and agreed with business and operational teams. In addition Board Risk Appetite cascaded down into more detailed metrics and limits within Functional and Divisional Sub-Board Risk Appetite Statements along with additional supporting metrics which should be used to drive local decision making and behaviours.
- Policies – Group Policies updated to ensure they are aligned with Risk Appetite Statement.
- Reporting – Performance against Board Risk Appetite metrics reported to Divisional, Functional, and Group Risk Committees and the BRC and Board.
- Performance Management – Group and Divisional Scorecards include adherence to risk appetite as a general measure and include more detailed risk appetite measures which are pertinent for that area of the Group.
- Key Decision Making – Strategy operates in tandem with risk appetite and the Group's annual Operating Plan is developed within the boundaries set by risk appetite.

Governance frameworks – the Board-approved frameworks set out key principles for the overall management of risk in the organisation, aligned with Group strategy and risk appetite; based on a current and comprehensive risk profile that identifies all material risks to the organisation. These Governance Frameworks are underpinned by a hierarchy of policies that is coherent, consistent, and accessible.

Three Lines of Defence model – the RMF is implemented through a 'Three lines of Defence' model which defines clear responsibilities and accountabilities and ensures effective independent oversight and assurance activities take place covering key decisions.

– Business lines (first line) have primary responsibility for risk decisions, identifying, measuring, monitoring and controlling risks within their areas of accountability. They are required to establish effective governance, and control frameworks for their business compliant with Group Policy requirements, to maintain appropriate risk management skills, mechanisms and toolkits, and to act within Group risk appetite parameters set and approved by the Board.
– Risk Division (second line) is a centralised function providing oversight and independent challenge to the effectiveness of risk decisions taken by business management, providing advice and guidance, reviewing challenging and reporting on the risk profile of the Group and ensuring that mitigating actions are appropriate.
– Group Audit (third line) provides independent, objective assurance and consulting activity designed to add value and improve the organisation's operations. It helps the Group accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Mandate of the Risk Division – the objective of Risk Division is to provide both proactive advice and constructive challenge to the business. It also has a key role in promoting the implementation of a strategic approach to risk management reflecting the risk appetite and RMF agreed by the Board that encompasses:

– embedded effective risk management processes;
– transparent focused risk monitoring and reporting;
– provision of expert and high quality advice and guidance to the Board, executives and management on strategic issues and horizon scanning including pending regulatory changes; and
– provision of a working environment in which Risk Division is trusted and respected, and promotes a constructive dialogue with the first line through advice, development of common methodologies, understanding, education, training, and development of new tools.

Risk Division, headed by the Chief Risk Officer, consists of seven risk directors and their specialist teams. These teams provide oversight and independent challenge to business management and support senior management and the Board with independent reporting on risks and opportunities. Risk directors, responsible for each risk type, meet on a regular basis under the chairmanship of the Chief Risk Officer to review and challenge the risk profile of the Group and to ensure that mitigating actions are appropriate.

The Chief Risk Officer is accountable for developing and leading an industry-wide recognised Risk function that adds value to the Group by:

– providing a regular comprehensive view of the Group's risk profile, key risks both current and emerging, and management actions;
– (with input from the business areas and Risk Division) proposing Group risk appetite to the Board for approval, and oversighting performance of the Group against risk appetite;
– developing an effective RMF meeting regulatory requirements for approval by the Board, and oversighting execution and compliance; and
– challenging management on emerging risks and providing expert risk and control advice to help management maintain an effective risk and control framework.

The Risk directors:

– provide independent advice, oversight and challenge to the business;
– design, develop and maintain policies, specific risk frameworks and guidance to ensure alignment with business imperatives and regulatory requirements;
– establish and maintain appropriate governance structures, culture, oversight and monitoring arrangements which ensure robust and efficient compliance with relevant risk-type risk appetites and policies;
– lead regulatory liaison on behalf of the Group including horizon scanning and regulatory development for their risk type; and
– propose risk appetite and oversight of the associated risk profile across the Group.

Risk identification, measurement and control – the process for risk identification, measurement and control is integrated into the overall framework for risk governance. Risk identification processes are forward-looking to ensure emerging risks are identified. Risks are captured in comprehensive risk logs/registers, and measured using robust and consistent quantification methodologies. The measurement of risks includes the application of sound stress testing and scenario analysis, and considers whether relevant controls are in place before risks are incurred.

Risk monitoring, aggregation and reporting – identified risks are logged and reported on a monthly basis or as frequently as necessary to the appropriate committee. The extent of the risk is compared to the overall risk appetite as well as specific limits or triggers. When thresholds are breached, committee minutes are clear on the actions and timeframes required to resolve the breach and bring risk within given tolerances. There is a clear process for escalation of risks and risk events.

Culture – supporting the formal frameworks of the RMF is the underlying culture, or shared behaviours and values, which sets out in clear terms what constitutes good behaviour and good practice. In order to effectively manage risk across the organisation, the functions encompassed within the Three lines of Defence have a clear understanding of risk appetite, business strategy and an understanding of (and commitment to) the role they play in delivering it. A number of levers are used to reinforce the risk culture, including tone from the top, clear accountabilities, effective communication and challenge and an appropriately aligned incentive structure.

Resources and capabilities – appropriate mechanisms are in place to avoid over-reliance on key personnel or system/technical expertise within the Group. Adequate resources are in place to deal with customers both under normal working conditions and in times of stress, and monitoring procedures are in place to ensure that the level of available resource can be increased if required. Colleagues undertake appropriate training to ensure they have the skills and knowledge necessary to enable them to deliver fair outcomes for customers, being mindful of the Group's Conduct Strategy, Customer Treatment Policy/Standards and Financial Conduct Authority requirements.

There is ongoing investment in risk systems and models alongside the Group's investment in customer and product systems and processes. This drives improvements in risk data quality, aggregation and reporting leading to effective and efficient risk decisions.

Independent challenge

Group Audit provides independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group Audit is fully independent of the Risk Division and the business, and seeks to ensure objective challenge to the effectiveness of the risk governance framework.

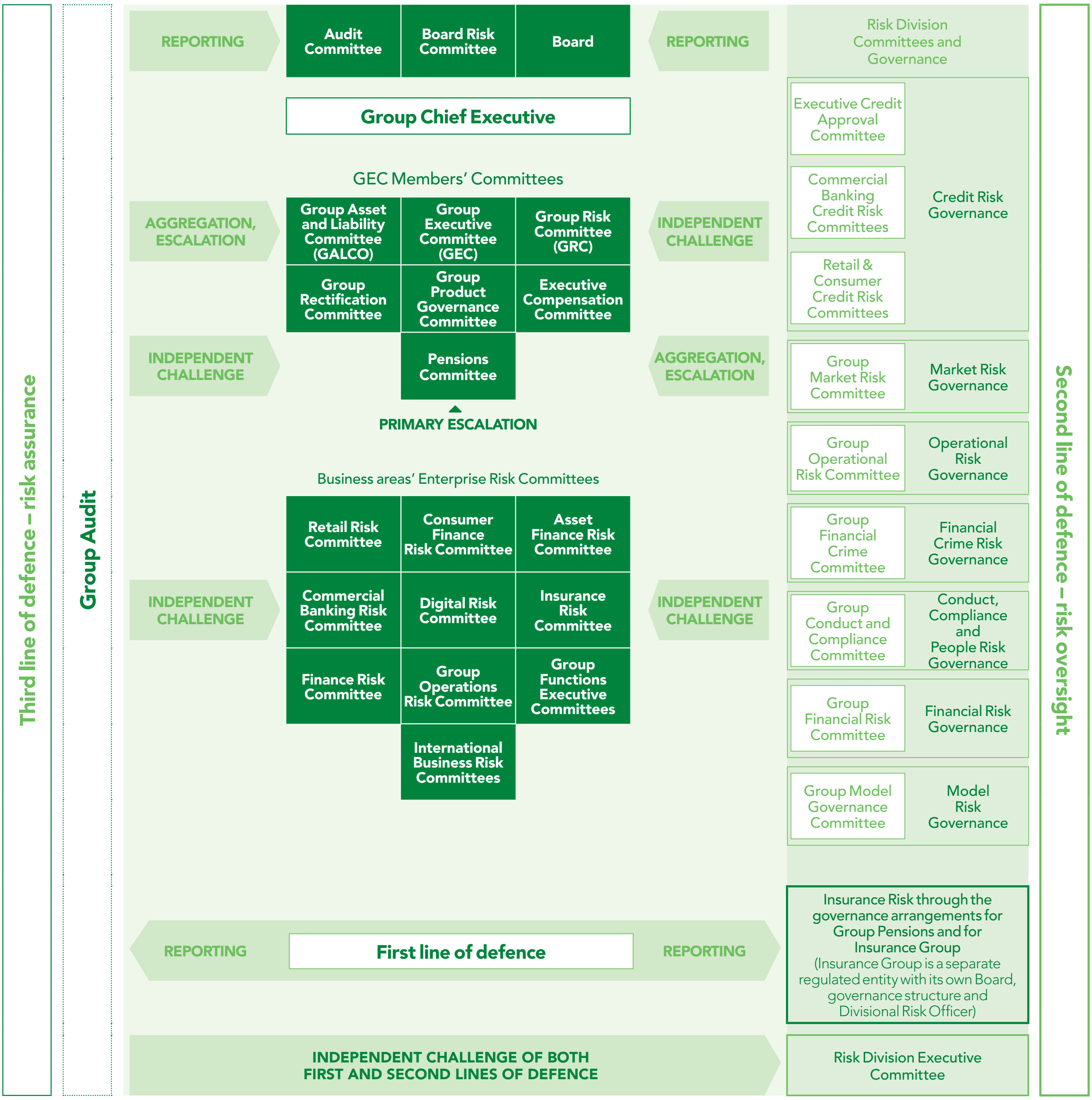
Risk management continued

RISK GOVERNANCE

The risk governance structure below is integral to implementing the RMF across the Group and, by ensuring risk is appropriately represented on key committees, ensures that risk management is discussed in these meetings. This structure outlines the flow and escalation of risk information and reporting from business areas and Risk Division to the GEC and Board. Conversely, strategic direction and guidance is cascaded down from the Board and GEC.

The components of the RMF can be found in the risk overview on page 31.

Table 1.2: **Risk governance structure**



BOARD, EXECUTIVE AND RISK COMMITTEES

The Group's risk governance structure (see table 1.2) strengthens risk evaluation and management, while also positioning the Group to manage the changing regulatory environment in an efficient and effective manner.

Assisted by the Board Risk and Audit Committees, the Board approves the Group's overall governance, risk and control frameworks and risk appetite. Refer to the Corporate Governance section on pages 58 to 81, for further information on Board committees.

The divisional/functional risk committees review and recommend divisional/functional risk appetite and monitors local risk profile and adherence to appetite.

The Insurance Division, as a separate regulated entity, has its own Board and governance structure. The Insurance Board, assisted by a Risk Oversight Committee and Audit Committee, approves the governance, risk and control frameworks for the Insurance business and the Insurance business risk appetite, ensuring it aligns with the Group's framework and risk appetite.

Table 1.3: **Executive and Risk Committees**

Committees	Risk focus
Group Executive Committee	
Group Executive Committee (GEC)	Supports the Group Chief Executive in ensuring the effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, while also reviewing the Group's aggregate risk exposures and concentrations of risk.
The Group Executive is supported by:	
Group Risk Committee	Reviews and recommends the Group's risk appetite and governance, risk and control frameworks, material Group policies and the allocation of risk appetite. The committee also regularly reviews risk exposures and risk/reward returns and approves material risk models.
Group Asset and Liability Committee	Responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.
Executive Compensation Committee	Provides governance and oversight for Group-wide remuneration matters and policies.
Group Executive Committee Members' Committees	
Group Product Governance Committee	Provides strategic and senior oversight over design, launch and management of products including new product approval, periodic product reviews and management of risk in the back book.
Group Rectification Committee	Ensures appropriate control and oversight of material events which have a customer impact.
Pensions Committee	Assists the Chief Financial Officer in relation to Group pension arrangements, all-employee share plans and benefits, except for executive and senior management incentive plans, which are specifically reserved to the Remuneration Committee.
The Group Risk Committee is supplemented by the following committees to ensure effective oversight of risk management:	
Credit Risk Committees	Responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of credit policy, and compliance with regulatory credit requirements.
Group Market Risk Committee	Monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
Group Operational Risk Committee	Responsible for identifying significant current and emerging operational risks or accumulation of risks and control deficiencies across the Group and reviewing associated oversight plans to ensure pre-emptive risk management action. The committee also seeks to ensure that adequate business area engagement occurs to develop, implement and maintain the Group's operational risk management framework.
Group Conduct and Compliance Risk Committee	Responsible for monitoring and challenging the Group's compliance and conduct risk management framework, aggregated compliance and conduct risk profile, and its alignment with agreed risk appetite.
Group Financial Crime Committee	Reviews and challenges the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.
Group Financial Risk Committee	Responsible for reviewing, challenging and recommending to GEC/GRC, the Group Individual Liquidity Adequacy Assessment and Internal Capital Adequacy Assessment Process submissions, the Group Recovery Plan, and the annual stress testing of the Group's operating plan, PRA and EBA stress tests, and other Group-wide macroeconomic stress tests.
Group Model Governance Committee	Responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group's risk modelling framework, specifically regarding consistency of approach across business units and risk types. It approves risk models other than material models which are approved by the Group Risk Committee. This also meets PRA requirements regarding the governance and approval for Internal Ratings Based models.

Strategic report
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Risk management continued

FULL ANALYSIS OF RISK DRIVERS

The Group's risk framework covers all types of risk which affect the Group and could impact on the achievement of its strategic objectives. A detailed description of each category is provided below.

PRIMARY RISK DRIVERS

Credit risk[1]	Conduct risk[1]	Market risk[1]	Operational risk[1]	Funding and liquidity risk[1]	Capital risk[1]	Regulatory risk[1]	Insurance risk	People risk[1]	Financial reporting risk	Governance risk
Page 116	Page 136	Page 138	Page 144	Page 146	Page 153	Page 166	Page 167	Page 168	Page 169	Page 170

[1] The Group considers these to be principal risks. See risk overview pages 30 to 33 for further details.

SECONDARY RISK DRIVERS

Credit risk	Conduct risk	Market risk	Operational risk	Funding and liquidity risk	Capital risk	Regulatory risk	Insurance risk	People risk	Financial reporting risk	Governance risk
Concentration risk Counterparty and customer risk Country transfer risk Collateral management	Customer risk Product risk Product distribution/ advice	Equity risk Foreign exchange risk Interest rate risk Credit spread risk Inflation risk Property risk Alternative assets Basis risk Commodity risk	Regulatory processes Client money/ fiduciary obligations Conduct processes Financial crime Fraud People processes Sourcing Service provision Physical security Information security IT systems Change Business processes Financial reporting processes Governance processes Risk processes	Funding risk Liquidity risk	Capital sufficiency risk Capital efficiency risk	Prudential risk Compliance risk Competition risk Legal risk	Mortality risk Longevity risk Morbidity risk Customer behaviour risk (including persistency risk) Property insurance risk Expenses risk	Resourcing Performance and reward Culture and engagement Talent and succession Learning Wellbeing Legal and regulatory (people)	Financial and prudential regulatory reporting Tax reporting and compliance Disclosure Pillar 3 report Delegated authorities Accounting policies	Governance

The Group considers reputational impact in the course of managing all its risks and therefore does not classify reputational impact as a separate risk driver.

CREDIT RISK

Definition

Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their obligations (both on and off-balance sheet).

Risk appetite

Credit risk appetite is described and reported on a monthly basis through a suite of Board metrics derived from a combination of accounting and credit portfolio performance measures, which include the use of credit risk rating systems as inputs. The Board metrics are supported by more detailed sub-Board appetite metrics at divisional and business level and by a comprehensive suite of credit risk appetite statements, credit policies, sector caps, and product and country limits to manage concentration risk and exposures within the Group's approved risk appetite. The metrics cover but are not limited to geographic concentration, single name customer concentration, mortgage exposure, Loan to Value ratios (LTVs), higher risk sector concentration, limit utilisation, leveraged exposure, equity exposure, affordability and the quality of new lending.

Credit risk appetite statements and credit policies are regularly reviewed to ensure that the metrics continue to reflect the Group's risk appetite appropriately.

For further information on risk appetite refer to page 112.

Exposures

The principal sources of credit risk within the Group arise from loans and advances, contingent liabilities, commitments, debt securities and derivatives to customers, financial institutions and sovereigns. The credit risk exposures of the Group are set out in note 54 on page 293. Credit risk exposures are categorised as 'retail', arising primarily in the Retail, Consumer Finance and Run-off divisions, and small and medium sized enterprises (SMEs) and corporate (including corporates, banks, financial institutions and sovereigns) arising primarily in the Commercial Banking, Run-off and Insurance divisions.

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer or bank as required. These commitments can take the form of loans and overdrafts or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially also exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit can be cancelled without notice and the creditworthiness of customers is monitored frequently. Most commercial term commitments to extend credit are contingent upon customers maintaining specific credit standards, which are monitored regularly.

Credit risk can also arise from debt securities, private equity investments and derivatives. The total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2014 is shown on page 124. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 54 on page 293.

Credit risk exposures in the Insurance business largely result from holding bond and loan assets in the shareholder funds (including the annuity portfolio) and from exposure to reinsurers. Second order credit risk exposure exists within the unit-linked funds, through the value of future fee income, and with-profits funds, through any guarantees.

Credit risk exposure also arises in the Group's defined benefit pension schemes from holding investments. Note 38 on page 240 provides further information on the defined benefit schemes' assets and liabilities.

Loans and advances, contingent liabilities, commitments, debt securities and derivatives also expose the Group to refinance risk. Refinance risk is the possibility that an outstanding exposure cannot be repaid at its contractual maturity date. If the Group does not wish to refinance the exposure then there is refinance risk if the obligor is unable to repay by securing alternative finance. This may be because the borrower is in financial difficulty, or because the terms required to refinance are outside acceptable appetite at the time. Refinance risk exposures are managed in accordance with the Group's existing credit risk policies, processes and controls, and are not considered to be material given the Group's prudent and through the cycle credit risk appetite. Where refinance risk exists (such as in the Run-off book) exposures are minimised through intensive account management and are impaired or forborne where appropriate.

Measurement

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components:

(i) the 'probability of default' by the counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

For regulatory capital purposes the Group's rating systems assess probability of default and if appropriate, exposure at default and loss given default, in order to derive an expected loss. If not appropriate, regulatory prescribed exposure at default and loss given default values are used in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes. Note 2(H) on page 193 provides details of the Group's approach to the impairment of financial assets.

The quality measurement of both retail and commercial counterparties/exposures is largely based on the outcomes of credit risk (probability of default – PD) models. The Group operates a significant number of different rating models, typically developed internally using statistical analysis and management judgement – retail models rely more on the former, commercial models include more of the latter, especially in the larger corporate and more specialised lending portfolios. Internal data is supplemented with external data in model development, where appropriate.

The models vary, inter alia, in the extent to which they are point in time versus through the cycle. The models are subject to rigorous validation and oversight/governance including, where appropriate, benchmarking to external information.

In commercial portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties/exposures migrate between rating grades if the assessment of the PD changes. The modelled PDs 'map' through local scales to a single Corporate (non-retail) Master Scale comprising of 19 non-default ratings. Together with four default ratings the Corporate Master Scale forms the basis on which internal reporting is completed.

In the principal retail portfolios, exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis combined, where appropriate, with external data and subject matter expert judgement.

For reporting purposes, counterparties are also segmented into a number of rating grades, each representing a defined range of default probabilities and exposures migrate between rating grades if the assessment of the counterparty probability of default changes.

Each rating model is subject to a validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. The most material rating models are approved by the Group Risk Committee. Responsibility for the approval of the remaining material rating models, and the governance framework in place around all Group models, is delegated to the Group Model Governance Committee.

Risk management continued

Mitigation

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

Credit principles, risk policies and appetite statements: Risk Division sets out the credit principles, risk policies and appetite statements. Principles and policies are reviewed regularly, and any changes are subject to a review and approval process. Policies and risk appetite statements, where appropriate, are supported by lending guidelines, which provide a disciplined and focused benchmark for credit decisions. Collectively they define chosen target market and risk acceptance criteria. Risk Division also use early warning indicators to help anticipate future areas of concern and allow the Group to take early and proactive mitigating actions. Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key appetite tolerances. Oversight and reviews are also undertaken by Group Audit and Credit Risk Assurance.

Controls over rating systems: The Group has established an independent team in the Risk Division that sets common minimum standards, designed to ensure risk models and associated rating systems are developed consistently, and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating systems are developed and owned by the Risk Division. The designated model owner takes responsibility for ensuring the validation of the rating systems, supported and challenged by an independent specialist group function.

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual, customer and bank limit guidelines. Credit policies and appetite statements are aligned to the Group's risk appetite and restricts exposure to higher risk countries and more vulnerable sectors and segments. Note 18 on page 222, provides an analysis of loans and advances to customers by industry (for commercial customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk and single name concentrations. 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 certain minimum policy and/or guideline requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.

Cross-border exposures: The Board sets country risk appetite. Within this, country limits are authorised by the country risk appetite committee, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support, the approved business and strategic plans of the Group.

Specialist expertise: Credit quality is managed and controlled by a number of specialist units within Risk Division providing, for example: intensive management and control (see Intensive care of customers in financial difficulty); 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.

Stress testing and scenario analysis: The Group's credit portfolios are also subjected to regular stress testing, with stress scenario assessments run at various levels of the organisation. Exercises focused on individual divisions and portfolios are performed in addition to the Group led and regulatory stress tests. For further information on the stress testing process, methodology and governance refer to page 111.

Credit risk assurance and review: A specialist team within Group Audit, comprising experienced credit professionals, is in place to perform credit risk assurance. This team carries out independent risk based internal control audits and credit quality reviews, providing an assessment of the effectiveness of internal controls, risk management practices, credit risk classification, as well as the accuracy of impairment provisions. These audits and reviews cover the diverse range of the Group's businesses and activities, and include both 'standard' risk based audits and reviews as well as bespoke assignments to respond to any emerging risks or regulatory requirement. The work of Group Audit therefore continues to provide executive and senior management (and Audit Committee) with assurance and guidance on credit quality, effectiveness of credit risk controls and Business Support Unit (BSU) work out strategies, as well as accuracy of impairments.

Credit risk oversight within Risk Division is also undertaken by independent Credit Risk Oversight functions operating within Retail and Consumer Credit Risk and Commercial Banking which are part of the Group's second line of defence. Its primary objective is to provide reasonable and independent oversight that credit risk is being managed with appropriate and effective controls. Oversight is executed through a combination of standard and non-standard reviews. Group Audit performs third line of credit risk assurance.

Additional mitigation for Retail and Consumer Finance customers

The Group uses a variety of lending criteria when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant's previous credit history using information held by credit reference agencies (CRA). The Group also assesses the affordability of the borrower under a stressed interest rate scenario. In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are hard limits above which the Group will reject the application. The Group also has certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

In 2014 the Group updated its policy for high-value mortgage lending, to restrict UK mortgage applications for greater than £500,000 to a maximum income multiple of four. This was a targeted policy change primarily designed to address specific inflationary pressures in the London housing market.

For UK mortgages, the Group's policy is to reject all standard applications with a LTV greater than 90 per cent. Applications with a LTV up to 95 per cent are permitted for certain schemes, for example the UK government's Help to Buy scheme. For mainstream mortgages the Group has maximum per cent LTV limits which depend upon the loan size. These limits are currently:

Table 1.4: **UK mainstream loan to value analysis**

Loan size From	To	Maximum LTV
£1	£600,000	95%
£600,001	£750,000	90%
£750,001	£1,000,000	85%
£1,000,001	£2,000,000	80%
£2,000,001	£5,000,000	70%

For mainstream mortgages greater than £5,000,000 the maximum LTV is 50 per cent. Buy-to-let mortgages are limited to a maximum of £1,000,000 and 75 per cent LTV. All mortgage applications above £500,000 are subject to manual underwriting.

The Group's approach to underwriting applications for unsecured products ensures that lending is affordable and sustainable. The Group takes reasonable steps to validate information used in the assessment of a customer's income and expenditure. The Group rejects any application for an unsecured product where a customer is registered as bankrupt or insolvent, or has a County Court Judgment registered at a CRA used by the Group. In addition, for credit cards the Group rejects any applicant with total unsecured debt greater than £50,000 registered at the CRA; revolving debt-to-income ratio greater than 75 per cent; or total unsecured debt-to-income ratio greater than 100 per cent. For unsecured personal loan applications, the Group rejects any applicant with total unsecured debt greater than £50,000 registered at the CRA.

Credit scoring: In its principal retail portfolios, the Group uses statistically based decisioning techniques (primarily credit scoring models). The Risk Division reviews model effectiveness, while new models and model changes are referred by them to the appropriate Model Governance Committees for approval. The most material changes are approved in accordance with the governance framework set by the Group Model Governance Committee.

Additional mitigation for commercial customers

Individual credit assessment and independent sanction: With the exception of small exposures on SME customers where relationship managers have limited delegated sanctioning authority, credit risk in commercial customer portfolios are subject to sanction by the independent Risk Division, which considers the strengths and weaknesses of individual transactions, the balance of risk and reward and how credit risk aligns to the Group's risk appetite. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities and limit guidelines. Approval requirements for each decision are based on a number of factors including 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 and customer underwriting is generally the same as that for assets intended to be held to maturity.

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 against agreed confidence intervals. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.

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.

Collateral

The principal collateral types for loans and advances, contingent liabilities and derivatives with commercial and bank counterparties/customers are:

– mortgages over residential and commercial real estate;

– charges over business assets such as premises, inventory and accounts receivables;

– financial instruments such as debt securities;

– cash; and

– guarantees received from third parties (such as export credit agencies).

The Group maintains appetite 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 bills are generally unsecured, with the exception of asset-backed securities and similar instruments such as covered bonds, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement.

It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. Collateral values are reviewed on a regular basis and will vary according to the type of lending and collateral involved. For residential mortgages, the Group adjusts open market property values to take account of the costs of realisation and any discount associated with the realisation of the collateral. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are identified for the relevant individual loans and advances.

Risk management continued

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.

Refer to note 54 for further information on collateral.

Master netting agreements

Where it is appropriate and likely to be effective, the Group seeks to enter into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, 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 this is the net position of all trades under the master netting agreement.

Other credit risk transfers

The Group also undertakes asset sales, credit derivative based transactions and securitisations as a means of mitigating or reducing credit risk, taking into account the nature of assets and the prevailing market conditions.

Monitoring

In conjunction with Risk Division, businesses identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed and monitored in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Risk Division in turn produces an aggregated review of credit risk throughout the Group, including reports on significant credit exposures, which are presented to the Divisional Risk Committees, GRC and the BRC.

The performance of all rating models is monitored on a regular basis, in order to seek to ensure that models provide appropriate risk differentiation capability, the generated ratings remain as accurate and robust as practical, and the models assign appropriate risk estimates to grades/pools. All models are monitored against a series of agreed key performance indicators. In the event that the monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated in accordance with the governance framework set by the Group Model Governance Committee.

Intensive care of customers in financial difficulty

The Group operates a number of treatments to assist borrowers who are experiencing financial stress. The material elements of these treatments through which the Group has granted a concession, whether temporarily or permanently, are set out below and in note 54 on page 293.

Retail and Consumer Finance customers

The Group's aim in offering forbearance and other assistance to retail customers in financial distress is to benefit both the customer and the Group by discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests and by bringing customer facilities back into a sustainable position which, for residential mortgages, also means keeping customers in their homes. The Group offers a range of tools and assistance to support retail customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework, controls around the execution of policy, regular review of the different treatments to confirm that they remain appropriate, monitoring of customers' performance and the level of payments received, and management visibility of the nature and extent of assistance provided and the associated risk.

Assistance is provided through trained colleagues in branches and dedicated telephony units, and via online guidance material. For those customers requiring more intensive help, assistance is provided through dedicated support units where tailored repayment programmes can be agreed. Customers are actively supported and referred to free money advice agencies when they have multiple credit facilities, including those at other lenders that require restructuring. Within the Collections and Recoveries functions, the sharing of best practice and alignment of policies across the Group has helped to drive more effective customer outcomes and achieve operational efficiencies.

One component of the Group's relationship management approach is to contact customers showing signs of financial difficulty to discuss their circumstances and offer solutions to prevent their accounts falling into arrears.

The specific tools available to assist customers vary by product and the customer's status. In defining the treatments offered to customers who have experienced financial distress, the Group distinguishes between the following categories:

- Reduced contractual monthly payment: a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments, for example temporary interest only arrangements and short-term payment holidays granted in collections. Any arrears existing at the commencement of the arrangement are retained.
- Reduced payment arrangements: a temporary arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay.
- Term extensions: a permanent account change for customers in financial distress where the overall term of the mortgage is extended, resulting in a lower contractual monthly payment.
- Repair: a permanent account change used to repair a customer's position when they have emerged from financial difficulty, for example capitalisation of arrears.

To assist customers in financial distress, the Group also participates in, or benefits from, the following UK government sponsored programmes for households:

– Income Support for Mortgage Interest – This is a government medium-term initiative that provides certain defined categories of customers, principally those who are unemployed, access to a benefit scheme, paid for by the government, which covers all or part of the interest on the mortgage. Qualifying customers are able to claim for mortgage interest on up to £200,000 of the mortgage. All decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the government. Payments are made directly to the Group by the appropriate government department.
– Mortgage Rescue Scheme – This is a government short-term initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full.

Commercial customers

Early identification, control and monitoring are key in order to support the customer and protect the Group. With the exception of small exposures on SME customers all non-retail loans and advances in the Commercial Banking and Run-off Divisions are reviewed at least annually by the independent Risk Division (and more frequently where required). As part of the Group's established Credit Risk Classification system, every loan and advance in the good book is categorised as either 'good' or 'watchlist'. This complements the Group's risk rating tools and is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. All watchlist names are reviewed by the business and Risk Division regularly, and the classification is updated if required. This process seeks to ensure that relationship managers act promptly to identify, and highlight to senior management those customers who have the possibility to become higher risk in the future.

Those customers deemed higher risk where there is cause for concern over future repayment capability or where there is a risk of impairment will lead to the customer being transferred to the Business Support Unit (BSU) at an early stage. In addition, any forbearance concession requested by a customer is reviewed and must be approved by the independent Risk Division. If approved and Risk Division determines that the customer is in financial difficulty and the concession is outside of the Group's appetite, then the customer will be transferred to BSU. The over-arching aim of the BSU is to provide support and work with each customer to try and resolve the issues, to restore the business to a financially viable position and thereby bring about a business turnaround. This may involve a combination of debt restructuring, work out strategies and other types of forbearance.

BSU case officers manage non-retail distressed assets in Commercial Banking and Run-off Divisions, and are part of the independent Risk Division. They are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and close scrutiny by senior management. The BSU case officers will continue to work in partnership with Relationship Managers throughout the process to achieve the shared common goals.

A detailed assessment is undertaken by the specialist risk team for cases in BSU and to assist in reducing and minimising risk exposure and to also highlight potential strategic options. A range of information is required to fully appraise and understand the customer's business, cashflow (and therefore debt serviceability) and will involve the Group, in addition to using its own internal sector experts, engaging professional advisers to perform asset valuations, strategic reviews and where applicable independent business reviews. The assessment may also involve:

– critically assessing customer's ability to successfully manage the business effectively in a distressed situation where turnaround is required;
– analysis of market sector factors, i.e. products, customers, suppliers, pricing and margin issues;
– performance review of operational areas that should be considered in terms of current effectiveness and efficiency and scope for improvements;
– financial analysis to model plans and factor in potential sensitivities, vulnerabilities and upsides; and
– determining the most appropriate corporate and capital structure suitable for the work-out strategy concerned.

The above assessment, monitoring and control processes continue throughout the period the case is managed within the BSU. All the analysis performed around cash flows is used to determine appropriate impairment provisions.

The level of Commercial Banking Division BSU gross lending to customers reduced from £7.3 billion to £5.0 billion between 31 December 2013 and 31 December 2014. The net reduction of £2.3 billion in BSU managed lending in Commercial Banking was driven by returns to mainstream, disposals, write-offs and repayments. In addition, as a result of the continued deleverage of the non-retail Run-off portfolio during 2014 and the focus on reducing the level of higher risk loans, the level of Run-off assets managed by BSU has reduced materially during the year.

The Group's accounting policy for loan renegotiations and forbearance is set out in note 2 on page 194. Income statement information set out in the credit risk tables is on an underlying basis (see page 41).

The Group credit risk portfolio in 2014

Significant reduction in impairments

– The impairment charge decreased by 60 per cent from £3,004 million in 2013 to £1,200 million in 2014. The impairment charge has decreased across all divisions. The material reduction reflects lower levels of new impairment as a result of effective risk management, improving economic conditions and the continued low interest rate environment.
– The charge also benefited from significant provision releases but at lower levels than seen during 2013.
– The impairment charge as a percentage of average loans and advances to customers improved to 24 basis points compared to 57 basis points during 2013.
– Impaired loans as a percentage of closing advances reduced to 2.9 per cent at 31 December 2014, from 6.3 per cent at 31 December 2013, driven by improvements in all divisions. Impaired loans reduced substantially by £18 billion during the period, mainly due to disposals and write-offs, and lower levels of newly impaired loans.
– Impairment provisions as a percentage of impaired loans increased from 50.1 per cent at 31 December 2013 to 56.4 per cent at 31 December 2014, driven by the Retail, Commercial Banking and Run-off divisions.

Risk management continued

Low risk culture and prudent risk appetite

- The Group is delivering sustainable growth by maintaining the Group's lower risk origination discipline. The overall quality of the portfolio has improved over the last 12 months.
- The Group continues to deliver above market lending growth in SME whilst maintaining the Group's prudent risk appetite. Portfolio credit quality has remained stable or improved across key metrics.
- The Group continues to adopt a conservative stance across the Eurozone, maintaining close portfolio scrutiny and oversight. Detailed contingency plans are in place and exposures to financial institutions domiciled in peripheral Eurozone countries remain modest and managed within tight risk parameters.

Re-shaping of the Group is substantially complete

- Run-off net assets have reduced from £33.3 billion to £16.9 billion at the end of 2014. This reduction was capital accretive.
- The Run-off portfolio now represents only 3.0 per cent of the overall Group's total loans and advances and poses substantially less downside risk to the Group. The remaining assets are the subject of frequent review, and are impaired to appropriate levels based on external evidence and internal reviews.
- The Group's UK Direct Real Estate gross lending at 31 December 2014 in Commercial Banking, Wealth (within Retail division) and Run-off divisions was £21.6 billion (31 December 2013: gross £27.8 billion). The portfolio continues to reduce significantly, and the higher risk Run-off element of the book has reduced from gross £7.6 billion to gross £3.3 billion during 2014. The remaining gross lending of £18.3 billion (31 December 2013: £20.2 billion) is the lower risk element in Commercial Banking and Wealth, where the Group continues to write new business within conservative risk appetite parameters. The loan to value (LTV) profile of the UK Direct Real Estate portfolio in Commercial Banking continues to improve.
- The Group continues to reduce its exposure to Ireland with gross loans and advances reducing by £7.5 billion during 2014 mainly due to strategic transactions, disposals, write-offs and net repayments. The Group has disposed of two significant impaired portfolios in 2014, with a combined gross book value of £2.4 billion.
- The Irish commercial portfolio remains significantly impaired at 89 per cent, with provision coverage of 81 per cent. Net exposure in Ireland commercial has fallen to £1.0 billion (31 December 2013: £3.4 billion).
- The Irish Retail portfolio has reduced from £5,944 million at 31 December 2013 to £4,464 million at 31 December 2014. Within this portfolio, impaired loans have reduced from £1,002 million (16.9 per cent) at 31 December 2013 to £120 million (2.7 per cent) at 31 December 2014, driven primarily by the disposal of the majority of impaired assets in the second half of 2014.
- The Acquisition Finance (leverage lending) portfolio has materially reduced and gross loans and advances totalled £1,910 million as at 31 December 2014. The Run-off element of the Acquisition Finance portfolio totalled only £40 million (net £22 million) as at 31 December 2014.

Table 1.5: **Group impairment charge by division**

	2014 £m	2013 £m	Change %
Retail	**599**	760	21
Commercial Banking	**83**	398	79
Consumer Finance	**215**	343	37
Run-off	**203**	1,389	85
TSB	**98**	109	10
Central items	**2**	5	60
Total impairment charge	**1,200**	3,004	60
Impairment charge as a % of average advances	**0.24%**	0.57%	

Table 1.6: **Total impairment charge**

	2014 £m	2013 £m	Change %
Loans and advances to customers	**1,183**	2,988	60
Debt securities classified as loans and receivables	**2**	1	(100)
Available-for-sale financial assets	**5**	15	67
Other credit risk provisions	**10**	–	
Total impairment charge	**1,200**	3,004	60

Table 1.7: **Movement in gross impaired loans**

	2014 Retail £m	2014 Commercial Banking £m	2014 Consumer Finance £m	2014 Run-off £m	2014 TSB £m	2014 Total £m	2013 Total £m
At 1 January	**6,730**	**5,047**	**946**	**19,309**	**227**	**32,259**	46,293
Classified as impaired during the year	**2,067**	**963**	**262**	**1,397**	**136**	**4,825**	9,552
Transferred to not impaired during the year	**(1,751)**	**(745)**	**(91)**	**(1,872)**	**(67)**	**(4,526)**	(3,054)
Repayments	**(1,090)**	**(732)**	**(98)**	**(1,108)**	**(47)**	**(3,075)**	(1,603)
Amounts written off	**(965)**	**(719)**	**(156)**	**(5,120)**	**(44)**	**(7,004)**	(9,520)
Impact of disposal of business and asset sales	**(64)**	**(357)**	**(96)**	**(6,771)**	**–**	**(7,288)**	(9,377)
Exchange and other movements	**–**	**(216)**	**(47)**	**(620)**	**–**	**(883)**	(32)
At 31 December	**4,927**	**3,241**	**720**	**5,215**	**205**	**14,308**	32,259

Table 1.8: **Group impaired loans and provisions**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as % of closing advances %	Impairment provisions[1] £m	Impairment provision as % of impaired loans[2] %
At 31 December 2014					
Retail	**317,347**	**4,927**	**1.6**	**1,734**	**38.8**
Commercial Banking	**102,459**	**3,241**	**3.2**	**1,594**	**49.2**
Consumer Finance	**21,273**	**720**	**3.4**	**309**	**70.5**
Run-off	**18,316**	**5,215**	**28.5**	**3,927**	**75.3**
TSB	**21,729**	**205**	**0.9**	**88**	**42.9**
Reverse repos and other items[3]	**9,635**				
Total gross lending	**490,759**	**14,308**	**2.9**	**7,652**	**56.4**
Impairment provisions	**(7,652)**				
Fair value adjustments[4]	**(403)**				
Total Group	**482,704**				
At 31 December 2013					
Retail	316,765	6,730	2.1	1,838	29.5
Commercial Banking[5]	108,050	5,047	4.7	2,384	47.2
Consumer Finance	19,547	946	4.8	411	76.0
Run-off	38,481	19,309	50.2	10,975	56.8
TSB	23,553	227	1.0	99	43.6
Reverse repos and other items[3]	2,779				
Total gross lending	509,175	32,259	6.3	15,707	50.1
Impairment provisions	(15,707)				
Fair value adjustments[4]	(516)				
Total Group	492,952				

[1] Impairment provisions include collective unimpaired provisions.

[2] Impairment provisions as a percentage of impaired loans are calculated excluding Retail and Consumer Finance loans in recoveries (31 December 2014: £437 million in Retail loans and overdrafts, £26 million in Retail Business Banking and £282 million in Consumer Finance credit cards; 31 December 2013: £476 million in Retail loans and overdrafts, £34 million in Retail Business Banking and £405 million in Consumer Finance credit cards).

[3] Includes £4.4 billion (31 December 2013: £2.6 billion) of lower risk loans (social housing, infrastructure and education) transferred from Commercial Banking division into Insurance division shareholder funds to support the Group's annuity portfolio.

[4] The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Group's consolidated financial records at their fair value and took into account both the expected losses and market liquidity at the date of acquisition. The unwind relating to future impairment losses requires significant management judgement to determine its timing which includes an assessment of whether the losses incurred in the current period were expected at the date of the acquisition and assessing whether the remaining losses expected at the date of the acquisition will still be incurred. The element relating to market liquidity unwinds to the income statement over the estimated expected lives of the related assets (until 2014 for commercial loans and 2018 for retail loans) although if an asset is written-off or suffers previously unexpected impairment then this element of the fair value will no longer be considered a timing difference (liquidity) but permanent (impairment). The fair value unwind in respect of impairment losses incurred was £251 million for the period ended 31 December 2014 (31 December 2013: £512 million). The fair value unwind in respect of loans and advances is expected to continue to decrease in future years as fixed-rate periods on mortgages expire, loans are repaid or written-off, and will reduce to zero over time.

[5] Loans and advances to customers restated. See note 1, page 188.

Risk management continued

Table 1.9: **Derivative credit risk exposures**

	Traded on recognised exchanges £m	Traded over the counter: Settled by central counterparties £m	Traded over the counter: Not settled by central counterparties £m	Total £m
At 31 December 2014				
Notional balances				
Foreign exchange	**–**	**–**	**456,215**	**456,215**
Interest rate	**82,201**	**5,768,373**	**972,531**	**6,823,105**
Equity and other	**4,808**	**–**	**10,034**	**14,842**
Credit	**–**	**–**	**18,063**	**18,063**
Total	**87,009**	**5,768,373**	**1,456,843**	**7,312,225**
Fair values				
Assets		**127**	**35,322**	
Liabilities		**(117)**	**(32,988)**	
Net asset		**10**	**2,334**	
At 31 December 2013[1]				
Notional balances				
Foreign exchange	104	11,244	421,824	433,172
Interest rate	234,360	3,880,519	926,554	5,041,433
Equity and other	3,972	–	14,808	18,780
Credit	336	–	6,171	6,507
Total	238,772	3,891,763	1,369,357	5,499,892
Fair values				
Assets		1,376	28,808	
Liabilities		(1,310)	(26,464)	
Net asset		66	2,344	

[1] See note 1.

The total notional principle amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2014 is shown in the table above. The notional principle amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 54 on page 293.

Retail

- The Retail impairment charge was £599 million in 2014, a decrease of 21 per cent compared to 2013. The decrease was primarily driven by underlying improvements in portfolio quality and the sale of recoveries assets in the Loans and Overdrafts portfolios.
- The Retail impairment charge, as an annualised percentage of average loans and advances to customers, decreased to 19 basis points in 2014 from 24 basis points in 2013.
- Retail impaired loans decreased by £1,803 million to £4,927 million compared with 31 December 2013, driven by the Secured portfolio. Retail impaired loans represent 1.6 per cent of closing loans and advances to customers compared with 2.1 per cent at 31 December 2013.

Table 1.10: **Retail impairment charge**

	2014 £m	2013 £m	Change %
Secured	**281**	249	(13)
Loans and overdrafts	**279**	478	42
Wealth	**8**	14	43
Retail Business Banking	**31**	19	(63)
Total impairment charge	**599**	760	21
Impairment charge as a % of average advances	**0.19%**	0.24%	

Table 1.11: **Retail impaired loans and provisions**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2014					
Secured	**303,121**	**3,911**	**1.3**	**1,446**	**37.0**
Loans and overdrafts:					
Collections		**258**		**220**	**85.3**
Recoveries[3]		**437**		**–**	
	10,395	**695**	**6.7**	**220**	**85.3**
Wealth	**2,962**	**270**	**9.1**	**40**	**14.8**
Retail Business Banking:					
Collections		**25**		**28**	
Recoveries[3]		**26**		**–**	
	869	**51**	**5.9**	**28**	**112.0**
Total gross lending	**317,347**	**4,927**	**1.6**	**1,734**	**38.8**
Impairment provisions	**(1,734)**				
Fair value adjustments	**(392)**				
Total	**315,221**				

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2013					
Secured	302,019	5,503	1.8	1,447	26.3
Loans and overdrafts:					
Collections		343		285	83.1
Recoveries[3]		476		–	
	10,598	819	7.7	285	83.1
Wealth	3,232	325	10.1	55	16.9
Retail Business Banking:					
Collections		49		51	
Recoveries[3]		34		–	
	916	83	9.1	51	104.1
Total gross lending	316,765	6,730	2.1	1,838	29.5
Impairment provisions	(1,838)				
Fair value adjustments	(673)				
Total	314,254				

[1] Impairment provisions include collective unimpaired provisions.

[2] Impairment provisions as a percentage of impaired loans are calculated excluding unsecured loans in recoveries.

[3] Recoveries assets are written down to the present value of future expected cash flows on these assets.

Secured

- Impaired loans reduced to £3,911 million at 31 December 2014 compared to £5,503 million at 31 December 2013.
- Impairment provisions remained stable at £1,446 million at 31 December 2014 (31 December 2013: £1,447 million). As a result of this impairment provisions as a percentage of impaired loans increased to 37.0 per cent from 26.3 per cent at 31 December 2013.
- The impairment charge increased by £32 million, to £281 million compared with 2013. The impairment charge as an annualised percentage of average loans and advances to customers, increased to 9 basis points in 2014 from 8 basis points in 2013.
- The value of mortgages greater than three months in arrears (excluding repossessions) decreased by £2,249 million to £6,344 million at 31 December 2014 compared to £8,593 million at 31 December 2013.

Risk management continued

– The average indexed loan to value (LTV) on the mortgage portfolio at 31 December 2014 decreased to 49.2 per cent compared with 53.3 per cent at 31 December 2013. The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent decreased to 2.2 per cent at 31 December 2014, compared with 5.4 per cent at 31 December 2013.
– The average LTV for new mortgages and further advances written in 2014 was 64.8 per cent compared with 64.0 per cent for 2013 reflecting the Group's participation in the UK government's Help to Buy scheme.

Loans and overdrafts

– The impairment charge decreased by £199 million, to £279 million compared with 2013. The annualised impairment charge, as a percentage of average loans and advances to customers, reduced to 2.6 per cent in 2014 from 4.2 per cent in 2013.
– Impaired loans have decreased by £124 million since 31 December 2013 to £695 million at 31 December 2014 which represents 6.7 per cent of closing loans and advances to customers, compared with 7.7 per cent at 31 December 2013.
– Impairment provisions decreased by £65 million compared with 31 December 2013.

Table 1.12: **Retail secured and unsecured loans and advances to customers**

	At 31 Dec 2014 £m	At 31 Dec 2013 £m
Secured:		
Mainstream	**228,176**	228,030
Buy-to-let	**53,322**	50,346
Specialist[1]	**21,623**	23,643
	303,121	302,019
Loans and overdrafts:		
Loans	**8,204**	8,282
Overdrafts	**2,191**	2,316
	10,395	10,598
Wealth	**2,962**	3,232
Retail Business Banking	**869**	916
Total gross lending	**317,347**	316,765

[1] Specialist lending has been closed to new business since 2009.

Table 1.13: **Mortgages greater than three months in arrears (excluding repossessions)**

	Number of cases		Total mortgage accounts %		Value of loans[1]		Total mortgage balances %	
	2014 cases	2013 cases	2014 %	2013 %	2014 £m	2013 £m	2014 %	2013 %
Mainstream	**37,849**	50,437	**1.7**	2.2	**4,102**	5,683	**1.8**	2.5
Buy-to-let	**5,077**	6,250	**1.1**	1.4	**658**	859	**1.2**	1.7
Specialist	**9,429**	11,870	**6.3**	7.3	**1,584**	2,051	**7.3**	8.7
Total	**52,355**	68,557	**1.8**	2.3	**6,344**	8,593	**2.1**	2.8

[1] Value of loans represents total book value of mortgages more than three months in arrears.

The stock of repossessions decreased to 1,740 cases at 31 December 2014 compared to 2,179 cases at 31 December 2013.

Table 1.14: **Period end and average LTVs across the Retail mortgage portfolios**

	Mainstream %	Buy-to-let %	Specialist %	Total %	Unimpaired %	Impaired %
At 31 December 2014						
Less than 60%	**44.6**	**32.4**	**31.4**	**41.5**	**41.7**	**22.5**
60% to 70%	**19.9**	**27.3**	**19.5**	**21.2**	**21.3**	**15.3**
70% to 80%	**18.5**	**21.8**	**19.8**	**19.2**	**19.2**	**17.8**
80% to 90%	**10.6**	**9.4**	**14.9**	**10.7**	**10.6**	**16.7**
90% to 100%	**4.5**	**6.8**	**8.7**	**5.2**	**5.2**	**11.9**
Greater than 100%	**1.9**	**2.3**	**5.7**	**2.2**	**2.0**	**15.8**
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Outstanding loan value (£m)	**228,176**	**53,322**	**21,623**	**303,121**	**299,210**	**3,911**
Average loan to value:[1]						
Stock of residential mortgages	**46.3**	**61.3**	**59.2**	**49.2**		
New residential lending	**65.3**	**62.7**	**n/a**	**64.8**		
Impaired mortgages	**60.1**	**81.0**	**72.6**	**64.9**		
At 31 December 2013						
Less than 60%	36.4	19.1	20.1	32.3	32.6	15.3
60% to 70%	16.6	20.7	15.7	17.2	17.3	11.2
70% to 80%	19.8	26.5	19.3	20.9	21.0	15.4
80% to 90%	15.2	15.7	20.1	15.6	15.6	17.7
90% to 100%	7.4	11.6	14.3	8.6	8.5	16.1
Greater than 100%	4.6	6.4	10.5	5.4	5.0	24.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
Outstanding loan value (£m)	228,030	50,346	23,643	302,019	296,516	5,503
Average loan to value:[1]						
Stock of residential mortgages	49.9	67.9	66.2	53.3		
New residential lending	64.0	64.0	n/a	64.0		
Impaired mortgages	67.2	90.4	80.8	72.2		

[1] Average loan to value is calculated as total loans and advances as a percentage of the total collateral of these loans and advances.

Interest only mortgages

The Group provides interest only mortgages to customers, whereby payments of interest only are made for the term of the mortgage, with the customer responsible for repaying the principal outstanding at the end of the loan term.

Retail has reduced its exposure to residential interest only mortgages throughout 2014. New residential interest only mortgages are limited to a maximum loan to value of 75 per cent, with a verifiable repayment vehicle sufficient to repay the loan. Interest only mortgages represented 0.1 per cent of new residential mortgages in 2014 (0.4 per cent in 2013).

Table 1.15: **Analysis of residential interest-only mortgages, excluding Buy-to-let mortgages**

	2014	2013
Interest only balances (£m)[1]	**90,649**	101,293
Impaired Loans (£m)	**2,012**	2,829
Interest only balances as a % of total mortgage book	**37.2**	41.1
Average loan to value (%)	**51.0**	55.9

[1] In addition the Group has Buy-to-let interest only balances of £47,761 million (2013: £44,978 million) and certain other interest only balances of £4,153 million (2013: £4,669 million).

For existing interest only mortgages, a contact strategy is in place throughout the term of the mortgage to ensure that customers are aware of their obligations to repay the principal upon maturity of the loan. The weighted average term to maturity of the interest only balances included in the table above is 12 years; the profile of residential interest only maturities is shown below.

Risk management continued

Table 1.16: **Analysis of residential interest-only mortgages maturities, excluding Buy-to-let mortgages**

£bn	1 Year	2-5 Years	6-10 Years	> 11 Years
Value of loans as at 31 December 2014[1]	**1.8**	**9.2**	**14.6**	**52.7**
Value of loans as at 31 December 2013[1]	1.7	9.5	15.1	61.2

[1] Excludes mortgage accounts which consist of partial interest only and partial capital repayment.

Treatment strategies exist to help customers who may not be able to fully repay the principal balance at maturity. Of the residential interest only mortgages which have missed the payment of principal at the end of term, balances of £1,117 million remain at 31 December 2014 (£895 million at 31 December 2013). The average loan to value of these accounts is 28.7 per cent at 31 December 2014 (28.0 per cent at 31 December 2013). Of these accounts, 8.4 per cent are impaired (7.4 per cent at 31 December 2013).

Commercial Banking

- Commercial Banking net impairment charge was £83 million in 2014, substantially lower than £398 million in 2013. The material reduction reflects better quality origination, improving economic conditions, continued low interest rates and provision releases.
- The obligor credit quality of the Commercial Banking lending portfolio is predominantly rated good or better. New business is of good quality and generally better than the back book average.
- Impaired loans reduced substantially by 35.8 per cent to £3,241 million compared with 31 December 2013 mainly due to disposals and write-offs. As a percentage of closing loans and advances to customers, impaired loans reduced to 3.2 per cent from 4.7 per cent at 31 December 2013.
- Impairment provisions reduced to £1,594 million (31 December 2013: £2,384 million) and includes collective unimpaired provisions of £338 million (31 December 2013: £436 million).

Table 1.17: **Commercial Banking impairment charge**

	2014 £m	2013 £m	Change %
SME	**15**	162	91
Other	**68**	236	71
Total impairment charge	**83**	398	79
Impairment charge as a % of average advances	**0.08%**	0.38%	

Table 1.18: **Commercial Banking impaired loans and provisions**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2014					
SME	**28,256**	**1,546**	**5.5**	**398**	**25.7**
Other	**74,203**	**1,695**	**2.3**	**1,196**	**70.6**
Total gross lending	**102,459**	**3,241**	**3.2**	**1,594**	**49.2**
Reverse repos	**5,145**				
Impairment provisions	**(1,594)**				
Fair value adjustments	**–**				
Total	**106,010**				
At 31 December 2013					
SME	27,268	2,194	8.0	623	28.4
Other[2]	80,782	2,853	3.5	1,761	61.7
Total gross lending	108,050	5,047	4.7	2,384	47.2
Reverse repos	120				
Impairment provisions	(2,384)				
Fair value adjustments	18				
Total	105,804				

[1] Includes collective unimpaired provisions of £338 million (31 December 2013: £436 million).

[2] Loans and advances to customers restated. See note 1, page 188.

SME

– The SME portfolio continues to grow within prudent and consistent credit risk appetite parameters. Net lending has increased 5 per cent since 2013 reflecting the Group's commitment to the UK economy and the Funding for Lending Scheme.

– Portfolio credit quality has remained stable or improved across all key metrics.

Other Commercial Banking

– Other Commercial Banking comprises £74,203 million of gross loans and advances to customers in Mid Markets, Global Corporates and Financial Institutions.

– The Mid Markets portfolio remains UK-focused and dependent on the performance of the domestic economy. Overall credit quality remained stable during 2014.

– The real estate business within Mid Markets is focused predominantly upon unquoted private real estate portfolios. Credit quality continues to improve and the number of new impaired connections is minimal.

– The Global Corporate portfolio continues to be predominantly investment grade focused.

– The real estate business within Global Corporate is focused on the upper end of the UK property market with a bias to the quoted publicly listed and funds sector. Portfolio credit quality remains good being underpinned by seasoned management teams with proven asset management skills.

– The Financial Institutions portfolio relates to relationships which are either client focused or held to support the Group's funding, liquidity or general hedging requirements.

– Traded products continue to be predominantly short-term and/or collateralised with inter-bank activity mainly undertaken with strong investment grade counterparties.

Commercial Banking UK Direct Real Estate LTV analysis

– The Group classifies Direct Real Estate as exposure which is directly supported by cash flows from property activities (as opposed to trading activities such as hotels, care homes and housebuilders).

– The Group manages its exposures to Direct Real Estate across a number of different coverage segments.

– Approximately three quarters of loans and advances to UK Direct Real Estate relate to commercial real estate with the remainder residential real estate.

– The Group makes use of a variety of methodologies to assess the value of property collateral, where external valuations are not available. These include use of market indexes, models and subject matter expert judgement.

Table 1.19: **LTV – UK direct real estate**

	At 31 December 2014[1]				At 31 December 2013[1]			
	Unimpaired £m	Impaired £m	Total £m	%	Unimpaired £m	Impaired £m	Total £m	%
UK exposures >£5 million								
Less than 60%	**3,985**	**52**	**4,037**	**47.8**	4,365	79	4,444	42.4
60% to 70%	**1,644**	**62**	**1,706**	**20.2**	2,113	69	2,182	20.8
70% to 80%	**964**	**17**	**981**	**11.6**	1,117	42	1,159	11.0
80% to 100%	**66**	**211**	**277**	**3.3**	285	122	407	3.9
100% to 120%	**–**	**–**	**–**	**–**	20	351	371	3.5
120% to 140%	**130**	**6**	**136**	**1.6**	130	170	300	2.9
Greater than 140%	**–**	**95**	**95**	**1.1**	79	206	285	2.7
Unsecured	**1,222**	**–**	**1,222**	**14.4**	1,336	6	1,342	12.8
	8,011	**443**	**8,454**	**100.0**	9,445	1,045	10,490	100.0
UK exposures <£5 million	**8,833**	**644**	**9,477**		8,565	715	9,280	
Total	**16,844**	**1,087**	**17,931**		18,010	1,760	19,770	

[1] Exposures exclude £0.4 billion of gross UK Direct Real Estate lending in Wealth (within Retail division).

Risk management continued

Consumer Finance

- The Consumer Finance impairment charge reduced by 37 per cent to £215 million in 2014 with a substantial improvement in the asset quality ratio. This has been driven by a continued underlying improvement of portfolio quality supported by the sale of recoveries assets in the Credit Cards and Asset Finance portfolios.
- Total impaired loans as a percentage of closing loans and advances to customers decreased to 3.4 per cent (£720 million) at 31 December 2014 compared to 4.8 per cent (£946 million) at 31 December 2013.

Table 1.20: **Consumer Finance impairment charge**

	2014 £m	2013 £m	Change %
Credit Cards	**186**	274	32
Asset Finance UK	**30**	52	42
Asset Finance Europe	**(1)**	17	
Total impairment charge	**215**	343	37
Impairment charge as a % of average advances	**1.05%**	1.76%	

Table 1.21: **Consumer Finance impaired loans and provisions**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2014					
Credit Cards:					
Collections		**217**		**166**	**76.5**
Recoveries		**282**			
	9,119	**499**	**5.5**	**166**	**76.5**
Asset Finance UK	**7,204**	**160**	**2.2**	**112**	**70.0**
Asset Finance Europe	**4,950**	**61**	**1.2**	**31**	**50.8**
	12,154	**221**	**1.8**	**143**	**64.7**
	21,273	**720**	**3.4**	**309**	**70.5**
Impairment provisions	**(309)**				
Fair value adjustments	**(30)**				
Total	**20,934**				
At 31 December 2013					
Credit Cards:					
Collections		234		226	96.6
Recoveries		405			
	9,008	639	7.1	226	96.6
Asset Finance UK	5,061	221	4.4	140	63.3
Asset Finance Europe	5,478	86	1.6	45	52.3
	10,539	307	2.9	185	60.3
	19,547	946	4.8	411	76.0
Impairment provisions	(411)				
Fair value adjustments	(47)				
Total	19,089				

[1] Impairment provisions include collective unimpaired provisions.

Run-off

– Run-off impairment charge was £203 million in 2014, substantially lower than £1,389 million in 2013. The material reduction reflects continued proactive management and deleveraging (for example, disposals and write-offs).
– Impaired assets reduced substantially by 73 per cent to £5,215 million compared with 31 December 2013, mainly due to disposals and write-offs.

Table 1.22: Run-off impairment charge

	2014 £m	2013 £m	Change %
Ireland retail	**(6)**	(26)	(77)
Ireland commercial real estate	**67**	219	69
Ireland corporate	**247**	415	40
Corporate real estate and other corporate	**(28)**	522	
Specialist finance	**22**	345	94
Other	**(99)**	(86)	15
Total	**203**	1,389	85
Impairment charge as a % of average advances	**0.64%**	2.36%	

Table 1.23: Run-off impaired loans and provisions

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions £m	Impairment provisions as a % of impaired loans %
At December 2014					
Ireland retail	**4,464**	**120**	**2.7**	**141**	**117.5**
Ireland commercial real estate	**1,797**	**1,659**	**92.3**	**1,385**	**83.5**
Ireland corporate	**1,639**	**1,393**	**85.0**	**1,095**	**78.6**
Corporate real estate and other corporate	**3,947**	**1,548**	**39.2**	**911**	**58.9**
Specialist finance	**4,835**	**364**	**7.5**	**254**	**69.8**
Other	**1,634**	**131**	**8.0**	**141**	**107.6**
	18,316	**5,215**	**28.5**	**3,927**	**75.3**
Impairment provisions	**(3,927)**				
Fair value adjustments	**19**				
Total	**14,408**				
At December 2013					
Ireland retail	5,944	1,002	16.9	638	63.7
Ireland commercial real estate	5,512	5,087	92.3	3,775	74.2
Ireland corporate	3,918	3,235	82.6	2,305	71.3
Corporate real estate and other corporate	11,571	8,131	70.3	3,320	40.8
Specialist finance	9,017	1,368	15.2	565	41.3
Other	2,519	486	19.3	372	76.5
	38,481	19,309	50.2	10,975	56.8
Impairment provisions	(10,975)				
Fair value adjustments	186				
Total	27,692				

Risk management continued

Specialist Finance

- The Specialist Finance Run-off portfolio has been proactively deleveraged down from £9.0 billion gross (£8.5 billion net) to £4.8 billion gross (£4.6 billion net).
- Gross loans and advances to customers include the Run-off Asset Based Finance portfolios (which mainly include Ship Finance, Aircraft Finance and Infrastructure) and the element of the Acquisition Finance (leverage lending) portfolio classified as Run-off. The Specialist Finance Run-off portfolio also includes a significantly reduced Treasury Asset legacy investment portfolio.
- The majority of remaining lending of £4.8 billion is in the lower risk Leasing sector where gross drawn lending totalled £2.5 billion as at 31 December 2014.

Ireland

- The most significant contribution to impaired loans is the Commercial Real Estate portfolio. 92.3 per cent of the portfolio is impaired. The impairment coverage ratio has increased to 83.5 per cent from 74.2 per cent at 31 December 2013 reflecting additional impairments on already impaired connections as well as the impact of deleveraging activities. Net lending in Ireland Commercial Real Estate has reduced to £0.4 billion (31 December 2013: £1.7 billion).
- Total impaired loans within the Irish retail mortgage portfolio decreased by 88.2 per cent (£878 million) to £118 million compared with £996 million at 31 December 2013. The reduction was driven by the disposal of the majority of impaired assets in the second half of 2014.
- In the Irish retail mortgage portfolio the average indexed loan to value (LTV) at 31 December 2014 decreased to 88.5 per cent compared with 102.3 per cent at 31 December 2013. The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent decreased to 38.9 per cent at 31 December 2014, compared with 54.0 per cent at 31 December 2013.

Table 1.24: **Ireland Retail mortgage LTV analysis**

	Unimpaired		Impaired		Total	
	£m	%	£m	%	£m	%
At 31 December 2014						
Less than 60%	**979**	**22.5**	**18**	**15.2**	**997**	**22.4**
60% to 70%	**356**	**8.2**	**4**	**3.4**	**360**	**8.1**
70% to 80%	**425**	**9.8**	**4**	**3.4**	**429**	**9.6**
80% to 100%	**925**	**21.3**	**14**	**11.9**	**939**	**21.0**
100% to 120%	**933**	**21.5**	**15**	**12.7**	**948**	**21.2**
120% to 140%	**505**	**11.6**	**14**	**11.9**	**519**	**11.6**
Greater than 140%	**221**	**5.1**	**49**	**41.5**	**270**	**6.1**
Total	**4,344**	**100.0**	**118**	**100.0**	**4,462**	**100.0**
Average loan to value:						
Stock of residential mortgages						**88.5**
Impaired mortgages						**124.7**
At 31 December 2013						
Less than 60%	800	16.3	109	10.9	909	15.3
60% to 70%	297	6.0	56	5.6	353	5.9
70% to 80%	362	7.3	81	8.1	443	7.5
80% to 100%	826	16.7	199	20.0	1,025	17.3
100% to 120%	936	18.9	218	21.9	1,154	19.4
120% to 140%	894	18.1	161	16.2	1,055	17.8
Greater than 140%	826	16.7	172	17.3	998	16.8
Total	4,941	100.0	996	100.0	5,937	100.0
Average loan to value:						
Stock of residential mortgages						102.3
Impaired mortgages						104.7

Ireland Commercial real estate

Net lending in Ireland Commercial real estate has reduced to £0.4 billion (31 December 2013: £1.7 billion). Table 1.25 details the loan to value breakdown based on gross lending of £1.8 billion (31 December 2013: £5.5 billion).

Table 1.25: **Ireland Commercial real estate LTV analysis**

	At 31 December 2014 loans and advances (gross) £m	%	At 31 December 2013 loans and advances (gross) £m	%
Gross exposures >€5m				
Less than 100%	**65**	**5.0**	198	4.6
100% to 200%	**281**	**21.3**	550	12.9
200% to 300%	**151**	**11.5**	891	20.8
300% to 400%	**90**	**6.8**	513	12.0
Greater than 400%	**494**	**37.5**	1,682	39.4
Unsecured	**236**	**17.9**	440	10.3
	1,317	**100.0**	4,274	100.0
Gross exposures <€5m	**480**		1,238	
Total gross exposure	**1,797**		5,512	
Impairment provisions	**(1,385)**		(3,775)	
Total net exposure	**412**		1,737	

Corporate real estate and other corporate

- This portfolio predominantly consists of UK real estate loans together with other Corporate loans relating to real estate sectors, supported by trading activities (such as hotels, housebuilders and care homes).
- Net loans and advances reduced by £5.2 billion from £8.2 billion to £3.0 billion. The book continues to reduce significantly ahead of expectations.

Run-off UK Direct Real Estate LTV analysis

- The Group considers this portfolio to be appropriately provided for after taking into account the provisions held for each loan and the value of the collateral held.
- In the case of impaired UK Direct Real Estate exposures (over £5 million), there is a net property collateral shortfall of approximately £60 billion. This figure excludes benefits of credit mitigants such as cross collateralisation and cross guarantees, The Group makes use of a variety of methodologies to assess the value of property collateral, where external valuations are not available. These include use of market indexes, models and subject matter expert judgement.

Table 1.26: **Run-off UK Direct Real Estate LTV analysis**

	At 31 December 2014				At 31 December 2013			
	Unimpaired £m	Impaired £m	Total £m	%	Unimpaired £m	Impaired £m	Total £m	%
UK exposures >£5 million								
Less than 100%	**1,578**	**204**	**1,782**	**67.6**	2,021	725	2,746	42.3
100% to 200%	**34**	**440**	**474**	**18.0**	34	1,630	1,664	25.6
200% to 300%	**–**	**86**	**86**	**3.3**	–	461	461	7.1
300% to 400%	**–**	**149**	**149**	**5.7**	–	400	400	6.2
Greater than 400%	**–**	**144**	**144**	**5.4**	6	1,196	1,202	18.5
Unsecured	**–**	**–**	**–**	**–**	–	23	23	0.3
	1,612	**1,023**	**2,635**	**100.0**	2,061	4,435	6,496	100.0
UK exposures <£5 million	**412**	**261**	**673**		618	525	1,143	
Total gross exposure	**2,024**	**1,284**	**3,308**		2,679	4,960	7,639	
Impairment provisions	**–**	**(547)**	**(547)**		–	(2,635)	(2,635)	
Total net exposure	**2,024**	**737**	**2,761**		2,679	2,325	5,004	

Risk management continued

Eurozone exposures

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2014. The exposures comprise on-balance sheet exposures based on their balance sheet carrying values and off-balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

The Group manages its exposures to individual countries through authorised country limits which take into account economic, financial, political and social factors. In addition, the Group manages its direct risks to the selected countries by establishing and monitoring risk limits for individual banks, financial institutions, corporates and individuals.

Identified indirect exposure information, where available is also taken into account when setting limits and determining credit risk appetite for individual counterparties. This forms part of the Group's credit analysis undertaken at least annually for counterparty and sector reviews, with interim updates performed as necessary. Interim updates would usually be triggered by specific credit events such as rating downgrades, sovereign events or other developments such as spread widening. Examples of indirect risk which have been identified, where information is available, are: European Banking groups with lending and other exposures to certain Eurozone Countries; corporate customers with operations or significant trade in certain European jurisdictions; major travel operators known to operate in certain Eurozone Countries; and international banks with custodian operations based in certain European locations.

The Group Financial Stability Forum (GFSF) monitors developments within the Eurozone, carries out stress testing through detailed scenario analysis and completes appropriate due diligence on the Group's exposures.

The GFSF has carried out a number of scenario analyses and rehearsals to test the Group's resilience in the event of further instability in certain Eurozone countries. The Group has developed and refined pre-determined action plans that would be executed in such scenarios. The plans set out governance requirements and responsibilities for the key actions which would be carried out and cover risk areas such as payments, liquidity and capital, communications, suppliers and systems, legal, credit, delivery channels and products, employees and the impact on customers.

The gross IFRS reported values for the exposures to Eurozone countries are detailed in the following tables. However, derivative balances are included within exposures to financial institutions or corporates, as appropriate, at fair value adjusted for master netting agreements at obligor level and net of cash collateral in line with legal agreements. Exposures in respect of reverse repurchase agreements are included on a gross IFRS basis and are disclosed based on the counterparty rather than the collateral (repos and stock lending are excluded); reverse repurchase exposures are not, therefore, reduced as a result of collateral held. Reverse repurchase exposures to Institutional funds secured by UK Gilts are excluded from all Eurozone exposures as detailed in the footnotes. Exposures to central clearing counterparties are shown net.

For multi-country asset backed securities exposures, the Group has reported exposures based on the largest country exposure. The country of exposure for asset backed securities is based on the location of the underlying assets which are predominantly residential mortgages not on the domicile of the issuer.

Insurance shareholder assets are assets where the Group is directly exposed to risk of loss and are held outside the with-profits and unit-linked funds. These exposures relate to direct investments where the issuer is resident in Spain, Italy, Greece, Portugal or Ireland and the credit rating is consistent with the tight credit criteria defined under the appropriate investment mandate. Insurance also has interests in two funds domiciled in Ireland (Global Liquidity Fund and the Investment Cash Fund) where, in line with the investment mandates, cash is invested in short term financial instruments. For these funds, the exposure is analysed on a look through basis to the country risk of the obligors of the underlying assets rather than treating the insurance holding in the funds as exposure to Ireland.

Exposures to selected Eurozone countries

The Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries.

Table 1.27: **Selected Eurozone exposures**

	Sovereign debt		Financial institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other[1] £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance assets £m	Total £m
At 31 December 2014									
Ireland	**–**	**–**	**359**	**–**	**115**	**1,672**	**4,325**	**–**	**6,471**
Spain	**–**	**–**	**57**	**116**	**–**	**1,160**	**49**	**13**	**1,395**
Portugal	**–**	**–**	**9**	**5**	**–**	**133**	**6**	**–**	**153**
Italy	**–**	**–**	**354**	**5**	**–**	**93**	**–**	**34**	**486**
Greece	**–**	**–**	**–**	**–**	**–**	**3**	**–**	**–**	**3**
	–	**–**	**779**	**126**	**115**	**3,061**	**4,380**	**47**	**8,508**
At 31 December 2013									
Ireland	–	–	30	392	177	3,851	5,308	116	9,874
Spain	6	5	554	116	23	1,857	41	24	2,626
Portugal	–	–	153	–	193	195	9	–	550
Italy	–	–	74	1	–	106	–	10	191
Greece	–	–	–	–	–	111	–	–	111
	6	5	811	509	393	6,120	5,358	150	13,352

[1] Excludes reverse repurchase exposure to Institutional funds domiciled in Ireland secured by UK gilts of £10,456 million (2013: £4,590 million) on a gross basis.

In addition to the exposures detailed above, the Group has the following exposures to sovereigns, financial institutions, asset backed securities, corporates and personal customers in the following Eurozone countries:

Table 1.28: **Other Eurozone exposures**

	Sovereign debt		Financial institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other[1] £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance assets £m	Total £m
At 31 December 2014									
Netherlands	**320**	**5,611**	**597**	**129**	**307**	**1,682**	**4,888**	**432**	**13,966**
France	**245**	**–**	**3,198**	**1,435**	**134**	**2,453**	**73**	**1,069**	**8,607**
Germany	**181**	**133**	**806**	**1,180**	**339**	**1,729**	**32**	**877**	**5,277**
Luxembourg	**–**	**–**	**8**	**799**	**74**	**2,241**	**–**	**11**	**3,133**
Belgium	**75**	**–**	**906**	**2**	**–**	**404**	**–**	**27**	**1,414**
Austria	**311**	**–**	**913**	**–**	**–**	**163**	**–**	**–**	**1,387**
All other Eurozone countries	**116**	**–**	**449**	**–**	**–**	**64**	**–**	**94**	**723**
	1,248	**5,744**	**6,877**	**3,545**	**854**	**8,736**	**4,993**	**2,510**	**34,507**
At 31 December 2013									
Netherlands	–	8,683	741	188	216	2,025	5,434	798	18,085
France	–	–	1,425	17	42	3,199	115	1,017	5,815
Germany	174	1,831	1,107	495	442	1,613	–	721	6,383
Luxembourg	–	–	1	1,337	–	1,595	–	46	2,979
Belgium	–	–	700	1	–	582	–	53	1,336
Austria	127	–	–	–	–	249	–	9	385
All other Eurozone countries	–	–	5	–	–	57	–	163	225
	301	10,514	3,979	2,038	700	9,320	5,549	2,807	35,208

[1] Excludes reverse repurchase exposure to Institutional funds secured by UK gilts of £1,455 million (2013: £1,559 million) on a gross basis.

Environmental risk management

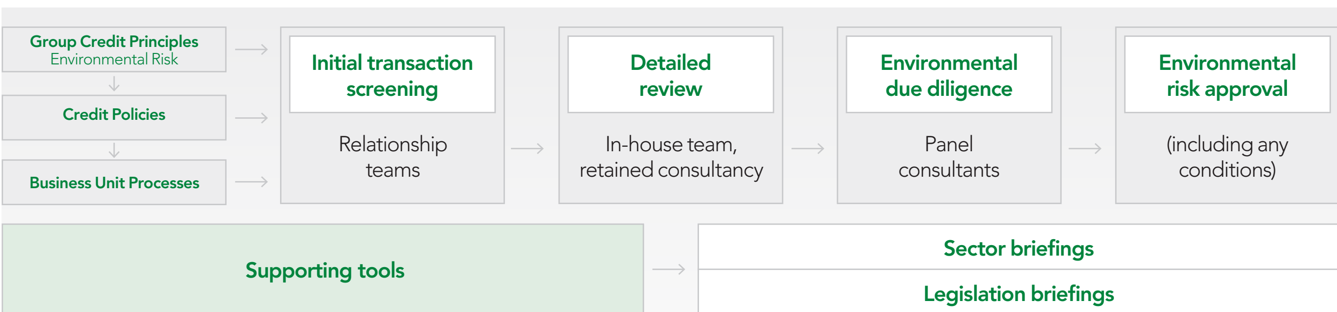
The Group ensures appropriate management of the environmental impact of its lending activities. The Group-wide Credit Risk principles require all credit risk to be incurred with due regard to environmental legislation and the Group's Code of Business Responsibility.

Within Commercial Banking, an electronic environmental risk screening system has been the primary mechanism for assessing environmental risk in lending transactions. This system provides screening of location specific and sector based risks that may be present in a transaction. Identified risk sees the transaction referred to the Group's expert in-house Environmental Risk team for further review and assessment, as outlined below. Where required, the Group's panel of environmental consultants provide additional expert support.

The Group provides colleague training in environmental risk management as part of the standard suite of credit risk courses. Supporting this training, a range of online resource is available to colleagues and includes environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

The Group has been a signatory to the Equator Principles since 2006 and has adopted and applied the expanded scope of Equator Principles III. The Equator Principles support the Group's approach to assessing and managing environmental and social issues in Project Finance, Project-Related Corporate loans and Bridge loans. Further information is contained within the Group's Responsible Business Report.

Table 1.29: **Environmental risk management approach**



Risk management continued

CONDUCT RISK

Definition

Conduct risk is defined as the risk of customer detriment or regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

Risk appetite

The Group has no appetite for systemic unfair customer outcomes arising from any of its activities: through product design, sales or other after sales processes.

The appetite is reviewed and approved annually by the Board. To stay within appetite, the Group has policies, processes and standards which provide the framework for businesses and colleagues to operate in accordance with the laws, regulations and voluntary codes which apply to the Group and its activities.

For further information on risk appetite refer to page 112.

Exposures

Conduct risk affects all aspects of the Group's operations, all types of customers and other stakeholders. The Group faces significant conduct risks, for example, through products or services not meeting the needs of its customers; sales processes resulting in poor advice; failure to deal with a customer's complaint effectively where the Group has got something wrong and not met customer expectations; or engaging in conduct which disrupts the fair and effective operation of a market in which it is active. Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media, politicians and consumer groups, there is a risk that certain aspects of the Group's current or legacy business may be determined by the Financial Conduct Authority (FCA) and other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or in a manner that fails to deliver fair and reasonable treatment. The Group may also be liable for damages to third parties harmed by the conduct of its business.

Measurement

To articulate its conduct risk appetite, the Group has sought more granularity through the use of suitable conduct risk metrics and tolerances that indicate where it may potentially be operating outside its conduct appetite. Conduct Risk Appetite Metrics (CRAMs) have been designed for all 139 product families offered by the Group; a set of common metrics have been agreed for all products to support a consistent approach. These contain a range of product, sales and post-sales metrics to provide a more holistic view of conduct risks; each product also has additional bespoke metrics. These metrics are part of the Board approved risk appetite. The Group also continues to measure how effectively the overall conduct strategy is embedded across all divisions and functions and its impact on customer outcomes. The common metrics are sales volume, product governance adherence, target market, outcome testing: meet customer needs, outcome testing: information disclosure, outcome testing: regulatory compliance, retention, usage, claims (decline rates), complaints per 1,000 accounts, Financial Ombudsman Service (FOS) uphold rate and complaints outcome testing. Each of the tolerances for the metrics are agreed for the individual product and are tracked month by month. In relation to market conduct, metrics have also been generated, covering, for example, the way in which confidential information and potential conflicts of interest are managed.

Mitigation

The Group takes a range of mitigating actions with respect to this risk; it has implemented a customer-focused, UK-centric strategy, strengthened its culture and values, improved systems and processes, and implemented more effective controls. These actions are being embedded throughout the Group (across all business areas and all supporting functional areas) as part of the Group's Conduct Strategy and will support continuing the journey to become the industry leader for complaints performance.

This includes:

- Conduct risk appetite established at Group and business area level;
- Customer needs explicitly considered within business and product level planning and strategy;
- Cultural transformation, supported by strong direction and tone from senior executives and the Board. This is underpinned by the Group's values and Codes of Responsibility, to deliver the best bank for customers;
- Enhanced product governance framework to ensure products continue to offer customers fair value, and meet the needs of the relevant target market throughout their life cycle;
- Sales processes and governance framework to deliver consistently fair outcomes;
- Effective root cause analysis which enables issues to be rectified at an earlier stage;
- Enhanced recruitment and training, and a focus on how the Group manages colleagues' performance with clearer customer accountabilities; and
- Application of the conduct strategy to third parties involved in serving the Group's customers.

The Group has also prioritised activity designed to reinforce good conduct in its engagement with the markets in which it operates, together with the development of preventative and detective controls in order to be able to demonstrate this.

The Group's leadership team is committed to embedding the Conduct Strategy within the business and to creating the right customer centric culture. The Board and Group Risk Committee receive regular reports and metrics to track progress on how the Group is meeting customer needs and minimising conduct risk.

All Group business areas continue to apply significant resources to the Conduct Strategy and ambitious conduct transformation plans are aligned with the Group's strategy.

The Group's Conduct Strategy continues to evolve and be enhanced. The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns, and those relating to the fairness and effectiveness of markets, to ensure that the implementation of the Group's conduct strategy meets evolving stakeholder expectations.

Monitoring
Monitoring and reporting is undertaken at Board, Group and business area committees. As part of the reporting of Conduct Risk Appetite Measures, a robust outcomes testing regime is in place to test performance of customer critical activities. Customer metrics are proactively used when reviewing business performance and feedback loops have been established to take learnings from root cause/outcome testing. There is also focus on the enhancement of preventative and detective controls to encourage and demonstrate the Group's support for the fair and effective operation of relevant markets.

Risk management continued

MARKET RISK

Definition

Market risk is defined as the risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and bond prices, foreign exchange rates, equity, property and commodity prices and other instruments), lead to reductions in earnings and/or value.

Risk appetite

The Group's Risk Management Framework articulates accountabilities for the management of market risk across the Group, and how this is discharged through a robust governance structure against sanctioned risk appetite. Market risk exposures are measured and controlled through a combination of scenario/stress analysis, percentile based measures and sensitivity analysis.

For further information on risk appetite refer to page 112.

Exposures

Table 1.30 below shows relevant balance sheet items relating to banking, trading and insurance activities. The trading book Value at Risk (VaR) sensitivity inputs are separately identified.

The information provided in table 1.30 (below) aims to facilitate the understanding of linkages between balance sheet items and the positions disclosed in the Group's market risk disclosures. This breakdown of financial instruments included and not included in trading book VaR provides a linkage with the market risk measures reported later on in the market risk section. It is important to highlight that this table does not reflect how the Group manages market risk, since it does not discriminate between assets and liabilities in its VaR model.

Table 1.30: **Market risk linkage to the balance sheet**

		Banking			
2014	Total £m	Trading book only £m	Non-trading £m	Insurance £m	Primary risk factor
Assets					
Cash and balances at central banks	50,492	–	50,492	–	Interest rate
Items in the course of collection from banks	1,173	–	1,173	–	Interest rate
Trading and other financial assets at fair value through profit or loss	151,931	48,494	9,123	94,314	Interest rate, foreign exchange, credit spread
Derivative financial instruments	36,128	30,209	4,233	1,686	Interest rate, foreign exchange, credit spread
Loans and receivables:					
Loans and advances to banks	26,155	–	4,843	21,312	Interest rate
Loans and advances to customers	482,704	–	482,704	–	Interest rate
Debt securities	1,213	–	1,213	–	Interest rate, credit spread
	510,072	–	488,760	21,312	
Available-for-sale financial assets	56,493	–	56,491	2	Interest rate, credit spread, foreign exchange
Value of in-force business	4,864	–	–	4,864	Equity
Other assets	43,743	–	19,808	23,935	Interest rate
Total assets	854,896	78,703	630,080	146,113	
Liabilities					
Deposits from banks	10,887	–	10,887	–	Interest rate
Customer deposits	447,067	–	447,067	–	Interest rate
Items in course of transmission to banks	979	–	979	–	Interest rate
Trading and other financial liabilities at fair value through profit or loss	62,102	55,359	6,743	–	Interest rate, foreign exchange
Derivative financial instruments	33,187	27,811	3,616	1,760	Interest rate, foreign exchange, credit spread
Debt securities in issue	76,233	–	76,233	–	Interest rate
Liabilities arising from insurance and investment contracts	114,166	–	–	114,166	Credit spread
Subordinated liabilities	26,042	–	23,485	2,557	Interest rate, foreign exchange
Other liabilities	34,330	–	8,575	25,755	Interest rate
Total liabilities	804,993	83,170	577,585	144,238	

The Group's trading book assets and liabilities are originated by Financial Markets within the Commercial Banking division. Within the Group's balance sheet these fall under the trading assets and liabilities and derivative financial instruments. The assets and liabilities are classified as trading books if they have been acquired or incurred for the purpose of selling or repurchasing in the near future. These consist of government, corporate and financial institution bonds and loans/deposits and repos.

Derivative assets and liabilities are held for three main purposes; to provide risk management solutions for clients, to manage portfolio risks arising from client business and to manage and hedge the Group's own risks. The majority of derivatives exposure arises within Financial Markets.

Insurance business assets and liabilities relate to unit-linked funds and with-profit funds, as well as shareholder invested assets, including annuity funds. The Group recognises the value of in-force business (VIF) in respect of Insurance's long-term life assurance contracts as an asset in the balance sheet. This asset represents the present value of future profits expected to arise from the portfolio of in-force life assurance contracts.

The Group ensures that it has adequate cash and balances at central banks and stocks of high quality liquid assets (e.g. Gilts or US Treasury Securities) that can be converted easily into cash to meet liquidity requirements. The majority of these assets are held as Available-for-Sale with the remainder held as financial assets at fair value through profit and loss. Further information on these balances can be found under the Risk Management section – Funding and Liquidity risk. Interest rate risk in the asset portfolios is swapped into floating.

The majority of debt issuance originates from the Issuance, Capital Vehicles and Medium Term Notes desks and the interest rate risk of the debt issued is hedged by swapping them into a floating rate.

The table below shows the key market risks for the Group's defined benefit pension schemes and trading, banking and Insurance activities.

Table 1.31: **Key market risks for the Group by individual business activity (profit before tax impact measured against Group single stress scenarios)**

	Risk type					
	Interest rate	Basis risk	FX	Credit spread	Equity	Inflation
Defined benefit pension schemes	£50m to <£250m		<£50m	£250m to £500m	£50m to <£250m	<£50m
Trading portfolios	<£50m		<£50m	<£50m		<£50m
Banking activities	£50m to <£250m	£50m to <£250m	<£50m	£250m to £500m	£250m to £500m	<£50m
Insurance portfolios	£50m to <£250m		<£50m	>£500m	>£500m	£50m to <£250m

Key:
Profit before tax:
>£500m ● £250m to £500m ● £50m to <£250m ● <£50m ●

Defined benefit pension schemes

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 real interest rate, credit spread, equity, and alternative asset risks. Interest rate risk arises from the liability discount rate, with partial offsets from fixed interest assets such as gilts and corporate bonds, and swaps. Credit spread risk also arises from the liability discount rate, with partial offsets from the credit portfolio. Equity and alternative asset risk arises from direct asset holdings.

For further information on defined benefit pension scheme assets and liabilities please refer to note 38 on page 240.

Trading portfolios

The Group's trading activity is small relative to its peers and the Group does not have a programme of proprietary trading activities. All the trading VaR resides within Commercial Banking. The average 95 per cent 1-day trading VaR was £4.3 million for the year to 31 December 2014 (31 December 2013: £4.1 million). The Group's trading activity is undertaken to meet the requirements of commercial and retail customers for foreign exchange, credit spread and interest rate products.

Trading market risk measures are applied to all the Group's regulatory trading books where positions arise from supporting customer flow and market making. All positions are held with trading intent. Measures include daily VaR (table 1.32), sensitivity based measures, and stress testing.

Banking activities

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset or liability.

Interest rate risk in the Group's divisional portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets, liabilities (see loans and advances to customers and customer deposits in table 1.30 above) and off balance sheet positions of the Group. Interest rate risk arises predominantly from the mismatch between interest rate sensitive assets and liabilities, but also to the reinvestment rate on the Group's structural hedging of rate insensitive liabilities comprising customer deposits and net free reserves, and the need to minimise income volatility.

Margin compression risk also arises from the current low rate environment, which may restrict the ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Prepayment risk arises, predominantly in the Retail division, as customer balances amortise more quickly or slowly than anticipated due to economic conditions or customer's response to changes in economic conditions.

Risk management continued

Pipeline and pre hedge risk arises where new business volumes are higher or lower than forecasted, requiring the business to unwind or execute additional hedging at rates which may differ to what was expected.

Basis risk arises from the possible changes in spreads, for example where the bank lends with reference to a central bank rate but funds with reference to LIBOR and the spread between these widens or tightens.

Foreign currency risk arises from:

– translational exposure: the Group's investment in its overseas operations. Net investment exposures are disclosed (see note 54 on page 293) and it is Group policy to hedge non-functional currency exposures; and
– transactional exposure: where assets and liabilities are denominated in currencies other than the business' functional currency. The Group has a policy of forward hedging its forecasted currency income less impairments to year end.

Equity Risk arises from different sources:

– The Group's equity holdings in Banco Sabadell and Aberdeen;
– Exposure to Lloyds Banking Group share price through deferred shares and deferred options granted to employees as part of their benefits package; and
– The Group's private equity investments.

Credit spread risk arises largely from the following:

– The assets held mainly within the liquid asset portfolio; and
– The credit and debit valuation adjustments (CVA and DVA) sensitivity to credit spreads. As explained within the notes to the Consolidated Financial Statements CVA and DVA are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking Division.

Insurance portfolios

The Group's insurance activities expose it to market risk including equity, credit and credit spread, interest rate, exchange rate and property risk:

– With-profits funds are managed with the aim of generating smoothed returns consistent with policyholders' expectations. Exposure arises where the value of the underlying funds are insufficient to meet the obligations, termed burnthrough.
– Unit-linked funds where policyholders select their investments. Exposure arises as future fee income is dependent upon the performance of those assets. This fee income forms part of the value of in-force business, see note 25 on page 227.
– Annuities where policyholders' future cashflows are guaranteed at retirement. Exposure arises if the assets, predominantly bonds and loans, backing the liabilities do not perform in line with expectations.
– Insurance's surplus assets also result in market risk exposure. These assets are held primarily in three portfolios: (i) in the long-term funds within the life insurance companies; (ii) in the corresponding shareholder funds; and (iii) in investment portfolios within the general insurance business.

Measurement

Market risk is managed within a Board approved framework and risk appetite. This is supplemented by divisional market risk appetite limits and triggers. A variety of risk measures are used such as:

– Scenario/stress based measures (e.g. single factor stresses, macroeconomic scenarios);
– Percentile based measures (e.g. VaR and Stressed VaR); and
– Sensitivity based measures (e.g. sensitivity to 1 basis point move in interest rates).

Scenario based measures include the use of five different economic multi-risk scenarios which the Group introduced as part of its Board risk appetite. These assess the impact of unlikely, but plausible adverse scenarios on income, with the worst case for defined benefit pensions, trading portfolios, banking activities and insurance portfolios being reported against the Board risk appetite.

Internal market risk models for trading book activities comprise VaR, Stressed VaR and Incremental Risk Charge and these are explained in detail in the Group's Market Risk section of the Pillar 3 Report.

In addition:

– A trigger on the pension scheme deficit is used in respect of defined benefit pensions which has a material impact on capital resources;
– Profit and loss triggers are used in the trading books in order to ensure that mitigating action is considered if profit and loss becomes volatile;
– Interest rate repricing gaps, earnings sensitivity analysis, and open foreign exchange positions are used for banking book activity; and
– Stress testing and scenario analysis are also used in certain portfolios and at Group level, to simulate the impact of extreme conditions and to understand more fully the interdependence of different parts of the balance sheet.

These measures are reviewed regularly by senior management to inform effective decision making.

Defined benefit pension schemes

Management of the assets is the responsibility of the Trustees of the schemes who are responsible for setting the investment strategy and for agreeing funding requirements with the Group. The difference between assets and liabilities determines whether there is a surplus or deficit. Any deficit must be met by the Group with additional funding agreed with the Trustees as part of a triennial valuation process.

For accounting purposes, a AA corporate bond based discount rate is used to determine present value of liabilities resulting in significant credit spread risk. Assets are marked to market.

Trading portfolios

Based on the 1-day 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 2014 and 2013 based on the Group's global trading positions is detailed in table 1.32.

The risk of loss measured by the VaR model is the minimum expected loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR reported below does not assume any diversification benefit across the five risk types. The Group internally uses VaR as the primary measure for all trading book positions arising from short term market facing activity. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The average VaR for 2014 was similar to the average over 2013.

Table 1.32: **Trading portfolios: VaR (1-day 95 per cent confidence level) (audited)**

	At 31 December 2014				At 31 December 2013			
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m	Average £m	Maximum £m	Minimum £m
At 31 December 2014								
Interest rate risk	**1.7**	**2.8**	**4.8**	**1.3**	3.5	2.9	4.8	2.0
Foreign exchange risk	**0.2**	**0.4**	**1.3**	**0.0**	0.2	0.4	2.0	0.1
Equity risk	**–**	**–**	**–**	**–**	–	–	–	–
Credit spread risk	**0.6**	**0.7**	**1.1**	**0.5**	0.8	0.5	1.4	0.3
Inflation risk	**0.4**	**0.3**	**0.8**	**0.2**	0.2	0.3	0.7	0.1
Total VaR	**2.8**	**4.3**	**6.4**	**2.5**	4.7	4.1	6.5	2.7

Open market risk for the trading operations continues to be low with respect to the size of the Group and similar institutions, reflecting the fact that the Group's trading operations are customer-centric, focusing on hedging and recycling client risks.

Trading risk appetite is controlled with VaR limits. Limits are allocated on a 95 per cent 1-day VaR. VaR limits are complemented with profit and loss referrals, positional limits, and stress test triggers. VaR limits are set and managed at both desk and overall trading book levels.

Although an important market standard measure of risk, VaR has limitations. These arise from the use of limited historical data which may not encompass all potential events, particularly those which describe extreme market conditions, defined holding periods which assume the risk can be liquidated or hedged within that period and the exposure level at the confidence interval does not convey any information about potential losses which may occur if this level is exceeded. The Group recognises these limitations and supplements the use of VaR with a variety of other measurements which reflect the nature of the business activity. These include detailed sensitivity analysis, position reporting and stress testing analysis.

Trading book VaR (1-day 99 per cent) is compared daily against both forecast and actual profit and loss. 1-day 99 per cent VaR charts for Lloyds Bank, HBOS and Lloyds Banking Group models can be found in the Group's Pillar 3 Report.

The Group holds securities within its trading books mainly under the Credit Trading, Gilts and Repo Trading businesses within Financial Markets for funding and to meet customer requirements. The outright interest rate risk exposure, after hedging, is small relative to the Group.

Banking activities

Market risk in non-trading books consists of exposure to changes in interest rates including basis risk. This is the potential impact on earnings and value that occurs due to mismatches in the timing of repricing assets and liabilities.

Interest rate risk exposure is monitored monthly using, primarily:

(a) Market value sensitivity: this methodology considers all repricing mismatches (behaviourally adjusted where appropriate) in the current balance sheet and calculates the change in market value that would result from an instantaneous 25, 100 and 200 basis points parallel rise or fall in the yield curve (subject to a floor at zero per cent).

(b) Interest income sensitivity: this measures the impact on future net interest income arising from an instantaneous 25, 100 and 200 basis points parallel rise or fall in all the yield curves over a rolling 12 month basis (subject to a floor at zero per cent). Unlike the market value sensitivities, the interest income sensitivities incorporate additional behavioural assumptions as to how and when individual products would reprice in response to such change.

(c) Market Value notional limit: this caps the amount of conventional and inflation-linked government bonds held by the Group for liquidity purposes.

The Group has an integrated Asset and Liability Management (ALM) system which supports non traded asset and liability management of the Group. This provides a single consolidated tool to measure and manage interest rate repricing profiles (including behavioural assumptions), perform stress testing and produce forecast outputs. Interest rate repricing profiles are reported by currency and used to calculate the income and value sensitivities (in GBP equivalent). Repricing assumptions and customer reaction to changes in product pricing is a major determinant of the risk profile. The Group is aware that any assumptions based model is open to challenge. However, a full behavioural review is performed annually by Group ALM functions to ensure the assumptions remain appropriate, and is reviewed by Risk Division.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

Risk management continued

Table 1.33 below shows, split by material currency, the Group's market value sensitivities to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.33: **Banking activities: market value sensitivity**

	2014				2013			
	Up 25bps £m	**Down 25bps £m**	**Up 100bps £m**	**Down 100bps £m**	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m
Sterling	**(15.7)**	**15.5**	**(63.8)**	**3.9**	(25.1)	25.6	(97.2)	63.0
US dollar	**4.7**	**(4.9)**	**17.8**	**(15.9)**	16.3	(16.5)	64.9	(38.9)
Euro	**(7.2)**	**4.8**	**(27.3)**	**15.0**	(0.4)	0.6	(0.6)	9.6
Australian dollar	**(0.4)**	**0.4**	**(1.3)**	**1.8**	(0.7)	(0.1)	(2.6)	(0.8)
Other	**(0.3)**	**0.3**	**(1.2)**	**0.8**	(0.3)	0.3	(1.1)	1.1
Total	**(18.9)**	**16.1**	**(75.8)**	**5.6**	(10.2)	9.9	(36.6)	34.0

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio. The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

Table 1.34 below shows the banking book income sensitivity to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.34: **Banking activities: net interest income sensitivity (audited)**

	2014				2013			
	Up 25bps £m	**Down 25bps £m**	**Up 100bps £m**	**Down 100bps £m**	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m
Client facing activity and associated hedges	**(4.6)**	**(46.0)**	**176.3**	**(222.3)**	48.2	(136.0)	390.3	(364.4)

Income sensitivity is measured over a rolling 12 month basis.

The market value sensitivity is driven by temporary customer flow positions not yet hedged plus other positions occasionally held within limits, by the Group's wholesale funding desks in order to minimise overall funding and hedging costs. The level of risk is low relative to the size of the total balance sheet.

Low interest income sensitivity continues to reflect structural hedging against margin compression, with small year on year variances reflecting changes in operational flows.

The Group ensures that it has adequate stock of high-quality liquid assets (for example Gilts or US Treasury Securities) that can be converted easily into cash to meet liquidity requirements. The interest rate risk in these portfolios is hedged with interest rate swaps on an asset swap basis.

Insurance portfolios

Current and potential future market risk exposures within Insurance are assessed using a range of stress testing exercises and scenario analyses. Risk measures include 1-in-200 year stresses for Insurance's Individual Capital Assessment (ICA) and single factor stresses for profit before tax.

Table 1.35 demonstrates the impact of the Group's Fiscal Solvency stress scenario (with no diversification benefit) on Insurance's portfolio; this is the most onerous scenario for Insurance out of the Group scenarios. The amounts include movements in assets, liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts. Impacts can be assumed to be reasonably symmetrical.

Table 1.35: **Insurance activities: profit before tax sensitivities**

	Increase (reduction) in profit before tax £m	
	2014	2013
Interest rates – increase 100 basis points	**(124)**	(214)
Inflation – increase 50 basis points	**(143)**	(128)
Credit spreads – 100% widening	**(582)**	(697)
Equity – 30% fall	**(745)**	(692)
Property – 25% fall	**(60)**	(68)

The key market risks within Insurance are equity and credit spread risks. The majority of Insurance's equity risk exposure relates to unit-linked funds, through the value of future fee income, and with-profits funds, through burnthrough. Credit spread risk exposure largely results from holding bond and loan assets in the annuity portfolio with the aim of providing additional returns.

Further stresses that show the effect of reasonably possible changes in key assumptions, including the risk-free rate, equity investment volatility, widening of credit default spreads on corporate bonds and an increase in illiquidity premia, as applied to profit before tax are set out in note 34 on page 238.

Mitigation

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

Defined benefit pension schemes

The Group takes an active involvement in agreeing risk management and mitigation strategies with the Trustees of the schemes through whom any such activity must be conducted. An interest rate and inflation hedging programme is in place to reduce liability risk. The schemes have also reduced equity allocation and are investing the proceeds in credit assets as part of a programme to de-risk the portfolio.

Trading portfolios and banking activities

The Group's policy is to optimise reward whilst managing its interest rate risk exposures within the risk appetite defined by the Board. For individual banking divisions, simple positional interest rate risk is minimal due to the Group requirement for these businesses to hedge (or match fund) promptly all open positions directly via the Group Corporate Treasury (GCT) function.

As defined within the scope of the Group Interest Rate Risk in the banking book Policy, all hedgeable interest rate risk in the non-traded book should be transferred to GCT via the Interest Rate Risk Transfer Pricing (ITP) framework. GCT is responsible for managing centralised risk and does this through natural offsets of matching assets and liabilities, and appropriate hedging activity of the residual exposures, subject to the authorisation and mandate of Group Asset and Liability Committee (GALCO) within the Board risk appetite. The Group centrally manages the overall interest rate structure of the balance sheet giving consideration to both the stability of net interest income and protection of shareholder value from changes in market interest rates. A structural hedging programme is in place to manage rate insensitive balances through investing in longer term fixed rate assets or interest rate swaps, subject to the authorisation and mandate of Group Asset and liability Committee within the Board risk appetite. Derivative desks in Financial Markets will then externalise the hedges to the market. However, certain residual interest rate risks may remain outside the centre due to differences in basis and profile mismatches, largely arising from customer behaviour. Whilst the bank faces margin decompression in the current low rate environment, its exposure to pipeline and prepayment risk are not considered material, and are appropriately monitored and controlled through Divisional ALCOs.

Customer facing divisions incur foreign exchange risk in the course of providing services to their customers. GCT incurs foreign exchange risk through its various debt and capital management programmes. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled within the trading risk appetite and any residual risk is hedged in the market.

Insurance portfolios

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to reduce 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. Where considered appropriate, hedges are in place to reduce exposure to market risk, principally equity, interest rate risk and foreign currency.

For annuity 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. Further, in assessing the current value of these future cashflows, it is not always possible to achieve equally resilient levels of matching between the different capital measures that are used to assess regulatory solvency.

Monitoring

The Group Asset and Liability Committee and the Group Market Risk Committee regularly review high level market risk exposure, as part of the wider risk management framework. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits and triggers are monitored by Risk Division and where appropriate, escalation procedures are in place.

Defined benefit pension schemes

In addition to the wider risk management framework, governance of the schemes includes two specialist pensions committees (one Group executive sub-committee and a supporting management committee).

The surplus or deficit in the schemes is tracked on a monthly basis along with various single factor and scenario stresses which consider the assets and liabilities holistically. The impact on Group capital resources of the schemes is monitored monthly. Performance against risk appetite triggers is also regularly monitored. Hedges are in place and asset/liability matching positions are also actively monitored.

Trading portfolios and banking activities

Trading is restricted to a number of specialist centres, the most important centre being the Financial Markets business in London. These centres also manage market risk in the Commercial Banking 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 portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's divisional portfolios and in the Group's capital and funding activities is managed centrally within triggers defined in the Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

Insurance portfolios

Ongoing monitoring is in place to track market risks. This includes monitoring the progression of market risk capital against risk appetite limits, as well as the sensitivity of profit before tax to combined market risk stress scenarios and in year market movements. Asset/liability matching positions and hedges in place are actively monitored and if necessary rebalanced to be within certain tolerances. In addition market risk is controlled via approved investment policies and mandates.

Risk management continued

OPERATIONAL RISK

Definition

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The aim of operational risk management is to manage operational risks in line with defined appetites, and to protect both customers and the Group whilst delivering sustainable growth. The Group Operational Risk framework is the method by which operational risks are managed in terms of setting risk appetite, evaluating key exposures, measuring risk, mitigating risk, and monitoring risks on an ongoing basis, as set out below.

Risk appetite

The Group's Operational risk appetite is designed to safeguard the interests of customers, internal and external stakeholders, and shareholders. Appetite is expressed through six high level statements summarised below, each of which are defined with limits and triggers approved by the Board, and are regularly monitored by executive and Board risk committees:

– Customer: The Group builds trust and does not expect its customers to be impacted negatively.

– Reputation: The Group manages its external profile effectively. The Group will manage and mitigate any prominent negative sentiment.

– Financial loss: The Group does not expect to experience cumulative fraud or operational losses above a defined level of budgeted Group income, or individual losses above a defined amount.

– Management time and resources: The Group does not expect internal events that divert excessive senior management time from running the business or have extensive impact on colleague time and/or morale.

– Cyber: The Group minimises the impact from cyber attacks and information breaches that result in a significant loss of customer confidence or undermine the financial stability of the Group.

– Risk culture: All colleagues are responsible for risk within their individual roles. The Group sets a strong tone from the top and embraces a risk culture across the business which is aligned to its strategy, vision, values and codes of responsibility. The Group encourages an open dialogue and rapid escalation of potential threats and events.

For further information on risk appetite refer to page 112.

Exposures

The principal operational risks to the Group are:

– The risk that the Group is unable to provide services to customers as a result of an IT systems failure;

– Cyber risks associated with malicious attacks on the confidentiality or integrity of electronic data, or the availability of systems;

– External fraud arising from an act of deception or omission;

– Risks arising from inadequate delivery of services to customers;

– The risk associated with the ongoing provision of services to TSB and other organisations.

The risks below also have potential to negatively impact customers and the Group's future results:

– Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events and responses to those acts/events may create economic and political uncertainties, which could have a material adverse effect on UK and international macroeconomic conditions generally, and more specifically on the Group's results of operations, financial condition or prospects in ways that cannot necessarily be predicted.

– Systems and procedures are implemented and maintained by the Group to comply with increasingly complex and detailed anti-money laundering and anti-terrorism laws and regulations. However, these may not always be fully effective in preventing third parties from using the Group as a conduit for money laundering and other illegal or prohibited activities. Should the Group be associated with money laundering or breaches of financial crime regulations and prohibitions, its reputation could suffer and/or it could become subject to fines, sanctions and legal enforcement; any one of which could have a material adverse effect upon operating results, financial condition and prospects.

Measurement

Operational risk is managed within a Board approved framework and risk appetite, as set out above. A variety of measures are used such as: scoring of potential risks, using impact and likelihood, with impact thresholds aligned to the risk appetite statements above; assessment of the effectiveness of controls; monitoring of events and losses by size, business unit and internal risk categories.

In 2014, the highest frequency of events occurred in external fraud (63.17 per cent) and execution, delivery and process management (20.70 per cent). Clients, products and business practices accounted for 75.86 per cent of losses by value driven by legacy issues where impacts materialised in 2014 (excluding PPI).

The table overleaf shows high level loss and event trends for the Group using Basel II categories.

Table 1.36: **Operational risk events by risk category (losses greater than or equal to £10,000)**

	% of total volume		% of total losses	
	2014	2013	**2014**	2013
Business disruption and system failures	**1.38**	0.92	**0.26**	0.86
Clients, products and business practices (excl. PPI)	**14.05**	11.02	**75.86**	39.66
Damage to physical assets	**–**	0.81	**–**	0.45
Employee practices and workplace safety	**0.29**	0.61	**0.02**	0.36
Execution, delivery and process management	**20.70**	24.58	**16.71**	38.64
External fraud	**63.17**	61.96	**7.09**	20.01
Internal fraud	**0.41**	0.10	**0.06**	0.02
Total	**100.00**	100.00	**100.00**	100.00

Operational risk exposure and actual losses are used by the Group to calculate the appropriate holding of operational risk regulatory capital under the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its operational risk capital requirements using the Standardised Approach (TSA), which the Basel Committee states as being appropriate for an 'internationally active' bank.

Mitigation

The Group has a strong control environment that is subject to ongoing enhancements through regular reviews and investment. Risks are reported and discussed at local governance forums and escalated to executive management as appropriate. This ensures the correct level of visibility and engagement. The Group employs a range of risk management strategies, including: avoidance, mitigation, transfer (which would also include insurance) and acceptance. Contingency plans are maintained for a range of potential scenarios, with regular disaster recovery and scenario testing scheduled to test and challenge the readiness of the Group to respond in the event of an incident.

- An independent review of the Group's IT Resilience and supporting capabilities was completed in 2013. This highlighted areas of strength alongside known risks that have the potential to impact resilience, and a three year investment programme of strategic enhancements was initiated. The first year of this programme has been completed. Additionally the Group has developed a customer focused risk appetite for IT systems that support the Group's Critical Customer and Business Processes and continues to monitor these on a regular basis.
- The threat landscape associated with Cyber risk has continued to evolve alongside an increasing industry and Regulator focus. The Board is developing a revised Cyber Risk Appetite and is supporting incremental investment to help mitigate this risk.
- In addition to initiatives that protect the Group against a malicious Cyber attack the Group continues to invest in enhanced protection of customer information, including limiting access to key systems and enhancing the security, durability and accessibility of critical information.
- The Group adopts a risk based approach to mitigate the external fraud risks it faces, reflecting the current and emerging external fraud risks within the market. This approach drives an annual programme of enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real time detective controls wherever feasible. Through Group-wide policies and operational control frameworks, the Group has developed a robust fraud operating model with centralised accountability. The Group's fraud awareness programme remains a key component of its fraud control environment.
- The Group remediates issues that are identified in its Customer Processes, addressing root cause and rectifying customers as required. Enhancing the overall servicing environment remains a focus of dedicated Group programmes such as Simplification.
- Following the successful divestment of TSB the Group retains responsibility for the ongoing provision of key services which are managed via robust change management governance and a consolidated strategic change plan. There are separate governance arrangements in place to oversee the impacts of the divestment on the retained business customers, operations and controls.
- Operational resilience measures and recovery planning defined in the Group's Business Continuity Management policy ensure an appropriate and consistent approach to the management of continuity risks, including potential interruptions from a range of internal and external incidents or threats including environmental and climatic issues, terrorism, cyber, economic instability, pandemic planning and operational incidents.
- The Group has adopted policies and procedures to detect and prevent the use of its banking network for money laundering, bribery and activities prohibited by legal and regulatory sanctions. The Group regularly reviews and assesses these policies to keep them current, effective and consistent across markets. The Group requires mandatory training on these topics for all employees. Specifically, the Anti-money-laundering procedures include 'know-your-customer' requirements, transaction monitoring technologies and reporting of suspicions of money laundering to the applicable regulatory authorities and the Anti-Bribery Policy prohibits the payment, offer, acceptance or request of a bribe, including ' facilitation payments' by any employee or agent and provides a confidential reporting service for anonymous reporting for suspected or actual bribery activity. The Sanctions and the Related Prohibitions Policy sets out a framework of controls for compliance with legal and regulatory sanctions.

Monitoring

Monitoring and reporting is undertaken at Board, Group and business area committees, in accordance with delegated limits of authority which are regularly reviewed and refreshed. Business unit risk exposure is aggregated and discussed at the monthly Group Operational Risk Committee, and matters are escalated to the Chief Risk Officer, or higher committees, if appropriate. A combination of systems, monthly reports from business areas, and oversight and challenge from the Risk Division; audit; and assurance teams ensures that key risks are regularly presented and debated by an executive audience.

The Group maintains a formal approach to operational risk event escalation, whereby material events are identified, captured and escalated. Root causes of events are determined, where possible and action plans put in place to ensure an optimum level of control to keep customers and the business safe, reduce costs, and improve efficiency.

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.

Risk management continued

FUNDING AND LIQUIDITY RISK

Definition

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient. Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Risk appetite

Funding and liquidity risk is managed separately for the Banking and Insurance businesses. Funding and liquidity risk appetite for the Banking business is set with the support of the Group Asset and Liability Committee (GALCO). Within the Banking business, funding and liquidity risks are managed separately for TSB. The liquidity risk appetite for the Insurance business is reviewed and set annually by the Insurance Board.

For the Banking Group, the liquidity risk appetite covers a range of metrics considered key to maintaining a strong liquidity and funding position, with regular reporting to GALCO and the Board. Strict criteria and limits are in place to ensure central bank cash and highly liquid marketable securities are available as part of the portfolio of liquid assets. Risk appetite is a key element of the annual Group planning process with risk appetite defined over the life of the funding plan.

For further information on risk appetite refer to page 112.

Exposure

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

Measurement

A series of measures are used across the Group to monitor both short and long-term liquidity, including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival periods from two weeks out to a year.

Details of contractual maturities for assets and liabilities form an important source of information for the management of liquidity risk. Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturity. Contractual maturities also form the basis of the Group's liquidity stress testing. Note 54 on page 293 sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. Divisional teams form a view of customer behaviour based on quantitative and qualitative analysis. The analysis takes into account items such as early repayment, forbearance and impairment for assets and rollover and early withdrawal for liabilities. The assumptions are subject to governance via divisional asset and liability committees. The behavioural reviews form the foundation of the Group's Liquidity Transfer Pricing (LTP) and are applied to the contractual profile of the Group for the liquidity risk stress testing framework.

Mitigation

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through short-term liquidity management and over the life of the funding plan. Short-term liquidity management is considered from two perspectives; business as usual and stressed conditions, in the less than one year time horizon. The Group manages its risk appetite and liquidity position as a coverage ratio (proportion of stressed outflows covered by eligible liquid assets) corresponding with the PRA and CRD IV liquidity requirements. Longer term funding is used to manage the Group's strategic liquidity profile, determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and is supported by strong relationships with corporate customers and certain wholesale market segments. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although mostly repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise interbank deposits and to issue debt securities to meet short-term obligations. Funding concentration by counterparty and currency is monitored on an ongoing basis. Where concentrations do exist (for example, maturity profile); these are limited by the internal risk appetite and considered manageable.

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. In addition to central bank reserves, the Group holds sizeable balances of high grade marketable debt securities and other assets, as set out in table 1.43. The assets can be sold to provide, or used to secure, additional cash inflows should the need arise from either market counterparties or central bank facilities (Bank of England, European Central Bank and Federal Reserve).

To assist in managing the balance sheet the Group operates a LTP Policy which: allocates relevant interest expenses from GCT to the Group's Banking businesses within the internal management accounts in a manner consistent with the Group Funding and Liquidity Policy; helps drive the correct inputs to customer pricing and supports the overall Group balance sheet strategy; and is consistent with regulatory requirements.

Relevant interest expenses allocated via LTP include term funding spreads incurred over a three month LIBOR benchmark and the cost of funding and holding liquid asset reserves. LTP makes extensive use of behavioural maturity profiles, taking account of expected customer loan prepayments and stability of customer deposits. Such behavioural maturity assumptions are subject to formal governance, reviewed at least annually and founded on analysis and evidence of actual customer behaviour using historical data gathered over several years.

Liquidity risk within the Insurance business may result from the inability to sell financial assets quickly at their fair values; or from an insurance liability falling due for payment earlier than expected; or from the inability to generate cash inflows as anticipated; or from an unexpected large operational event; or from a general insurance catastrophe e.g. a significant weather event. The shareholder is exposed to liquidity risk through the shareholder business. This is predominantly the annuity portfolio, where the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. Unit-linked and with-profits funds are normally expected to meet their own liquidity obligations. Liquidity risk is actively managed and monitored within the Insurance business to ensure that, even under stress conditions, there is sufficient liquidity to meet obligations and remains within approved risk appetite. In addition, liquidity risk is controlled via approved funding and liquidity policies.

Monitoring

Liquidity is actively monitored at Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular GALCO which meets monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent internal oversight.

Daily monitoring and control processes are in place to address internal and regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group. These are a mixture of quantitative and qualitative measures, including: daily variation of customer balances, changes in maturity profiles, cash outflows, funding concentration, changes in primary liquidity portfolio, credit default swap (CDS) spreads and changing funding costs.

In addition, the monitoring framework has two other important components. Firstly, the Group carries out stress testing of its liquidity and potential cash flow mismatch position over both short (up to two weeks) and longer term (up to three months) horizons against a range of scenarios, including those prescribed by the PRA (the idiosyncratic, market wide and combined stresses) and the Group's own scenarios reflecting possible future liquidity risks. The Group's scenarios cover US market disruption, market counterparty failure, UK sovereign rating downgrade, Eurozone stress and a cyber attack. The key risk driver assumptions applied to the scenarios are:

Liquidity risk driver	Market wide and Group specific stresses
Marketable assets	Haircut widening and repos assumed not to roll on contractual maturity
Non marketable assets	Loan repayments under stress and possible liquidity value of less liquid assets
Wholesale funding	Outflows calculated based on contractual maturity of wholesale funding with limited roll over
Retail and commercial funding	Substantial outflows on customer deposit base
Intra-day liquidity	Liquidity required for clearing and payment systems under stressed conditions
Intra-group liquidity	Requirements from the stressed position of subsidiaries
Off balance sheet	Stressed cash outflows from commitments granted. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities
Downgrade	Contractual outflows resulting from short and long-term rating downgrades
Funding concentration risk	Segmentation by instrument, product, currency, counterparty and term structure
Franchise viability	Actions that need to be taken to maintain the Group's core business franchise and reputation

The scenarios and the assumptions are reviewed at least annually to gain assurance that they continue to be relevant to the nature of the business. The Group's liquidity risk appetite is calibrated against a number of stressed liquidity metrics. For further information on the Group's 2014 liquidity stress testing results refer to page 151. In addition to the liquidity stress testing framework, the Group funding plan is stressed against a range of macroeconomic scenarios, including those prescribed by the PRA. The Group also applies its own macroeconomic stress scenarios, including a one in 20 year recession. Liquidity risk appetite and regulatory metrics are calculated and monitored over the life the plan under base and stress conditions.

Secondly, the Group maintains a Contingency Funding Plan which is designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing. Contingency Funding Plan invocation and escalation processes are based on analysis of five major quantitative and qualitative components, comprising assessment of: early warning indicators, prudential and regulatory liquidity risk limits and triggers, stress testing results, event and systemic indicators and market intelligence.

Funding and liquidity management in 2014

The Group's funding position has been significantly strengthened and the Group has transformed its balance sheet structure in recent years. Total funded assets reduced by £14.5 billion to £493.4 billion. The Group loan to deposit ratio has improved to 107 per cent compared with 113 per cent at 31 December 2013. Customer deposits, excluding repos, increased by £10.6 billion and, excluding reverse repos, loans and advances to customers reduced by £15.3 billion primarily driven by a continued reduction in the Run-off portfolio (31 December 2014: £16.9 billion; 31 December 2013: £33.3 billion). The increase in customer deposits along with the continued reduction in the Run-off portfolio has enabled the Group to make changes in wholesale funding which reduced by £21.1 billion to £116.5 billion, with the volume with a residual maturity less than one year reducing to £41.1 billion (£44.2 billion at 31 December 2013). The Group's term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) reduced to 65 per cent (68 per cent at 31 December 2013) as expected in line with maturities of wholesale term funding and limited term wholesale issuance in 2014.

During 2014, the Group has experienced stable term issuance costs that have remained significantly lower than in previous years. The Group has had a limited demand for term wholesale funding in recent years but this may increase in the future as the Group continues to optimise the balance sheet structure.

Following the recent UK implementation of the EU Bank Recovery and Resolution Directive, ratings agencies may review their ratings to reassess the likelihood of UK extraordinary government support. On 3 February 2015 Standard & Poor's lowered the long term ratings on the two holding companies Lloyds Banking Group plc and HBOS plc by two notches to the BBB level. The operating companies Lloyds Bank plc and Bank of Scotland plc continue to have long term ratings of A but have been placed on CreditWatch with negative implications. At the same time Standard & Poor's announced that the holding companies of the Group have a positive outlook as they could revise upward the unsupported Group Credit Profile of Lloyds Banking Group. Lloyds Bank plc is currently rated A1 by Moody's and A by Fitch, however it is likely that they may review these ratings later in the year, taking into account regulatory changes, particularly relating to Recovery and Resolution. The effects of a downgrade from all three rating agencies are included in the Group liquidity stress testing.

The Liquidity Coverage Ratio (LCR) is due to become the Pillar 1 standard for liquidity in the UK from October 2015. The Group continues to monitor the requirements, has a robust and well governed reporting framework in place and expects to meet the minimum requirements following finalisation from the PRA. Based on the Group's current knowledge of the LCR standards due in October 2015, it believes that it met the upcoming requirements as at 31 December 2014.

Risk management continued

The combination of a strong balance sheet and access to a wide range of funding markets, including government and central bank schemes, provides the Group with a broad range of options with respect to funding the balance sheet in the future.

Table 1.37: **Summary funding and liquidity metrics**

	At 31 Dec 2014	At 31 Dec 2013	Change %
Primary liquidity buffer (£bn)	109.3	89.3	22
Term funding ratio (%)	64.7	67.9	(5)
Loan to deposit ratio (%)	106.8	112.9	(5)
Primary liquid assets/money market funding less than one year maturity (x)	5.8	4.2	38

Table 1.38: **Group funding position (audited)**

	At 31 Dec 2014 £bn	At 31 Dec 2013[1] £bn	Change %
Funding requirement			
Loans and advances to customers[2]	477.6	492.9	(3)
Loans and advances to banks[3]	3.0	5.1	(41)
Debt securities	1.2	1.4	(14)
Reverse repurchase agreements	–	0.2	
Available-for-sale financial assets – secondary[4]	8.0	4.4	82
Cash balances[5]	3.6	3.9	(8)
Funded assets	493.4	507.9	(3)
Other assets[6]	265.2	246.3	8
	758.6	754.2	1
On balance sheet primary liquidity assets[7]			
Reverse repurchase agreements	7.0	0.1	
Balances at central banks – primary[5]	46.9	46.0	2
Available-for-sale financial assets – primary	48.5	39.6	22
Trading and fair value through profit and loss	(6.1)	3.1	
Repurchase agreements	–	(0.6)	
	96.3	88.2	9
Total Group assets	854.9	842.4	1
Less: other liabilities[6]	(240.3)	(224.7)	7
Funding requirement	614.6	617.7	(1)
Funded by			
Customer deposits[8]	447.1	436.5	2
Wholesale funding[9]	116.5	137.6	(15)
	563.6	574.1	(2)
Repurchase agreements	1.1	4.3	(74)
Total equity	49.9	39.3	27
Total funding	614.6	617.7	(1)

[1] Loans and advances to customers and customer deposits restated. See note 1, page 188.

[2] Excludes £5.1 billion (31 December 2013: £0.1 billion) of reverse repurchase agreements.

[3] Excludes £21.3 billion (31 December 2013: £20.1 billion) of loans and advances to banks within the Insurance business and £1.9 billion (31 December 2013: £0.2 billion) of reverse repurchase agreements.

[4] Secondary liquidity assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

[5] Cash balances and balances at central banks – primary are combined in the Group's balance sheet.

[6] Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

[7] Primary liquidity assets are PRA eligible liquid assets, including: UK Gilts, US Treasuries, Euro AAA government debt, designated multilateral development bank debt and unencumbered cash balances held at central banks.

[8] Excluding repurchase agreements at 31 December 2014 of £nil (31 December 2013: £3.0 billion).

[9] The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

Table 1.39: **Reconciliation of Group funding to the balance sheet (audited)**

	Included in funding analysis £bn	Repos £bn	Fair value and other accounting methods £bn	Balance sheet £bn
At 31 December 2014				
Deposits from banks	**9.8**	**1.1**	**–**	**10.9**
Debt securities in issue	**80.6**	**–**	**(4.4)**	**76.2**
Subordinated liabilities	**26.1**	**–**	**(0.1)**	**26.0**
Total wholesale funding	**116.5**	**1.1**		
Customer deposits	**447.1**	**–**	**–**	**447.1**
Total	**563.6**	**1.1**		
At 31 December 2013				
Deposits from banks	12.1	1.9	–	14.0
Debt securities in issue	91.6	–	(4.5)	87.1
Subordinated liabilities	33.9	–	(1.6)	32.3
Total wholesale funding	137.6	1.9		
Customer deposits	436.5	3.0	–	439.5
Total	574.1	4.9		

Table 1.40: **Analysis of 2014 total wholesale funding by residual maturity (audited)**

	Less than one month £bn	One to three months £bn	Three to six months £bn	Six to nine months £bn	Nine months to one year £bn	One to two years £bn	Two to five years £bn	More than five years £bn	Total at 31 Dec 2014 £bn	Total at 31 Dec 2013 £bn
Deposit from banks	**7.0**	**1.2**	**0.5**	**0.3**	**0.1**	**0.1**	**0.1**	**0.5**	**9.8**	12.1
Debt securities in issue:										
Certificates of deposit	**1.0**	**2.7**	**1.2**	**0.6**	**1.3**	**–**	**–**	**–**	**6.8**	9.0
Commercial paper	**4.7**	**1.4**	**0.3**	**0.8**	**0.1**	**–**	**–**	**–**	**7.3**	4.8
Medium-term notes[1]	**1.0**	**0.7**	**1.1**	**1.4**	**1.3**	**4.5**	**8.5**	**10.7**	**29.2**	29.1
Covered bonds	**0.3**	**0.7**	**–**	**1.3**	**–**	**3.0**	**8.0**	**11.9**	**25.2**	29.4
Securitisation	**0.1**	**0.9**	**2.0**	**1.9**	**2.0**	**2.2**	**2.4**	**0.6**	**12.1**	19.3
	7.1	**6.4**	**4.6**	**6.0**	**4.7**	**9.7**	**18.9**	**23.2**	**80.6**	91.6
Subordinated liabilities	**–**	**1.1**	**1.3**	**0.7**	**0.1**	**3.3**	**4.6**	**15.0**	**26.1**	33.9
Total wholesale funding[2]	**14.1**	**8.7**	**6.4**	**7.0**	**4.9**	**13.1**	**23.6**	**38.7**	**116.5**	137.6

[1] Medium-term notes include funding from the National Loan Guarantee Scheme (31 December 2014: £1.4 billion; 31 December 2013: £1.4 billion).

[2] The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

Risk management continued

Table 1.41: **Total wholesale funding by currency (audited)**

	Sterling £bn	US dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2014	**34.4**	**35.6**	**40.1**	**6.4**	**116.5**
At 31 December 2013	44.4	36.1	48.7	8.4	137.6

Table 1.42: **Analysis of 2014 term issuance (audited)**

	Sterling £bn	US dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	**1.2**	**–**	**–**	**–**	**1.2**
Medium-term notes	**0.3**	**0.6**	**2.0**	**0.3**	**3.2**
Covered bonds	**1.5**	**–**	**0.8**	**–**	**2.3**
Private placements[1]	**0.3**	**1.5**	**1.1**	**0.4**	**3.3**
Subordinated liabilities	**–**	**0.6**	**–**	**–**	**0.6**
Total issuance	**3.3**	**2.7**	**3.9**	**0.7**	**10.6**

[1] Private placements include structured bonds and term repurchase agreements (repos).

Term issuance for 2014 totalled £10.6 billion with the majority across medium-term notes and private placements. Utilisation of the UK government's Funding for Lending Scheme (FLS) has further underlined the Group's support to the UK economic recovery and the Group remains committed to passing the benefits of this low cost funding on to its customers. The Group drew down £2.0 billion in January 2014, under the 2013 FLS and a further £10.0 billion over the remainder of the year as part of the 2014 scheme, bringing total drawings under the FLS to £20.0 billion.

Liquidity portfolio

At 31 December 2014, the Banking business had £109.3 billion (2013: £89.3 billion) of highly liquid unencumbered assets in its primary liquidity portfolio which are available to meet cash and collateral outflows and PRA regulatory requirements. A separate liquidity portfolio to mitigate any insurance liquidity risk is managed within the Insurance business. Primary liquid assets of £109.3 billion represent 5.8 times (31 December 2013: 4.2 times) the Group's money market funding less than one year maturity (excluding derivative collateral margins and settlement accounts) and are 2.7 times (31 December 2013: 2.0 times) all wholesale funding less than one year maturity, and thus provides a substantial buffer in the event of continued market dislocation.

Table 1.43: **Liquidity portfolio**

	At 31 Dec 2014 £bn	At 31 Dec 2013 £bn	Average 2014 £bn	Average 2013 £bn
Primary liquidity				
Central bank cash deposits	**46.9**	46.0	**62.3**	69.4
Government/MDB bonds[1]	**62.4**	43.3	**47.9**	28.2
Total	**109.3**	89.3	**110.2**	97.6
Secondary liquidity				
High-quality ABS/covered bonds[2]	**3.9**	1.4	**3.6**	2.0
Credit institution bonds[2]	**0.9**	0.4	**1.4**	1.2
Corporate bonds[2]	**0.6**	0.1	**0.3**	0.1
Own securities (retained issuance)	**20.6**	22.1	**22.2**	33.3
Other securities	**5.7**	4.3	**5.5**	4.8
Other[3]	**67.5**	77.1	**74.1**	75.2
Total	**99.2**	105.4	**107.1**	116.6
Total liquidity	**208.5**	194.7		

[1] Designated multilateral development bank (MDB).

[2] Assets rated A- or above.

[3] Includes other central bank eligible assets.

Table 1.44: **Liquidity portfolio: currency**

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2014					
Primary liquidity	**81.1**	**14.5**	**13.7**	**–**	**109.3**
Secondary liquidity	**91.3**	**1.2**	**6.7**	**–**	**99.2**
Total	**172.4**	**15.7**	**20.4**	**–**	**208.5**
At 31 December 2013					
Primary liquidity	65.3	13.3	10.5	0.2	89.3
Secondary liquidity	100.4	0.8	4.0	0.2	105.4
Total	165.7	14.1	14.5	0.4	194.7

In addition the Banking business had £99.2 billion (31 December 2013: £105.4 billion) of secondary liquidity, the vast majority of which is eligible for use in a range of central bank or similar facilities and the Group routinely makes use of as part of its normal liquidity management practices. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions.

The entire primary liquidity portfolio and a subset of the secondary portfolio are LCR eligible. The Group considers diversification across geography, currency, markets and tenor when assessing appropriate holdings of primary and secondary liquid assets. This liquidity is managed as a single pool in the centre and is under the control of the function charged with managing the liquidity of the Group apart from the TSB Liquidity Buffer which is managed separately. It is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of the Group's liquidity management process.

Stress testing results

Internal stress testing results at 31 December 2014 showed that the Banking business had liquidity resources representing 148 per cent of modelled outflows from all wholesale funding sources, retail and corporate deposits, intra-day requirements and rating dependent contracts under the Group's most severe liquidity stress scenario (the three month PRA combined scenario). Assets and liabilities within the TSB Banking Group were not included as their stress testing is managed separately.

The liquidity stress testing assumes that further credit rating downgrades may reduce investor appetite for some of the Group's liability classes and therefore funding capacity. A hypothetical idiosyncratic two notch downgrade of the Group's current long-term debt rating and accompanying short-term downgrade implemented instantaneously by all major rating agencies, could result in an outflow of £2.5 billion of cash over a period of up to one year, £2.4 billion of collateral posting related to customer financial contracts and £8.6 billion of collateral posting associated with secured funding. The Group's internal liquidity risk appetite includes such a stress scenario. The stress scenario modelling demonstrates the Group has available liquidity resources to manage such an event.

Encumbered assets

This disclosure provides further detail on the availability of assets that could be used to support potential future funding requirements of the Group. The disclosure is not designed to identify assets that would be available in the event of a resolution or bankruptcy.

The Group has analysed its balance sheet between unencumbered and encumbered assets.

Encumbered assets: Assets recognised on the Group's balance sheet which have been pledged as collateral against an existing liability, and as a result are assets which are unavailable to the Group to secure funding, satisfy collateral needs or be sold to reduce potential future funding requirements.

The following sub analyses have been provided for unencumbered assets:

Unencumbered – Readily realisable: Assets regarded by the Group to be readily realisable in the normal course of business, to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, and are not subject to any restrictions on their use for these purposes.

Unencumbered – Other realisable: Assets where there are no restrictions on their use to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, but are not readily realisable in the normal course of business in their current form.

Unencumbered – Cannot be used: Assets that have not been pledged but which the Group has assessed could not be pledged and therefore could not be used to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements.

Assets held within the Group's Insurance businesses are generally held to either back liabilities to policyholders or to support the solvency of the Insurance subsidiaries; accordingly all Insurance assets are classified as unencumbered – cannot be used.

Assets held within consolidated limited liability partnerships to provide security for the Group's obligations to its pension schemes are classified as unencumbered – cannot be used.

The Board and GALCO monitor and manage total balance sheet encumbrance and readily realisable unencumbered assets via a number of risk appetite metrics. At 31 December 2014, the Group had £134,916 million (31 December 2013: £118,446 million) of encumbered and £719,980 million (31 December 2013: £723,934 million) of unencumbered on balance sheet assets. Of the unencumbered assets, £355,298 million (31 December 2013: £384,502 million) was classified as realisable for potential future funding requirements with a large pool (£188,141 million; 31 December 2013: £201,191 million) of readily realisable assets, from which if needed the Group could meet potential funding requirements at short notice. Primarily the Group encumbers mortgages and term lending through the issuance programmes and tradable securities through securities financing activity.

Risk management continued

Table 1.45: **On balance sheet encumbered and unencumbered assets**

		Unencumbered – can be used			Unencumbered – cannot be used			Total assets
	Encumbered £m	Readily realisable assets £m	Other realisable £m	Total £m	Reverse repo & Derivatives £m	Other £m	Total £m	£m
At 31 December 2014								
Cash and balances at central banks	**–**	**48,302**	**–**	**48,302**	**–**	**2,190**	**2,190**	**50,492**
Trading and other financial assets at fair value through profit or loss	**13,389**	**5,149**	**2,259**	**7,408**	**36,725**	**94,409**	**131,134**	**151,931**
Derivative financial instruments	**–**	**–**	**–**	**–**	**34,094**	**2,034**	**36,128**	**36,128**
Loans and receivables:								
Loans and advances to banks	**26**	**424**	**712**	**1,136**	**1,899**	**23,094**	**24,993**	**26,155**
Loans and advances to customers	**102,333**	**94,220**	**161,458**	**255,678**	**5,148**	**119,545**	**124,693**	**482,704**
Debt securities	**728**	**281**	**100**	**381**	**–**	**104**	**104**	**1,213**
	103,087	**94,925**	**162,270**	**257,195**	**7,047**	**142,743**	**149,790**	**510,072**
Available-for-sale financial assets	**18,440**	**37,711**	**30**	**37,741**	**–**	**312**	**312**	**56,493**
Other[1]	**–**	**2,054**	**2,598**	**4,652**	**–**	**45,128**	**45,128**	**49,780**
Total assets	**134,916**	**188,141**	**167,157**	**355,298**	**77,866**	**286,816**	**364,682**	**854,896**
At 31 December 2013								
Cash and balances at central banks	–	46,272	–	46,272	–	3,643	3,643	49,915
Trading and other financial assets at fair value through profit or loss	5,415	7,258	2,233	9,491	29,288	98,489	127,777	142,683
Derivative financial instruments	–	–	–	–	29,741	1,063	30,804	30,804
Loans and receivables:								
Loans and advances to banks	31	1,354	880	2,234	183	22,917	23,100	25,365
Loans and advances to customers	106,416	106,079	177,103	283,182	120	103,234	103,354	492,952
Debt securities	389	574	9	583	–	383	383	1,355
	106,836	108,007	177,992	285,999	303	126,534	126,837	519,672
Available-for-sale financial assets	6,195	36,857	26	36,883	–	898	898	43,976
Other[1]	–	2,797	3,060	5,857	–	49,473	49,473	55,330
Total assets	118,446	201,191	183,311	384,502	59,332	280,100	339,432	842,380

[1] Other comprises: items in the course of collection from banks, investment properties, goodwill, value of in-force business, other intangible assets, tangible fixed assets, current tax recoverable, deferred tax assets, retirement benefit assets and other assets.

The above table sets out the carrying value of the Group's encumbered and unencumbered assets, separately identifying those that are available to support the Group's funding needs. It should be noted that the table does not include collateral received by the Group that is not recognised on its balance sheet, some of which the Group is permitted to repledge.

The Group provides collateralised security financing services to its clients, providing them with cash financing or specific securities. Collateralised security financing is also used to manage the Group's own short-term cash and collateral needs. For securities accepted as collateral the reverse repo, margin and bond borrowing mandate is credit rating driven with appropriate notional limits per rating, asset and individual bond concentration. All securities are investment grade. With regard to repo and stock lending agreements the Group only trades with regulated entities. Many factors are taken into consideration the main being, the credit worthiness of the counterpart, pricing transparency, underlying bond liquidity, central bank eligibility, credit rating, concentration and country risk. The vast majority of collateral the Group uses in repo/reverse repo and stock lending/stock borrowing transactions is investment grade Government issued, primarily UK Government debt. The majority of repo/reverse repo and stock lending/stock borrowing transactions are short-term, having a residual maturity of less than three months.

CAPITAL RISK

Definition

Capital risk is defined as the risk that the Group has a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Risk appetite

Capital risk appetite is set by the Group Board, reflecting the Group's strategic plans, regulatory capital constraints and market expectations. It is defined by a number of minimum capital ratios in normal and stressed conditions, a minimum leverage ratio and a minimum buffer over regulatory solvency requirements for the Insurance business set by the Insurance Board. The Group monitors its actual and forecast capital positions aiming to remain within its appetite at all times.

For further information on risk appetite refer to page 112.

Exposures

A capital exposure arises where the Group has insufficient capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. This could arise due to a depletion of the Group's capital resources as a result of the crystallisation of any of the risks to which it is exposed. Alternatively a shortage of capital could arise from an increase in the amount of capital that is needed to be held. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures while optimising value for shareholders.

Measurement

The Group measures the amount of capital it holds using the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation Authority (PRA) policy statement PS7/13. Full details on the Group's regulatory capital framework are provided on page 20 of the Pillar 3 Report.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is determined as 8 per cent of the aggregate risk-weighted assets calculated in respect of credit risk, counterparty credit risk, operational risk and market risk. At least 4 per cent of risk-weighted assets were required to be covered by Common Equity Tier 1 (CET1) capital in 2014, increasing to 4.5 per cent from 1 January 2015.

The minimum requirement for capital is supplemented by Pillar 2 of the regulatory framework.

Under Pillar 2A, additional minimum requirements are set through the issuance of bank specific Individual Capital Guidance (ICG), which adjusts the Pillar 1 minimum for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICG setting process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process (ICAAP). The Group's Pillar 2A ICG equates to 3.8 per cent of RWAs, of which 2.1 per cent must be covered by CET1 capital. This reflects a point in time estimate by the PRA, which may change over time, of the total amount of capital that is needed and includes risks that are not fully covered by Pillar 1 such as credit concentration and operational risk, and those risks not covered by Pillar 1 such as pensions and interest rate risk.

As part of the capital planning process, forecast capital positions are subjected to extensive stress analyses to determine the adequacy of the Group's capital resources against the minimum requirements, including ICG. Under Pillar 2B the PRA uses the outputs from some of these stress analyses to inform the setting of the Group's Capital Planning Buffer (CPB), defining a minimum level of capital over and above the minimum regulatory requirements that should be maintained in non-stressed conditions as mitigation against potential future periods of stress. The PRA requires the CPB to remain confidential between the Group and the PRA.

In addition to the CPB, a countercyclical capital buffer could potentially apply of up to 2.5 per cent. This buffer is time-varying and is designed to require banks to hold additional capital to remove or reduce the build up of systemic risk in times of credit boom, providing additional loss absorbing capacity and acting as an incentive for banks to constrain further credit growth. The Group is not currently required to hold a countercyclical capital buffer.

The Financial Policy Committee (FPC) of the Bank of England can also set sectoral capital requirements which are temporary increases to banks' capital requirements on exposures to specific sectors, if the FPC judges that exuberant lending to these sectors poses risks to financial stability. No sectoral capital requirements currently apply to the Group.

Under CRD IV two other CET1 capital buffers, the capital conservation buffer of 2.5 per cent and the systemic risk buffer of up to 3 per cent, will be phased in over the period from 1 January 2016 to 2019. To recognise these new buffers the PRA intends to rename the CPB as the PRA buffer and when setting the PRA buffer, will take into account the extent to which these CRD IV buffers already capture the risks identified in the PRA buffer assessment.

In addition to the risk-based capital framework described above, the Group is also subject to minimum capital requirements under the leverage ratio framework. The leverage ratio is calculated by dividing tier 1 capital resources by a defined measure of on-balance sheet assets and off-balance sheet items.

The Group's leverage ratio currently exceeds the aggregate minimum levels proposed by the FPC which require major domestic banks to meet a minimum ratio of 3 per cent, a supplementary systemic risk based buffer of up to 1.05 per cent (to apply from 2016 for globally systemically important banks (G-SIBs) and from 2019 for major domestic banks) and a time-varying countercyclical leverage buffer of up to 0.9 per cent (currently set at zero per cent). At least 75 per cent of the minimum 3 per cent and the entirety of any buffers must be met by CET1 capital. It is expected that the proposals will be implemented during 2015.

Mitigation

The Group has a capital management framework including policies and procedures that are designed to ensure that it operates within its risk appetite, continues to comply with regulatory requirements and is positioned to meet anticipated future changes to its capital requirements.

The Group is able to accumulate additional capital through the accumulation of profits over time, by raising new equity via, for example, a rights issue or debt exchange and by raising additional tier 1 and tier 2 capital by issuing subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time. The Group is also able to manage the demand for capital through management actions including adjusting its lending strategy, risk hedging strategies and through business disposals.

Risk management continued

Additional measures to manage the Group's capital position include seeking to strike an appropriate balance of capital held within its Insurance and Banking subsidiaries and through improving the quality of its capital through liability management exercises.

Monitoring

Capital is actively managed and regulatory ratios are a key factor in the Group's planning processes and stress analyses. Five year forecasts of the Group's capital position, based upon the Group's operating plan, are produced at least annually to inform the Group's capital strategy whilst shorter term forecasts are more frequently undertaken to understand and respond to variations of the Group's actual performance against the plan. The capital plans are tested for capital adequacy using a range of stress scenarios covering adverse economic conditions as well as other adverse factors that could impact the Group and the Group maintains a Recovery Plan which sets out a range of potential mitigating actions that could be taken in response to a stress.

Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios, including those in stressed scenarios, is undertaken, including submissions to the Group Asset and Liability Committee, the Group Risk Committee, Board Risk Committee and the Board.

The regulatory framework within which the Group operates continues to be developed at a global level through the Financial Stability Board (FSB) and Basel Committee, at a European level mainly through the issuance of CRD IV technical standards and guidelines and within the UK by the PRA and through directions from the FPC.

At a global level the Basel Committee has set out a summary of various policy and disclosure initiatives that it expects to undertake during 2015 themed around reducing excessive variability in banks' regulatory capital ratios. Proposed revisions to the Standardised Approach risk-weight framework in addition to early stage proposals on the design of a new capital floors framework were issued toward the end of 2014.

At a European level a number of capital related CRD IV technical standards and guidelines were published by the European Banking Authority (EBA) during the year, with further technical standards and guidelines expected to be published in 2015, which the Group will continue to be required to meet.

In the UK the Financial Policy Committee (FPC) finalised proposals for a UK leverage ratio framework. In January 2015 the PRA issued a consultation on proposals to reform the Pillar 2 framework, including new approaches for determining Pillar 2A capital requirements and the setting of Pillar 2B capital requirements (the PRA buffer).

The Group continues to monitor these developments very closely, analysing the potential capital impacts to ensure the Group continues to maintain a strong capital position that exceeds the minimum regulatory requirements and the Group's risk appetite and is consistent with market expectations.

Capital management in 2014

The Group continued to strengthen its capital position during 2014 through capital-efficient profit generation, further dividends from the Insurance business, changes to and improved valuations of the Group's defined benefit pension arrangements and a reduction in risk-weighted assets. The positive impact of these items was partly offset by the recommended dividend, charges relating to legacy issues and the Enhanced Capital Notes (ECNs) exchange and tender offers where the Group repurchased the equivalent of £5 billion nominal (£4 billion regulatory value) of ECNs and issued £5.3 billion of new CRD IV compliant additional tier 1 (AT1) securities.

- The CET 1 ratio increased 2.5 percentage points from 10.3 per cent (pro forma) to 12.8 per cent.
- The leverage ratio increased 1.1 percentage points from 3.8 per cent (pro forma) to 4.9 per cent.
- The transitional total capital ratio increased 3.2 percentage points from 18.8 per cent (pro forma) to 22.0 per cent.
- The Group is now assuming a steady state CET 1 ratio requirement of around 12 per cent.

The directors have recommended a dividend of 0.75 pence per share. The dividend, amounting to approximately £535 million, will be recognised in the Group's 2015 financial statements.

The Group intends to have a progressive dividend policy with dividends starting at a modest level and increasing over the medium term to a dividend payout ratio of at least 50 per cent of sustainable earnings. The ability of the Group to pay a dividend is subject to a number of constraints. Under the Companies Act 2006, dividends may only be paid out of 'profits available for distribution', which are determined by reference to a company's separate financial statements. Lloyds Banking Group plc acts a holding company which also raises debt to fund the activities of the Group. The profitability of the Company is therefore dependent upon the receipt of dividends from its subsidiaries and consequently its ability to sustain dividend payments is in turn largely dependent on the ability of its subsidiaries to continue making dividend payments.

At 31 December 2014 the Company had accumulated distributable reserves of approximately £8,500 million. Substantially all of the Company's merger reserve is available for distribution under UK company law as a result of transactions undertaken to recapitalise the Company in 2009.

As the parent company of a banking group payment of a dividend is also dependent upon the maintenance of an adequate level of regulatory capital. The Group remains strongly capitalised, increasing its CET 1 capital ratio from 10.3 per cent at 31 December 2013 to 13.0 per cent (pre dividend) at 31 December 2014. The payment of a dividend reduces an entity's CET 1 capital and, as a result, reduces its CET 1 capital ratio. The current recommended dividend reduces the Group's CET 1 ratio to 12.8 per cent.

Capital position at 31 December 2014

The Group's capital position as at 31 December 2014 is presented in the following section applying CRD IV transitional arrangements, as implemented in the UK by PRA policy statement PS7/13, and also on a fully loaded CRD IV basis.

Table 1.46: **Capital resources (audited)**

	Transitional		Fully loaded	
	At 31 Dec 2014 £m	At 31 Dec 2013[2] £m	**At 31 Dec 2014 £m**	At 31 Dec 2013[2] £m
Capital resources				
Common equity tier 1				
Shareholders' equity per balance sheet	**43,335**	39,191	**43,335**	39,191
Adjustment to retained earnings for foreseeable dividends	**(535)**	–	**(535)**	–
Deconsolidation of insurance entities[1]	**(824)**	(1,367)	**(824)**	(1,367)
Adjustment for own credit	**158**	185	**158**	185
Cash flow hedging reserve	**(1,139)**	1,055	**(1,139)**	1,055
Other adjustments	**333**	133	**333**	133
	41,328	39,197	**41,328**	39,197
less: deductions from common equity tier 1				
Goodwill and other intangible assets	**(1,875)**	(1,979)	**(1,875)**	(1,979)
Excess of expected losses over impairment provisions and value adjustments	**(565)**	(866)	**(565)**	(866)
Removal of defined benefit pension surplus	**(909)**	(78)	**(909)**	(78)
Securitisation deductions	**(211)**	(141)	**(211)**	(141)
Significant investments[1]	**(2,546)**	(2,890)	**(2,546)**	(3,090)
Deferred tax assets	**(4,533)**	(5,025)	**(4,533)**	(5,118)
Common equity tier 1 capital	**30,689**	28,218	**30,689**	27,925
Additional tier 1				
Additional tier 1 instruments	**9,728**	4,486	**5,355**	–
less: deductions from tier 1				
Significant investments	**(859)**	(677)	**–**	–
Total tier 1 capital	**39,558**	32,027	**36,044**	27,925
Tier 2				
Tier 2 instruments	**14,197**	19,870	**10,836**	15,636
Eligible provisions	**333**	349	**333**	349
less: deductions from tier 2				
Significant investments	**(1,288)**	(1,015)	**(2,146)**	(1,692)
Total capital resources	**52,800**	51,231	**45,067**	42,218
Risk-weighted assets (unaudited)	**239,734**	272,641	**239,734**	271,908
Common equity tier 1 capital ratio	**12.8%**	10.3%	**12.8%**	10.3%
Tier 1 capital ratio	**16.5%**	11.7%	**15.0%**	10.3%
Total capital ratio	**22.0%**	18.8%	**18.8%**	15.5%

[1] The amount of post-acquisition reserves for the Group's Insurance business are excluded from shareholders' equity. The remaining cost of the Group's investment in the equity of the Insurance business is risk-weighted as part of threshold risk-weighted assets up to a limit based on the size of the Group's common equity tier 1 capital position, with the residual amount deducted from common equity tier 1 capital.

[2] 31 December 2013 comparatives reflect CRD IV rules as implemented by the PRA at 1 January 2014 and are reported on a pro forma basis that includes the benefit of the sales of Heidelberger Leben, Scottish Widows Investment Partnership and the Group's 50 per cent stake in Sainsbury's Bank. 31 December 2013 common equity tier 1 ratios, excluding the benefit of these sales, were 10.0 per cent fully loaded and 10.1 per cent on transitional rules, while risk-weighted assets under fully loaded rules were £271.1 billion and under transitional rules were £272.1 billion.

Risk management continued

The key differences between the transitional capital calculation as at 31 December 2014 and the fully loaded equivalent are as follows:

– Capital securities that previously qualified as tier 1 or tier 2 capital, but do not qualify under CRD IV, can be included in tier 1 or tier 2 capital (as applicable) up to a specified limit which reduces by 10 per cent per annum until 2022.
– The significant investment deduction from AT1 in 2014 will transition to tier 2 by 2018.

The movements in the transitional CET1, AT1, tier 2 and total capital positions in the period are provided below.

Table 1.47: **Movements in capital**

	Common Equity Tier 1 £m	Additional Tier 1 £m	Tier 2 £m	Total capital £m
At 31 December 2013[1]	28,218	3,809	19,204	51,231
Profit attributable to ordinary shareholders[2]	**1,235**			**1,235**
Adjustment to above re December 13 pro forma	**(202)**			**(202)**
Adjustment to retained earnings for foreseeable dividends	**(535)**			**(535)**
Pension movements:				
Deduction of pension asset	**(831)**			**(831)**
Movement through other comprehensive income	**739**			**739**
Available-for-sale reserve	**548**			**548**
Deferred tax asset	**492**			**492**
Goodwill and intangible assets deductions	**104**			**104**
Excess of expected losses over impairment provisions and value adjustments	**301**			**301**
Significant investment deduction	**344**	**(182)**	**(273)**	**(111)**
Eligible provisions	**–**		**(16)**	**(16)**
Subordinated debt movements:				
Restructuring to ensure CRD IV compliance	**–**	**5,355**	**(4,006)**	**1,349**
Subordinated debt issuance	**–**	**–**	**645**	**645**
Repurchases, redemptions and other	**–**	**(113)**	**(2,312)**	**(2,425)**
Other movements	**276**	**–**	**–**	**276**
At 31 December 2014	**30,689**	**8,869**	**13,242**	**52,800**

[1] 31 December 2013 comparatives reflect CRD IV transitional rules as implemented by the PRA at 1 January 2014 and are reported on a pro forma basis that includes the benefit of the sales of Heidelberger Leben, Scottish Widows Investment Partnership and the Group's 50 per cent stake in Sainsbury's Bank.

[2] As the Insurance business is excluded from the scope of the Group's regulatory capital consolidation, profits made by Insurance are removed from CET1 capital. Dividends paid to the Group by Insurance, however, are recognised through CET1 Capital and for the period include £400 million paid in March 2014 and £300 million paid in December 2014. In addition, the sale of Heidelberger Leben resulted in the payment of an additional dividend by Insurance to the Group of £295 million.

CET1 capital resources have increased by £2,471 million in the period, mainly due to profit attributable to ordinary shareholders, reflecting underlying profit, dividends from the Insurance business, and a pensions credit resulting from changes to the Group's defined benefit pension arrangements, partly offset by charges relating to legacy issues and the ECN exchange and lender offers. Additionally, favourable pension variations through other comprehensive income, favourable movements in available-for-sale (AFS) reserves, a reduction in the excess of expected losses over impairment provisions and value adjustments and a reduction in deferred tax and significant investment deductions, further increased CET1 capital resources partially offset by an increase in the pensions asset deducted from capital and foreseeable dividends.

AT1 capital resources have increased by £5,060 million in the period, mainly due to the ECN exchange and tender offers that resulted in the issuance of £5.3 billion of CRD IV compliant AT1 instruments, partially offset by other movements in grandfathered tier 1 subordinated debt, including foreign exchange movements and fair value unwind.

As a result of the offers launched in the first half of the year, the Group has met its AT1 requirement under the CRD IV capital framework. Through the exchange and tender offers, the Group repurchased the equivalent of £5 billion nominal (£4 billion regulatory value) of ECNs and issued £5.3 billion of new AT1 securities. In addition to delivering the Group's AT1 requirement, the exchange and tender offers also increased the Group's leverage ratios by approximately 50 basis points, improved the Group's rating agency metrics, and has benefited the Group's net interest margin in 2014 by approximately 7 basis points. Coupon payments on the new AT1 securities are accounted for as distributions from reserves. The exchanges resulted in a net accounting charge of approximately £1.1 billion, which has reduced the Group's fully loaded CET1 capital ratio by approximately 50 basis points.

Tier 2 capital resources have reduced by £5,962 million in the period. This primarily reflects the ECN exchange and tender offers, which resulted in £4.0 billion of existing tier 2 ECN instruments being redeemed in exchange for the issuance of AT1 instruments as outlined above and the Group's stated intention to approach the PRA to seek the appropriate permission to redeem a number of remaining ECN instruments following the Capital Disqualification Event that occurred upon the release of the PRA stress test results which resulted in a further reduction of £0.5 billion. Additional factors contributing to the reduction in tier 2 capital resources included a reduction in eligible provisions and other movements in tier 2 subordinated debt, including foreign exchange, fair value unwind, amortisation of dated instruments and other calls and redemptions. The reduction in tier 2 capital resources was partially offset by the issuance of a £0.6 billion CRD IV compliant tier 2 dated subordinated debt instrument in November 2014.

Table 1.48: **Risk-weighted assets**

	Transitional[1] At 31 Dec 2014 £m	At 31 Dec 2013 £m
Risk-weighted assets		
Divisional analysis of risk-weighted assets:		
Retail	**67,666**	72,948
Consumer Finance	**20,882**	20,136
Commercial Banking	**106,185**	123,951
Central Items	**12,193**	7,743
TSB[2]	**5,170**	5,591
Run-off	**16,814**	30,569
Underlying risk-weighted assets	**228,910**	260,938
Threshold risk-weighted assets[3]	**10,824**	11,154
Total risk-weighted assets	**239,734**	272,092
Movement to fully loaded risk-weighted assets[4]	**–**	(1,014)
Fully loaded risk-weighted assets	**239,734**	271,078
Risk type analysis of risk-weighted assets:		
Foundation Internal Ratings Based (IRB) Approach	**72,393**	84,882
Retail IRB Approach	**72,886**	83,815
Other IRB Approach	**15,324**	9,526
IRB Approach	**160,603**	178,223
Standardised Approach	**25,444**	33,819
Contribution to the default fund of central counterparty	**515**	484
Credit risk	**186,562**	212,526
Counterparty credit risk	**9,108**	7,546
Credit valuation adjustment	**2,215**	3,190
Operational risk	**26,279**	26,594
Market risk	**4,746**	11,082
Underlying risk-weighted assets	**228,910**	260,938
Threshold risk-weighted assets[3]	**10,824**	11,154
Total risk-weighted assets	**239,734**	272,092
Movement to fully loaded risk-weighted assets[4]	**–**	(1,014)
Fully loaded risk-weighted assets	**239,734**	271,078
Pro forma transitional rules risk-weighted assets		272,641
Pro forma fully loaded risk-weighted assets		271,908

[1] CRD IV rules as implemented by the PRA at 1 January 2014.

[2] TSB risk-weighted assets are on a Lloyds Banking Group reporting basis and differ to those reported by TSB as a standalone regulated entity.

[3] Threshold risk-weighted assets reflect the element of significant investments and deferred tax assets that are permitted to be risk-weighted instead of deducted from CET1 capital under threshold rules. Significant investments primarily arise from the investment in the Group's Insurance business.

[4] Differences may arise between transitional and fully loaded threshold risk-weighted assets where deferred tax assets reliant on future profitability and arising from temporary timing differences and significant investments exceed the fully loaded threshold limit, resulting in an increase in amounts deducted from CET1 rather than being risk-weighted. At 31 December 2014 the fully loaded threshold was not exceeded and therefore no further adjustment was applied to the transitional threshold risk-weighted assets.

Risk management continued

Key differences between risk-weighted assets at 31 December 2014 and 31 December 2013 under transitional rules are as follows:

- Retail division risk-weighted assets reduced by £5.2 billion in the year primarily due to improvements in credit quality arising from active portfolio management and the impact of positive economic factors (including favourable movements in UK house prices and reduced unemployment) as well as the exit from its joint venture banking operations with Sainsbury's. These movements are partially offset by risk-weighted asset increases arising from model changes.
- Consumer Finance division risk-weighted assets increased by £0.8 billion largely due to new business lending and model changes partially offset by reductions arising from improvements in credit quality and economic factors.
- Commercial Banking risk-weighted assets reduced by £17.8 billion mainly reflecting market risk reductions, active portfolio management and methodology refinements. The market risk-weighted asset reduction of £6.3 billion is primarily due to the removal of a temporary capital buffer applied to the Group's internal market risk models on completion of specific market risk infrastructure projects.
- Central Items risk-weighted assets primarily comprise the Group's liquidity portfolio and strategic equity investments and other balance sheet assets such as fixed assets and sundry debtors. The increase in the year of £4.4 billion is primarily due to equity received in consideration for the disposal of Scottish Widows Investment Partnership (SWIP).
- The reduction in Run-off risk-weighted assets of £13.8 billion is mainly due to disposals, including the sale of loans in the Irish retail mortgage portfolio and movements in external economic factors.

Table 1.49: **Risk-weighted assets movement by key driver**

	Credit risk[1] £m	Counter party credit risk[1] £m	Market risk £m	Operational risk £m	Total £m
Risk-weighted assets at 31 December 2013	212,526	10,736	11,082	26,594	260,938
Management of the balance sheet	(4,694)	(366)	(1,850)	–	(6,910)
Disposals	(9,781)	(170)	–	–	(9,951)
External economic factors	(10,459)	1,187	26	–	(9,246)
Model and methodology changes	(995)	(64)	(4,512)	–	(5,571)
Other	(35)	–	–	(315)	(350)
Risk-weighted assets	186,562	11,323	4,746	26,279	228,910
Threshold risk-weighted assets					10,824
Total risk-weighted assets					239,734

[1] Credit risk includes movements in contributions to the default fund of central counterparties and counterparty credit risk includes the movements in credit valuation adjustments.

The risk-weighted asset movements table provides an analysis of the movement in risk-weighted assets in the year and an insight in to the key drivers of the movements. The analysis is compiled on a monthly basis through the identification and categorisation of risk-weighted asset movements and is subject to management judgement.

Management of the balance sheet includes risk-weighted asset movements arising from new lending and asset run-off and management of market risk positions. During the year risk-weighted assets decreased £6.9 billion primarily in Commercial Banking, partially offset by business growth in Consumer Finance and equities received in consideration for the disposal of Scottish Widows Investment Partnership within Central Items.

Disposals include risk-weighted asset reductions arising from the sale of assets, portfolios and businesses. Disposals reduced risk-weighted assets by £10.0 billion, primarily in the Run-off portfolio, including the sale of loans in the Irish retail mortgage portfolio as well as exiting the joint venture banking operation with Sainsbury's, in Retail.

External economic factors captures movements driven by changes in the economic environment. The reduction in risk-weighted assets of £9.2 billion is mainly due to positive macroeconomic factors including favourable movements in UK house prices and reduced unemployment which have led to improvements in the credit risk profile of customers.

Model and methodology changes include the movement in risk-weighted assets arising from new model implementation, model enhancement and changes in credit risk approach applied to certain portfolios. Model and methodology changes reduced risk-weighted assets by £5.6 billion, primarily due to the removal of a temporary capital buffer applied to the Group's internal market risk models on completion of specific market risk infrastructure projects. Reductions in credit risk arise from a number of small methodology refinements in Commercial Banking, partially offset by risk-weighted asset increases arising from updates to mortgage models and refinement of risk models for unsecured products in Retail and Consumer Finance.

Leverage ratio

The leverage ratio is calculated by dividing tier 1 capital (excluding grandfathered tier 1 securities) by a defined measure of on-balance sheet assets and off-balance sheet items.

On 12 January 2014 the Basel Committee issued a revised Basel III leverage ratio framework that included a number of amendments to the original calculation of the exposure measure, in particular the methodologies applied in determining the exposure measures for derivatives, securities financing transactions (SFTs) and off-balance sheet items. In addition the scope of consolidation has been fully aligned to that applied to the risk-based capital framework, thereby requiring all on-balance sheet assets and off-balance sheet items of the Insurance division to be excluded from the Group's total exposure measure and replaced by a measure of the banking group's investment in Insurance.

In January 2015 the existing CRD IV rules on the calculation of the leverage ratio were amended to align with the European Commission's interpretation of the revised Basel III leverage ratio framework. Although there remain some minor differences between the framework and the amended CRD IV rules, the Group does not consider these to be material and has therefore elected, in accordance with PRA guidance, to disclose on the basis of the revised Basel III leverage ratio framework, in keeping with the interim 2014 disclosures.

Table 1.50: **Leverage ratio**

	Fully loaded	
	At 31 Dec 2014 £m	At 31 Dec 2013[1] £m
Total tier 1 capital for leverage ratio[2]		
Common equity tier 1 capital	30,689	27,041
Additional Tier 1 capital	5,355	–
Total tier 1 capital	36,044	27,041
Exposure measure[3]		
Statutory balance sheet assets		
Derivative financial instruments	36,128	30,804
Securities financing transactions (SFTs)	43,772	29,592
Loans and advances and other assets	774,996	781,984
Total assets	854,896	842,380
Deconsolidation of insurance entities		
Derivative financial instruments	(1,686)	(1,030)
Loans and advances and other assets	(143,459)	(150,174)
Total scope of consolidation adjustments	(145,145)	(151,204)
Derivatives adjustments		
Adjustment for regulatory netting	(24,187)	(20,926)
Adjustment to cash collateral	(1,024)	(70)
Net written credit protection	425	280
Regulatory potential future exposure	12,722	13,368
Total derivatives adjustments	(12,064)	(7,348)
Counterparty credit risk add-on for SFTs	1,364	1,921
Off-balance sheet items	50,980	55,987
Regulatory deductions and other adjustments	(10,362)	(9,382)
Total exposure	739,669	732,354
Leverage ratio	4.9%	3.7%
Pro forma leverage ratio at 31 December 2013[4]		3.8%

[1] 31 December 2013 comparatives are reported on the same basis of calculation as the current year.

[2] Calculated in accordance with CRD IV rules.

[3] Calculated in accordance with the revised Basel III leverage ratio framework issued in January 2014, as interpreted through the July 2014 Basel III Quantitative Impact Study instructions and related guidance.

[4] Includes the pro forma benefit of the sales of Heidelberger Leben, Scottish Widows Investment Partnership and the Group's 50 per cent stake in Sainsbury's Bank.

Assets related to Group subsidiaries that fall outside of the Group's regulatory capital consolidation are deconsolidated. These are replaced with a proportion of the Group's investment in the subsidiaries, reflecting amounts not already deducted from tier 1 capital as part of significant investment deductions. This primarily applies to the Group's Insurance subsidiaries resulting in the removal of assets related to Insurance division.

Risk management continued

Adjustments are applied to the balance sheet asset value of derivatives financial instruments to reflect the application of regulatory netting rules, adjustments for the recognition of cash variation margin (subject to certain restrictions), the addition of notional amounts of written credit derivatives and the requirement to reflect potential future exposure amounts in accordance with regulatory rules.

Securities financing transactions, predominantly comprising repurchase transactions, are subject to the netting rules imposed by the framework. These are considered to be similar to current IFRS accounting rules on netting. In addition a counterparty credit risk amount is calculated and added to the SFT measure, representing the extent to which a SFT is under-collateralised.

Off-balance sheet items primarily consist of undrawn credit facilities, including facilities that may be cancelled unconditionally at any time without notice. The leverage ratio exposure value for off-balance sheet items is determined by applying set credit conversion factors to the nominal values of the items, based on the classification of the item. In accordance with the requirements of the framework the credit conversion factors applied to off-balance sheet items follow those prescribed by Standardised credit risk rules, subject to a floor of 10 per cent.

Other regulatory adjustments consist of other balance sheet assets that are required under CRD IV rules to be deducted from tier 1 capital such as deferred tax asset amounts, pension assets and goodwill and intangibles. The removal of these assets from the exposure measure ensures consistency is maintained between the capital and exposure components of the ratio.

Key movements

The 1.1 per cent increase in the Group's fully loaded leverage ratio from 3.8 per cent (pro forma) to 4.9 per cent predominantly reflects the increase in the Group's tier 1 capital position over the period, including the issuance of £5.3 billion of CRD IV compliant AT1 instruments and the growth in CET1 capital, as discussed on page 154.

G-SIB requirements

Although the Group is not currently classified as a Global Systemically Important Bank (G-SIB), by virtue of the leverage exposure exceeding €200 billion, the Group is required to report G-SIB metrics to the PRA. The Group's metrics used within the 2014 Basel G-SIBs annual exercise will be disclosed from April 2015, and the results are expected to be made available by the Basel Committee later this year.

Life insurance businesses

The business transacted by the life insurance companies within the Group comprises unit-linked business, non-profit business and with-profits business. Several companies transact either unit-linked and/or non-profit business, but Scottish Widows plc (Scottish Widows) and Clerical Medical Investment Group Limited (Clerical Medical) hold the only With-Profit Funds managed by the Group.

Basis of determining regulatory capital of the life insurance businesses

Available capital resources

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the PRA.

Statutory basis: Assets are generally valued on a basis consistent with that used for accounting purposes (with the exception that, in certain cases, the value attributed to assets is limited) and which follows a market value approach where possible. If the market is not active, the Group establishes a fair value by using valuation techniques. Liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets in accordance with the PRA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

Regulatory capital requirements

Each life insurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the PRA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows and Clerical Medical, the regulatory capital requirement is a combination of amounts held in respect of actuarial reserves, sums at risk and maintenance expenses (the Long-Term Insurance Capital Requirement) and amounts required to cover various stress tests (the Resilience Capital Requirement). The regulatory capital requirement is deducted from the available capital resources to give statutory excess capital.

For Scottish Widows and Clerical Medical, no Resilience Capital Requirement is required. However, a further test is required in respect of the With-Profit Funds. This involves comparing the statutory basis of assessment with a realistic basis of assessment as described below.

Realistic basis: The PRA requires each life insurance company which contains a With-Profit Fund in excess of £500 million to also carry out a realistic valuation of that fund. The Group has two such funds; one within Scottish Widows and one within Clerical Medical. The word realistic in this context reflects the fact that assumptions are best-estimate as opposed to prudent. This realistic valuation is an assessment of the financial position of a With-Profit Fund calculated under a methodology prescribed by the PRA.

The valuation of with-profits assets in a With-Profit Fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profit business written therein, it includes the present value of the anticipated future release of the prudent margins for adverse deviation. In addition, the realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above. The realistic valuation of liabilities differs from the statutory basis in including an allowance for future bonuses whilst the value of options and guarantees are assessed using a stochastic simulation model which values these liabilities on a basis consistent with tradable market option contracts (a market-consistent basis). In calculating the realistic liabilities, the model also takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given in the section entitled Options and guarantees on page 164.

The realistic excess capital is calculated as the difference between realistic assets and realistic liabilities of the With-Profit Fund with a further deduction to cover various stress tests (the Risk Capital Margin). In circumstances where the realistic excess capital position is less than the statutory excess capital, the company is required to hold additional capital to cover the shortfall. Any additional capital requirement under this test is referred to as the With-Profits Insurance Capital Component.

The determination of realistic liabilities of the With-Profit Funds includes the value of internal transfers expected to be made from each With-Profit Fund to the Non-Profit Fund held within the same life insurance entity. These internal transfers may include charges on policies where the associated costs are borne by the Non-Profit Fund.

Capital statement

The following table provides more detail regarding the capital resources available to meet regulatory capital requirements in the life insurance businesses. The figures quoted are based on management's current expectations pending completion of the annual financial returns to the PRA.

Table 1.51: **Capital resources (audited)**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Funds £m	UK Life Shareholder Funds £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2014 (statutory basis)[1]						
Shareholders' funds:						
Held outside the long-term funds	**–**	**–**	**–**	**1,081**	**4**	**1,085**
Held within the long-term funds	**–**	**–**	**5,855**	**–**	**189**	**6,044**
Total shareholders' funds	**–**	**–**	**5,855**	**1,081**	**193**	**7,129**
Adjustments onto a regulatory basis:						
Unallocated surplus within Insurance business	**267**	**53**	**–**	**–**	**–**	**320**
Value of in-force business	**–**	**–**	**(3,596)**	**–**	**(70)**	**(3,666)**
Other differences between IFRS and regulatory valuation of assets and liabilities	**–**	**–**	**(564)**	**(1,328)**	**(20)**	**(1,912)**
Estimated share of realistic liabilities consistent with the PRA reporting treatment	**(328)**	**(53)**	**–**	**–**	**–**	**(381)**
Support arrangement assets	**186**	**–**	**(186)**	**–**	**–**	**–**
Qualifying loan capital	**–**	**–**	**–**	**2,530**	**–**	**2,530**
Available capital resources	**125**	**–**	**1,509**	**2,283**	**103**	**4,020**
At 31 December 2013 (statutory basis)						
Shareholders' funds:						
Held outside the long-term funds	–	–	–	2,362	4	2,366
Held within the long-term funds	–	–	6,139	–	181	6,320
Total shareholders' funds	–	–	6,139	2,362	185	8,686
Adjustments onto a regulatory basis:						
Unallocated surplus within Insurance business	336	55	–	–	–	391
Value of in-force business	–	–	(4,117)	–	(80)	(4,197)
Other differences between IFRS and regulatory valuation of assets and liabilities	–	–	(430)	(2,659)	(23)	(3,112)
Estimated share of realistic liabilities consistent with the PRA reporting treatment	(389)	(55)	–	–	–	(444)
Support arrangement assets	210	–	(210)	–	–	–
Qualifying loan capital	–	–	–	2,611	–	2,611
Available capital resources	157	–	1,382	2,314	82	3,935

[1] Available capital resources for With-Profit Funds are presented in the table on a realistic basis as this is more onerous than on a regulatory basis.

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Risk management continued

Formal intra group capital arrangements
Scottish Widows has also provided subordinated loans to its fellow group undertaking Scottish Widows Bank plc. No such arrangement exists for Clerical Medical.

Constraints over available capital resources

Scottish Widows

Scottish Widows was created following the demutualisation of Scottish Widows Fund and Life Assurance Society in 2000. The terms of the demutualisation are governed by a Court-approved Scheme of Transfer (the 'Scheme') which, inter alia, created a With-Profits 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. The requirements of the Scheme sit alongside Scottish Widows' published Principles and Practices of Financial Management of With-Profit business.

Requirement to maintain a Support Account: The Scheme requires the maintenance of a Support Account within the Non-Participating Fund. The quantum of the Support Account is calculated with reference to the value of assets backing current with-profits policies which also existed at the date of demutualisation. Under the Scheme assets can only be transferred from the Non-Participating Fund if the value of the remaining assets in the fund exceeds the value of the Support Account. Scottish Widows has obtained from the PRA permission to include the value of the Support Account or, if greater, the excess of realistic liabilities for business written before demutualisation over the relevant assets (subject to the Non-Participating Fund being able to cover this amount by its surplus admissible assets) in assessing the realistic value of assets available to the With-Profit Fund. At 31 December 2014 the estimated value of surplus admissible assets in the Non-Participating Fund was £796 million (2013: £1,902 million) and the estimated value of the Support Account was £nil (2013: £nil). However, at 31 December 2014, the excess of realistic liabilities of with-profits business written before demutualisation over the relevant assets was £39 million (2013: £54 million) which, in accordance with the PRA's permission, has been used to assess the estimated value of realistic assets available to the With-Profit Fund (and has therefore reduced the value of the Non-Participating Fund's surplus admissible assets by that amount).

Further Support Account: The Further Support Account is an extra tier of capital support for the with-profits policies in existence at the date of demutualisation. The Scheme requires that assets can only be transferred from the Non-Participating Fund if the economic value of the remaining assets in the fund exceeds the aggregate of the Support Account and Further Support Account. Unlike the Support Account test, the economic value used for this test includes both admissible assets and the present value of future profits of business written in the Non-Participating Fund or by any subsidiaries of that fund. The balance of the Further Support Account is expected to reduce to nil by the year 2030. At 31 December 2014, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £3,676 million (2013: £6,784 million) and the estimated combined value of the Support Account and Further Support Account was £1,930 million (2013: £2,070 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 2014 is £147 million (2013: £156 million). Scottish Widows has obtained from the PRA permission to include the value of this support in assessing the realistic value of assets available to the With-Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long-Term Fund to meet both policyholders' reasonable expectations in light of liabilities in force at a year-end and the new business expected to be written over the following year.

Clerical Medical

The surplus held in the Clerical Medical With-Profit Fund can only be applied to meet the requirements of the fund itself or distributed according to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses on traditional with-profits business. The use of capital within the fund is also subject to the terms of the Scheme of Demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. In extreme circumstances capital within the Clerical Medical Non-Profit Fund may be made available to support the With-Profit Fund.

Other life insurance businesses

Except as described above capital held in UK Non-Profit Funds is potentially transferable to other parts of the Group, subject to meeting the regulatory requirements of these businesses. There are no prior arrangements in place to allow capital to move freely between life insurance entities or other parts of the Group.

Overseas life business includes several life companies outside the UK. In all cases the available capital resources are subject to local regulatory requirements, and transfer to other parts of the Group is subject to additional complexity surrounding the transfer of capital from one country to another.

Movements in regulatory capital

The movements in the Group's available capital resources in the life business can be analysed as follows:

Table 1.52: **Movements in available capital resources**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Funds £m	UK Life Shareholder Funds £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2013	157	–	1,382	2,314	82	3,935
Changes in estimations and in demographic assumptions used to measure life assurance liabilities	**–**	**1**	**431**	**–**	**11**	**443**
Dividends and capital transactions	**–**	**–**	**(500)**	**(202)**	**–**	**(702)**
Change in support arrangements	**(24)**	**–**	**24**	**–**	**–**	**–**
New business and other factors	**(8)**	**(1)**	**172**	**171**	**10**	**344**
At 31 December 2014	**125**	**–**	**1,509**	**2,283**	**103**	**4,020**

With-Profit Funds

Available capital in the Scottish Widows With-Profit Fund has decreased from £157 million at 31 December 2013 to an estimated £125 million at 31 December 2014 mainly due to a decrease in the liabilities of the transferred business. Available capital in the Clerical Medical With-Profit Fund is estimated to be zero at 31 December 2014 (no change from 31 December 2013). This is because the fund is in the process of distributing the free estate and all surplus will ultimately be distributed to policyholders.

UK Non-Profit Funds

Available capital in the UK Non-Profit Funds has increased from £1,382 million at 31 December 2013 to an estimated £1,509 million at 31 December 2014. This is mainly due to emergence of surplus on existing business and assumption charges offset by new business strain and a reduction due to transfers to Shareholder Funds.

UK Life Shareholder Funds

Available capital in the UK Life Shareholder Funds has decreased from £2,314 million at 31 December 2013 to an estimated £2,283 million at 31 December 2014. The decrease mainly reflects the funding used to pay the dividend from Scottish Widows Group to Lloyds Bank and a tranche of subordinated debt due to be redeemed in 2015 which therefore no longer contributes to capital, partly offset by receipt of transfers from the Non-Profit Funds.

Overseas life business

Available capital has increased during 2014 due to profits emerging on in force business and the impact of assumption charges.

Analysis of policyholder liabilities reported in the balance sheet in respect of the Group's life insurance business is as follows. With-Profit Fund liabilities are valued in accordance with FRS 27.

Risk management continued

Table 1.53: **Analysis of policyholder liabilities**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Funds £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2014					
With-Profit Fund liabilities	**14,345**	**6,946**	**–**	**–**	**21,291**
Unit-linked business (excluding that accounted for as non-participating investment contracts)	**–**	**–**	**48,475**	**3,932**	**52,407**
Other life insurance business	**–**	**–**	**12,531**	**41**	**12,572**
Insurance and participating investment contract liabilities	**14,345**	**6,946**	**61,006**	**3,973**	**86,270**
Non-participating investment contract liabilities	**–**	**–**	**26,547**	**701**	**27,248**
Total policyholder liabilities	**14,345**	**6,946**	**87,553**	**4,674**	**113,518**
At 31 December 2013					
With-Profit Fund liabilities	13,539	7,427	–	–	20,966
Unit-linked business (excluding that accounted for as non-participating investment contracts)	–	–	45,310	4,064	49,374
Other life insurance business	–	–	11,702	–	11,702
Insurance and participating investment contract liabilities	13,539	7,427	57,012	4,064	82,042
Non-participating investment contract liabilities	–	–	26,722	868	27,590
Total policyholder liabilities	13,539	7,427	83,734	4,932	109,632

Capital sensitivities

Shareholders' funds

Shareholders' funds outside the long-term business fund are invested in readily tradable assets (e.g. cash and fixed interest securities), cash and a range of less liquid fixed interest instruments, at levels consistent with the liquidity risk appetite of the Insurance business.

With-Profit Funds

The with-profits realistic liabilities and the available capital for the With-Profit Funds are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund. The available capital resources (and capital requirements) are sensitive to the level of the stock market, with the position worsening at low stock market levels as a result of the guarantees to policyholders increasing in value. However, the exposure to guaranteed annuity options increases under rising stock market levels. An increase in the level of equity volatility implied by the market cost of equity put options also increases the market consistent value of the options given to policyholders and worsens the capital position. Various hedging strategies are used to manage these exposures.

The most critical non-economic assumptions are the level of take-up of options inherent in the contracts (higher take-up rates are more onerous), mortality rates (lower mortality rates are generally more onerous) and lapses prior to dates at which a guarantee would apply (lower lapse rates are generally more onerous where guarantees are in the money). The sensitivity of the capital position and capital requirements of the With-Profit Funds is partly mitigated by the actions that can be taken by management.

Other long-term funds

Outside the With-Profit Funds, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower mortality rates are more onerous). Assumptions relating to future expenses are also significant with increases in the expected level of future costs leading to increases in the value of the liabilities and consequently leading to a reduction in available capital. Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of non-annuity life insurance contracts such that assured life mortality is a less significant assumption. For Clerical Medical, assumptions relating to the provision in relation to German insurance business litigation are also significant.

Assets held in excess of those backing reserves are invested in readily tradable assets (e.g. cash and fixed interest securities), cash and a range of less liquid fixed interest instruments, at levels consistent with the liquidity risk appetite of the Insurance business.

Options and guarantees

The Group has sold insurance products that contain options and guarantees, both within the With-Profit Funds and in other funds.

Options and guarantees within the With-Profit Funds

The most significant options and guarantees provided from within the With-Profit Funds are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies.

For those policies written in Scottish Widows pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up within the With-Profit Fund of Scottish Widows called the Additional Account which is available, inter alia, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2014 of £2.6 billion (2013: £2.2 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the PRA, the liabilities of both the Clerical Medical and Scottish Widows With-Profit Funds are valued using a market-consistent stochastic simulation model. This model is used in order to place a value on the options and guarantees which captures both their intrinsic value and their time value.

The most significant economic assumptions included in the model are:

– Risk-free yield. The risk-free yield is defined as spot yields derived from swap yield curves.
– 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, at 31 December 2014, the 10 year equity-implied at-the-money assumption was set at 22.3 per cent (2013: 22.1 per cent). The assumption for property volatility was 13 per cent (2013: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 27 per cent (2013: 17 per cent).

The model includes a matrix of the correlations between each of the underlying modelled asset types. The correlations used are consistent with long-term historical returns. The most significant non-economic assumptions included in the model are management actions (in respect of investment policy and bonus rates), guaranteed annuity option take-up rates and assumptions regarding persistency (both of which are based on recent actual experience and include an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities), and assumptions regarding mortality (which are based on recent actual experience and industry tables).

Options and guarantees outside the With-Profit Funds

A number of typical guarantees are provided outside the With-Profit Funds such as guaranteed payments on death (e.g. term assurance) or guaranteed income for life (e.g. annuities). In addition, certain personal pension policyholders in Scottish Widows, for whom reinstatement to their occupational pension scheme was not an option, have been given a guarantee that their pension and other benefits will correspond in value to the benefits of the relevant occupational pension scheme. The key assumptions affecting the ultimate value of the guarantee are future salary growth, gilt yields at retirement, annuitant mortality at retirement, marital status at retirement and future investment returns. There is currently a provision, calculated on a deterministic basis, of £61 million (2013: £63 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 approximately £1 million. If yields were 0.5 per cent lower than assumed, the liability would increase by approximately £9 million.

Risk management continued

REGULATORY RISK

Definition
Regulatory risk is defined as the risk that the Group is exposed to fines, censure, or legal or enforcement action due to failing to comply with applicable laws, regulations, codes of conduct or legal obligations.

Risk appetite
The Group has zero risk appetite for material regulatory breaches. This appetite is reviewed and approved annually by the Board. To achieve this, the Group has policies, processes and standards which provide the framework for businesses and colleagues to operate in accordance with the laws, regulations and voluntary codes which apply to the Group and its activities.

For further information on risk appetite refer to page 112.

Exposures
The Group periodically experiences material regulatory breaches outside its risk appetite. Regulatory exposure is also 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 interpreted, implemented and embedded into day-to-day operational and business practices across the Group. This is particularly the case currently; the industry still continues to witness increased levels of government and regulatory intervention in the financial sector with an increasing number of regulatory rules from both the UK and overseas affecting the Group's operations. It is clear that regulatory challenges remain, including the area of conduct where the Group incurred a combined fine of £217 million by UK and US regulators for serious misconduct relating to the Special Liquidity Scheme (SLS), the Repo Rate benchmark and the London Interbank Offered Rate (LIBOR).

Measurement
Regulatory risks are measured against a set of risk appetite metrics, with appropriate thresholds, which have been approved by the Board and which are regularly reviewed and monitored. Metrics include assessments of control and material regulatory rule breaches.

Mitigation
Mitigation is undertaken across the Group and comprises the following key components:

- Risks are assessed by the business and controls put in place to mitigate them;
- Enhanced regulatory reporting;
- Implementation of systems, processes and effective controls including mandatory training for colleagues;
- Regulatory horizon scanning;
- Oversight and assurance of the regulatory risks within the business;
- Quality assurance theme reviews to assess compliance with rules, regulations and policies;
- Continued investment in the Group's IT systems is enabling the Group to meet its regulatory commitments;
- Senior business leaders monitor the progress of these assessments and mitigations;
- Material risks and issues are escalated to Group-level bodies which challenge the business on its management of risks and issues; and
- Mandated policies and processes require appropriate control frameworks, management information and standards to be implemented.

Monitoring
Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. The report forms the basis of challenge to the business at the monthly Group Compliance and Conduct Risk Committee. This committee may escalate matters to the Chief Risk Officer, or higher committees. The report also forms the basis of the regulatory sections in the Group's consolidated risk reporting.

INSURANCE RISK

Definition

Insurance risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

Risk appetite

Insurance risk appetite in the Insurance business is set by the Insurance Board and includes maximum earnings exposures to longevity and persistency risk in defined stresses. Insurance risk appetite for longevity in the defined benefit pension schemes is set by the Board using two key metrics: a one year increase to life expectancy and a combined market and longevity stress. Insurance risk appetite is monitored through Group, Insurance business and pension scheme governance.

For further information on risk appetite refer to page 112.

Exposures

The major sources of insurance risk within the Group are the Insurance business 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 and expenses for the life and pension business, and property insurance for the general insurance business. The prime insurance risk of the Group's defined benefit pension schemes is 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 on a range of stresses including risk measures based on 1-in-200 year stresses for Insurance's Individual Capital Assessment (Group defined benefit pension schemes utilise 1-in-20 year stresses) and other supporting measures where appropriate, including those set out in notes 36 and 37 to the financial statements.

Mitigation

A key element of the control framework is the consideration of insurance risk by an appropriate combination of high level committees and Boards. For the Insurance business the ultimate control body is the Insurance Board but significant risks from Insurance and the defined benefit pension schemes are reviewed by the Group executive and Group Risk Committees and/or Board. Governance of the Group's defined benefit pension schemes also includes two specialist pension committees (one Group executive sub committee and a supporting management committee).

Insurance risk is mitigated through pooling and through diversification across large numbers of individuals, geographical areas, and different types of risk exposure. A number of processes are used to control insurance risk including: underwriting (the process to ensure that new insurance proposals are properly assessed); pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products); claims management; product design and management; policy wording; reinsurance and cost controls and efficiencies.

In addition, exposure limits by risk type are assessed through the business planning process and used as a control mechanism to ensure risks are taken within risk appetite.

The most significant insurance risks within the Insurance business are longevity risk, persistency risk and expenses. Longevity risk transfer and hedging solutions, as potential risk mitigants, are considered on a regular basis. It is not practical to hedge persistency risk. 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 different reinsurers (with limits on the level of risk placed with each reinsurer).

The most significant insurance risk in the defined benefit pension schemes is longevity risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed.

Monitoring

Ongoing monitoring is in place to track the progression of insurance risks. In respect of the Insurance business this involves monitoring relevant experiences against expectations (for example claims experience, persistency experience, expenses and non-disclosure at the point of sale) as well as tracking the progression of insurance risk capital against limits and the sensitivity of profit before tax to the most significant insurance risks persistency and longevity. The effectiveness of controls put in place to manage insurance risk is evaluated and significant divergences from experience or movements in risk exposures are investigated and remedial action taken. Progress against risk appetite metrics in respect of longevity risk in the Group's defined benefit pension schemes is regularly reported and reviewed by the relevant committees.

Risk management continued

PEOPLE RISK

Definition

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to reductions in earnings and/or value.

Risk appetite

The Group's people risk appetite and corresponding measures enable the Group to lead responsibly and proficiently, manage people resource effectively, support and develop colleague talent, and meet legal and regulatory obligations related to its people.

For further information on risk appetite refer to page 112.

Exposures

The Group's management of material people risks is critical to its capacity to deliver against its strategic objectives and to be the best bank for customers. Over the coming year the Group anticipates the following key people risk exposures:

- The pending introduction of a new Senior Managers' Regime and Certification Regime which introduces a reverse burden of proof and increased accountability may impact the Group's ability to attract and retain talent through appropriate incentive and reward schemes;
- Attracting and retaining talent may be impacted by a more active external market alongside regulatory changes which impact remuneration and reward arrangements;
- Colleague engagement may be challenged by ongoing media attention on banking sector culture, sales practices and ethical conduct;
- Maintaining organisational people capability in response to an increasingly digital business environment; and
- Resource stretch due to pace and volume of organisational change.

Measurement

People risk is measured through a series of quantitative and qualitative indicators, aligned to key sources of people risk for the Group such as succession, retention and whistleblowing. In addition to risk appetite measures and limits, people risks and controls are monitored across individual Divisions and business units. Divisional metrics are calibrated against the Group's risk appetite and monitored on a monthly basis via the Group's risk governance framework and reporting structures.

Mitigation

The Group takes many mitigating actions with respect to people risk. Key areas of focus include:

- Working with the Regulators to ensure their guidance on increased accountability in the new regimes and strengthening remuneration governance is clear and pragmatic to balance implementation costs with the benefits gained from enhanced governance;
- Continued focus on the Group's culture by developing and delivering initiatives that reinforce behaviours which generate the best possible long-term outcomes for customers and colleagues;
- Maintain effective remuneration arrangements to ensure they promote an appropriate culture and colleague behaviours that meet customer needs and regulatory expectations;
- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;
- Ensuring compliance with legal and regulatory requirements related to Senior Manager Regime and Certification Regime, embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities; and
- Ongoing consultation with the Group's recognised unions on changes which impact their members.

Monitoring

People risks from across the Group are monitored and reported through Board and Group Governance Committees in accordance with the Group Risk Management Framework and People Risk Sub-framework. Risk exposures are discussed monthly via the Group HR & People Risk Committee with upwards reporting to Group Risk and Executive Committees. In addition oversight, challenge and reporting is completed at Risk Division level and combined with Risk Assurance reviews, is intended to assess the effectiveness of controls against root cause, recommending follow up remedial action if relevant. At Business level a full assessment of the People Risk Profile is completed to ensure an optimum level of control is in place to protect colleagues, customers and the Group. All material People Risk events are escalated in accordance with the formal Group Operational Risk Policy and People Policies to the respective Divisional Managing Directors and the Group Compliance, Conduct & Operational Risk Director.

FINANCIAL REPORTING RISK

Definition

Financial reporting risk is defined as the risk that the Group suffers reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial and regulatory reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate and timely information.

Risk appetite

The risk appetite is set by the Board and reviewed on an annual basis or more frequently. It includes complying with statutory and regulatory reporting requirements and compliance with tax legislation in the jurisdictions in which the Group operates.

For further information on risk appetite refer to page 112.

Exposures

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate systems, processes and controls to support statutory, prudential regulatory and tax reporting, to prevent and detect financial reporting fraud, to manage the Group's tax position and to support market disclosures.

Measurement

Financial reporting risk is measured by the adequacy of and compliance with a number of key controls. Identification of potential financial reporting risk also forms a part of the Group's Operational Risk management framework.

Mitigation

The Group maintains a system of internal controls, which is designed to:

- ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded;
- enable the calculation, preparation and reporting of financial, prudential regulatory and tax outcomes in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements; and
- ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements and as far as possible are consistent with best practice and in compliance with the British Bankers' Association Code for Financial Reporting Disclosure.

Monitoring

Financial reporting risk is actively monitored at business unit and Group levels. There are specific programmes of work undertaken across the Group to support:

- annual assessments of (1) the effectiveness of internal controls over financial reporting; and (2) the effectiveness of the Group's disclosure controls and procedures, both in accordance with the requirements of the US Sarbanes Oxley Act;
- annual certifications by the Senior Accounting Officer with respect to the maintenance of appropriate tax accounting arrangements, in accordance with the requirements of the 2009 Finance Act.

The Group also has in place an assurance process to support its prudential regulatory reporting and monitoring activities designed to identify and review tax exposures on a regular basis. There is ongoing monitoring to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

The Group has a Disclosure Committee which assists the Group Chief Executive and Chief Financial Officer in fulfilling their disclosure responsibilities under relevant listing and other regulatory and legal requirements. In addition, the Audit Committee reviews the quality and acceptability of the Group's financial disclosures. For further information on the Audit Committee's responsibilities relating to financial reporting see pages 75 to 78.

Risk management continued

GOVERNANCE RISK

Definition

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

Risk appetite

Governance risk appetite is defined and embedded through the Group's Governance Principle and Policy which are reviewed and approved by the Board on an annual basis. The Group has governance arrangements that support the effective long-term operation of the business and the vision of being the best bank for customers, maximise shareholder value and meet regulatory and social expectations.

For further information on risk appetite refer to page 112.

Exposures

The internal and corporate governance arrangements of major financial institutions continue to be subject to a high level of regulatory and public scrutiny. The Group's exposure to governance risk is also reflective of the significant volume of existing and proposed legislation and regulation within the UK and overseas with which it must comply. Risk governance and risk culture are mutually reinforcing.

Measurement

The Group's governance arrangements are assessed against new or proposed legislation and regulation and best practice among peer organisations in order to identify any areas of enhancement required.

Mitigation

The Group's Risk Management Framework establishes robust arrangements for risk governance, in particular by:

- defining individual and collective accountabilities for risk management, risk oversight and risk assurance through a Three lines of Defence model which supports the discharge of responsibilities to customers, shareholders and regulators;
- outlining governance arrangements which articulate the enterprise-wide approach to risk management; and
- supporting a consistent approach to Group-wide behaviour and risk decision making through a Group Policy Framework which helps everyone understand their responsibilities by clearly articulating and communicating rules, boundaries and risk appetite measures which can be controlled, enforced and monitored.

Under the banner of the Risk Management Framework new training modules have been launched during 2014 to support all colleagues in understanding and fulfilling their risk responsibilities.

The Ethics and Responsible Business Policy and supporting Codes of Personal Responsibility and Business Responsibility embody the Group's values and reflect its commitment to operating responsibly and ethically both at a business and an individual level. All colleagues are required to adhere to the Codes in all aspects of their roles.

Driving adherence to the Group's Risk Management framework goes 'hand in glove' with its approach to risk culture which is embedded in the Group's approach to recruitment, selection, training, performance management and reward.

Monitoring

A review of the Group's Risk Management Framework, which includes the status of the Group's Principles and Policy Framework, and the design and operational effectiveness of key governance committees, is undertaken on an annual basis and the findings are reported to the Group Risk Committee, Board Risk Committee and the Board.

This includes a review of the Group's current approach to governance and ongoing initiatives in light of the latest regulatory guidance.

For further information on Corporate Governance see pages 62 to 81.

FINANCIAL STATEMENTS

Independent auditors' report to the members of Lloyds Banking Group plc

REPORT ON THE FINANCIAL STATEMENTS

OUR OPINION

In our opinion:

- Lloyds Banking Group plc's Group financial statements and Parent Company financial statements (the 'financial statements') give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 December 2014 and of the Group's profit and the Group's and the Parent Company's cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

WHAT WE HAVE AUDITED

Lloyds Banking Group plc's financial statements comprise:

- the Consolidated and Parent Company balance sheets as at 31 December 2014;
- the Consolidated income statement and the Consolidated statement of comprehensive income for the year then ended;
- the Consolidated and Parent Company cash flow statements for the year then ended;
- the Consolidated and Parent Company statements of changes in equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

Certain disclosures have been presented elsewhere in the Annual Report and Accounts (the 'Annual Report'), rather than in the notes to the financial statements. These are cross-referenced from the financial statements and are identified as audited.

The financial reporting framework that has been applied in the preparation of the financial statements is applicable law and IFRSs as adopted by the European Union and, as regards the Parent Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

OUR AUDIT APPROACH

Overview

Set out below is an overview of our audit approach, highlighting key aspects including materiality level, scope and areas of focus of our audit. These are described in further detail later in this audit report.

Overall Group materiality	We have determined overall Group materiality to be £268 million which represents 5 per cent of adjusted profit before tax. Profit before tax was adjusted for a number of non-recurring items.
Scope	We conducted a full scope audit across individually financially significant business reporting units. Additional business reporting units were selected to increase the level of audit evidence for each account balance, on which a combination of controls and substantive tests of detail was undertaken. Business reporting units that are not subject to specific audit procedures are still subject to audit work on entity level controls and group level analytical review procedures over their financial information.
Areas of focus	The areas of focus for our audit which involved the greatest allocation of our resources and effort were: – Credit risk and impairment of loans and advances to customers – Conduct risk and provisions – Actuarial assumptions used in the valuation of insurance contracts – Uncertain tax positions – Recognition of deferred tax assets – Pension valuations and obligations – One-off transactions – Fair value adjustments applied to uncollateralised derivative financial instruments

THE SCOPE OF OUR AUDIT AND OUR AREAS OF FOCUS

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ('ISAs (UK & Ireland)').

We designed our audit by determining materiality and assessing the risks of material misstatement in the financial statements. In particular, we looked at where the directors and management made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all our audits, we also addressed the risk of management override of internal controls, including evaluating whether there was evidence of bias by the directors or management that represented a risk of material misstatement due to fraud.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as 'areas of focus' in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit. We discussed these areas of focus with the Audit Committee. Their report on those matters that they considered to be significant issues in relation to the financial statements is set out on page 77.

Area of focus	How our audit addressed the area of focus
Credit risk and impairment of loans and advances to customers *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), page 199 (Critical Accounting Estimates and Judgements) and page 295 (notes).* Impairment is a highly subjective area due to the level of judgement applied by management in determining provisions. Our work covered impairment of loans and advances to customers within Retail, Consumer Finance and Commercial Banking. We focused on the identification of impairment events, which differs based upon the type of lending product and customer. Judgement is required to determine whether a loss has been incurred. We also focused on the measurement of impairment, including the assessment of whether historic experience is appropriate when assessing the likelihood of incurred losses in the portfolios (particularly given the improving economic conditions). Judgement is applied to determine appropriate parameters and assumptions used to calculate impairment. For example, the assumption of customers that will default, the valuation of collateral for secured lending and the future cash flows of commercial loan customers. Management also apply adjustments, or overlays, where they believe the data driven parameters and calculations are not appropriate, either due to emerging trends or models not capturing the risks in the loan portfolio. An example of this is an overlay for the current low interest rates which management apply on top of the impairment model output. These overlays require significant judgement.	We understood and tested key controls and focused on: – the identification of impairment events; – the governance controls over the impairment processes, including the continuous re-assessment by management that impairment models are still calibrated in a way which is appropriate for the impairment risks in the Group's loan portfolios; – the transfer of data between underlying source systems and the impairment models that the Group operates; and – the review and approval process that management have in place for the outputs of the Group's impairment models, and the adjustments and overlays that are applied to modelled outputs. We found the key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these key controls for the purposes of our audit. In addition to testing the key controls, we have also performed the following procedures: *Retail and Consumer Finance* We understood management's basis for determining whether a loan is impaired and assessed the reasonableness using our understanding of the Group's lending portfolios and our broader industry knowledge. For Retail and Consumer Finance exposures, impairment is calculated using models. We therefore tested the completeness and accuracy of data from underlying systems and data warehouses that is used in those models. We understood and critically assessed the models used. Where changes had been made in model parameters and assumptions, we understood the reasons why changes had taken place and used our industry knowledge and experience to evaluate the appropriateness of such changes. We performed a sensitivity analysis on the key assumptions as well as using our own models to estimate the impairment provision for a sample of loans. In evaluating the models and assumptions, we also considered whether all relevant risks were reflected in the modelled provision, and where not, whether overlays to modelled calculations appropriately reflected those risks. We challenged management to provide objective evidence to support the overlay adjustments made to the modelled provision. Modelling assumptions and parameters, such as probability of default, are based on historic data. We challenged whether historic experience was representative of current circumstances and of the losses incurred in the portfolios. This included consideration of the improving economic conditions. We also considered if there was evidence of incurred losses which were not being identified from the historic data. Based on the evidence obtained we found that the impairment model assumptions, data used within the models and overlays to modelled outputs were reasonable. *Commercial Banking* We understood and evaluated the processes for identifying impairment events within the loan portfolios, as well as the impairment assessment processes for loans within the business support unit and run-off portfolio. We assessed critically the criteria for determining whether an impairment event had occurred and therefore whether there was a requirement to calculate an impairment provision. We tested a sample of performing loans with characteristics that might imply an impairment event had occurred (for example a customer experiencing financial difficulty or approaching a refinancing deadline) to challenge whether all impairment events had been identified by management. We also haphazardly selected an additional sample of performing loans to further challenge whether all impairment events had been identified by management. We did not identify further impairment events. For a sample of individually impaired loans we understood the latest developments at the borrower and the basis of measuring the impairment provisions and considered whether key judgments were appropriate given the borrowers' circumstances. We also re-performed management's impairment calculation. In addition, we tested key inputs to the impairment calculation including the expected future cash flows and valuation of collateral held, and challenged management as to whether valuations were up to date, consistent with the strategy being followed in respect of the particular borrower and appropriate for the purpose. We further challenged management on the value of the provisions held by comparing the gains or losses crystallised when impaired loans have been sold. This provided evidence that provisions held were appropriate. From the testing performed we concluded that specific impairment provisions had been made in respect of incurred losses in the Commercial Banking loan portfolios. For the collective unimpaired provision, which reflects losses incurred but not yet identified, we tested the completeness and accuracy of the underlying loan information used in the impairment models by agreeing details to the Group's source systems as well as re-performing the calculation of the modelled provision. For the key assumptions in the model, we challenged management who provide objective evidence that they were appropriate. Further, we used our industry experience and knowledge to consider the appropriateness of the provision. For overlays to the modelled output, we challenged management who provide objective evidence that the overlays were appropriate.

Independent auditors' report to the members of Lloyds Banking Group plc continued

Area of focus	How our audit addressed the area of focus
Conduct risk and provisions *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), page 199 (Critical Accounting Estimates and Judgements) and page 248 (notes).* Given the continued regulatory focus on the financial services sector there is a significant risk that further claims or regulatory investigations will emerge that impact the financial statements. There is a risk across the Group that emerging conduct risk areas have not yet been identified or appropriately assessed by management for financial reporting purposes, including whether a provision is required or a contingent liability disclosed. Where provisions or contingent liability disclosures are made, judgement is required in measuring the liabilities. Judgement is required in estimating future redress payments to be made to customers, regulatory fines, and operational costs of processing complaints and reviewing past business.	We understood and tested the key controls and management's processes for: – identifying conduct risk exposures and assessing whether provisions or disclosures were necessary; and – the calculation and review of conduct provisions including governance processes and approvals of model assumptions and outputs. We found the key controls were designed, implemented and operated effectively and therefore we determined that we could place reliance on these key controls for the purposes of our audit. We met with Divisional and Group management to understand the emerging and potential issues that they had identified. We assessed independently emerging and potential areas where exposures might have arisen based upon our knowledge and experience of emerging industry issues and the regulatory environment. We used this to challenge the completeness of the issues identified by management and whether a provision was required. We understood customer complaints received and assessed the trends. We tested a sample of complaints to understand whether there were indicators of more systemic issues being present for which provisions or disclosures may need to be made in the financial statements. We read the Group's correspondence with the Financial Conduct Authority and Prudential Regulation Authority and discussed the output of any meetings held. We also met with the Financial Conduct Authority and Prudential Regulation Authority on a bilateral basis, and on a trilateral basis with the Prudential Regulation Authority and the Chair of the Group Audit Committee. We read the minutes of key governance meetings including those of the Board, and of various management committees, as well as attending Audit Committee and Board Risk Committee meetings. We also understood the key activities of the Conduct and Compliance function. The majority of our detailed audit work was on the significant conduct provisions in relation to past sales of Payment Protection Insurance (PPI) policies, interest rate hedging products to small and medium-sized businesses and insurance products in the German branch of Clerical Medical. We also examined other areas of compensation payments made to customers. For significant provisions made, we understood and challenged the provisioning methodologies and underlying assumptions used by management. For example, we challenged the basis that management used for forecasting the number of PPI complaints that will be received in the future. For those assumptions based on historic information, we challenged whether this was appropriate for future experience. Where management made adjustments to historical experience, we challenged the basis for and appropriateness of such changes. We also independently performed sensitivity analysis on the key assumptions. Given the inherent uncertainty in the calculation of conduct provisions and their judgemental nature, we evaluated the disclosures made in the financial statements. In particular, we focused on challenging management that the disclosures were sufficiently clear in highlighting the exposures that remain, significant uncertainties that exist in respect of the provisions and the sensitivity of the provisions to changes in the underlying assumptions. No additional material conduct issues that would require either provision or disclosure in the financial statements were identified as a result of the audit work performed.

Area of focus	How our audit addressed the area of focus
Actuarial assumptions used in the valuation of insurance contracts (liabilities and assets representing the value of in-force business) *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), page 199 (Critical Accounting Estimates and Judgements) and page 227 (notes).* The valuation of the Group's insurance contracts is dependent on a number of subjective assumptions about future experience. Some of the economic and non-economic actuarial assumptions used in valuing insurance contracts are judgemental, in particular persistency (the retention of policies over time), longevity (the expectation of how long an annuity policyholder will live and how that might change over time), expenses (future expenses incurred to maintain existing policies to maturity), credit risk and illiquidity premium (adjustments made to the discount rate). Persistency can be impacted by changes to regulation for products sold by the Group. In recent times the Group's products have been affected by regulatory changes including the Retail Distribution Review, Pensions Auto-Enrolment and more recently the Finance Act 2014. We focused on whether management had made appropriate assumptions against this changing regulatory background. The Group's accounting policy is that the discount rate applied to cash flows is consistent with that applied to such cash flows in the capital markets. Management use the actual asset mix as a proxy for deriving a market consistent view of the illiquidity adjustment to the discount rate. Small changes in each of these assumptions can result in material impacts to the valuation of insurance contract liabilities, the value of in-force assets and the related movements in the income statement.	We understood and tested key controls and governance around the processes for analysing economic and non-economic assumptions. We found the key controls for the setting of assumptions, including the experience analysis data, were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We assessed the actuarial assumptions, including the consideration and challenge of management's rationale for the judgements applied and any reliance placed on industry information. Our assessment included reference to our independent benchmarking data which considers each of these principle areas. For persistency, longevity and expenses we considered recent experience and the appropriateness of the judgements applied by management on how future experience will evolve. For persistency, we also considered the appropriateness of management's assumptions about future improvements given the regulatory changes removing commission for certain business. In particular, we used historical data on nil commission business and analysis comparing lapse rates by product to initial commission paid. For longevity and expenses we assessed the appropriateness of the assumptions by comparing them to experience and latest industry data. For credit risk and illiquidity premium we assessed the appropriateness of the methodology and any modifications made against our knowledge and experience of the regulatory requirements and of the industry. We assessed the assumptions with reference to wider market practice and prevailing economic conditions. We challenged whether the actual asset mix remained an appropriate proxy to a market consistent portfolio by comparing the proportion of illiquid assets held to the most recent public information for other similar companies. We performed testing to confirm that the assumptions approved were those applied. Based on the results of our audit work we concluded that the data and assumptions used by management were reasonable.
Uncertain tax positions *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), and page 271 (notes).* The Group has a number of open tax matters, for which management is required to make certain judgements as to the likely outturn for the purposes of calculating the Group's tax liabilities. Such matters include an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary.	We examined the analysis performed by management which sets out the basis for their judgements in respect of the material tax exposures identified, together with relevant supporting evidence such as correspondence with tax authorities and legal opinions obtained. We used our understanding of the business and also read correspondence with tax authorities to challenge the completeness of identified exposures and the need for provisions. We made our own assessment of the likelihood of the tax exposures occurring based on our knowledge of tax legislation and applicable precedent. In making our assessment we considered the range of interpretation of the applicable tax legislation in the relevant jurisdictions. We also evaluated the calculation of the exposures and agreed these to the financial statements. We assessed whether the extent of the disclosures made, in particular, in relation to contingent liabilities, was based on the relevant facts and circumstances. Management's judgements in respect of the Group's positions on uncertain tax items are supportable in the context of the information currently available.
Recognition of deferred tax assets *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), and page 247 (notes).* The recognition of a deferred tax asset in respect of tax losses is permitted only to the extent that it is probable that future taxable profits will be available to utilise the tax losses carried forward. When considering the availability of future taxable profits, judgement is required when assessing projections of future taxable income which are based on approved business plans/forecasts. The allocation of forecast profits is also judgemental when considering the utilisation of the deferred tax assets in the separate legal entities where the assets reside.	We understood and tested key controls over the production and approval of the forecast taxable profits used to support the recognition of the deferred tax asset. We found the key controls were designed, implemented and operated effectively, and therefore we were able to place reliance on these controls for the purposes of our audit. We assessed whether the forecast profits were appropriate by challenging both the underlying and economic assumptions, focusing on those directly impacting the adjusted profit figures, for example interest rates, consumer spending rates and Gross Domestic Product. We used our independent benchmarking data to benchmark a number of the economic assumptions to external data sources where possible, and also assessed the accuracy of previous forecasts. We also tested management's basis for allocating forecast profits between legal entities by testing the allocation methodology, challenging significant assumptions and using our experience of the Group's activities. The Chancellor's autumn statement in December 2014 proposes to restrict to 50 per cent the amount of banks' profits than can be offset by carried forward tax losses for the purposes of calculating corporation tax liabilities. We obtained management's analysis of the impact this will have on the utilisation period and the disclosures they have made, deeming them to be reasonable.

Independent auditors' report to the members of Lloyds Banking Group plc continued

Area of focus	How our audit addressed the area of focus
Pension valuations and obligations *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), page 199 (Critical Accounting Estimates and Judgements) and page 240 (notes).* The Group operates a number of defined benefit schemes which in total are significant in the context of both the overall balance sheet and results of the Group. The valuations of the pension obligations are calculated with reference to a number of actuarial assumptions and inputs including discount rate, rate of inflation and mortality rates. The treatment of curtailments, settlements, past service costs and measurements and other amendments can significantly impact the balance sheet and results of the Group, as demonstrated by the curtailment gain recognised in the year. Small changes in assumptions can result in material impacts to the net pension liability or asset.	We understood and tested key controls over the completeness and accuracy of data extracted and supplied to the Group's actuary, which is used to calculate the pension scheme surplus or deficit. We also tested the controls for approving the fair value of the scheme assets and the actuarial assumptions and valuations. We found the key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We met with management and their actuary to understand the judgements made in determining key economic assumptions used in the calculation of the liability. We assessed the reasonableness of those assumptions by comparing to our own independently determined benchmarks and concluded that the assumptions used by management were appropriate. We tested the consensus and employee data used in calculating the obligation. We also considered the treatment of curtailments, settlements, past service costs and measurements, and any other amendments made to obligations during the year. We tested the fair value of scheme assets by independently calculating a fair value for a sample of the assets held. Based on the evidence obtained, we found that the data and assumptions used by management in the actuarial valuations and the fair value of the scheme assets are within a range we consider to be reasonable. We also read and assessed the disclosures made in the financial statements, including disclosures of the assumptions.
One-off transactions *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), and page 321 (notes).* One-off transactions were deemed to be an area of focus due to their nature and previous control deficiencies in relation to such transactions. The accounting for one-off transactions can often be judgemental and complex, and require transaction specific controls to be designed and operate effectively. Significant one-off transactions that we focused on this year that had a material impact on the financial statements included the share sales of TSB, including its continuing consolidation and the exchange of Enhanced Capital Notes for Additional Tier 1 securities.	During the year, in response to control deficiencies identified in the prior year, management introduced a new key control for one-off transactions. We tested the design, implementation and operating effectiveness of the control, and determined that we could rely on this control for the purposes of our audit. We met regularly with management throughout the year to understand any proposed large or unusual transactions and to discuss the accounting and disclosure implications. We read the analysis prepared by management for the accounting treatment for all significant one-off transactions, and challenged the appropriateness of assumptions and whether all the relevant accounting implications had been considered. We read the relevant legal contracts and agreed the receipt or payment of cash, where applicable. No issues were noted with the accounting treatments adopted. Given the judgemental nature of the accounting for certain one-off transactions, we assessed the disclosures made in the financial statements to check they complied with the relevant accounting standards and other pronouncements on disclosures. We particularly focused on challenging management that the disclosures were complete and sufficiently clear in highlighting the nature, accounting treatment and financial statement impact of the one-off transactions.
Fair value adjustments applied to uncollateralised derivative financial instruments *Refer to page 75 (Audit Committee Report), page 188 (Significant Accounting Policies), and page 285 (notes).* In order to comply with the IFRS definition of fair value, the Group continues to apply fair value adjustments to uncollateralised derivative positions, such as credit and debit valuation adjustments (CVA and DVA) and funding valuation adjustments (FVA). These are highly judgemental and complex calculations dependent on market data, and models developed by management. For CVA and DVA, the adjustments are sensitive to factors such as the value of the uncollateralised derivative financial instruments, their expected future market volatility and credit risks. For FVA, the methodology for calculating the adjustments continues to evolve across the banking industry.	We understood and tested the key controls over derivative valuations, which included the derivative valuation adjustments. In particular, we tested: – the key governance controls management had over the derivative valuation adjustments; – the controls over the completeness and accuracy of data inputs to the valuation models; and – the review of the derivative valuation adjustments calculated by the valuation models. We found the key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We assessed the models used by management to calculate the fair value adjustments. As there have been no significant changes to the models over the year, we challenged management to demonstrate to us that the models and the underlying methodologies remain appropriate. For the data inputs used in the models, such as the creditworthiness of the Group's counterparties, we challenged management to demonstrate their appropriateness. We also performed procedures to obtain evidence to support the inputs used in the model. We assessed the methodology for calculating FVA and compared it to our knowledge of current industry practices. The methodology, which is consistent with that used in the previous year, is acceptable. There is, however, no consensual industry practice currently for calculating FVA. We also read and assessed the disclosures made in the financial statements for valuation adjustments and concluded they are sufficient.

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the geographic structure of the Group, the accounting processes and controls, and the industry in which the Group operates.

The Group is structured into five segments being Retail, Commercial Banking, Insurance, Consumer Finance and TSB. Each of the segments comprises a number of business reporting units. The Group financial statements are a consolidation of the business reporting units.

In establishing the overall approach to the Group audit, we determined the type of work that needed to be performed over the business reporting units by us, as the Group engagement team, or auditors within PwC UK and from other PwC network firms operating under our instruction ('component auditors'). The vast majority of our audit work is undertaken by PwC UK component auditors.

Where the work was performed by component auditors, we determined the level of involvement we needed to have in the audit work at those business reporting units to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the Group financial statements as a whole. This included regular communication with the component auditors throughout the audit, the issuance of instructions, a review of the results of their work on the areas of focus and formal clearance procedures.

For the Group's individually financially significant reporting units a full scope audit was performed over their complete financial information. Additional business reporting units were selected to increase the level of audit evidence on each account balance, on which a combination of controls and substantive tests of detail were undertaken. The level of audit work was determined by our risk assessment for each account balance.

Business reporting units that are not subject to specific audit procedures are still subject to audit work on entity level controls and Group level analytical review procedures over their financial information.

The business reporting units within our audit scope contributed 87 per cent of Group total assets. The scope of our audit of Income Statement account balances was based on our risk assessment and focussed on the larger balances. The range of audit scope on Income Statement account balances was between 55 per cent and 97 per cent.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

Overall group materiality	£268 million.
How we determined it	5 per cent of adjusted profit before tax.
Rationale for benchmark applied	Our starting point was 5 per cent of profit before tax, a generally accepted auditing practice. However, profit before tax was adjusted to remove the disproportionate effect of non-recurring items, such as the costs associated with the disposal of TSB, conduct and litigation expenses and liability management losses.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £8 million as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

GOING CONCERN

Under the Listing Rules we are required to review the directors' statement, set out on page 104, in relation to going concern. We have nothing to report having performed our review.

As noted in the directors' statement, the directors have concluded that it is appropriate to prepare the financial statements using the going concern basis of accounting. The going concern basis presumes that the Group and Parent Company have adequate resources to remain in operation, and that the directors intend them to do so, for at least one year from the date the financial statements were signed. In drawing this conclusion the directors have considered:

– the regulatory capital position of the Group which is critical to the market maintaining confidence in the Group's ability to absorb losses that it may occur in a market stress; and
– the funding and liquidity position of the Group to be able to meet its liabilities as they fall due, including in a market stress.

As part of our audit we have concluded that the directors' use of the going concern basis is appropriate. However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Group's and the Parent Company's ability to continue as a going concern. In drawing our conclusion, we critically assessed the going concern assessment undertaken by management and approved by the Board of Directors. As part of our assessment we have:

– critically assessed and challenged the appropriateness of the stress scenarios used and their impact on the Group's capital and liquidity position;
– understood and challenged key economic and other assumptions used in both the capital and liquidity plan and the Group's five year operating plan; and
– substantiated the Group's unencumbered collateral position and potential to access central bank liquidity facilities.

Independent auditors' report to the members of Lloyds Banking Group plc continued

OTHER REQUIRED REPORTING

CONSISTENCY OF OTHER INFORMATION

Companies Act 2006 opinions

In our opinion:

– the information given in the Strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and

– the information given in the Corporate governance report set out on pages 62 to 72 with respect to internal control and risk management systems and about share capital structures is consistent with the financial statements.

ISAs (UK & Ireland) reporting

Under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

– information in the Annual Report is: – materially inconsistent with the information in the audited financial statements; or – apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group and Parent Company acquired in the course of performing our audit; or – otherwise misleading.	We have no exceptions to report arising from this responsibility.
– the statement given by the directors on page 104, in accordance with provision C.1.1 of the UK Corporate Governance Code (the 'Code'), that they consider the Annual Report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the Group's and Parent Company's performance, business model and strategy is materially inconsistent with our knowledge of the Group and Parent Company acquired in the course of performing our audit.	We have no exceptions to report arising from this responsibility.
– the section of the Annual Report on page 76, as required by provision C.3.8 of the Code, describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.	We have no exceptions to report arising from this responsibility.

ADEQUACY OF ACCOUNTING RECORDS AND INFORMATION AND EXPLANATIONS RECEIVED

Under the Companies Act 2006 we are required to report to you if, in our opinion:

– we have not received all the information and explanations we require for our audit; or

– adequate accounting records have not been kept by the Parent Company, or returns adequate for our audit have not been received from branches not visited by us; or

– the Parent Company financial statements and the part of the Directors' remuneration report to be audited are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

DIRECTORS' REMUNERATION

Directors' remuneration report - Companies Act 2006 opinion

In our opinion, the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

Other Companies Act 2006 reporting

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

CORPORATE GOVERNANCE STATEMENT

Under the Companies Act 2006 we are required to report to you if, in our opinion, a corporate governance statement has not been prepared by the Parent Company. We have no exceptions to report arising from this responsibility.

Under the Listing Rules we are required to review the part of the Corporate Governance Statement relating to the Parent Company's compliance with ten provisions of the UK Corporate Governance Code. We have nothing to report having performed our review.

RESPONSIBILITIES FOR THE FINANCIAL STATEMENTS AND THE AUDIT

OUR RESPONSIBILITIES AND THOSE OF THE DIRECTORS

As explained more fully in the Statement of directors' responsibilities set out on page 106, the directors are responsible for the preparation of the Group and Parent Company financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and ISAs (UK & Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Parent Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

WHAT AN AUDIT OF FINANCIAL STATEMENTS INVOLVES

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the Group's and the Parent Company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Philip Rivett (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
26 February 2015

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Strategic report
Financial results
Governance
Risk management
Financial statements
Other information

Consolidated income statement

for the year ended 31 December

	Note	2014 £ million	2013 £ million	2012 £ million
Interest and similar income		**19,211**	21,163	23,548
Interest and similar expense		**(8,551)**	(13,825)	(15,830)
Net interest income	5	**10,660**	7,338	7,718
Fee and commission income		**3,659**	4,119	4,650
Fee and commission expense		**(1,402)**	(1,385)	(1,444)
Net fee and commission income	6	**2,257**	2,734	3,206
Net trading income	7	**10,159**	16,467	15,005
Insurance premium income	8	**7,125**	8,197	8,284
Other operating income	9	**(309)**	3,249	4,700
Other income		**19,232**	30,647	31,195
Total income		**29,892**	37,985	38,913
Insurance claims	10	**(13,493)**	(19,507)	(18,396)
Total income, net of insurance claims		**16,399**	18,478	20,517
Regulatory provisions		**(3,125)**	(3,455)	(4,175)
Other operating expenses		**(10,760)**	(11,867)	(11,799)
Total operating expenses	11	**(13,885)**	(15,322)	(15,974)
Trading surplus		**2,514**	3,156	4,543
Impairment	12	**(752)**	(2,741)	(5,149)
Profit (loss) before tax		**1,762**	415	(606)
Taxation	13	**(263)**	(1,217)	(781)
Profit (loss) for the year		**1,499**	(802)	(1,387)
Profit (loss) attributable to ordinary shareholders		**1,125**	(838)	(1,471)
Profit attributable to other equity holders[1]		**287**	–	–
Profit (loss) attributable to equity holders		**1,412**	(838)	(1,471)
Profit attributable to non-controlling interests		**87**	36	84
Profit (loss) for the year		**1,499**	(802)	(1,387)
Basic earnings (loss) per share	14	**1.7p**	(1.2)p	(2.1)p
Diluted earnings (loss) per share	14	**1.6p**	(1.2)p	(2.1)p

[1] The profit after tax attributable to other equity holders of £287 million (2013: £nil; 2012: £nil) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £62 million (2013: £nil; 2012: £nil).

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

Consolidated statement of comprehensive income

for the year ended 31 December

	2014 £ million	2013 £ million	2012 £ million
Profit (loss) for the year	**1,499**	(802)	(1,387)
Other comprehensive income			
Items that will not subsequently be reclassified to profit or loss:			
Post-retirement defined benefit scheme remeasurements:			
Remeasurements before taxation	**674**	(136)	(2,136)
Taxation	**(135)**	28	491
	539	(108)	(1,645)
Items that may subsequently be reclassified to profit or loss:			
Movements in revaluation reserve in respect of available-for-sale financial assets:			
Adjustment on transfers from held-to-maturity portfolio	**–**	–	1,168
Change in fair value	**690**	(680)	900
Income statement transfers in respect of disposals	**(131)**	(629)	(3,547)
Income statement transfers in respect of impairment	**2**	18	42
Other income statement transfers	**–**	–	169
Taxation	**(13)**	277	339
	548	(1,014)	(929)
Movement in cash flow hedging reserve:			
Effective portion of changes in fair value taken to other comprehensive income	**3,896**	(1,229)	116
Net income statement transfers	**(1,153)**	(550)	(92)
Taxation	**(549)**	374	1
	2,194	(1,405)	25
Currency translation differences (tax: nil)	**(3)**	(6)	(14)
Other comprehensive income for the year, net of tax	**3,278**	(2,533)	(2,563)
Total comprehensive income for the year	**4,777**	(3,335)	(3,950)
Total comprehensive income attributable to ordinary shareholders	**4,403**	(3,371)	(4,032)
Total comprehensive income attributable to other equity holders	**287**	–	–
Total comprehensive income attributable to equity holders	**4,690**	(3,371)	(4,032)
Total comprehensive income attributable to non-controlling interests	**87**	36	82
Total comprehensive income for the year	**4,777**	(3,335)	(3,950)

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

Consolidated balance sheet

at 31 December

	Note	2014 £ million	2013 £ million
Assets			
Cash and balances at central banks		50,492	49,915
Items in the course of collection from banks		1,173	1,007
Trading and other financial assets at fair value through profit or loss	15	151,931	142,683
Derivative financial instruments[1]	16	36,128	30,804
Loans and receivables:			
Loans and advances to banks	17	26,155	25,365
Loans and advances to customers[1]	18	482,704	492,952
Debt securities		1,213	1,355
		510,072	519,672
Available-for-sale financial assets	22	56,493	43,976
Investment properties	23	4,492	4,864
Goodwill	24	2,016	2,016
Value of in-force business	25	4,864	5,335
Other intangible assets	26	2,070	2,279
Tangible fixed assets	27	8,052	7,570
Current tax recoverable		127	31
Deferred tax assets	39	4,145	5,104
Retirement benefit assets	38	1,147	98
Other assets	28	21,694	27,026
Total assets		854,896	842,380

[1] See note 1.

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

Equity and liabilities	Note	2014 £ million	2013 £ million
Liabilities			
Deposits from banks	29	10,887	13,982
Customer deposits[1]	30	447,067	439,467
Items in course of transmission to banks		979	774
Trading and other financial liabilities at fair value through profit or loss	31	62,102	43,625
Derivative financial instruments[1]	16	33,187	27,658
Notes in circulation		1,129	1,176
Debt securities in issue	32	76,233	87,102
Liabilities arising from insurance contracts and participating investment contracts	33	86,918	82,777
Liabilities arising from non-participating investment contracts	35	27,248	27,590
Unallocated surplus within insurance businesses	36	320	391
Other liabilities	37	28,105	40,456
Retirement benefit obligations	38	453	1,096
Current tax liabilities		69	147
Deferred tax liabilities	39	54	3
Other provisions	40	4,200	4,488
Subordinated liabilities	41	26,042	32,312
Total liabilities		**804,993**	803,044
Equity			
Share capital	42	7,146	7,145
Share premium account	43	17,281	17,279
Other reserves	44	13,216	10,477
Retained profits	45	5,692	4,088
Shareholders' equity		**43,335**	38,989
Other equity instruments	46	5,355	–
Total equity excluding non-controlling interests		48,690	38,989
Non-controlling interests		1,213	347
Total equity		**49,903**	39,336
Total equity and liabilities		**854,896**	842,380

[1] See note 1.

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

The directors approved the consolidated financial statements on 26 February 2015.

Lord Blackwell
Chairman

António Horta-Osório
Group Chief Executive

George Culmer
Chief Financial Officer

Consolidated statement of changes in equity

at 31 December

	Attributable to equity shareholders						
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2014	24,424	10,477	4,088	38,989	–	347	39,336
Comprehensive income							
Profit for the year	–	–	1,412	1,412	–	87	1,499
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of taxation	–	–	539	539	–	–	539
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	548	–	548	–	–	548
Movements in cash flow hedging reserve, net of tax	–	2,194	–	2,194	–	–	2,194
Currency translation differences (tax: £nil)	–	(3)	–	(3)	–	–	(3)
Total other comprehensive income	–	2,739	539	3,278	–	–	3,278
Total comprehensive income	–	2,739	1,951	4,690	–	87	4,777
Transactions with owners							
Dividends	–	–	–	–	–	(27)	(27)
Distributions on other equity instruments, net of tax	–	–	(225)	(225)	–	–	(225)
Issue of ordinary shares	3	–	–	3	–	–	3
Issue of other equity instruments (note 46)	–	–	(21)	(21)	5,355	–	5,334
Movement in treasury shares	–	–	(286)	(286)	–	–	(286)
Value of employee services:							
Share option schemes	–	–	123	123	–	–	123
Other employee award schemes	–	–	233	233	–	–	233
Adjustment on sale of non-controlling interest in TSB Banking Group plc (TSB) (note 56)	–	–	(171)	(171)	–	805	634
Other changes in non-controlling interests	–	–	–	–	–	1	1
Total transactions with owners	3	–	(347)	(344)	5,355	779	5,790
Balance at 31 December 2014	24,427	13,216	5,692	43,335	5,355	1,213	49,903

Further details of movements in the Group's share capital, reserves and other equity instruments are provided in notes 42, 43, 44, 45 and 46.

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

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2013	23,914	12,902	5,080	41,896	685	42,581
Comprehensive income						
(Loss) profit for the year	–	–	(838)	(838)	36	(802)
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of taxation	–	–	(108)	(108)	–	(108)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(1,014)	–	(1,014)	–	(1,014)
Movements in cash flow hedging reserve, net of tax	–	(1,405)	–	(1,405)	–	(1,405)
Currency translation differences (tax: £nil)	–	(6)	–	(6)	–	(6)
Total other comprehensive income	–	(2,425)	(108)	(2,533)	–	(2,533)
Total comprehensive income	–	(2,425)	(946)	(3,371)	36	(3,335)
Transactions with owners						
Dividends	–	–	–	–	(25)	(25)
Issue of ordinary shares	510	–	–	510	–	510
Movement in treasury shares	–	–	(480)	(480)	–	(480)
Value of employee services:						
Share option schemes	–	–	142	142	–	142
Other employee award schemes	–	–	292	292	–	292
Change in non-controlling interests	–	–	–	–	(349)	(349)
Total transactions with owners	510	–	(46)	464	(374)	90
Balance at 31 December 2013	24,424	10,477	4,088	38,989	347	39,336

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

Consolidated statement of changes in equity continued

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2012	23,422	13,818	8,266	45,506	674	46,180
Comprehensive income						
(Loss) profit for the year	–	–	(1,471)	(1,471)	84	(1,387)
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of taxation	–	–	(1,645)	(1,645)	–	(1,645)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(927)	–	(927)	(2)	(929)
Movements in cash flow hedging reserve, net of tax	–	25	–	25	–	25
Currency translation differences (tax: £nil)	–	(14)	–	(14)	–	(14)
Total other comprehensive income	–	(916)	(1,645)	(2,561)	(2)	(2,563)
Total comprehensive income	–	(916)	(3,116)	(4,032)	82	(3,950)
Transactions with owners						
Dividends	–	–	–	–	(56)	(56)
Issue of ordinary shares	492	–	–	492	–	492
Movement in treasury shares	–	–	(407)	(407)	–	(407)
Value of employee services:						
Share option schemes	–	–	81	81	–	81
Other employee award schemes	–	–	256	256	–	256
Change in non-controlling interests	–	–	–	–	(15)	(15)
Total transactions with owners	492	–	(70)	422	(71)	351
Balance at 31 December 2012	23,914	12,902	5,080	41,896	685	42,581

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

Consolidated cash flow statement

for the year ended 31 December

	Note	2014 £ million	2013 £ million	2012 £ million
Profit (loss) before tax		**1,762**	415	(606)
Adjustments for:				
Change in operating assets[1]	55(A)	**(872)**	20,383	49,189
Change in operating liabilities[1]	55(B)	**11,992**	(47,687)	(47,537)
Non-cash and other items	55(C)	**(2,496)**	11,382	2,081
Tax paid		**(33)**	(24)	(78)
Net cash (used in) provided by operating activities		**10,353**	(15,531)	3,049
Cash flows from investing activities				
Purchase of financial assets		**(11,533)**	(36,959)	(22,050)
Proceeds from sale and maturity of financial assets		**4,668**	21,552	37,664
Purchase of fixed assets		**(3,442)**	(2,982)	(3,003)
Proceeds from sale of fixed assets		**2,043**	2,090	2,595
Acquisition of businesses, net of cash acquired		**(1)**	(6)	(11)
Disposal of businesses, net of cash disposed	55(E)	**543**	696	37
Net cash (used in) provided by investing activities		**(7,722)**	(15,609)	15,232
Cash flows from financing activities				
Distributions on other equity instruments		**(287)**	–	–
Dividends paid to non-controlling interests		**(27)**	(25)	(56)
Interest paid on subordinated liabilities		**(2,205)**	(2,451)	(2,577)
Proceeds from issue of subordinated liabilities		**629**	1,500	–
Proceeds from issue of ordinary shares		**3**	350	170
Repayment of subordinated liabilities		**(3,023)**	(2,442)	(664)
Sale of non-controlling interest in TSB (note 56)		**634**	–	–
Other changes in non-controlling interests		**1**	–	23
Net cash (used in) provided by financing activities		**(4,275)**	(3,068)	(3,104)
Effects of exchange rate changes on cash and cash equivalents		**(6)**	(53)	(8)
Change in cash and cash equivalents		**(1,650)**	(34,261)	15,169
Cash and cash equivalents at beginning of year		**66,797**	101,058	85,889
Cash and cash equivalents at end of year	55(D)	**65,147**	66,797	101,058

[1] See note 1.

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

Notes to the consolidated financial statements

NOTE 1: BASIS OF PREPARATION

The consolidated financial statements of Lloyds Banking Group plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts. As stated on page 104, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

The Group has adopted the following new standards, amendments to standards and interpretations which became effective for financial years beginning on or after 1 January 2014:

IFRIC 21 Levies
This interpretation clarifies that the obligating event that gives rise to a liability to pay a government levy is the activity that triggers the payment of the levy as set out in the relevant legislation and that an entity's expectation of operating in a future period, irrespective of the difficulties involved in exiting a market, does not create a constructive obligation to pay a levy. The adoption of this interpretation has not had a material impact on these financial statements.

Amendments to IAS 32 Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities
The amendments to IAS 32 clarify the requirements for offsetting financial instruments and address inconsistencies identified in applying the offsetting criteria used in the standard.

In previous years the Group has separately reported, in the balance sheet, cash collateral balances and derivative positions with the same exchange; these cash collateral balances are now offset. The effect of this at 31 December 2014 has been to reduce both loans and advances to customers and derivative liabilities by £2,820 million and both customer deposits and derivative assets by £2,294 million. Comparative figures have been revised accordingly, the impact at 31 December 2013 being to reduce derivative assets by £2,321 million (31 December 2012: £923 million), loans and advances to customers by £2,329 million (31 December 2012: £461 million), customer deposits by £1,844 million (31 December 2012: £696 million) and derivative liabilities by £2,806 million (31 December 2012: £688 million).

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2014 and which have not been applied in preparing these financial statements are given in note 57.

NOTE 2: ACCOUNTING POLICIES

The Group's accounting policies are set out below. These accounting policies have been applied consistently.

(A) CONSOLIDATION

The assets, liabilities and results of Group undertakings (including structured entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures.

(1) Subsidiaries

Subsidiaries are entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through the exercise of its power. This generally accompanies a shareholding of more than one half of the voting rights although in certain circumstances a holding of less than one half of the voting rights may still result in the ability of the Group to exercise control. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of the above elements. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 9 to the parent company financial statements.

The Group consolidates collective investment vehicles if its beneficial ownership interests give it substantive rights to remove the external fund manager over the investment activities of the fund. Where a subsidiary of the Group is the fund manager of a collective investment vehicle, the Group considers a number of factors in determining whether it acts as principal and therefore controls the collective investment vehicle including: an assessment of the scope of the Group's decision making authority over the investment vehicle; the rights held by other parties including substantive removal rights without cause over the Group acting as fund manager; the remuneration to which the Group is entitled in its capacity as decision maker; and the Group's exposure to variable returns from the beneficial interest it holds in the investment vehicle. Consolidation may be appropriate in circumstances where the Group has less than a majority beneficial interest. Where a collective investment vehicle is consolidated the interests of parties other than the Group are reported in other liabilities.

Structured entities are entities that are designed so that their activities are not governed by way of voting rights. In assessing whether the Group has power over such entities in which it has an interest, the Group considers factors such as the purpose and design of the entity; its practical ability to direct the relevant activities of the entity; the nature of the relationship with the entity; and the size of its exposure to the variability of returns of the entity.

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

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

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see (E)(5) below) or share capital (see (R)(1) below). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) Joint ventures and associates

Joint ventures are joint arrangements over which the Group has joint control with other parties and has rights to the net assets of the arrangements. Associates are entities over which the Group has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of the entity, but is not control or joint control of those policies, and is generally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting and are initially recorded at cost and adjusted each year to reflect the Group's share of the post-acquisition results of the joint venture or associate based on audited accounts which are coterminous with the Group or made up to a date which is not more than three months before the Group's reporting date. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

(B) GOODWILL

Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates; goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. Goodwill arising on acquisitions of associates and joint ventures is included in the Group's investment in joint ventures and associates. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

(C) OTHER INTANGIBLE ASSETS

Other intangible assets include brands, core deposit intangible, purchased credit card relationships, customer-related intangibles and both internally and externally generated capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 7 years
Brands (which have been assessed as having finite lives)	10-15 years
Customer-related intangibles	up to 10 years
Core deposit intangible	up to 8 years
Purchased credit card relationships	5 years

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

(D) REVENUE RECOGNITION

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the effective interest method, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

including expected early redemption fees and related penalties and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account in the calculation. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see (H) below).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to life insurance and general insurance business are detailed below (see (O) below); those relating to leases are set out in (K)(2) below.

(E) FINANCIAL ASSETS AND LIABILITIES

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. The Group initially recognises loans and receivables, deposits, debt securities in issue and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

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

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

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

(1) Financial instruments at fair value through profit or loss

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

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

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

– it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases. The main type of financial assets designated by the Group at fair value through profit or loss are assets backing insurance contracts and investment contracts issued by the Group's life insurance businesses. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available-for-sale financial assets.
– the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis. As noted in (A)(2) above certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.
– where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 51(3) (Financial instruments: Financial assets and liabilities carried at fair value) 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:

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

– 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; or

– if the financial assets would not have met the definition of loans and receivables, they may be reclassified out of the held for trading category into available-for-sale financial assets in 'rare circumstances'.

(2) Available-for-sale financial assets

Debt securities and equity shares that are not classified as trading securities, at fair value through profit or loss, held-to-maturity investments or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Available-for-sale financial assets are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

(3) Loans and receivables

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

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

(4) Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity other than:

– those that the Group designates upon initial recognition as at fair value through profit or loss;

– those that the Group designates as available-for-sale; and

– those that meet the definition of loans and receivables.

These are initially recognised at fair value including direct and incremental transaction costs and measured subsequently at amortised cost, using the effective interest method, less any provision for impairment.

A sale or reclassification of a more than insignificant amount of held-to-maturity investments would result in the reclassification of all held-to-maturity investments to available-for-sale financial assets.

(5) Borrowings

Borrowings (which include deposits from banks, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense.

Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, net of tax, as distributions from equity in the period in which they are paid.

An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss.

(6) Sale and repurchase agreements (including securities lending and borrowing)

Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities borrowing and lending transactions are typically secured; collateral takes the form of securities or cash advanced or received. Securities lent to counterparties are retained on the balance sheet. Securities borrowed are not recognised on the balance sheet, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability. Cash collateral given or received is treated as a loan and receivable or customer deposit.

(F) DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 51(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

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

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

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

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

(1) Fair value hedges

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

(2) Cash flow hedges

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

(3) Net investment hedges

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instrument used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

(G) OFFSET

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. Cash collateral on exchange traded derivative transactions is presented gross unless the collateral cash flows are always settled net with the derivative cash flows. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

(H) IMPAIRMENT OF FINANCIAL ASSETS

(1) Assets accounted for at amortised cost

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition of the financial asset and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

Where such an event has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's commercial lending portfolios. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances in the Group's retail portfolios in both the Retail and Consumer Finance divisions that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

Individual assessment

In respect of individually significant financial assets in the Group's commercial lending portfolios, assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watchlist where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that would lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower; (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate; (iii) disappearance of an active market because of financial difficulties; or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable.

For impaired debt instruments which are held at amortised cost, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows. A reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment.

Collective assessment

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

Homogenous groups of loans

In respect of portfolios of smaller balance, homogenous loans, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

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

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

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data about economic and credit conditions (including unemployment rates and borrowers' behaviour) to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

Incurred but not yet identified impairment

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

Loan renegotiations and forbearance

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

Write offs

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

Debt for equity exchanges

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

(2) Available-for-sale financial assets

The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer, assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

(I) INVESTMENT PROPERTY

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital appreciation or both. The Group's investment property primarily relates to property held for long-term rental yields and capital appreciation within the life insurance funds. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income.

(J) TANGIBLE FIXED ASSETS

Tangible fixed assets are included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

– Freehold/long and short leasehold premises: shorter of 50 years and the remaining period of the lease.

– Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease.

Equipment:

– Fixtures and furnishings: 10-20 years.

– Other equipment and motor vehicles: 2-8 years.

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

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

(K) LEASES

(1) As lessee

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

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

(2) As lessor

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

Operating lease assets are included within tangible fixed assets at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

The Group evaluates non-lease arrangements such as outsourcing and similar contracts to determine if they contain a lease which is then accounted for separately.

(L) EMPLOYEE BENEFITS

Short-term employee benefits, such as salaries, paid absences, performance-based cash awards and social security costs are recognised over the period in which the employees provide the related services.

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Full actuarial valuations of the Group's principal defined benefit schemes are carried out every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method. 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.

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

The Group's income statement charge includes the current service cost of providing pension benefits, past service costs, net interest expense (income), and plan administration costs that are not deducted from the return on plan assets. Past service costs, which represents the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment, are recognised when the plan amendment or curtailment occurs. Net interest expense (income) is calculated by applying the discount rate at the beginning of the period to the net defined benefit liability or asset.

Remeasurements, comprising actuarial gains and losses, the return on plan assets (excluding amounts included in net interest expense (income) and net of the cost of managing the plan assets), and the effect of changes to the asset ceiling (if applicable) are reflected immediately in the balance sheet with a charge or credit recognised in other comprehensive income in the period in which they occur. Remeasurements recognised in other comprehensive income are reflected immediately in retained profits and will not subsequently be reclassified to profit or loss.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

The costs of the Group's defined contribution plans are charged to the income statement in the period in which they fall due.

The accounting for share-based compensation is set out in (M) below.

(M) SHARE-BASED COMPENSATION

The Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments, with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model or a Monte Carlo simulation. 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, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

(N) TAXATION

Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

For the Group's long-term insurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on shareholders' 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 substantively enacted by the balance sheet date which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the gain or loss.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

(O) INSURANCE

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

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

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

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

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

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

The general insurance business issues only insurance contracts.

(1) Life insurance business

(i) Accounting for insurance and participating investment contracts

Premiums and claims

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

Liabilities

– *Insurance and participating investment contracts in the Group's with-profit funds*

Liabilities of the Group's with-profit funds, including guarantees and options embedded within products written by these funds, are stated at their realistic values in accordance with the Prudential Regulation Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in the unallocated surplus (see below). Further details on the realistic capital regime are given on page 165. Changes in the value of these liabilities are recognised in the income statement through insurance claims.

– *Insurance and participating investment contracts which are not unit-linked or in the Group's with-profit funds*

A liability for contractual benefits that are expected to be incurred in the future is recorded when the premiums are recognised. The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date allowing for probabilities of occurrence. The liability will vary with movements in interest rates and with the cost of life insurance and annuity benefits where future mortality is uncertain.

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs.

Changes in the value of these liabilities are recognised in the income statement through insurance claims.

– *Insurance and participating investment contracts which are unit-linked*

Liabilities for unit-linked insurance contracts and participating investment contracts are stated at the bid value of units plus an additional allowance where appropriate (such as for any excess of future expenses over charges). The liability is increased or reduced by the change in the unit prices and is reduced by policy administration fees, mortality and surrender charges and any withdrawals. Changes in the value of the liability are recognised in the income statement through insurance claims. Benefit claims in excess of the account balances incurred in the period are also charged through insurance claims. Revenue consists of fees deducted for mortality, policy administration and surrender charges.

Unallocated surplus

Any amounts in the with-profit funds not yet determined as being due to policyholders or shareholders are recognised as an unallocated surplus which is shown separately from liabilities arising from insurance contracts and participating investment contracts.

(ii) Accounting for non-participating investment contracts

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment returns (including movements in fair value and investment income) allocated to those contracts are recognised in the income statement through insurance claims.

Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the non-participating investment contract liability.

The Group receives investment management fees in the form of an initial adjustment or charge to the amount invested. These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them over the estimated lives of the contracts, in line with the provision of investment management services.

Costs which are directly attributable and incremental to securing new non-participating investment contracts are deferred. This asset is subsequently amortised over the period of the provision of investment management services and is reviewed for impairment in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately through fee and commission expense in the income statement. All other costs are recognised as expenses when incurred.

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

(iii) Value of in-force business

The Group recognises as an asset the value of in-force business in respect of insurance contracts and participating investment contracts. The asset represents the present value of the shareholders' interest in the profits expected to emerge from those contracts written at the balance sheet date. This is determined after making appropriate assumptions about future economic and operating conditions such as future mortality and persistency rates and includes allowances for both non-market risk and for the realistic value of financial options and guarantees. Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. The asset in the consolidated balance sheet is presented gross of attributable tax and movements in the asset are reflected within other operating income in the income statement.

The Group's contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers are measured at fair value at the date of acquisition. The resulting asset is amortised over the estimated lives of the contracts. At each reporting date an assessment is made to determine if there is any indication of impairment. Where impairment exists, the carrying value of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement.

(2) General insurance business

The Group both underwrites and acts as intermediary in the sale of general insurance products. Underwriting premiums are included in insurance premium income, net of refunds, in the period in which insurance cover is provided to the customer; premiums received relating to future periods are deferred in the balance sheet within liabilities arising from insurance contracts and participating investment contracts and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

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

(3) Liability adequacy test

At each balance sheet date liability adequacy tests are performed to ensure the adequacy of insurance and participating investment contract liabilities net of related deferred cost assets and value of in-force business. In performing these tests current best estimates of discounted future contractual cash flows and claims handling and policy administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to the income statement, initially by writing off the relevant assets and subsequently by establishing a provision for losses arising from liability adequacy tests.

(4) Reinsurance

Contracts entered into by the Group with reinsurers under which the Group is compensated for benefits payable on one or more contracts issued by the Group are recognised as assets arising from reinsurance contracts held. Where the underlying contracts issued by the Group are classified as insurance contracts and the reinsurance contract transfers significant insurance risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the underlying contracts issued by the Group are classified as non-participating investment contracts and the reinsurance contract transfers financial risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as non-participating investment contracts.

Assets arising from reinsurance contracts held – Classified as insurance contracts

Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Premiums payable for reinsurance contracts are recognised as an expense when due within insurance premium income. Changes in the reinsurance recoverable assets are recognised in the income statement through insurance claims.

Assets arising from reinsurance contracts held – Classified as non-participating investment contracts

These contracts are accounted for as financial assets whose value is contractually linked to the fair values of financial assets within the reinsurers' investment funds. Investment returns (including movements in fair value and investment income) allocated to these contracts are recognised in insurance claims. Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the assets arising from reinsurance contracts held.

(P) FOREIGN CURRENCY TRANSLATION

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The consolidated financial statements are presented in sterling, which is the Company's functional and presentation currency.

Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value

NOTE 2: ACCOUNTING POLICIES (CONTINUED)

through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

– The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.
– The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see (F)(3) above). On disposal of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal.

(Q) PROVISIONS AND CONTINGENT LIABILITIES

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

The Group recognises provisions in respect of vacant leasehold property where the unavoidable costs of the present obligations exceed anticipated rental income.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

Provision is made for irrevocable undrawn loan commitments if it is probable that the facility will be drawn and result in the recognition of an asset at an amount less than the amount advanced.

(R) SHARE CAPITAL

(1) Share issue costs

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

(2) Dividends

Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

(3) Treasury shares

Where the Company or any member of the Group purchases the Company's share capital, the consideration paid is deducted from shareholders' equity as treasury shares until they are cancelled. Where such shares are subsequently sold or reissued, any consideration received is included in shareholders' equity.

(S) CASH AND CASH EQUIVALENTS

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

NOTE 3: CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows.

ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES

At 31 December 2014 gross loans and receivables totalled £516,612 million (2013: £531,763 million) against which impairment allowances of £6,540 million (2013: £12,091 million) had been made (see note 21). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2 (H)(1); this note also provides an overview of the methodologies applied.

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's commercial lending portfolios. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the

Notes to the consolidated financial statements continued

NOTE 3: CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)

resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in assessing the borrower's cash flows and debt servicing capability together with the realisable value of collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the retail portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were ten per cent lower than those estimated at 31 December 2014, the impairment charge would increase by approximately £195 million in respect of UK mortgages and a further £6 million in respect of Irish mortgages.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the Commercial Banking division, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £53 million (at 31 December 2013, a one month increase in the loss emergence period would have increased the collective unimpaired provision by an estimated £105 million).

RECOVERABILITY OF DEFERRED TAX ASSETS

At 31 December 2014 the Group carried deferred tax assets on its balance sheet of £4,145 million (2013: £5,104 million) and deferred tax liabilities of £54 million (2013: £3 million) (note 39). This presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 39 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward.

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

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

– The expected future economic outlook as set out in the Group Chief Executive's Review and Market Overview;

– The retail banking business disposal as required by the European Commission; and

– Future regulatory change.

The Group's total deferred tax asset includes £5,758 million (2013: £6,338 million) in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc and Lloyds Bank plc.

The deferred tax asset is expected to be utilised over different time periods in each of the entities in which the losses arise. Under current UK tax law there is no expiry date for unused tax losses. The losses are still expected to be fully utilised by 2019.

In December 2014 the Chancellor of the Exchequer announced proposals to restrict to 50 per cent the amount of banks' profits that can be offset by carried forward tax losses for the purposes of calculating corporation tax liabilities. These proposals are expected to be included in the Finance Bill 2015 and, if passed into law, will take effect in respect of profits arising after 1 April 2015. The Group estimates that these proposals will result in no change to the level of deferred tax recognition although it will increase the period over which it expects to fully utilise its tax losses from 2019 to 2025.

As disclosed in note 39, deferred tax assets totalling £921 million (2013: £802 million) have not been recognised in respect of certain capital losses carried forward, trading losses carried forward and unrelieved foreign tax credits as there are no predicted future capital or taxable profits against which these losses can be recognised.

RETIREMENT BENEFIT OBLIGATIONS

The net asset recognised in the balance sheet at 31 December 2014 in respect of the Group's retirement benefit obligations was £694 million (comprising an asset of £1,147 million and a liability of £453 million) (2013: a net liability of £998 million comprising an asset of £98 million and a liability of £1,096 million) related to post-retirement defined benefit schemes. The defined benefit pension schemes' net accounting surplus totalled £890 million (2013: deficit of £787 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

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

NOTE 3: CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (CONTINUED)

The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in note 38.

VALUATION OF ASSETS AND LIABILITIES ARISING FROM LIFE INSURANCE BUSINESS

At 31 December 2014, the Group recognised a value of in-force business asset of £4,446 million (2013: £4,874 million) and an acquired value of in-force business asset of £418 million (2013: £461 million). The value of in-force business asset represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. The acquired value of in-force business asset represents the contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers. The methodology used to value these assets is set out in note 25. The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to these assets. The key assumptions that have been made in determining the carrying value of the value of in-force business assets at 31 December 2014 are set out in note 25.

At 31 December 2014, the Group carried total liabilities arising from insurance contracts and participating investment contracts of £86,918 million (2013: £82,777 million). The methodology used to value these liabilities is described in note 33. Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The key assumptions that have been made in determining the carrying value of these liabilities are set out in note 33.

The effect on the Group's profit before tax and shareholders' equity of changes in key assumptions used in determining the life insurance assets and liabilities is set out in note 34.

PAYMENT PROTECTION INSURANCE AND OTHER REGULATORY PROVISIONS

At 31 December 2014, the Group carried provisions of £3,378 million (2013: £3,815 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches, principally the misselling of payment protection insurance. Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the number of future complaints, the extent to which they will be upheld and the average cost of redress. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

Note 40 contains more detail on the nature of the assumptions that have been made and key sensitivities.

FAIR VALUE OF FINANCIAL INSTRUMENTS

In accordance with IFRS 13 *Fair Value Measurement*, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques including discounted cash flow analysis and valuation models. These valuation techniques involve management judgement and estimates the extent of which depends on the complexity of the instrument and the availability of market observable information.

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

At 31 December 2014, the Group classified £8,145 million of financial assets, including £2,771 million of derivatives, and £1,512 million of financial liabilities, including £1,456 million of derivatives, as level 3. Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out in note 51. Details about sensitivities to market risk arising from trading assets and other treasury positions can be found in the Risk Management section on page 138.

Notes to the consolidated financial statements continued

NOTE 4: SEGMENTAL ANALYSIS

Lloyds Banking Group provides a wide range of banking and financial services in the UK and in certain locations overseas.

The Group Executive Committee has been determined to be the chief operating decision maker for the Group. The Group's operating segments reflect its organisational and management structures. The Group Executive Committee reviews the Group's internal reporting based around these segments in order to assess performance and allocate resources. GEC considers interest income and expense on a net basis and consequently the total interest income and expense for all reportable segments is presented net. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities.

The segmental results and comparatives are presented on an underlying basis, the basis reviewed by the chief operating decision maker. The effects of asset sales, volatile items, liability management, simplification costs, TSB build and dual running costs, regulatory provisions, certain past service pension credits or charges, the amortisation of purchased intangible assets and the unwind of acquisition-related fair value adjustments are excluded in arriving at underlying profit.

Following a reorganisation effective from 1 January 2014, the Group's activities are now organised into five financial reporting segments: Retail; Commercial Banking; Consumer Finance; Insurance and TSB. The most significant changes to the segmental structure are:

– The Wealth business has been integrated into the Retail division;

– The Consumer Finance division now includes credit cards, asset finance and the European online deposits businesses; the Retail and Commercial Banking credit cards businesses have transferred into Consumer Finance;

– TSB operates as a standalone listed entity following the IPO;

– The remaining portfolio of assets which are outside of the Group's risk appetite is managed within Other.

In addition certain regulatory costs, such as UK bank levy and charges in relation to the Financial Services Compensation Scheme, which were previously reported in Central items, are now attributed to the operating divisions. Comparative figures have been restated for all of these changes. The Group's underlying profit and statutory results are unchanged as a result of these restatements.

Retail offers a broad range of financial service products, including current accounts, savings, personal loans and mortgages, to UK retail customers, incorporating wealth and small business customers. It is also a distributor of insurance, protection and credit cards and a range of long-term savings and investment products.

Commercial Banking is client led, focusing on SME, Mid Markets, Global Corporates and Financial Institution clients providing products across Lending, Global Transaction Banking, Financial Markets and Debt Capital Markets and private equity financing through Lloyds Development Capital.

Consumer Finance comprises the Group's consumer and corporate Credit Card businesses, along with the Black Horse motor financing and Lex Autolease car leasing businesses in Asset Finance. The Group's European deposits and Dutch retail mortgage businesses are managed within Asset Finance.

Insurance is a core part of Lloyds Banking Group and is focused on four key markets: Corporate Pensions, Protection, Retirement and Home Insurance, to enable customers to protect themselves today and prepare for a secure financial future.

TSB is a separately listed multi-channel retail banking business with branches in England, Wales and Scotland; it has a digital distribution platform and four telephony contact centres. It serves retail and small business customers; providing a full range of retail banking products.

Other includes certain assets previously reported as outside of the Group's risk appetite and the results and gains on sale relating to businesses disposed in 2013 and 2014. Other also includes income and expenditure not recharged to divisions, including the costs of certain central and head office functions and the costs of managing the Group's technology platforms, branch and head office property estate, operations (including payments, banking operations and collections) and sourcing, the costs of which are predominantly recharged to the other divisions. It also reflects other items not recharged to the divisions.

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.

NOTE 4: SEGMENTAL ANALYSIS (CONTINUED)

For the majority of those derivative contracts entered into by business units for risk management purposes, the business unit recognises the net interest income or expense on an accrual accounting basis and transfers the remainder of the movement in the fair value of the derivative to the central group segment where the resulting accounting volatility is managed where possible through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the derivative and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results and leads to accounting volatility, which is managed centrally and reported within Other.

	Retail £m	Commercial Banking £m	Consumer Finance £m	Insurance £m	TSB £m	Other £m	Underlying basis total £m
Year ended 31 December 2014							
Net interest income	7,079	2,480	1,290	(131)	786	257	11,761
Other income (net of insurance claims)	1,212	1,956	1,364	1,725	140	210	6,607
Total underlying income, net of insurance claims	8,291	4,436	2,654	1,594	926	467	18,368
Total costs	(4,464)	(2,147)	(1,429)	(672)	(370)	(330)	(9,412)
Impairment	(599)	(83)	(215)	–	(98)	(205)	(1,200)
Underlying profit (loss)	3,228	2,206	1,010	922	458	(68)	7,756
External income	9,034	3,800	2,803	1,206	912	613	18,368
Inter-segment income	(743)	636	(149)	388	14	(146)	–
Segment income	8,291	4,436	2,654	1,594	926	467	18,368
Segment external assets	317,246	241,754	25,646	150,615	27,006	92,629	854,896
Segment customer deposits	285,539	119,882	14,955	–	24,625	2,066	447,067
Segment external liabilities	295,880	231,400	18,581	144,921	25,085	89,126	804,993
Other segment items reflected in income statement above:							
Depreciation and amortisation	353	153	773	127	17	172	1,595
(Decrease) increase in value of in-force business	–	–	–	(428)	–	–	(428)
Defined benefit scheme charges	121	37	9	9	7	161	344
Other segment items:							
Additions to fixed assets	419	242	1,633	449	44	655	3,442
Investments in joint ventures and associates at end of year	12	–	–	–	–	62	74

Notes to the consolidated financial statements continued

NOTE 4: SEGMENTAL ANALYSIS (CONTINUED)

	Retail £m	Commercial Banking £m	Consumer Finance £m	Insurance £m	TSB £m	Other £m	Underlying basis total £m
Year ended 31 December 2013[1]							
Net interest income	6,500	2,113	1,333	(107)	615	431	10,885
Other income (net of insurance claims)	1,435	2,259	1,359	1,864	163	840	7,920
Total underlying income, net of insurance claims	7,935	4,372	2,692	1,757	778	1,271	18,805
Total costs	(4,160)	(2,084)	(1,384)	(669)	(563)	(775)	(9,635)
Impairment	(760)	(398)	(343)	–	(109)	(1,394)	(3,004)
Underlying profit (loss)	3,015	1,890	965	1,088	106	(898)	6,166
External income	8,526	2,959	2,772	2,439	863	1,246	18,805
Inter-segment income	(591)	1,413	(80)	(682)	(85)	25	–
Segment income	7,935	4,372	2,692	1,757	778	1,271	18,805
Segment external assets[2]	317,146	227,771	25,025	155,378	24,084	92,976	842,380
Segment customer deposits[2]	283,189	111,654	18,733	–	23,100	2,791	439,467
Segment external liabilities[2]	300,412	206,729	21,868	149,445	23,289	101,301	803,044
Other segment items reflected in income statement above:							
Depreciation and amortisation	299	136	754	136	33	187	1,545
(Decrease) increase in value of in-force business	–	–	–	425	–	(9)	416
Defined benefit scheme charges	109	44	6	12	15	213	399
Other segment items:							
Additions to fixed assets	446	160	1,320	373	19	664	2,982
Investments in joint ventures and associates at end of year	23	–	1	–	–	77	101

[1] Restated to reflect changes in Divisional structure – see page 202.

[2] See note 1.

NOTE 4: SEGMENTAL ANALYSIS (CONTINUED)

	Retail £m	Commercial Banking £m	Consumer Finance £m	Insurance £m	TSB £m	Other £m	Underlying basis total £m
Year ended 31 December 2012[1]							
Net interest income	6,037	1,971	1,284	(87)	558	572	10,335
Other income (net of insurance claims)	1,406	2,254	1,396	1,880	179	936	8,051
Total underlying income, net of insurance claims	7,443	4,225	2,680	1,793	737	1,508	18,386
Total costs	(4,236)	(2,011)	(1,327)	(710)	(580)	(1,260)	(10,124)
Impairment	(914)	(664)	(407)	–	(118)	(3,594)	(5,697)
Underlying profit (loss)	2,293	1,550	946	1,083	39	(3,346)	2,565
External income	8,896	1,680	2,625	2,439	818	1,928	18,386
Inter-segment income	(1,453)	2,545	55	(646)	(81)	(420)	–
Segment income	7,443	4,225	2,680	1,793	737	1,508	18,386
Segment external assets[2]	319,140	267,679	24,156	152,100	21,261	148,501	932,837
Segment customer deposits[2]	276,911	102,858	20,228	–	22,712	3,507	426,216
Segment external liabilities[2]	304,153	236,189	21,993	152,600	22,712	152,609	890,256
Other segment items reflected in income statement above:							
Depreciation and amortisation	312	142	786	95	34	195	1,564
Increase (decrease) in value of in-force business	–	–	–	273	–	(4)	269
Defined benefit scheme charges	103	54	10	23	26	(106)	110
Other segment items:							
Additions to fixed assets	449	161	1,328	378	19	668	3,003
Investments in joint ventures and associates at end of year	185	–	6	–	–	122	313

[1] Restated to reflect changes in Divisional structure – see page 202.

[2] See note 1.

Notes to the consolidated financial statements continued

NOTE 4: SEGMENTAL ANALYSIS (CONTINUED)

RECONCILIATION OF UNDERLYING BASIS TO STATUTORY RESULTS

The underlying basis is the basis on which financial information is presented to the chief operating decision maker which excludes certain items included in the statutory results. The table below reconciles the statutory results to the underlying basis.

	Lloyds Banking Group statutory £m	Removal of: Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Regulatory provisions[2] £m	Fair value unwind £m	Underlying basis £m
Year ended 31 December 2014							
Net interest income	**10,660**	**(7)**	**–**	**482**	**–**	**626**	**11,761**
Other income, net of insurance claims	**5,739**	**1,141**	**228**	**(614)**	**–**	**113**	**6,607**
Total underlying income, net of insurance claims	**16,399**	**1,134**	**228**	**(132)**	**–**	**739**	**18,368**
Operating expenses	**(13,885)**	**1,175**	**–**	**132**	**3,125**	**41**	**(9,412)**
Impairment	**(752)**	**(197)**	**–**	**–**	**–**	**(251)**	**(1,200)**
Underlying (loss) profit	**1,762**	**2,112**	**228**	**–**	**3,125**	**529**	**7,756**

[1] Comprises the effects of asset sales (gain of £138 million), volatile items (gain of £286 million), liability management (loss of £1,386 million), Simplification costs related to severance, IT and business costs of implementation (£966 million), TSB build and dual running costs (£558 million), the past service pension credit of £710 million (which represents the curtailment credit of £843 million following the Group's decision to reduce the cap on pensionable pay partly offset by the cost of other changes to the pay, benefits and reward offered to employees) and the amortisation of purchased intangibles (£336 million).

[2] Comprises the payment protection insurance provision (£2,200 million) and other regulatory provisions (£925 million).

	Lloyds Banking Group statutory £m	Removal of: Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Regulatory provisions[2] £m	Fair value unwind £m	Underlying basis £m
Year ended 31 December 2013							
Net interest income	7,338	(14)	–	2,930	–	631	10,885
Other income, net of insurance claims	11,140	460	(668)	(3,074)	–	62	7,920
Total underlying income, net of insurance claims	18,478	446	(668)	(144)	–	693	18,805
Operating expenses	(15,322)	2,041	–	144	3,455	47	(9,635)
Impairment	(2,741)	249	–	–	–	(512)	(3,004)
Underlying (loss) profit	415	2,736	(668)	–	3,455	228	6,166

[1] Comprises the effects of asset sales (gain of £100 million), volatile items (loss of £678 million), liability management (loss of £142 million), Simplification costs related to severance, IT and business costs of implementation (£830 million), TSB build and dual running costs (£687 million), the amortisation of purchased intangibles (£395 million) and the past service pensions charge (£104 million, see note 11).

[2] Comprises the payment protection insurance provision (£3,050 million) and other regulatory provisions (£405 million).

	Lloyds Banking Group statutory £m	Removal of: Acquisition related and other items[1] £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Regulatory provisions[2] £m	Fair value unwind £m	Underlying basis £m
Year ended 31 December 2012							
Net interest income	7,718	(199)	(8)	2,587	–	237	10,335
Other income, net of insurance claims	12,799	(1,691)	(304)	(2,760)	50	(43)	8,051
Total underlying income, net of insurance claims	20,517	(1,890)	(312)	(173)	50	194	18,386
Operating expenses	(15,974)	1,478	–	173	4,175	24	(10,124)
Impairment	(5,149)	320	–	–	–	(868)	(5,697)
Underlying (loss) profit	(606)	(92)	(312)	–	4,225	(650)	2,565

[1] Comprises the effects of asset sales (gain of £2,547 million), volatile items (loss of £748 million), liability management (loss of £229 million), Simplification costs related to severance, IT and business costs of implementation (£676 million), TSB build and dual running costs (£570 million), the amortisation of purchased intangibles (£482 million) and the past service pensions credit (£250 million, see note 11).

[2] Comprises the payment protection insurance provision (£3,575 million) and other regulatory provisions (£650 million).

GEOGRAPHICAL AREAS

Following the continuing reduction in the Group's non-UK activities, an analysis between UK and non-UK activities is no longer provided.

NOTE 5: NET INTEREST INCOME

	Weighted average effective interest rate					
	2014 %	2013[1] %	2012 %	**2014 £m**	2013 £m	2012 £m
Interest and similar income:						
Loans and advances to customers	**3.53**	3.84	3.94	**17,806**	19,928	21,600
Loans and advances to banks	**0.52**	0.45	0.54	**406**	457	603
Debt securities held as loans and receivables	**2.57**	1.52	4.77	**42**	32	433
Interest receivable on loans and receivables	**3.12**	3.28	3.38	**18,254**	20,417	22,636
Available-for-sale financial assets	**1.90**	1.92	1.99	**957**	746	624
Held-to-maturity investments	**–**	–	2.80	**–**	–	288
Total interest and similar income	**3.03**	3.20	3.31	**19,211**	21,163	23,548
Interest and similar expense:						
Deposits from banks, excluding liabilities under sale and repurchase transactions	**0.74**	0.65	1.14	**(86)**	(129)	(324)
Customer deposits, excluding liabilities under sale and repurchase transactions	**1.15**	1.54	1.69	**(4,781)**	(6,119)	(6,637)
Debt securities in issue	**0.63**	1.30	2.04	**(552)**	(1,451)	(3,043)
Subordinated liabilities	**8.44**	8.57	7.41	**(2,475)**	(2,956)	(2,783)
Liabilities under sale and repurchase agreements	**2.61**	1.21	1.47	**(55)**	(79)	(245)
Interest payable on liabilities held at amortised cost	**1.45**	1.88	2.08	**(7,949)**	(10,734)	(13,032)
Other	**3.23**	12.08	8.90	**(602)**	(3,091)	(2,798)
Total interest and similar expense	**1.51**	2.32	2.41	**(8,551)**	(13,825)	(15,830)
Net interest income				**10,660**	7,338	7,718

[1] See note 1.

Included within interest and similar income is £407 million (2013: £901 million; 2012: £1,133 million) in respect of impaired financial assets. Net interest income also includes a credit of £1,153 million (2013: credit of £550 million; 2012: credit of £92 million) transferred from the cash flow hedging reserve (see note 44).

NOTE 6: NET FEE AND COMMISSION INCOME

	2014 £m	2013 £m	2012 £m
Fee and commission income:			
Current accounts	**918**	973	1,008
Credit and debit card fees	**1,050**	984	941
Other	**1,691**	2,162	2,701
Total fee and commission income	**3,659**	4,119	4,650
Fee and commission expense	**(1,402)**	(1,385)	(1,444)
Net fee and commission income	**2,257**	2,734	3,206

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 consolidated financial statements continued

NOTE 7: NET TRADING INCOME

	2014 £m	2013 £m	2012 £m
Foreign exchange translation (losses) gains	(95)	162	(167)
Gains on foreign exchange trading transactions	344	238	502
Total foreign exchange	249	400	335
Investment property gains (losses) (note 23)	513	156	(264)
Securities and other gains (see below)	9,397	15,911	14,934
Net trading income	**10,159**	**16,467**	**15,005**

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

	2014 £m	2013 £m	2012 £m
Net income arising on assets held at fair value through profit or loss:			
Debt securities, loans and advances	4,805	55	4,042
Equity shares	3,816	15,813	10,847
Total net income arising on assets held at fair value through profit or loss	8,621	15,868	14,889
Net expense arising on liabilities held at fair value through profit or loss – debt securities in issue	(75)	(93)	(576)
Total net gains arising on assets and liabilities held at fair value through profit or loss	8,546	15,775	14,313
Net (losses) gains on financial instruments held for trading	851	136	621
Securities and other gains	**9,397**	**15,911**	**14,934**

NOTE 8: INSURANCE PREMIUM INCOME

	2014 £m	2013 £m	2012 £m
Life insurance			
Gross premiums	6,397	7,382	7,391
Ceded reinsurance premiums	(142)	(182)	(222)
Net earned premiums	6,255	7,200	7,169
Non-life insurance			
Gross written premiums	869	972	1,081
Ceded reinsurance premiums	(14)	(18)	(31)
Net written premiums	855	954	1,050
Change in provision for unearned premiums (note 33(2))	18	49	72
Change in provision for ceded unearned premiums (note 33(2))	(3)	(6)	(7)
Net earned premiums	870	997	1,115
Total net earned premiums	7,125	8,197	8,284

Life insurance gross premiums can be further analysed as follows:

	2014 £m	2013 £m	2012 £m
Life and pensions	6,070	6,823	6,755
Annuities	327	549	630
Other	–	10	6
Gross premiums	6,397	7,382	7,391

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

	2014 £m	2013 £m	2012 £m
Credit protection	93	141	173
Home	773	828	904
Health	3	3	4
Gross written premiums	869	972	1,081

Notes to the consolidated financial statements continued

NOTE 9: OTHER OPERATING INCOME

	2014 £m	2013 £m	2012 £m
Operating lease rental income	**1,126**	1,120	1,145
Rental income from investment properties (note 23)	**269**	308	389
Gains less losses on disposal of available-for-sale financial assets (note 44)	**131**	629	3,547
Movement in value of in-force business (note 25)	**(428)**	416	269
Liability management	**(1,386)**	(142)	(338)
Share of results of joint ventures and associates	**32**	43	28
Other	**(53)**	875	(340)
Total other operating income	**(309)**	3,249	4,700

LIABILITY MANAGEMENT

In April 2014, the Group completed concurrent Sterling, Euro and Dollar exchange offers with holders of certain series of its Enhanced Capital Notes (ECNs) to exchange the ECNs for new Additional Tier 1 (AT1) securities. In addition the Group completed a tender offer to eligible retail holders outside the United States to sell their Sterling-denominated ECNs for cash. The exchange offers completed with the equivalent of £5.0 billion of ECNs being exchanged for the equivalent of £5.35 billion of AT1 securities, before issue costs. The retail tender offer completed with approximately £58.5 million of ECNs being repurchased for cash. A loss of £1,362 million has been recognised in relation to these exchange and tender transactions in the year ended 31 December 2014.

Losses of £24 million arose in the year ended 31 December 2014 (2013: losses of £142 million; 2012: losses of £338 million) on other transactions undertaken as part of the Group's management of its wholesale funding and subordinated debt.

OTHER

On 31 March 2014 the Group completed the sale of Scottish Widows Investment Partnership, realising a gain of £128 million; this gain has been more than offset by losses on other asset sales.

During 2013 the Group had completed a number of disposals of assets and businesses, including the sale of its shareholding in St James's Place plc (profit of £540 million), a portfolio of US residential mortgage-backed securities (profit of £538 million), its Spanish retail banking operations (loss of £256 million), its Australian operations (profit of £49 million) and its German life insurance business (this disposal completed in the first quarter of 2014, but an impairment of £382 million was recognised in the year ended 31 December 2013).

NOTE 10: INSURANCE CLAIMS

Insurance claims comprise:

	2014 £m	2013 £m	2012 £m
Life insurance and participating investment contracts			
Claims and surrenders:			
Gross	(7,506)	(8,495)	(8,719)
Reinsurers' share	69	108	185
	(7,437)	(8,387)	(8,534)
Change in insurance and participating investment contracts (note 33(1)):			
Change in gross liabilities	(4,392)	(5,184)	(4,284)
Change in assets arising from reinsurance contracts held	8	(48)	(186)
	(4,384)	(5,232)	(4,470)
Change in non-participating investment contracts:			
Change in gross liabilities	(1,448)	(5,409)	(5,058)
Change in assets arising from reinsurance contracts held	32	–	–
	(1,416)	(5,409)	(5,058)
Change in unallocated surplus (note 36)	74	(123)	31
Total life insurance and participating investment contracts	(13,163)	(19,151)	(18,031)
Non-life insurance			
Claims and claims paid:			
Gross	(400)	(388)	(439)
Reinsurers' share	–	–	1
	(400)	(388)	(438)
Change in liabilities (note 33(2)):			
Gross	70	33	74
Reinsurers' share	–	(1)	(1)
	70	32	73
Total non-life insurance	(330)	(356)	(365)
Total insurance claims	(13,493)	(19,507)	(18,396)
Life insurance and participating investment contracts gross claims can also be analysed as follows:			
Deaths	(549)	(611)	(618)
Maturities	(1,656)	(2,240)	(2,238)
Surrenders	(4,102)	(4,489)	(4,795)
Annuities	(884)	(860)	(789)
Other	(315)	(295)	(279)
Total life insurance gross claims	(7,506)	(8,495)	(8,719)

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

Notes to the consolidated financial statements continued

NOTE 11: OPERATING EXPENSES

	2014 £m	2013 £m	2012 £m
Staff costs:			
Salaries	**3,178**	3,331	3,411
Performance-based compensation	**390**	473	395
Social security costs	**398**	385	383
Pensions and other post-retirement benefit schemes (note 38):			
Past service charges (credits)[1]	**(822)**	104	(250)
Other	**596**	654	589
	(226)	758	339
Restructuring costs	**264**	111	217
Other staff costs	**741**	783	746
	4,745	5,841	5,491
Premises and equipment:			
Rent and rates	**424**	467	488
Hire of equipment	**12**	15	17
Repairs and maintenance	**221**	178	174
Other	**234**	310	270
	891	970	949
Other expenses:			
Communications and data processing	**1,118**	1,169	1,082
Advertising and promotion	**336**	313	314
Professional fees	**481**	425	550
UK bank levy	**237**	238	179
Other	**1,017**	971	1,108
	3,189	3,116	3,233
Depreciation and amortisation:			
Depreciation of tangible fixed assets (note 27)	**1,391**	1,374	1,431
Amortisation of acquired value of in-force non-participating investment contracts (note 25)	**43**	54	79
Amortisation of other intangible assets (note 26)	**501**	512	616
	1,935	1,940	2,126
Total operating expenses, excluding regulatory provisions	**10,760**	11,867	11,799
Regulatory provisions:			
Payment protection insurance provision (note 40)	**2,200**	3,050	3,575
Other regulatory provisions (note 40)[2]	**925**	405	600
	3,125	3,455	4,175
Total operating expenses	**13,885**	15,322	15,974

[1] On 11 March 2014 the Group announced a change to its defined benefit pension schemes, revising the existing cap on the increases in pensionable pay used in calculating the pension benefit, from 2 per cent to nil with effect from 2 April 2014. The effect of this change was to reduce the Group's retirement benefit obligations recognised on the balance sheet by £843 million with a corresponding curtailment gain recognised in the income statement. This has been partly offset by a charge of £21 million following changes to pension arrangements for staff within the TSB business.

In 2013, the Group agreed certain changes to early retirement and commutation factors in two of its principal defined benefit pension schemes, resulting in a curtailment cost of £104 million recognised in the Group's income statement in the year ended 31 December 2013.

During 2012, following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change was a reduction in the Group's defined benefit obligation of £258 million, recognised in the Group's income statement in 2012, net of a charge of £8 million resulting from a change to the commutation factors in one of the Group's smaller schemes.

[2] Regulatory provisions of £50 million were charged against income in 2012.

NOTE 11: OPERATING EXPENSES (CONTINUED)

PERFORMANCE-BASED COMPENSATION

The table below analyses the Group's performance-based compensation costs (excluding branch-based sales incentives) between those relating to the current performance year and those relating to earlier years.

	2014 £m	2013 £m	2012 £m
Performance-based compensation expense comprises:			
Awards made in respect of the year ended 31 December	**324**	394	362
Awards made in respect of earlier years	**66**	79	33
	390	473	395
Performance-based compensation expense deferred until later years comprises:			
Awards made in respect of the year ended 31 December	**152**	47	37
Awards made in respect of earlier years	**32**	30	15
	184	77	52

Performance-based awards expensed in 2014 include cash awards amounting to £104 million (2013: £126 million; 2012: £128 million).

AVERAGE HEADCOUNT

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

	2014	2013	2012
UK	**94,241**	96,001	110,295
Overseas	**847**	1,868	3,322
Total	**95,088**	97,869	113,617

FEES PAYABLE TO THE AUDITORS

Fees payable to the Company's auditors by the Group are as follows:

	2014 £m	2013 £m	2012 £m
Fees payable for the audit of the Company's current year annual report	**1.4**	1.5	1.6
Fees payable for other services:			
Audit of the Company's subsidiaries pursuant to legislation	**15.5**	17.4	18.0
Other services supplied pursuant to legislation	**2.1**	2.6	2.7
Total audit fees	**19.0**	21.5	22.3
Other services – audit related fees	**9.1**	4.5	1.2
Total audit and audit related fees	**28.1**	26.0	23.5
Services relating to taxation:			
Taxation compliance services	**0.2**	0.3	0.2
All other taxation advisory services	**0.3**	0.3	0.6
	0.5	0.6	0.8
Other non-audit fees:			
Services relating to corporate finance transactions	**0.3**	0.3	0.5
Other services	**3.2**	5.6	2.2
Total other non-audit fees	**3.5**	5.9	2.7
Total fees payable to the Company's auditors by the Group	**32.1**	32.5	27.0

Notes to the consolidated financial statements continued

NOTE 11: OPERATING EXPENSES (CONTINUED)

The following types of services are included in the categories listed above:

Audit fees: This category includes fees in respect of the audit of the Group's annual financial statements and other services in connection with regulatory filings. Other services supplied pursuant to legislation relate primarily to the costs associated with the Sarbanes-Oxley Act audit requirements together with the cost of the audit of the Group's Form 20-F filing.

Audit related fees: This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements, for example acting as reporting accountants in respect of prospectuses and circulars required by the UKLA listing rules.

Services relating to taxation: This category includes tax compliance and tax advisory services.

Other non-audit fees: This category includes due diligence relating to corporate finance, including venture capital transactions and other assurance and advisory services.

It is the Group's policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants. Such assignments typically relate to the provision of advice on tax issues, assistance in transactions involving the acquisition and disposal of businesses and accounting advice.

The Group has procedures that are designed to ensure auditor independence, including that fees for audit and non-audit services are approved in advance. This approval can be obtained either on an individual engagement basis or, for certain types of non-audit services, particularly those of a recurring nature, through the approval of a fee cap covering engagements of that type provided the fee is below that cap.

All statutory audit work as well as non-audit assignments where the fee is expected to exceed the relevant fee cap must be pre-approved by the Audit Committee on an individual engagement basis. On a quarterly basis, the Audit Committee receives a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services. The audit committee reviews on an on-going basis the total level of non-audit fees paid to PwC against various regulatory and other thresholds. The regulation, which was issued by the European Parliament in April 2014, specifies a cap of 70 per cent for non-audit fees as a percentage of total audit fees for the last three years, although the precise requirement remains subject to the national implementation process. Whilst noting that uncertainties remain regarding the detailed application of the requirement and that it is a three year measure, the Group estimates that the level of non-audit fees versus audit fees stood at 72 per cent for the year to 31 December 2014.

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

	2014 £m	2013 £m	2012 £m
Audits of Group pension schemes	0.3	0.3	0.4
Audits of the unconsolidated Open Ended Investment Companies managed by the Group	0.4	0.5	0.8
Reviews of the financial position of corporate and other borrowers	5.0	6.5	5.4
Acquisition due diligence and other work performed in respect of potential venture capital investments	1.0	2.1	0.7

NOTE 12: IMPAIRMENT

	2014 £m	2013 £m	2012 £m
Impairment losses on loans and receivables:			
Loans and advances to customers	735	2,725	5,125
Debt securities classified as loans and receivables	2	1	(4)
Total impairment losses on loans and receivables (note 21)	737	2,726	5,121
Impairment of available-for-sale financial assets	5	15	37
Other credit risk provisions	10	–	(9)
Total impairment charged to the income statement	752	2,741	5,149

NOTE 13: TAXATION

(A) ANALYSIS OF TAX (CHARGE) CREDIT FOR THE YEAR

	2014 £m	2013 £m	2012 £m
UK corporation tax:			
Current tax on profit for the year	(162)	(226)	(181)
Adjustments in respect of prior years	213	(205)	58
	51	(431)	(123)
Foreign tax:			
Current tax on profit for the year	(39)	(60)	(86)
Adjustments in respect of prior years	3	26	(8)
	(36)	(34)	(94)
Current tax credit (charge)	15	(465)	(217)
Deferred tax (note 39):			
Origination and reversal of temporary differences	(72)	(434)	(329)
Due to change in UK corporation tax rate	(24)	(594)	(320)
Adjustments in respect of prior years	(182)	276	85
	(278)	(752)	(564)
Tax charge	**(263)**	(1,217)	(781)

The charge for tax on the profit for 2014 is based on a UK corporation tax rate of 21.5 per cent (2013: 23.25 per cent; 2012: 24.5 per cent).

The income tax charge is made up as follows:

	2014 £m	2013 £m	2012 £m
Tax charge attributable to policyholders	(18)	(328)	(950)
Shareholder tax (charge) credit	(245)	(889)	169
Tax charge	**(263)**	(1,217)	(781)

Notes to the consolidated financial statements continued

NOTE 13: TAXATION (CONTINUED)

(B) FACTORS AFFECTING THE TAX CHARGE FOR THE YEAR

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

	2014 £m	2013 £m	2012 £m
Profit (loss) before tax	**1,762**	415	(606)
Tax (charge) credit thereon at UK corporation tax rate of 21.5 per cent (2013: 23.25 per cent; 2012: 24.5 per cent)	**(379)**	(96)	148
Factors affecting (charge) credit:			
UK corporation tax rate change and related impacts	**(24)**	(594)	(320)
Disallowed items	**(195)**	(167)	(186)
Non-taxable items	**153**	132	240
Overseas tax rate differences	**(24)**	(116)	75
Gains exempted or covered by capital losses	**181**	57	36
Policyholder tax	**(14)**	(251)	(144)
Further factors affecting the life business[1]:			
Derecognition of deferred tax on policyholder tax credit	**–**	–	(583)
Taxation of certain insurance assets arising on transition to new tax regime	**–**	–	(221)
Changes to the taxation of pension business:			
Policyholder tax cost	**–**	–	(182)
Shareholder tax benefit	**–**	–	206
Deferred tax on losses no longer recognised following sale of Australian operations	**–**	(348)	–
Tax losses where no deferred tax recognised	**–**	–	(25)
Deferred tax on Australian tax losses not previously recognised	**–**	60	12
Adjustments in respect of previous years	**34**	97	135
Effect of results of joint ventures and associates	**7**	9	23
Other items	**(2)**	–	5
Tax charge on profit (loss) on ordinary activities	**(263)**	(1,217)	(781)

[1] The Finance Act 2012 introduced a new UK tax regime for the taxation of life insurance companies which takes effect from 1 January 2013. The new regime, combined with current economic forecasts, had a number of impacts on the tax charge in 2012.

The Finance Act 2013 (the Act) was substantively enacted on 2 July 2013. The Act further reduced the main rate of corporation tax to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015.

NOTE 14: EARNINGS PER SHARE

	2014 £m	2013 £m	2012 £m
Profit (loss) attributable to equity shareholders – basic and diluted	**1,125**	(838)	(1,471)
Tax relief on distributions to other equity holders	**62**	–	–
	1,187	(838)	(1,471)

	2014 million	2013 million	2012 million
Weighted average number of ordinary shares in issue – basic	**71,350**	71,009	69,841
Adjustment for share options and awards	**1,097**	–	–
Weighted average number of ordinary shares in issue – diluted	**72,447**	71,009	69,841
Basic earnings (loss) per share	**1.7p**	(1.2)p	(2.1)p
Diluted earnings (loss) per share	**1.6p**	(1.2)p	(2.1)p

Basic earnings per share are calculated by dividing the net profit attributable to equity shareholders by the weighted average number of ordinary shares in issue during the year, which has been calculated after deducting 22 million (2013: 18 million; 2012: 13 million) ordinary shares representing the Group's holdings of own shares in respect of employee share schemes.

For the calculation of diluted earnings per share the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares that arise in respect of share options and awards granted to employees. The number of shares that could have been acquired at the average annual share price of the Company's shares based on the monetary value of the subscription rights attached to outstanding share options and awards is determined. This is deducted from the number of shares issuable under such options and awards to leave a residual bonus amount of shares which are added to the weighted-average number of ordinary shares in issue, but no adjustment is made to the profit attributable to equity shareholders.

The weighted-average number of anti-dilutive share options and awards excluded from the calculation of diluted earnings per share was 7 million at 31 December 2014 (2013: 28 million; 2012: 37 million).

NOTE 15: TRADING AND OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

These assets are comprised as follows:

	2014			2013		
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m
Loans and advances to customers	**28,513**	**–**	**28,513**	21,083	27	21,110
Loans and advances to banks	**8,212**	**–**	**8,212**	8,333	–	8,333
Debt securities:						
Government securities	**7,976**	**17,497**	**25,473**	4,259	16,430	20,689
Other public sector securities	**–**	**2,170**	**2,170**	14	2,183	2,197
Bank and building society certificates of deposit	**554**	**–**	**554**	1,491	–	1,491
Asset-backed securities:						
Mortgage-backed securities	**187**	**847**	**1,034**	5	793	798
Other asset-backed securities	**129**	**721**	**850**	171	756	927
Corporate and other debt securities	**1,486**	**20,604**	**22,090**	1,929	18,691	20,620
	10,332	**41,839**	**52,171**	7,869	38,853	46,722
Equity shares	**–**	**61,576**	**61,576**	4	66,399	66,403
Treasury and other bills	**1,437**	**22**	**1,459**	61	54	115
Total	**48,494**	**103,437**	**151,931**	37,350	105,333	142,683

Notes to the consolidated financial statements continued

NOTE 15: TRADING AND OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS (CONTINUED)

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

(i) financial assets backing insurance contracts and investment contracts of £94,314 million (2013: £101,185 million) which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise. Included within these assets are investments in unconsolidated structured entities of £27,590 million (2013: £24,552 million), see note 20;

(ii) loans and advances to customers of £27 million at 31 December 2013 which were economically hedged by interest rate derivatives which were not in hedge accounting relationships and where significant measurement inconsistencies would otherwise have arisen if the related derivatives had not been treated as trading liabilities and the loans and advances had not been carried at amortised cost; and

(iii) private equity investments of £2,350 million (2013: £2,632 million) that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The maximum exposure to credit risk at 31 December 2013 of the loans and advances to banks and customers designated at fair value through profit or loss at that date was £27 million; the Group did not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk which was determined by reference to the publicly available credit ratings of the instruments involved.

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

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 54; and
- Derivatives held in policyholder funds as permitted by the investment strategies of those funds.

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 51.

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.
- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place. The Group also uses credit default swaps to securitise, in combination with external funding, £611 million (2013: £828 million) of corporate and commercial banking loans.
- Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

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

	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
At 31 December 2014			
Trading and other			
Exchange rate contracts:			
Spot, forwards and futures	36,894	941	801
Currency swaps	301,451	4,849	4,706
Options purchased	49,085	1,244	–
Options written	49,784	–	1,443
	437,214	7,034	6,950
Interest rate contracts:			
Interest rate swaps	3,999,343	18,733	16,569
Forward rate agreements	1,791,219	9	56
Options purchased	58,600	3,755	–
Options written	54,031	–	3,725
Futures	134,117	9	24
	6,037,310	22,506	20,374
Credit derivatives	18,063	279	1,066
Embedded equity conversion feature	–	646	–
Equity and other contracts	14,842	1,430	1,181
Total derivative assets/liabilities – trading and other	6,507,429	31,895	29,571
Hedging			
Derivatives designated as fair value hedges:			
Currency swaps	7,281	113	131
Interest rate swaps	115,394	2,342	831
Options purchased	553	17	–
	123,228	2,472	962
Derivatives designated as cash flow hedges:			
Interest rate swaps	518,746	1,606	2,536
Futures	151,102	–	5
Currency swaps	11,720	155	113
	681,568	1,761	2,654
Total derivative assets/liabilities – hedging	804,796	4,233	3,616
Total recognised derivative assets/liabilities	7,312,225	36,128	33,187

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 54 Credit risk.

The embedded equity conversion feature of £646 million (2013: £1,212 million) reflects the value of the equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009; the gain of £401 million arising from the change in fair value over 2014 (2013: loss of £209 million; 2012: gain of £249 million) is included within net gains on financial instruments held for trading within net trading income (note 7). In addition, £967 million of the embedded derivative, being that portion of the embedded equity conversion feature related to ECNs derecognised pursuant to the Group's exchange and retail tender transactions completed in April 2014 (see note 9), has been derecognised on completion of those transactions.

Notes to the consolidated financial statements continued

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
At 31 December 2013[1]			
Trading and other			
Exchange rate contracts:			
Spot, forwards and futures	38,213	699	639
Currency swaps	291,667	3,207	4,196
Options purchased	33,061	780	–
Options written	33,445	–	836
	396,386	4,686	5,671
Interest rate contracts:			
Interest rate swaps	1,892,322	14,789	12,582
Forward rate agreements	1,991,371	17	13
Options purchased	107,374	3,395	–
Options written	101,136	–	3,194
Futures	141,669	2	12
	4,233,872	18,203	15,801
Credit derivatives	6,507	208	190
Embedded equity conversion feature	–	1,212	–
Equity and other contracts	18,780	1,753	1,478
Total derivative assets/liabilities – trading and other	4,655,545	26,062	23,140
Hedging			
Derivatives designated as fair value hedges:			
Currency swaps	35,651	383	453
Interest rate swaps	154,657	2,662	1,044
Options purchased	522	10	–
	190,830	3,055	1,497
Derivatives designated as cash flow hedges:			
Interest rate swaps	559,690	1,670	3,017
Futures	92,692	5	–
Currency swaps	1,135	12	4
	653,517	1,687	3,021
Total derivative assets/liabilities – hedging	844,347	4,742	4,518
Total recognised derivative assets/liabilities	5,499,892	30,804	27,658

[1] See note 1.

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

HEDGED CASH FLOWS

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

2014	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	**250**	**458**	**680**	**845**	**745**	**1,928**	**112**	**111**	**5,129**
Forecast payable cash flows	**(130)**	**(136)**	**(53)**	**(58)**	**(57)**	**(346)**	**(459)**	**(104)**	**(1,343)**
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	**391**	**536**	**769**	**830**	**646**	**1,736**	**114**	**107**	**5,129**
Forecast payable cash flows	**(174)**	**(105)**	**(54)**	**(57)**	**(63)**	**(358)**	**(433)**	**(99)**	**(1,343)**

2013	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	354	762	1,247	1,356	1,418	5,443	3,097	424	14,101
Forecast payable cash flows	(46)	(41)	(57)	(75)	(75)	(429)	(503)	(143)	(1,369)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	575	999	1,275	1,382	1,429	5,143	2,894	404	14,101
Forecast payable cash flows	(51)	(48)	(63)	(70)	(75)	(432)	(491)	(139)	(1,369)

There were no transactions for which cash flow hedge accounting had to be ceased in 2014 or 2013 as a result of the highly probable cash flows no longer being expected to occur.

NOTE 17: LOANS AND ADVANCES TO BANKS

	2014 £m	2013 £m
Lending to banks	**2,902**	2,168
Money market placements with banks	**23,253**	23,197
Total loans and advances to banks before allowance for impairment losses	**26,155**	25,365
Allowance for impairment losses (note 21)	**–**	–
Total loans and advances to banks	**26,155**	25,365

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

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NOTE 18: LOANS AND ADVANCES TO CUSTOMERS

	2014 £m	2013[1] £m
Agriculture, forestry and fishing	**6,586**	6,051
Energy and water supply	**3,853**	4,414
Manufacturing	**6,000**	7,650
Construction	**6,425**	7,024
Transport, distribution and hotels	**15,112**	22,294
Postal and telecommunications	**2,624**	2,364
Property companies	**36,682**	44,277
Financial, business and other services	**44,979**	42,478
Personal:		
Mortgages	**333,318**	335,611
Other	**23,123**	23,230
Lease financing	**3,013**	4,435
Hire purchase	**7,403**	5,090
Total loans and advances to customers before allowance for impairment losses	**489,118**	504,918
Allowance for impairment losses (note 21)	**(6,414)**	(11,966)
Total loans and advances to customers	**482,704**	492,952

[1] See note 1.

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

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

	2014 £m	2013 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**573**	557
Later than 1 year and not later than 5 years	**1,214**	1,736
Later than 5 years	**3,136**	4,542
	4,923	6,835
Unearned future finance income on finance leases	**(1,837)**	(2,330)
Rentals received in advance	**(73)**	(70)
Net investment in finance leases	**3,013**	4,435

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

	2014 £m	2013 £m
Not later than 1 year	**339**	277
Later than 1 year and not later than 5 years	**763**	1,140
Later than 5 years	**1,911**	3,018
Net investment in finance leases	**3,013**	4,435

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 2014 and 2013 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 £1 million (2013: £6 million).

NOTE 19: SECURITISATIONS AND COVERED BONDS

SECURITISATION PROGRAMMES

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. As the structured entities 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 structured entities 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.

COVERED BOND PROGRAMMES

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

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in note 32.

	2014		2013	
	Loans and advances securitised £m	Notes in issue £m	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes[1]				
UK residential mortgages	50,250	28,392	55,998	36,286
Commercial loans	13,372	12,533	10,931	11,259
Credit card receivables	6,762	4,278	6,314	3,992
Dutch residential mortgages	3,866	4,004	4,381	4,508
Personal loans	1,318	751	2,729	750
PFI/PPP and project finance loans	402	99	525	106
	75,970	50,057	80,878	56,901
Less held by the Group		(38,149)		(38,288)
Total securitisation programmes (note 32)		11,908		18,613
Covered bond programmes				
Residential mortgage-backed	47,795	31,730	59,576	36,473
Social housing loan-backed	2,826	1,800	2,536	1,800
	50,621	33,530	62,112	38,273
Less held by the Group		(6,339)		(7,606)
Total covered bond programmes (note 32)		27,191		30,667
Total securitisation and covered bond programmes		39,099		49,280

[1] Includes securitisations utilising a combination of external funding and credit default swaps.

Cash deposits of £11,251 million (2013: £13,500 million) held by the Group are restricted in use to repayment of the debt securities issued by the structured entities, the term advances relating to covered bonds and other legal obligations. Additionally, the Group had certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2014 these obligations had not been triggered; the maximum exposure under these facilities was £392 million (2013: £402 million).

The Group has a number of covered bond programmes, for which Limited Liability Partnerships have been established to ring-fence asset pools and guarantee the covered bonds issued by the Group. At the reporting date the Group had over-collateralised these programmes as set out in the table above to meet the terms of the programmes, to secure the rating of the covered bonds and to provide operational flexibility. From time-to-time, the obligations of the Group to provide collateral may increase due to the formal requirements of the programmes. The Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group are limited to the cash flows generated from the underlying assets. The Group could be required to provide additional support to a number of the securitisation programmes to support the credit ratings of the debt securities issued, in the form of increased cash reserves and the holding of subordinated notes. Further, certain programmes contain contractual obligations that require the Group to repurchase assets should they become credit impaired.

The Group has not voluntarily offered to repurchase assets from any of its public securitisation programmes during 2014 (2013: none). Such repurchases are made in order to ensure that the expected maturity dates of the notes issued from these programmes are met.

Notes to the consolidated financial statements continued

NOTE 20: STRUCTURED ENTITIES

The Group's interests in structured entities are both consolidated and unconsolidated. Detail of the Group's interests in consolidated structured entities are set out in: note 19 for securitisations and covered bond vehicles, note 38 for structured entities associated with the Group's pension schemes, and below in part (A) and (B). Details of the Group's interests in unconsolidated structured entities are included below in part (C).

(A) ASSET-BACKED CONDUITS

In addition to the structured entities discussed in note 19, which are used for securitisation and covered bond programmes, the Group sponsors an active asset-backed conduit, Cancara, which invests in debt securities and client receivables. The total consolidated exposure of Cancara at 31 December 2014 was £5,245 million (2013: £5,081 million), comprising £4,605 million of loans and advances (2013: £4,781 million) and £640 million of asset-backed securities (2013: £300 million).

All debt securities and lending assets held by the Group in Cancara are restricted in use, as they are held by the collateral agent for the benefit of the commercial paper investors and the liquidity providers only. The Group provides liquidity facilities to Cancara under terms that are usual and customary for standard lending activities in the normal course of the Group's banking activities. The Group could be asked to provide support under the contractual terms of these arrangements if Cancara experienced a shortfall in external funding, which may occur in the event of market disruption. As at 31 December 2014 and 2013 these obligations had not been triggered.

In addition, the Group sponsors two further asset-backed conduits, which are being run down. These asset-backed conduits have no commercial paper in issue and no external liquidity providers.

The external assets in all of the Group's conduits are consolidated in the Group's financial statements.

(B) CONSOLIDATED COLLECTIVE INVESTMENT VEHICLES

The assets and liabilities of the Insurance business held in consolidated collective investment vehicles, such as Open-Ended Investment Companies and limited partnerships, are not directly available for use by the Group. However, the Group's investment in the majority of these collective investment vehicles is readily realisable. As at 31 December 2014, the total carrying value of these consolidated collective investment vehicle assets and liabilities held by the Group was £66,070 million (2013: £55,934 million).

The Group has no contractual arrangements (such as liquidity facilities) that would require it to provide financial or other support to the consolidated collective investment vehicles; the Group has not previously provided such support and has no current intentions to provide such support.

(C) UNCONSOLIDATED COLLECTIVE INVESTMENT VEHICLES AND LIMITED PARTNERSHIPS

The Group's direct interests in unconsolidated structured entities comprise investments in collective investment vehicles, such as Open-Ended Investment Companies, and limited partnerships with a total carrying value of £27,255 million at 31 December 2014 (2013: £24,552 million), included within financial assets designated at fair value through profit and loss (see note 15). These investments include both those entities managed by third parties and those managed by the Group. At 31 December 2014, the total asset value of these unconsolidated structured entities, including the portion in which the Group has no interest, was £620 billion (2013: £543 billion).

The Group's maximum exposure to loss is equal to the carrying value of the investment. However, the Group's investments in these entities are primarily held to match policyholder liabilities in the Insurance division and the majority of the risk from a change in the value of the Group's investment is matched by a change in policyholder liabilities. The collective investment vehicles are primarily financed by investments from investors in the vehicles.

During the year the Group has not provided any non-contractual financial or other support to these entities and has no current intention of providing any financial or other support. There were no transfers from/to these unconsolidated collective investment vehicles and limited partnerships.

The Group considers itself the sponsor of a structured entity where it is primarily involved in the design and establishment of the structured entity; and further where the Group transfers assets to the structured entity; market products associated with the structured entity in its own name and/or provide guarantees regarding the structured entity's performance.

The Group sponsors a range of diverse investment funds and limited partnerships where it acts as the fund manager or equivalent decision maker and markets the funds under one of the Group's brands.

The Group earns fees from managing the investments of these funds. The investment management fees that the Group earned from these entities, including those in which the Group held no ownership interest at 31 December 2014, are reported in note 49.

NOTE 21: ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES

	Loans and advances to customers £m	Loans and advances to banks £m	Debt securities £m	Total £m
At 1 January 2013	15,250	3	206	15,459
Exchange and other adjustments	291	–	–	291
Disposal of businesses	(176)	–	–	(176)
Advances written off	(6,229)	(3)	(82)	(6,314)
Recoveries of advances written off in previous years	456	–	–	456
Unwinding of discount	(351)	–	–	(351)
Charge (release) to the income statement (note 12)	2,725	–	1	2,726
At 31 December 2013	11,966	–	125	12,091
Exchange and other adjustments	**(410)**	**–**	**9**	**(401)**
Disposal of businesses	**–**	**–**	**–**	**–**
Advances written off	**(6,432)**	**–**	**(10)**	**(6,442)**
Recoveries of advances written off in previous years	**681**	**–**	**–**	**681**
Unwinding of discount	**(126)**	**–**	**–**	**(126)**
Charge to the income statement (note 12)	**735**	**–**	**2**	**737**
At 31 December 2014	**6,414**	**–**	**126**	**6,540**

Of the total allowance in respect of loans and advances to customers, £5,551 million (2013: £10,217 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £1,482 million (2013: £2,217 million) was assessed on a collective basis.

NOTE 22: AVAILABLE-FOR-SALE FINANCIAL ASSETS

	2014			2013		
	Conduits £m	Other £m	Total £m	Conduits £m	Other £m	Total £m
Debt securities:						
Government securities	**–**	**47,402**	**47,402**	–	38,290	38,290
Bank and building society certificates of deposit	**–**	**298**	**298**	–	208	208
Asset-backed securities:						
Mortgage-backed securities	**27**	**647**	**674**	139	1,124	1,263
Other asset-backed securities	**223**	**462**	**685**	217	698	915
Corporate and other debt securities	**–**	**5,529**	**5,529**	–	1,855	1,855
	250	**54,338**	**54,588**	356	42,175	42,531
Equity shares	**–**	**1,042**	**1,042**	–	570	570
Treasury and other bills	**–**	**863**	**863**	–	875	875
Total available-for-sale financial assets	**250**	**56,243**	**56,493**	356	43,620	43,976

Details of the Group's asset-backed conduits shown in the table above are included in note 20.

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

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2(H).

Notes to the consolidated financial statements continued

NOTE 23: INVESTMENT PROPERTIES

	2014 £m	2013 £m
At 1 January	**4,864**	5,405
Exchange and other adjustments	**(6)**	11
Additions:		
Acquisitions of new properties	**293**	270
Consolidation of new subsidiary undertakings	**–**	805
Additional expenditure on existing properties	**83**	39
Total additions	**376**	1,114
Disposals	**(1,255)**	(1,240)
Changes in fair value (note 7)	**513**	156
Disposal of businesses	**–**	(582)
At 31 December	**4,492**	4,864

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

	2014 £m	2013 £m
Rental income (note 9)	**269**	308
Direct operating expenses arising from investment properties that generate rental income	**37**	59

Capital expenditure in respect of investment properties which had been contracted for but not recognised in the financial statements was £47 million (2013: £2 million).

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.

The fair value of investment properties is measured using the market approach and incorporates the income approach where appropriate. The fair value of investment property is generally measured using observable inputs. Whether investment properties are categorised as level 2 or 3 (see note 51 (4) for details of levels in the fair value hierarchy) depends on the extent of the adjustments made to observable inputs and this depends on the investment property concerned. Investment property is compared to property for which there is observable market data about its realisable value on disposal. Adjustments to this observable data are applied, if necessary, for specific characteristics of the property, such as the nature, location or condition of the specific asset. If such information is not available, alternative valuation methods using unobservable inputs, such as discounted cash flow analysis or recent prices in less active markets are used. For investment property under construction, the value on disposal is considered to be at the point at which the property is fully constructed. Adjustments are made for the costs and risks associated with construction. Investment property under construction for which fair value is not yet reliably measurable is valued at cost, until the fair value can be reliably measured.

The table above analyses movements in investment properties, all of which are categorised as level 3.

NOTE 24: GOODWILL

	2014 £m	2013 £m
At 1 January and 31 December	**2,016**	2,016
Cost[1]	**2,362**	2,362
Accumulated impairment losses	**(346)**	(346)
At 31 December	**2,016**	2,016

[1] For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is included net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,016 million (2013: £2,016 million), £1,836 million, or 91 per cent of the total (2013: £1,836 million, 91 per cent of the total) has been allocated to Scottish Widows in the Group's Insurance division and £170 million, or 8 per cent of the total (2013: £170 million, 8 per cent of the total) to Asset Finance in the Group's Consumer Finance division.

NOTE 24: GOODWILL (CONTINUED)

The recoverable amount of the goodwill relating to Scottish Widows has been based on a value-in-use calculation. The calculation uses pre-tax projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 10 per cent. 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 above would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of the goodwill relating to Asset Finance has also been based on a value-in-use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 14 per cent. The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Asset Finance participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Asset Finance to fall below the balance sheet carrying value.

NOTE 25: VALUE OF IN-FORCE BUSINESS

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

	2014 £m	2013 £m
Acquired value of in-force non-participating investment contracts	418	461
Value of in-force insurance and participating investment contracts	4,446	4,874
Total value of in-force business	**4,864**	5,335

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

	2014 £m	2013 £m
At 1 January	461	1,312
Amortisation taken to income statement (note 11)	(43)	(54)
Disposal of businesses	–	(797)
At 31 December	**418**	461

The acquired value of in-force non-participating investment contracts includes £251 million (2013: £277 million) in relation to OEIC business.

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

	2014 £m	2013 £m
At 1 January	4,874	5,488
Exchange and other adjustments		21
Movements in the year:		
New business	425	595
Existing business:		
Expected return	(441)	(432)
Experience variances	(65)	(246)
Assumption changes	(586)	37
Economic variance	239	462
Movement in the value of in-force business taken to income statement (note 9)	(428)	416
Disposal of businesses	–	(1,051)
At 31 December	**4,446**	4,874

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

Notes to the consolidated financial statements continued

NOTE 25: VALUE OF IN-FORCE BUSINESS (CONTINUED)

The principal features of the methodology and process used for determining key assumptions used in the calculation of the value of in-force business are set out below:

ECONOMIC ASSUMPTIONS

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn a risk-free rate and all cash flows are discounted at a risk-free rate. The certainty equivalent approach covers all investment assets relating to insurance and participating investment contracts, other than the annuity business (where an illiquidity premium is included, see below).

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. Further information on options and guarantees can be found on page 164.

The liabilities in respect of the Group's UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds and illiquid loan assets. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings and relevant illiquid loan assets. The determination of the market premium for illiquidity reflects actual asset allocation and relevant observable market data, and has been checked for consistency with the capital markets. The illiquidity premium is estimated to be 120 basis points at 31 December 2014 (2013: 91 basis points).

The risk-free rate is derived from the relevant swap curve with a deduction for credit risk.

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

	2014 %	2013 %
Risk-free rate (value of in-force non-annuity business)[1]	**0.00 to 3.27**	0.00 to 4.04
Risk-free rate (value of in-force annuity business)[1]	**1.02 to 4.56**	0.64 to 5.06
Risk-free rate (financial options and guarantees)[1]	**0.29 to 2.20**	0.21 to 3.45
Retail price inflation	**3.26**	3.59
Expense inflation	**3.92**	4.25

[1] All risk-free rates are quoted as the range of rates implied by the relevant swap curve.

NON-MARKET RISK

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk, reinsurer default and the with-profit funds these can be asymmetric in the range of potential outcomes for which an explicit allowance is made.

NON-ECONOMIC ASSUMPTIONS

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

Mortality and morbidity

The mortality and morbidity assumptions, including allowances for improvements in longevity, are set with regard to the Group's actual experience where this provides a reliable basis and relevant industry data otherwise.

Lapse (persistency) and paid-up rates

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

Maintenance expenses

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs. Explicit allowance is made for future expense inflation.

These assumptions are intended to represent a best estimate of future experience, and further information about the effect of changes in key assumptions is given in note 34.

NOTE 26: OTHER INTANGIBLE ASSETS

	Brands £m	Core deposit intangible £m	Purchased credit card relationships £m	Customer-related intangibles £m	Capitalised software enhancements £m	Total £m
Cost:						
At 1 January 2013	596	2,770	300	881	1,133	5,680
Exchange and other adjustments	–	–	–	–	22	22
Additions	–	–	15	–	274	289
Disposals	–	–	–	–	(92)	(92)
Disposal of businesses	–	–	–	(343)	(17)	(360)
At 31 December 2013	596	2,770	315	538	1,320	5,539
Additions	–	–	–	–	297	297
Disposals	–	–	–	–	(108)	(108)
At 31 December 2014	**596**	**2,770**	**315**	**538**	**1,509**	**5,728**
Accumulated amortisation:						
At 1 January 2013	86	1,560	238	526	478	2,888
Exchange and other adjustments	–	–	–	–	9	9
Charge for the year	21	300	62	20	109	512
Disposals	–	–	–	–	(45)	(45)
Disposal of businesses	–	–	–	(104)	–	(104)
At 31 December 2013	107	1,860	300	442	551	3,260
Charge for the year	21	300	5	14	161	501
Disposals	–	–	–	–	(103)	(103)
At 31 December 2014	**128**	**2,160**	**305**	**456**	**609**	**3,658**
Balance sheet amount at 31 December 2014	**468**	**610**	**10**	**82**	**900**	**2,070**
Balance sheet amount at 31 December 2013	489	910	15	96	769	2,279

Included within brands above are assets of £380 million (31 December 2013: £380 million) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not have an indefinite useful life.

The core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates, and the balance sheet amount at 31 December 2014 shown above will be amortised, in accordance with the Group's accounting policy, on a straight line basis over its remaining useful life of two years.

The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased.

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income.

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

Notes to the consolidated financial statements continued

NOTE 27: TANGIBLE FIXED ASSETS

	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:				
At 1 January 2013	2,616	3,553	4,898	11,067
Exchange and other adjustments	–	83	(17)	66
Additions	300	758	1,326	2,384
Disposals	(48)	(406)	(1,460)	(1,914)
Disposal of businesses	(2)	(94)	(80)	(176)
At 31 December 2013	2,866	3,894	4,667	11,427
Exchange and other adjustments	**1**	**1**	**24**	**26**
Additions	**212**	**971**	**1,673**	**2,856**
Disposals	**(186)**	**(223)**	**(1,759)**	**(2,168)**
At 31 December 2014	**2,893**	**4,643**	**4,605**	**12,141**
Accumulated depreciation and impairment:				
At 1 January 2013	1,191	1,510	1,024	3,725
Exchange and other adjustments	4	18	(10)	12
Depreciation charge for the year	145	418	811	1,374
Disposals	(41)	(305)	(808)	(1,154)
Disposal of businesses	–	(68)	(32)	(100)
At 31 December 2013	1,299	1,573	985	3,857
Exchange and other adjustments	**–**	**1**	**7**	**8**
Depreciation charge for the year	**142**	**462**	**787**	**1,391**
Disposals	**(67)**	**(153)**	**(947)**	**(1,167)**
At 31 December 2014	**1,374**	**1,883**	**832**	**4,089**
Balance sheet amount at 31 December 2014	**1,519**	**2,760**	**3,773**	**8,052**
Balance sheet amount at 31 December 2013	1,567	2,321	3,682	7,570

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

	2014 £m	2013 £m
Receivable within 1 year	**965**	1,053
1 to 5 years	**1,103**	1,165
Over 5 years	**203**	356
Total future minimum rentals receivable	**2,271**	2,574

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2014 and 2013 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £45 million at 31 December 2014 (£19 million at 31 December 2013) is expected to be received under non-cancellable sub-leases of the Group’s premises.

NOTE 28: OTHER ASSETS

	2014 £m	2013 £m
Assets arising from reinsurance contracts held (notes 33 and 35)	**682**	732
Deferred acquisition and origination costs	**114**	130
Settlement balances	**1,676**	2,904
Corporate pension asset	**12,741**	9,984
Investments in joint ventures and associates	**74**	101
Assets of disposal groups	**–**	7,988
Other assets and prepayments	**6,407**	5,187
Total other assets	**21,694**	27,026

NOTE 29: DEPOSITS FROM BANKS

	2014 £m	2013 £m
Liabilities in respect of securities sold under repurchase agreements	**1,075**	1,874
Other deposits from banks	**9,812**	12,108
Deposits from banks	**10,887**	13,982

NOTE 30: CUSTOMER DEPOSITS

	2014 £m	2013[1] £m
Non-interest bearing current accounts	**46,487**	40,802
Interest bearing current accounts	**86,131**	77,789
Savings and investment accounts	**256,701**	265,422
Liabilities in respect of securities sold under repurchase agreements	**–**	2,978
Other customer deposits[1]	**57,748**	52,476
Customer deposits	**447,067**	439,467

[1] See note 1.

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

Included in the amounts reported above are deposits of £260,129 million (2013: £258,384 million) which are protected under the UK Financial Services Compensation Scheme.

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NOTE 31: TRADING AND OTHER FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT OR LOSS

	2014 £m	2013 £m
Liabilities held at fair value through profit or loss	6,744	5,306
Trading liabilities:		
Liabilities in respect of securities sold under repurchase agreements	50,007	28,902
Short positions in securities	3,219	6,890
Other	2,132	2,527
	55,358	38,319
Trading and other financial liabilities at fair value through profit or loss	62,102	43,625

Liabilities designated at fair value through profit or loss primarily 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.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2014 was £10,112 million, which was £3,373 million higher than the balance sheet carrying value (2013: £6,625 million, which was £1,358 million higher than the balance sheet carrying value). At 31 December 2014 there was a cumulative £181 million increase in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of Lloyds Bank plc, the issuing entity within the Group. Of the cumulative amount a decrease of £33 million arose in 2014 and a decrease of £40 million arose in 2013.

For the fair value of collateral pledged in respect of repurchase agreements see note 54.

NOTE 32: DEBT SECURITIES IN ISSUE

	2014 £m	2013 £m
Medium-term notes issued	22,728	23,921
Covered bonds (note 19)	27,191	30,667
Certificates of deposit issued	7,033	8,866
Securitisation notes (note 19)	11,908	18,613
Commercial paper	7,373	5,035
Total debt securities in issue	76,233	87,102

NOTE 33: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS

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

	2014			2013		
	Gross £m	Reinsurance[1] £m	Net £m	Gross £m	Reinsurance[1] £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	72,168	(636)	71,532	67,626	(675)	66,951
Participating investment contracts	14,102	–	14,102	14,416	–	14,416
	86,270	(636)	85,634	82,042	(675)	81,367
Non-life insurance contracts (see (2) below):						
Unearned premiums	424	(7)	417	442	(10)	432
Claims outstanding	224	–	224	293	–	293
	648	(7)	641	735	(10)	725
Total	86,918	(643)	86,275	82,777	(685)	82,092

[1] Reinsurance balances are reported within other assets (note 28).

NOTE 33: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS (CONTINUED)

(1) LIFE INSURANCE

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

	Insurance contracts £m	Participating investment contracts £m	Gross £m	Reinsurance £m	Net £m
At 1 January 2013	65,650	16,489	82,139	(2,257)	79,882
New business	4,008	295	4,303	(28)	4,275
Changes in existing business	3,230	(2,349)	881	76	957
Change in liabilities charged to the income statement (note 10)	7,238	(2,054)	5,184	48	5,232
Exchange and other adjustments	(2)	(11)	(13)	(7)	(20)
Disposal of businesses	(5,260)	(8)	(5,268)	1,541	(3,727)
At 31 December 2013	67,626	14,416	82,042	(675)	81,367
New business	**3,123**	**28**	**3,151**	**(20)**	**3,131**
Changes in existing business	**1,582**	**(341)**	**1,241**	**12**	**1,253**
Change in liabilities charged to the income statement (note 10)	**4,705**	**(313)**	**4,392**	**(8)**	**4,384**
Exchange and other adjustments	**(163)**	**(1)**	**(164)**	**47**	**(117)**
At 31 December 2014	**72,168**	**14,102**	**86,270**	**(636)**	**85,634**

Liabilities for insurance contracts and participating investment contracts can be split into with-profit fund liabilities, accounted for using the PRA's realistic capital regime (realistic liabilities) and non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

	2014			2013		
	With-profit fund £m	Non-profit fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	**12,334**	**59,834**	**72,168**	11,739	55,887	67,626
Participating investment contracts	**8,957**	**5,145**	**14,102**	9,227	5,189	14,416
Total	**21,291**	**64,979**	**86,270**	20,966	61,076	82,042

With-profit fund realistic liabilities

(i) Business description

The Group has with-profit funds within Scottish Widows plc and Clerical Medical Investment Group Limited containing both insurance contracts and participating investment contracts.

The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a smoothed investment vehicle to policyholders, protecting them against short-term market fluctuations. Payouts may be subject to a guaranteed minimum payout if certain policy conditions are met. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at retirement.

(ii) Method of calculation of liabilities

With-profit liabilities are stated at their realistic value, the main components of which are:

– With-profit benefit reserve, the total asset shares for with-profit policies;

– Cost of options and guarantees (including guaranteed annuity options);

– Deductions levied against asset shares;

– Planned enhancements to with-profits benefits reserve; and

– Impact of the smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market-consistent basis. The calculation of realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 25.

Notes to the consolidated financial statements continued

NOTE 33: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS (CONTINUED)

(iii) Assumptions
Key assumptions used in the calculation of with-profit liabilities, and the processes for determining these, are:

Investment returns and discount rates
The realistic capital regime dictates that with-profit fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant swap curve, adjusted for credit risk. Further information on significant options and guarantees is given on page 164.

Guaranteed annuity option take-up rates
Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract. For contracts that contain such options, key assumptions in determining the cost of options are economic conditions in which the option has value, mortality rates and take up rates of other options. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

Investment volatility
The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical volatility where it is not possible to observe meaningful prices.

Mortality
The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.

Lapse rates (persistency)
Lapse rates refer to the rate of policy termination or the rate at which policyholders stop paying regular premiums due under the contract.

Historical persistency experience is analysed using statistical techniques. As experience can vary considerably between different product types and for contracts that have been in force for different periods, the data is broken down into broadly homogenous groups for the purposes of this analysis.

The most recent experience is considered along with the results of previous analyses and management's views on future experience, taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions, in order to determine a 'best estimate' view of what persistency will be. In determining this best estimate view a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration, any known or expected trends in underlying data and relevant published market data.

Non-profit fund liabilities

(i) Business description
The Group principally writes the following types of life insurance contracts within its non-profit funds. Shareholder profits on these types of business arise from management fees and other policy charges.

Unit-linked business – This includes unit-linked pensions and unit-linked bonds, the primary purpose of which is to provide an investment vehicle where the policyholder is also insured against death.

Life insurance – The policyholder is insured against death or permanent disability, usually for predetermined amounts. Such business includes whole of life and term assurance and long-term creditor policies.

Annuities – The policyholder is entitled to payments for the duration of their life and is therefore insured against surviving longer than expected.

(ii) Method of calculation of liabilities
The non-profit fund liabilities are determined on the basis of recognised actuarial methods and consistent with the approach required by regulatory rules. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting the cash flows back to the valuation date allowing for probabilities of occurrence.

(iii) Assumptions
Generally, assumptions used to value non-profit fund liabilities are prudent in nature and therefore contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgement and reflects management's views on the inherent level of uncertainty. The key assumptions used in the measurement of non-profit fund liabilities are:

Interest rates
The rates used are derived in accordance with the guidelines set by local regulatory bodies. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the guidelines set by local regulatory bodies, including reductions made to the available yields to allow for default risk based upon the credit rating of the securities allocated to the insurance liability.

NOTE 33: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS (CONTINUED)

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 (persistency)

Lapse rates are allowed for on some non-profit fund contracts. The process for setting these rates is as described for with-profit liabilities, however a prudent scenario is assumed by the inclusion of a margin for adverse deviation within the non-profit fund liabilities.

Maintenance expenses

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation.

Key changes in assumptions

A detailed review of the Group's assumptions in 2014 resulted in the following key impacts on profit before tax:

– Change in persistency assumptions (£119 million decrease).
– Change in the assumption in respect of current and future mortality rates (£23 million increase).
– Change in expenses assumptions (£51 million increase).
– Change in credit default methodology (£36 million increase).

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

(2) NON-LIFE INSURANCE

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

	2014 £m	2013 £m
Credit protection	**45**	60
Home	**600**	673
Health	**3**	2
Total gross non-life insurance contract liabilities	**648**	735

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 consolidated financial statements continued

NOTE 33: LIABILITIES 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:

	Gross £m	Reinsurance £m	Net £m
Provisions for unearned premiums			
At 1 January 2013	494	(16)	478
Increase in the year	972	(18)	954
Release in the year	(1,021)	24	(997)
Change in provision for unearned premiums charged to income statement (note 8)	(49)	6	(43)
Exchange and other adjustments	(3)	–	(3)
At 31 December 2013	442	(10)	432
Increase in the year	**870**	**(13)**	**857**
Release in the year	**(888)**	**16**	**(872)**
Change in provision for unearned premiums charged to income statement (note 8)	**(18)**	**3**	**(15)**
Exchange and other adjustments	**–**	**–**	**–**
At 31 December 2014	**424**	**(7)**	**417**

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

	Gross £m	Reinsurance £m	Net £m
Claims outstanding			
Notified claims	280	–	280
Incurred but not reported	40	(1)	39
At 1 January 2013	320	(1)	319
Cash paid for claims settled in the year	(385)	–	(385)
Increase (decrease) in liabilities:			
Arising from current year claims	379	–	379
Arising from prior year claims	(27)	1	(26)
Change in liabilities charged to income statement (note 10)	(33)	1	(32)
Exchange and over adjustments	6	–	6
At 31 December 2013	293	–	293
Cash paid for claims settled in the year	**(398)**	**–**	**(398)**
Increase (decrease) in liabilities:			
Arising from current year claims	**368**	**–**	**368**
Arising from prior year claims	**(40)**	**–**	**(40)**
Change in liabilities charged to income statement (note 10)	**(70)**	**–**	**(70)**
Exchange and other adjustments	**1**	**–**	**1**
At 31 December 2014	**224**	**–**	**224**
Notified claims	**194**	**–**	**194**
Incurred but not reported	**30**	**–**	**30**
At 31 December 2014	**224**	**–**	**224**
Notified claims	263	–	263
Incurred but not reported	30	–	30
At 31 December 2013	293	–	293

NOTE 33: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS (CONTINUED)

Non-life insurance claims development table

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year shown has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

Non-life insurance all risks – gross

	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	**2014 £m**	**Total £m**
Accident year								
Estimate of ultimate claims costs:								
At end of accident year	205	639	609	446	421	349	**283**	**2,952**
One year later	199	539	517	366	382	339		
Two years later	195	494	497	353	393			
Three years later	187	487	493	367				
Four years later	186	483	506					
Five years later	186	479						
Six years later	180							
Current estimate in respect of above claims	180	479	506	367	393	339	**283**	**2,547**
Current estimate of claims relating to general insurance business acquired in 2009	257	–	–	–	–	–	**–**	**257**
Current estimate of cumulative claims	437	479	506	367	393	339	**283**	**2,804**
Cumulative payments to date	(434)	(475)	(494)	(355)	(377)	(294)	**(173)**	**(2,602)**
Liability recognised in the balance sheet	3	4	12	12	16	45	**110**	**202**
Liability in respect of earlier years								**8**
Total liability included in the balance sheet								**210**

The liability of £210 million shown in the above table excludes £10 million of unallocated claims handling expenses and £4 million of unexpired risk reserve.

Notes to the consolidated financial statements continued

NOTE 34: LIFE INSURANCE SENSITIVITY ANALYSIS

The following table demonstrates the effect of reasonably possible changes in key assumptions on profit before tax and equity disclosed in these financial statements assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated. These amounts include movements in assets, liabilities and the value of the in-force business in respect of insurance contracts and participating investment contracts. The impact is shown in one direction but can be assumed to be reasonably symmetrical.

	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
At 31 December 2014			
Non-annuitant mortality and morbidity[1]	**5% reduction**	**37**	**30**
Annuitant mortality[2]	**5% reduction**	**(176)**	**(141)**
Lapse rates[3]	**10% reduction**	**105**	**84**
Future maintenance and investment expenses[4]	**10% reduction**	**259**	**208**
Risk-free rate[5]	**0.25% reduction**	**29**	**24**
Guaranteed annuity option take up[6]	**5% addition**	**1**	**1**
Equity investment volatility[7]	**1% addition**	**(3)**	**(3)**
Widening of credit default spreads on corporate bonds[8]	**0.25% addition**	**(260)**	**(208)**
Increase in illiquidity premia[9]	**0.10% addition**	**101**	**81**

	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
At 31 December 2013			
Non-annuitant mortality and morbidity[1]	5% reduction	39	31
Annuitant mortality[2]	5% reduction	(151)	(121)
Lapse rates[3]	10% reduction	132	106
Future maintenance and investment expenses[4]	10% reduction	194	155
Risk-free rate[5]	0.25% reduction	50	40
Guaranteed annuity option take up[6]	5% addition	–	–
Equity investment volatility[7]	1% addition	(8)	(6)
Widening of credit default spreads on corporate bonds[8]	0.25% addition	(238)	(191)
Increase in illiquidity premia[9]	0.10% addition	82	66

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

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

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

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

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

[5] This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

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

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

[8] This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Swap curves, the risk-free rate and illiquidity premia are all assumed to be unchanged.

[9] This sensitivity shows the impact of a 10 basis point increase in the allowance for illiquidity premia. It assumes the overall spreads on assets are unchanged and hence market values are unchanged. Swap curves and the non-annuity risk-free rate are both assumed to be unchanged. The increased illiquidity premium increases the annuity risk-free rate.

NOTE 35: LIABILITIES ARISING FROM NON-PARTICIPATING INVESTMENT CONTRACTS

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

	Gross £m	Reinsurance £m	Net £m
At 1 January 2013	54,372	(46)	54,326
New business	1,294	(1)	1,293
Changes in existing business	1,899	–	1,899
Disposal of businesses	(29,953)	–	(29,953)
Exchange and other adjustments	(22)	–	(22)
At 31 December 2013	27,590	(47)	27,543
New business	**257**	**(1)**	**256**
Changes in existing business	**(583)**	**9**	**(574)**
Exchange and other adjustments	**(16)**	**–**	**(16)**
At 31 December 2014	**27,248**	**(39)**	**27,209**

NOTE 36: UNALLOCATED SURPLUS WITHIN INSURANCE BUSINESSES

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

	2014 £m	2013 £m
At 1 January	**391**	267
Change in unallocated surplus recognised in the income statement (note 10)	**(74)**	123
Exchange and other adjustments	**3**	1
At 31 December	**320**	391

NOTE 37: OTHER LIABILITIES

	2014 £m	2013 £m
Settlement balances	**1,024**	3,358
Unitholders' interest in Open Ended Investment Companies	**19,525**	22,219
Liabilities of disposal groups	**–**	7,302
Other creditors and accruals	**7,556**	7,577
Total other liabilities	**28,105**	40,456

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS

	2014 £m	2013 £m	2012 £m
Charge to the income statement			
Past service (credits) charges [1]	**(822)**	104	(250)
Other	**334**	392	349
Defined benefit pension schemes	**(488)**	496	99
Other post-retirement benefit schemes	**10**	7	11
Total defined benefit schemes	**(478)**	503	110
Defined contribution pension schemes	**252**	255	229
Total (credit) charge to the income statement (note 11)	**(226)**	758	339

[1] On 11 March 2014 the Group announced a change to its defined benefit pension schemes, revising the existing cap on the increases in pensionable pay used in calculating the pension benefit, from 2 per cent to nil with effect from 2 April 2014. The effect of this change was to reduce the Group's retirement benefit obligations recognised on the balance sheet by £843 million with a corresponding curtailment gain recognised in the income statement. This has been partly offset by a charge of £21 million following changes to pension arrangements for staff within the TSB business. In 2013, the Group agreed certain changes to early retirement and commutation factors in two of its principal defined benefit pension schemes, resulting in a cost of £104 million recognised in the Group's income statement in the year ended 31 December 2013. In 2012, there was a net credit of £250 million following a decision to link discretionary pension increases in certain schemes to the Consumer Price Index.

	2014 £m	2013 £m
Amounts recognised in the balance sheet		
Retirement benefit assets	**1,147**	98
Retirement benefit obligations	**(453)**	(1,096)
Total amounts recognised in the balance sheet	**694**	(998)

The total amount recognised in the balance sheet relates to:

	2014 £m	2013 £m
Defined benefit pension schemes	**890**	(787)
Other post-retirement benefit schemes	**(196)**	(211)
Total amounts recognised in the balance sheet	**694**	(998)

PENSION SCHEMES

Defined benefit schemes

(i) Characteristics of and risks associated with the Group's schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas. All significant schemes are based in the UK, with the three most significant being the defined benefit sections of the Lloyds Bank Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme. These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2014 is generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The Group operates a number of funded and unfunded pension arrangements, the majority, including the three most significant schemes, are funded schemes in the UK. All schemes are operated as separate legal entities under trust law by the trustees. All UK schemes are funded in compliance with the Pensions Act 2004. A valuation exercise is carried out for each scheme at least every three years, whereby scheme assets are measured at market value and liabilities ('Technical Provisions') are measured using prudent assumptions, if a deficit is identified a recovery plan is agreed and sent to the Pensions Regulator for review. The outcome of this valuation process, including agreement of any recovery plans, is agreed between the Group and the scheme Trustee. The Group's overseas defined benefit pension schemes are subject to local regulatory arrangements.

The latest full valuations of the three main schemes were carried out as at 30 June 2011; the results have been updated to 31 December 2014 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 2014 by qualified independent actuaries.

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

During 2009, the Group made one-off contributions to the Lloyds Bank Pension Scheme No 1 and Lloyds Bank Pension Scheme No 2 of approximately £1 billion in aggregate. These contributions took the form of interests in limited liability partnerships for each of the two schemes which contained assets of approximately £5.4 billion in aggregate entitling the schemes to annual payments of approximately £215 million in aggregate until 31 December 2014. As all scheduled distributions have now been made, the value of the partnership interests equates to a nominal amount and the limited liability partnerships will continue to hold assets to provide security for the Group's obligations to the Lloyds Bank Pension Scheme No1 and Lloyds Bank Pension Scheme No 2. At 31 December 2014, the limited liability partnerships held assets of approximately £5.1 billion and cash payments of £215 million were made to the pension schemes during the year (2013: £215 million). The limited liability partnerships are consolidated fully in the Group's balance sheet (see note 20).

The Group has also established two private limited companies which hold assets to provide security for the Group's obligations to the HBOS Final Salary Pension Scheme and a section of the Lloyds Bank Pension Scheme No 1. At 31 December 2014 these held assets of approximately £2.8 billion in aggregate; they do not make any distributions to the pension schemes. The private limited companies are consolidated fully in the Group's balance sheet. The terms of these arrangements require the Group to maintain assets in these vehicles to agreed minimum values in order to secure obligations owed to the relevant Group pension schemes. The Group has satisfied this requirement during 2014.

The Group currently expects to pay contributions of approximately £425 million to its defined benefit schemes in 2015.

The responsibility for the governance of the Group's funded defined benefit pension schemes lies with the Pension Trustees. Each of the Group's funded UK defined benefit pension schemes are managed by a Trustee Board (the Trustee) whose role is to ensure that their Scheme is administered in accordance with the Scheme rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the triennial valuation process. The Board of Trustees must be composed of representatives of the Company and plan participants in accordance with the Scheme's regulations.

(ii) Amounts in the financial statements

	2014 £m	2013 £m
Amount included in the balance sheet		
Present value of funded obligations	**(37,243)**	(33,355)
Fair value of scheme assets	**38,133**	32,568
Net amount recognised in the balance sheet	**890**	(787)

	2014 £m	2013 £m
Net amount recognised in the balance sheet		
At 1 January	**(787)**	(957)
Net defined benefit pension credit (charge)	**488**	(496)
Actuarial losses on defined benefit obligation	**(4,272)**	(1,265)
Return on plan assets	**4,928**	1,133
Employer contributions	**531**	804
Exchange and other adjustments	**2**	(6)
At 31 December	**890**	(787)

Notes to the consolidated financial statements continued

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

	2014 £m	2013 £m
Movements in the defined benefit obligation		
At 1 January	(33,355)	(31,324)
Current service cost	(277)	(351)
Interest expense	(1,471)	(1,414)
Remeasurements:		
Actuarial (losses) gains – experience	186	184
Actuarial (losses) gains – demographic assumptions	(13)	15
Actuarial (losses) gains – financial assumptions	(4,445)	(1,464)
Benefits paid	1,147	1,061
Past service cost	(20)	(5)
Employee contributions	(2)	(3)
Curtailments	822	(104)
Settlements	117	62
Exchange and other adjustments	68	(12)
At 31 December	(37,243)	(33,355)
The total defined benefit obligation comprises:		
Amounts owing to active members	(7,801)	(8,647)
Amounts owing to deferred members	(12,928)	(9,927)
Amounts owing to pensioners	(15,139)	(13,547)
Amounts owing to dependents	(1,375)	(1,234)
Total defined benefit obligation at 31 December	(37,243)	(33,355)

	2014 £m	2013 £m
Changes in the fair value of scheme assets		
At 1 January	32,568	30,367
Return on plan assets excluding amounts included in interest income	4,928	1,133
Interest income	1,477	1,392
Employer contributions	531	804
Employee contributions	2	3
Benefits paid	(1,147)	(1,061)
Settlements	(124)	(55)
Administrative costs paid	(36)	(21)
Exchange and other adjustments	(66)	6
At 31 December	38,133	32,568

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

Composition of scheme assets:

	2014			2013		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equity instruments	1,047	–	1,047	1,276	–	1,276
Debt instruments	21,243	–	21,243	12,845	–	12,845
Property	–	1,138	1,138	–	1,062	1,062
Pooled investment vehicles	3,603	10,555	14,158	4,684	10,671	15,355
Money market instruments, cash, derivatives and other assets and liabilities	1,179	(632)	547	506	1,524	2,030
At 31 December	27,072	11,061	38,133	19,311	13,257	32,568

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

An analysis by credit rating of the pension schemes' debt securities is provided below:

	Investment grade[1] £m	Sub-investment grade £m	Not rated £m	Total £m
At 31 December 2014				
Fixed interest government bonds	3,933	210	7	4,150
Index linked government bonds	10,396	–	–	10,396
Corporate and other debt securities	4,880	1,535	208	6,623
Asset-backed securities	–	–	74	74
Total debt securities	19,209	1,745	289	21,243
At 31 December 2013				
Fixed interest government bonds	2,122	80	–	2,202
Index linked government bonds	6,955	–	–	6,955
Corporate and other debt securities	3,080	482	75	3,637
Asset-backed securities	–	–	51	51
Total debt securities	12,157	562	126	12,845

[1] Credit ratings equal to or better than 'BBB'.

The pension schemes' pooled investment vehicles comprise:

	2014 £m	2013 £m
Equity funds	2,581	4,699
Hedge and mutual funds	2,170	2,382
Liquidity funds	2,566	3,588
Bond and debt funds	2,570	1,996
Other	4,271	2,690
At 31 December	14,158	15,355

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

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

	2014 £m	2013 £m	2012 £m
Current service cost	277	351	360
Net interest amount	(6)	22	(60)
Past service credits and curtailments (see below)	(822)	104	(250)
Settlements	7	(7)	4
Past service cost – plan amendments	20	5	16
Plan administration costs incurred during the year	36	21	29
Total defined benefit pension expense	**(488)**	**496**	**99**

Assumptions

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

	2014 %	2013 %
Discount rate	3.67	4.60
Rate of inflation:		
Retail Prices Index	2.95	3.30
Consumer Price Index	1.95	2.30
Rate of salary increases	0.00	2.00
Weighted-average rate of increase for pensions in payment	2.59	2.80

	2014 Years	2013 Years
Life expectancy for member aged 60, on the valuation date:		
Men	27.5	27.4
Women	29.8	29.7
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	28.7	28.6
Women	31.1	31.0

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 at 31 December 2014 is assumed to live for, on average, 27.5 years for a male and 29.8 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.

(iii) Amount timing and uncertainty of future cash flows

Risk exposure of the defined benefit schemes

Whilst the Group is not exposed to any unusual, entity specific or scheme specific risks in its defined benefit pension schemes, it is exposed to a number of significant risks, detailed below:

Inflation rate risk: the majority of the plans' benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings.

Longevity risk: The majority of the schemes obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: Scheme assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the pension expense in the Group's income statement.

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

Sensitivity analysis

The effect of reasonably possible changes in key assumptions on the value of scheme liabilities and the resulting pension charge in the Group's income statement and on the net defined benefit pension scheme liability, for the Group's three most significant schemes, is set out below. The sensitivities provided assume that all other assumptions and the value of the schemes' assets remain unchanged, and are not intended to represent changes that are at the extremes of possibility. The calculations are approximate in nature and full detailed calculations could lead to a different result. It is unlikely that isolated changes to individual assumptions will be experienced in practice. Due to the correlation of assumptions, aggregating the effects of these isolated changes may not be a reasonable estimate of the actual effect of simultaneous changes in multiple assumptions.

	Effect of reasonably possible alternative assumptions			
	Increase (decrease) in the income statement charge		Increase (decrease) in the net defined benefit pension scheme liability	
	2014 £m	2013 £m	**2014 £m**	2013 £m
Inflation (including pension increases):[1]				
Increase of 0.1 per cent	**18**	24	**383**	414
Decrease of 0.1 per cent	**(16)**	(6)	**(362)**	(122)
Discount rate:[2]				
Increase of 0.1 per cent	**(30)**	(30)	**(611)**	(542)
Decrease of 0.1 per cent	**29**	33	**623**	550
Expected life expectancy of members:				
Increase of one year	**34**	38	**750**	686
Decrease of one year	**(32)**	(36)	**(738)**	(676)

[1] At 31 December 2014, the assumed rate of RPI inflation is 2.95 per cent and CPI inflation 1.95 per cent (2013: RPI 3.3 per cent and CPI 2.3 per cent).

[2] At 31 December 2014, the assumed discount rate is 3.67 per cent (2013: 4.60 per cent).

Sensitivity analysis method and assumptions

The sensitivity analysis above reflects the impact on the Group's three most significant schemes which account for over 90 per cent of the Group's defined benefit obligations. Whilst differences in the underlying liability profiles for the remainder of the Group's pension arrangements mean they may exhibit slightly different sensitivities to variations in these assumptions, the sensitivities provided above are indicative of the impact across the Group as a whole.

The inflation assumption sensitivity applies to both the assumed rate of increase in the Consumer Prices Index (CPI) and the Retail Prices Index (RPI), and include the impact on the rate of increases to pensions, both before and after retirement. These pension increases are linked to inflation (either CPI or RPI) subject to certain minimum and maximum limits.

The sensitivity analysis (including the inflation sensitivity) does not include the impact of any change in the rate of salary increases as pensionable salaries have been frozen since 2 April 2014.

The life expectancy assumption has been applied by allowing for an increase/decrease in life expectation from age 60 of one year, based upon the approximate weighted average age for each scheme. Whilst this is an approximate approach and will not give the same result as a one year increase in life expectancy at every age, it provides an appropriate indication of the potential impact on the schemes from changes in life expectancy.

There was no change in the methods and assumptions used in preparing the sensitivity analysis from the prior year.

Asset-liability matching strategies

The main schemes' assets are invested in a diversified portfolio, consisting primarily of debt securities. The investment strategy is not static and will evolve to reflect the structure of liabilities within the schemes. Specific asset-liability matching strategies for each pension plan are independently determined by the responsible governance body for each scheme and in consultation with the employer.

A significant goal of the asset-liability matching strategies adopted by Group schemes is to reduce volatility caused by changes in market expectations of interest rates and inflation. In the main, this is achieved by investing scheme assets in bonds, primarily fixed interest gilts and index linked gilts, and by entering into interest rate and inflation swap arrangements. These investments are structured to take into account the profile of scheme liabilities, and actively managed to reflect both changing market conditions and changes to the liability profile.

The asset-liability matching strategy currently mitigates approximately 89 per cent (2013: 54 per cent) of the interest rate volatility and 94 per cent (2013: 71 per cent) of the inflation rate volatility of the liabilities.

Notes to the consolidated financial statements continued

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

Maturity profile of defined benefit obligation

The following table provides information on the weighted average duration of the defined benefit pension obligations and the distribution and timing of benefit payments:

	2014 Years	2013 Years
Duration of the defined benefit obligation	**19**	19

	2014 £m	2013 £m
Maturity analysis of benefits expected to be paid		
Benefits expected to be paid within 12 months	**1,179**	1,067
Benefits expected to be paid between 1 and 2 years	**1,059**	1,009
Benefits expected to be paid between 2 and 5 years	**3,538**	3,420
Benefits expected to be paid between 5 and 10 years	**7,334**	7,207
Benefits expected to be paid between 10 and 15 years	**8,831**	8,945
Benefits expected to be paid between 15 and 25 years	**20,011**	21,102
Benefits expected to be paid between 25 and 35 years	**18,995**	20,851
Benefits expected to be paid between 35 and 45 years	**14,434**	16,374
Benefits expected to be paid in more than 45 years	**9,617**	11,403

Maturity analysis method and assumptions

The projected benefit payments are based on the assumptions underlying the assessment of the obligations, including allowance for expected future inflation. They are shown in their undiscounted form and therefore appear large relative to the discounted assessment of the defined benefit obligations recognised in the Group's balance sheet. They are in respect of benefits that have been accrued prior to the respective year-end date only and make no allowance for any benefits that may have been accrued subsequently.

Defined contribution schemes

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow and the defined contribution sections of the Lloyds Bank Pension Scheme No. 1.

During the year ended 31 December 2014 the charge to the income statement in respect of defined contribution schemes was £252 million (2013: £255 million; 2012: £229 million), representing the contributions payable by the employer in accordance with each scheme's rules.

OTHER POST-RETIREMENT BENEFIT SCHEMES

The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants. The principal scheme relates to former Lloyds Bank staff and under this scheme the Group has undertaken to meet the cost of post-retirement healthcare for all eligible former employees (and their dependants) who retired prior to 1 January 1996. The Group has entered into an insurance contract to provide these benefits and a provision has been made for the estimated cost of future insurance premiums payable.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 31 December 2014 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 6.55 per cent (2013: 6.90 per cent).

NOTE 38: RETIREMENT BENEFIT OBLIGATIONS (CONTINUED)

Movements in the other post-retirement benefits obligation:

	2014 £m	2013 £m
At 1 January	(211)	(207)
Actuarial gain (loss)	18	(4)
Insurance premiums paid	7	7
Charge for the year	(10)	(7)
At 31 December	**(196)**	(211)

NOTE 39: DEFERRED TAX

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

	2014 £m	2013 £m
Asset at 1 January	5,101	4,586
Exchange and other adjustments	9	7
Disposals	(60)	558
Income statement charge (note 13):		
Due to change in UK corporation tax rate and related impacts	(24)	(594)
Other	(254)	(158)
	(278)	(752)
Amount credited (charged) to equity:		
Post-retirement defined benefit scheme remeasurements	(135)	28
Available-for-sale financial assets (note 44)	(13)	274
Cash flow hedges (note 44)	(549)	374
Share-based compensation	16	26
	(681)	702
Asset at 31 December	**4,091**	5,101

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

Statutory position	2014 £m	2013 £m
Deferred tax assets	4,145	5,104
Deferred tax liabilities	(54)	(3)
Asset at 31 December	**4,091**	5,101

Tax disclosure	2014 £m	2013 £m
Deferred tax assets	7,033	8,097
Deferred tax liabilities	(2,942)	(2,996)
Asset at 31 December	**4,091**	5,101

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

	2014 £m	2013 £m	2012 £m
Accelerated capital allowances	34	482	410
Pensions and other post-retirement benefits	(243)	(14)	(237)
Long-term assurance business	312	86	(869)
Allowances for impairment losses	(24)	(86)	(332)
Tax losses carried forward	(565)	(1,049)	974
Tax on fair value of acquired assets	159	322	28
Other temporary differences	49	(493)	(538)
Deferred tax charge in the income statement	**(278)**	(752)	(564)

Notes to the consolidated financial statements continued

NOTE 39: DEFERRED TAX (CONTINUED)

Deferred tax assets and liabilities are comprised as follows:

	2014 £m	2013 £m
Deferred tax assets:		
Pensions and other post-retirement benefits	–	288
Accelerated capital allowances	682	649
Allowances for impairment losses	5	22
Other provisions	15	45
Available-for-sale asset revaluation	–	–
Tax losses carried forward	5,758	6,338
Other temporary differences	573	755
Total deferred tax assets	**7,033**	8,097

	2014 £m	2013 £m
Deferred tax liabilities:		
Pensions and other post-retirement benefits	(87)	–
Long-term assurance business	(944)	(1,195)
Available-for-sale asset revaluation	(13)	(30)
Tax on fair value of acquired assets	(1,072)	(1,236)
Effective interest rates	(10)	(19)
Derivatives	(421)	(190)
Other temporary differences	(395)	(326)
Total deferred tax liabilities	**(2,942)**	(2,996)

The Finance Act 2013 (the Act) was substantively enacted on 2 July 2013. The Act further reduced the main rate of corporation tax to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015.

DEFERRED TAX ASSETS

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised deferred tax assets of £5,758 million (2013: £6,338 million) in relation to trading tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset (see note 3).

Deferred tax assets of £190 million (2013: £168 million) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

Deferred tax assets of £614 million (2013: £593 million) have not been recognised in respect of trading losses carried forward, mainly in certain overseas companies and in respect of other temporary differences in the insurance businesses. Trading losses can be carried forward indefinitely, except for losses in the USA which expire after 20 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward at 31 December 2014 of £117 million (2013: £41 million), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits c an be carried forward indefinitely.

NOTE 40: OTHER PROVISIONS

	Provisions for commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property £m	Other £m	Total £m
At 1 January 2014	177	2,807	1,008	69	427	4,488
Exchange and other adjustments	(86)	–	–	15	(5)	(76)
Provisions applied	–	(2,458)	(1,104)	(19)	(184)	(3,765)
Charge for the year	10	2,200	925	5	413	3,553
At 31 December 2014	**101**	**2,549**	**829**	**70**	**651**	**4,200**

NOTE 40: OTHER PROVISIONS (CONTINUED)

PROVISIONS FOR COMMITMENTS

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

PAYMENT PROTECTION INSURANCE

Following the unsuccessful legal challenge by the British Bankers' Association against the Financial Services Authority (FSA) (now known as the Financial Conduct Authority (FCA)) and the Financial Ombudsman Service (FOS), the Group made provisions totalling £9,825 million to 31 December 2013 against the costs of paying redress to customers in respect of past sales of PPI policies, including the related administrative expenses.

During 2014 customer initiated complaints have continued to fall, albeit slower than expected. The proactive mailings have been substantially completed and remediation of previously defended cases commenced. A further £2,200 million has been added to the provision in 2014, which brings the total amount provided to £12,025 million, of which approximately £2,520 million relates to anticipated administrative expenses.

As at 31 December 2014, £2,549 million of the provision remained unutilised (21 per cent of total provision) relative to an average monthly spend including administration costs in 2014 of approximately of £205 million. The main drivers of the provision are as follows:

Volumes of customer initiated complaints (after excluding complaints from customers where no PPI policy was held)

At 31 December 2013, the provision assumed a total of 3.0 million complaints would be received. During 2014, complaint volumes were 22 per cent lower than 2013, but continue to be higher than expected. As a result, the Group is forecasting a slower decline in future volumes than previously expected, largely due to more sustained Claims Management Company (CMC) activity; non-CMC complaints have declined sharply. This has resulted in a further provision of approximately £1,080 million. At 31 December 2014, approximately 3 million complaints have been received, with the provision assuming approximately a further 0.6 million complaints will be received in the future.

Quarter	Average monthly reactive complaint volume	Quarter on Quarter %
Q1 2012	109,893	
Q2 2012	130,752	19%
Q3 2012	110,807	(15)%
Q4 2012	84,751	(24)%
Q1 2013	61,259	(28)%
Q2 2013	54,086	(12)%
Q3 2013	49,555	(8)%
Q4 2013	37,457	(24)%
Q1 2014	**42,259**	**13%**
Q2 2014	**39,426**	**(7)%**
Q3 2014	**40,624**	**3%**
Q4 2014	**35,910**	**(12)%**

During the fourth quarter the Group has seen a fall of approximately 12 per cent in complaint levels. However, the provision remains sensitive to future trends.

Proactive mailing resulting from Past Business Reviews (PBR)

The Group is proactively mailing customers where it has been identified that there was a risk of potential mis-sale. At 31 December 2014 mailing of the original scope has been completed. During 2014, as a result of ongoing monitoring, some limited additional mailings have been added to the PBR scope. In addition, PBR responses to mailings have been higher than expected resulting in a further provision for PBR of approximately £300 million added during 2014.

Uphold rates

Uphold rates have increased following changes to the complaint handling policy. The impact to date and going forward resulted in a £110 million increase to the provision.

Average redress

Average redress per policy has increased, reversing the trend seen in the first three quarters of 2014. This higher level is expected to continue going forward and has resulted in an additional provision for the year of £40 million.

Re-review of previously handled cases

Approximately 0.6 million cases were included within the scope of remediation at 31 December 2013. These largely related to previously defended complaints which are being reviewed again to ensure consistency with the current complaint handling policy, now in operation. This exercise has commenced and is expected to be substantially complete by the end of June 2015, albeit with payments made in the second half of 2015 for some cases. The Group expects to uphold more of these cases due to the recent increase in uphold rates. Further cases have also been added to the remediation scope and relate to previously upheld cases. These cases have previously received redress and may receive a top-up payment. Given the increase in uphold rates and additional volumes to the scope, this has resulted in a further provision for the year of £250 million.

Notes to the consolidated financial statements continued

NOTE 40: OTHER PROVISIONS (CONTINUED)

Expenses

The Group expects to maintain the PPI operation on its current scale for longer than previously expected given the update to volume related assumptions and the re-review of previously handled cases continuing into 2015. The estimate for administrative expenses, which comprise litigation and complaint handling costs as well as costs arising from cases subsequently referred to the FOS, has increased by approximately £420 million in 2014.

An Enforcement team of the FCA is investigating the Group's governance of third party suppliers and potential failings in the PPI complaint handling process. This investigation is ongoing and it is not possible at this stage to make any assessment of what, if any, additional liability may result from the investigation, although the administration costs of supporting the investigation have been provided for previously.

The Group estimates that it has sold approximately 16 million policies since 2000. These include policies that were not mis-sold as they were suitable for, and appropriately disclosed to, the customer. Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 45 per cent of the policies sold since 2000, covering both customer-initiated complaints and actual and expected proactive mailings undertaken by the Group.

The total amount provided for PPI represents the Group's best estimate of the likely future costs, albeit a number of risks and uncertainties remain, including complaint volumes, uphold rates, average redress paid, the scope and cost of proactive mailings and remediation, litigation costs and the outcome of the FCA Enforcement investigation. The cost of these factors could differ materially from the Group's estimates and the assumptions underpinning them and could result in a further provision being required.

Key metrics and sensitivities are highlighted in the table below:

Sensitivities[1]	To date unless noted	Future	Sensitivity
Customer initiated complaints since origination (m)[2]	**3.0**	**0.6**	**0.1 = £230m**
Proactive Mailing: – number of policies (m)[3]	**2.7**	**0.1**	**0.1 = £45m**
– response rate[4]	**34%**	**30%**	**1% = £3m**
Average uphold rate per policy[5]	**85%**	**80%**	**1% = £12m**
Average redress per upheld policy[6]	**£1,700**	**£1,790**	**£100 = £90m**
Remediation Cases (m)[7]	**0.2**	**1.0**	**1 case = £600**
Administrative expenses (£m)	**2,035**	**485**	**1 case = £500**
FOS Referral Rate[8]	**40%**	**40%**	**1% = £3m**
FOS Change Rate[9]	**58%**	**30%**	**1% = £2m**

[1] All sensitivities exclude claims where no PPI policy was held.

[2] Sensitivity includes complaint handling costs, and has increased as a result of higher uphold rates and a shift towards older policies.

[3] To date volume includes customer initiated complaints.

[4] Metric has been adjusted to include mature mailings only. Future response rates are expected to be lower than experienced to date as mailings to higher risk customers have been prioritised. The sensitivity has reduced from the half year as the higher risk population continues to decrease.

[5] The percentage of complaints where the Group finds in favour of the customer. This is a blend of proactive and customer initiated complaints. The 85 per cent uphold rate is based on six months to December 2014. The lower uphold rate in the future reflects a lower proportion of PBR related cases which typically have a higher uphold rate, reflecting the higher risk nature of those policy sales.

[6] The amount that is paid in redress in relation to a policy found to have been mis-sold, comprising, where applicable, the refund of premium, compound interest charged and interest at 8 per cent per annum. Actuals are based on the six months to December 2014. The increase in future average redress is influenced by fewer PBR policies due to the maturity of the PBR mailing. The increase is also due to a shift in the reactive complaint mix towards older, and therefore more expensive, policies.

[7] Remediation to date is based on cases reviewed as at 31 December 2014, but not necessarily settled and also includes a small portion relating to previously upheld complaints. The average cost included in the sensitivity is based on all cases included within the remediation scope, and is therefore a weighted average of full payments, top-up payments on previously upheld cases, and nil payouts where the original decision is retained.

[8] The percentage of cases reviewed by the Group that are subsequently referred to the FOS by the customer. A complaint is considered mature when six months have elapsed since initial decision. Actuals are based on decisions made by the Group during January 2014 to June 2014 and subsequently referred to the FOS.

[9] The percentage of complaints referred where the FOS arrive at a different decision to the Group. Actuals are based on the six months to December 2014. The overturn rate to date is high as it continues to include a significant number of cases assessed prior to the implementation of changes to the case review process during 2013.

The provision remains sensitive to future trends; as an example, were reactive complaint levels in the first two quarters of 2015 to remain broadly in line with the fourth quarter of 2014 then the revised modelled total complaints and associated administration costs would increase the provision by approximately £700 million.

OTHER REGULATORY PROVISIONS

Litigation in relation to insurance branch business in Germany

Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice in Germany the Group recognised provisions totalling £400 million in 2012 and 2013. Volumes of claims have not decreased as quickly as expected and as a result the Group has recognised a further £120 million during 2014 bringing the total provision to £520 million. The remaining unutilised provision as at 31 December 2014 is £199 million.

NOTE 40: OTHER PROVISIONS (CONTINUED)

The validity of the claims facing CMIG depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once all relevant claims have been resolved.

LIBOR and other trading rates

During 2014 the Group charged £225 million to the income statement in respect of this matter. In July, the Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate.

On LIBOR, the Group has reached settlements with the FCA in the United Kingdom, the United States Commodity Futures Trading Commission (CFTC) and the United States Department of Justice (DOJ) in relation to investigations into submissions between May 2006 and 2009 and related systems and controls failings.

The settlements in relation to LIBOR are part of an industry-wide investigation into the setting of interbank offered rates across a range of currencies. Under the settlement, the Group has paid £35 million, £62 million and £50 million to the FCA, CFTC and DOJ respectively. As part of the settlement with the DOJ, the Group has also entered into a two-year Deferred Prosecution Agreement in relation to one count of wire fraud relating to the setting of LIBOR.

In relation to the BBA Sterling Repo Rate, the Group has reached a settlement with the FCA regarding submissions made between April 2008 and September 2009. This issue involved four individuals who the FCA has concluded manipulated BBA Repo Rate submissions to reduce fees payable under the Special Liquidity Scheme (SLS). The issue was proactively brought to the FCA's attention when it was identified by the Group as part of its internal investigation into the LIBOR issues.

The Group has paid £70 million to the FCA in connection with the resolution of the BBA Repo Rate issue and related systems and controls failings. Both the CFTC and DOJ settlements are in respect of LIBOR only and neither agency has taken action regarding the BBA Repo Rate.

The BBA Repo Rate was used by the Bank of England (BoE) to calculate the fees for the SLS. During the period that Lloyds TSB and HBOS used the SLS they paid £1,278 million in fees, just under half of all the fees payable by the industry under the Scheme. As a result of the actions of the four individuals involved, the Group has paid nearly £8 million to compensate the BoE for amounts underpaid (by Lloyds TSB and HBOS and the other banks that used the SLS).

Interest rate hedging products

In June 2012, a number of banks, including the Group, reached agreement with the FSA (now FCA) to carry out a review of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. As at 31 December 2014 the Group had identified 1,676 sales of IRHPs to customers within scope of the agreement with the FCA which have opted in and are being reviewed and, where appropriate, redressed. The Group agreed that on conclusion of this review it would provide redress to any in-scope customers where appropriate. The Group continues to review the remaining cases within the scope of the agreement with the FCA but has met all of the regulator's requirements to date.

During 2014, the Group has charged a further £150 million in respect of estimated redress costs, increasing the total amount provided for redress and related administration costs for in-scope customers to £680 million (31 December 2013: £530 million). This increase relates to an extension in the timetable for customers being able to opt-in to the review and the volume and complexity of claims. As at 31 December 2014, the Group has utilised £571 million (31 December 2013: £162 million), with £109 million (31 December 2013: £368 million) of the provision remaining.

Other legal actions and regulatory matters

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints and claims from customers in connection with its past conduct and, where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. In 2014 the provision was increased by a further £430 million, in respect of a number of matters affecting the Retail, Commercial Banking and Consumer Finance divisions, including potential claims and remediation in respect of products sold through the branch network and continuing investigation of matters highlighted through industry-wide regulatory reviews, as well as legacy product sales and historical systems and controls such as those governing legacy incentive schemes. This brings the total amount charged to £730 million of which £209 million had been utilised at 31 December 2014. This increase reflected the Group's assessment of a limited number of matters under discussion, none of which currently is individually considered financially material in the context of the Group.

VACANT LEASEHOLD PROPERTY

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

OTHER

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure.

Other provisions include those arising out of the insolvency of a third party insurer, which remains exposed to asbestos and pollution claims in the US. The ultimate cost and timing of payments are uncertain. The provision held of £28 million at 31 December 2014 represents management's current best estimate of the cost after having regard to actuarial estimates of future losses.

NOTE 41: SUBORDINATED LIABILITIES

	2014 £m	2013 £m
Preference shares	**1,091**	876
Preferred securities	**3,819**	4,301
Undated subordinated liabilities	**1,852**	1,916
Enhanced Capital Notes	**3,683**	8,938
Dated subordinated liabilities	**15,597**	16,281
Total subordinated liabilities	**26,042**	32,312

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of holders of the dated subordinated liabilities. The subordination of the dated Enhanced Capital Notes (ECNs) ranks equally with that of the dated subordinated liabilities. The Group has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during 2014 (2013: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the Prudential Regulation Authority.

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

	2014 £m	2013 £m
At 1 January	**32,312**	34,092
Issued during the year	**629**	1,500
Exchange offer in respect of Enhanced Capital Notes (notes 9 and 46)	**(4,961)**	–
Other repurchases and redemptions during the year	**(3,023)**	(2,442)
Foreign exchange and other movements	**1,085**	(838)
At 31 December	**26,042**	32,312

	Note	2014 £m	2013 £m
Preference shares			
6% Non-cumulative Redeemable Preference Shares	a	**–**	–
6.0884% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (£745 million)		**11**	10
5.92% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015 (US$750 million)		**136**	127
6.267% Non-cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million)		**279**	274
6.3673% Non-cumulative Fixed to Floating Rate Preference Shares callable 2019 (£335 million)		**2**	2
6.475% Non-cumulative Preference Shares callable 2024 (£186 million)		**43**	39
6.413% Non-cumulative Fixed to Floating Rate Preference Shares callable 2035 (US$750 million)		**115**	51
6.657% Non-cumulative Fixed to Floating Rate Preference Shares callable 2037 (US$750 million)		**54**	16
9.25% Non-cumulative Irredeemable Preference Shares (£300 million)		**375**	304
9.75% Non-cumulative Irredeemable Preference Shares (£100 million)		**76**	53
Total preference shares		**1,091**	876

a Since 2004, the Company has had in issue 400 6 per cent non-cumulative preference shares of 25p each. The shares, which are redeemable at the option of the Company at any time, carry the rights to a fixed rate non-cumulative preferential dividend of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Company.

NOTE 41: SUBORDINATED LIABILITIES (CONTINUED)

	Note	2014 £m	2013 £m
Preferred securities			
6.90% Perpetual Capital Securities (US$1,000 million)	a	–	209
6.85% Non-cumulative Perpetual Preferred Securities (US$1,000 million)	a	259	121
8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million)	a, b	250	256
7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million)	a, c	77	66
6.35% Step-up Perpetual Capital Securities (€500 million)	a, d	–	212
6.071% Non-cumulative Perpetual Preferred Securities (US$750 million)		–	423
7.834% Sterling Step-up Non-voting Non-cumulative Preferred Securities callable 2015 (£250 million)		5	5
4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million)		27	26
7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million)		138	132
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)		77	89
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities (£600 million)		481	455
13% Step-up Perpetual Capital Securities callable 2019 (£785 million)		10	8
13% Step-up Perpetual Capital Securities callable 2019 (€532 million)		47	50
7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million)		105	101
12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US$2,000 million)		1,326	1,211
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)		117	90
13% Step-up Perpetual Capital Securities callable 2029 (£700 million)		662	660
7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million)		238	187
Total preferred securities		**3,819**	**4,301**

a These securities have passed their first call date, and are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the PRA.

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

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

d The fixed rate on this security was reset from 6.35 per cent to 3 month Euribor plus 2.50 per cent with effect from 25 February 2013.

Notes to the consolidated financial statements continued

NOTE 41: SUBORDINATED LIABILITIES (CONTINUED)

	Note	2014 £m	2013 £m
Undated subordinated liabilities			
6.625% Undated Subordinated Step-up Notes (£410 million)	a, b	5	6
Floating Rate Undated Subordinated Step-up Notes (€300 million)	a	19	16
6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	a, c	10	8
4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)		–	79
Floating Rate Undated Subordinated Notes (€500 million)		–	49
4.25% Perpetual Fixed to Floating Rate Reset Subordinated Guaranteed Notes (€750 million) (Clerical Medical Finance plc)		295	283
10.25% Subordinated Undated Instruments (£100 million)		1	1
7.375% Subordinated Undated Instruments (£150 million)		–	–
5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million) (Scottish Widows plc)		548	533
5.125% Undated Subordinated Fixed to Floating Notes (€750 million)		50	49
7.5% Undated Subordinated Step-up Notes (£300 million)		4	5
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)		2	2
6.5% Undated Subordinated Step-up Notes callable 2019 (£270 million)		1	1
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)		–	–
7.375% Undated Subordinated Guaranteed Bonds (£200 million) (Clerical Medical Finance plc)		41	44
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019 (£500 million)		–	5
12% Perpetual Subordinated Bonds (£100 million)		20	20
5.75% Undated Subordinated Step-up Notes (£600 million)		2	3
8.75% Perpetual Subordinated Bonds (£100 million)		5	5
9.375% Perpetual Subordinated Bonds (£50 million)		14	14
5.75% Undated Subordinated Step-up Notes (£500 million)		6	4
6.5% Undated Subordinated Step-up Notes callable 2029 (£450 million)		–	–
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)		10	10
Floating Rate Primary Capital Notes (US$250 million)	a	116	109
Primary Capital Undated Floating Rate Notes:			
Series 1 (US$750 million)	a	172	162
Series 2 (US$500 million)	a	180	169
Series 3 (US$600 million)	a	231	218
13.625% Perpetual Subordinated Bonds (£75 million)		18	19
11.75% Perpetual Subordinated Bonds (£100 million)		102	102
Total undated subordinated liabilities		**1,852**	**1,916**

a These securities have passed their first call date, and are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the PRA.

b The fixed rate on this security was reset from 6.625 per cent to 4.64821 per cent with effect from 15 July 2010.

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

NOTE 41: SUBORDINATED LIABILITIES (CONTINUED)

With the exception of the two series identified in footnote b below, the ECNs were issued in lower tier 2 format and are convertible into ordinary shares on the breach of a defined trigger. The trigger is if the published core tier 1 ratio of the Group (as defined by the Financial Services Authority in May 2009) falls below 5 per cent.

	Note	2014 £m	2013 £m
Enhanced Capital Notes			
7.625% Enhanced Capital Notes due 2019 (£151 million)		38	145
8.125% Enhanced Capital Notes due 2019 (£4 million)		4	4
9% Enhanced Capital Notes due 2019 (£97 million)		15	102
7.8673% Enhanced Capital Notes due 2019 (£331 million)		17	333
15% Enhanced Capital Notes due 2019 (£775 million)		936	1,064
15% Enhanced Capital Notes due 2019 (€487 million)		514	567
8.875% Enhanced Capital Notes due 2020 (€125 million)		108	116
9.334% Enhanced Capital Notes due 2020 (£208 million)		23	231
7.375% Enhanced Capital Notes due 2020 (€95 million)		76	80
Floating Rate Enhanced Capital Notes due 2020 (€53 million)	a	34	37
7.875% Enhanced Capital Notes due 2020 (US$408 million)		220	258
11.04% Enhanced Capital Notes due 2020 (£736 million)		67	824
7.5884% Enhanced Capital Notes due 2020 (£732 million)		59	706
6.385% Enhanced Capital Notes due 2020 (€662 million)		457	524
6.439% Enhanced Capital Notes due 2020 (€711 million)		36	563
8% Fixed to Floating Rate Undated Enhanced Capital Notes callable 2020 (US$1,259 million)	b	373	662
9.125% Enhanced Capital Notes due 2020 (£148 million)		50	157
12.75% Enhanced Capital Notes due 2020 (£57 million)		16	71
7.869% Enhanced Capital Notes due 2020 (£597 million)		26	593
7.625% Enhanced Capital Notes due 2020 (€226 million)		174	185
7.875% Enhanced Capital Notes due 2020 (US$986 million)		44	595
11.125% Enhanced Capital Notes due 2020 (£39 million)		5	44
8.5% Undated Enhanced Capital Notes callable 2021 (US$277 million)	b	156	146
14.5% Enhanced Capital Notes due 2022 (£79 million)		20	110
9.875% Enhanced Capital Notes due 2023 (£57 million)		6	66
11.25% Enhanced Capital Notes due 2023 (£95 million)		22	115
10.5% Enhanced Capital Notes due 2023 (£69 million)		10	78
11.875% Enhanced Capital Notes due 2024 (£35 million)		20	44
7.975% Enhanced Capital Notes due 2024 (£102 million)		26	99
16.125% Enhanced Capital Notes due 2024 (£61 million)		21	94
15% Enhanced Capital Notes due 2029 (£68 million)		106	108
9% Enhanced Capital Notes due 2029 (£107 million)		1	112
8.5% Enhanced Capital Notes due 2032 (£104 million)		3	105
Total Enhanced Capital Notes		**3,683**	**8,938**

a Interest is payable quarterly in arrears at a rate of 3 month Euribor plus 3.1 per cent per annum.

b Issued in upper tier 2 format.

Notes to the consolidated financial statements continued

NOTE 41: SUBORDINATED LIABILITIES (CONTINUED)

	Note	2014 £m	2013 £m
Dated subordinated liabilities			
Subordinated Step-up Floating Rate Notes 2016 (€500 million)	a	–	172
Subordinated Step-up Floating Rate Notes 2016 (£300 million)	a	–	183
Callable Floating Rate Subordinated Notes 2016 (€500 million)	a	99	109
Callable Floating Rate Subordinated Notes 2016 (€500 million)	a	158	156
Subordinated Callable Notes 2016 (US$750 million)	a	260	218
Subordinated Callable Notes 2017 (€1,000 million)	a	284	276
6.75% Subordinated Callable Fixed to Floating Rate Instruments 2017 (Aus$200 million)	a, b	–	5
Subordinated Callable Floating Rate Instruments 2017 (Aus$400 million)	a	–	33
5.109% Callable Fixed to Floating Rate Notes 2017 (Can$500 million)	a, c	10	10
Subordinated Callable Notes 2017 (US$1,000 million)	a	245	211
6.305% Subordinated Callable Fixed to Floating Rate Notes 2017 (£500 million)	a, d	26	23
11% Subordinated Bonds 2014 (£250 million)		–	275
5.875% Subordinated Notes 2014 (£150 million)		–	155
5.875% Subordinated Guaranteed Bonds 2014 (€750 million)		–	658
4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)		–	621
4.875% Subordinated Notes 2015 (€1,000 million)		801	862
6.625% Subordinated Notes 2015 (£350 million)		369	371
6.9625% Callable Subordinated Fixed to Floating Rate Notes 2020 callable 2015 (£750 million)		741	701
11.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (€1,147 million)		923	975
10.75% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (£466 million)		465	458
9.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (US$568 million)		369	349
10.125% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Can$387 million)		217	223
13% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Aus$417 million)		228	234
10.5% Subordinated Bonds 2018 (£150 million)		169	174
6.75% Subordinated Fixed Rate Notes 2018 (US$2,000 million)		1,203	1,102
10.375% Subordinated Fixed to Fixed Rate Notes 2024 callable 2019 (€154 million)		130	141
6.375% Subordinated Instruments 2019 (£250 million)		266	256
6.5% Dated Subordinated Notes 2020 (€1,500 million)		1,393	1,433
7.375% Dated Subordinated Notes 2020		3	3
5.75% Subordinated Fixed to Floating Rate Notes 2025 callable 2020 (£350 million)		347	331
6.5% Subordinated Fixed Rate Notes 2020 (US$2,000 million)		1,338	1,231
Subordinated Floating Rate Notes 2020 (€100 million)		78	85
9.375% Subordinated Bonds 2021 (£500 million)		648	617
5.374% Subordinated Fixed Rate Notes 2021 (€160 million)		147	147
9.625% Subordinated Bonds 2023 (£300 million)		371	341
7.07% Subordinated Fixed Rate Notes 2023 (€175 million)		179	175
5.50% Subordinated Notes 2023 (£850 million) (Scottish Widows plc)		930	794
4.5% Fixed Rate Subordinated Debt Securities due 2024 (US$1,000 million)		649	–
4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)		506	445
7.625% Dated Subordinated Notes 2025 (£750 million)		904	822
6% Subordinated Notes 2033 (US$750 million)		433	313
7.00% Subordinated Notes 2043 (£650 million) (Scottish Widows plc)		708	593
Total dated subordinated liabilities		**15,597**	16,281

a These securities have passed their first call dates, and are callable at specific dates as per the terms of the securities at the option of the issuer and with approval of the PRA.

b The interest rate payable on this security was reset from 6.75 per cent fixed to Bank Bill Swap Rate plus 0.76 per cent with effect from 1 May 2012.

c The interest rate payable on this security was reset from 5.109 per cent fixed to Canadian Dealer Offered Rate plus 0.65 per cent with effect from 21 June 2012.

d The interest rate payable on this security was reset from 6.305 per cent fixed to 3-month LIBOR plus 1.2 per cent with effect from 18 October 2012.

NOTE 42: SHARE CAPITAL

(1) AUTHORISED SHARE CAPITAL

As permitted by the Companies Act 2006, the Company removed references to authorised share capital from its articles of association at the annual general meeting on 5 June 2009. This change took effect from 1 October 2009.

(2) ISSUED AND FULLY PAID SHARE CAPITAL

	2014 Number of shares	2013 Number of shares	2012 Number of shares	2014 £m	2013 £m	2012 £m
Ordinary shares of 10p (formerly 25p) each						
At 1 January	**71,368,435,941**	70,342,844,289	68,726,627,112	**7,137**	7,034	6,873
Issued in relation to the payment of coupons on certain hybrid capital securities	**–**	712,973,022	479,297,215	**–**	71	47
Issued under employee share schemes	**5,299,416**	312,618,630	1,136,919,962	**1**	32	114
At 31 December	**71,373,735,357**	71,368,435,941	70,342,844,289	**7,138**	7,137	7,034
Limited voting ordinary shares of 10p (formerly 25p) each						
At 1 January and 31 December	**80,921,051**	80,921,051	80,921,051	**8**	8	8
Total issued share capital				**7,146**	7,145	7,042

Share issuances

The 5 million shares issued in 2014 were in respect of employee share schemes (2013: 312 million shares; 2012: 1,137 million shares). In 2013 the Group issued 713 million new ordinary shares (2012: 479 million shares) in relation to payment of coupons in the year on certain hybrid capital securities that are non-cumulative.

(3) SHARE CAPITAL AND CONTROL

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association and:

- certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws);
- pursuant to the UK Listing Authority's listing rules where directors and certain employees of the Company require the approval of the Company to deal in the Company's shares; and
- pursuant to the rules of some of the Company's employee share plans where certain restrictions may apply while the shares are subject to the plans.

Where, under an employee share plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised by the registered owner at the direction of the participant. Outstanding awards and options would normally vest and become exercisable on a change of control, subject to the satisfaction of any performance conditions at that time.

In addition, the Company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights.

Information regarding significant direct or indirect holdings of shares in the Company can be found on page 105.

The directors have authority to allot and issue ordinary and preference shares and to make market purchases of ordinary and preference shares as granted at the annual general meeting on 15 May 2014. The authority to issue shares and the authority to make market purchases of shares will expire at the next annual general meeting. Shareholders will be asked, at the annual general meeting, to give similar authorities.

Subject to any rights or restrictions attached to any shares, on a show of hands at a general meeting of the Company every holder of shares present in person or by proxy and entitled to vote has one vote and on a poll every member present and entitled to vote has one vote for every share held.

Further details regarding voting at the annual general meeting can be found in the notes to the notice of the annual general meeting.

Ordinary shares

The holders of ordinary shares (excluding the limited voting ordinary shares), who held 99.9 per cent of the total ordinary share capital at 31 December 2014, are entitled to receive the Company's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares (excluding the limited voting ordinary shares) may also receive a dividend (subject to the provisions of the Company's articles of association) and on a winding up may share in the assets of the Company.

Limited voting ordinary shares

The limited voting ordinary shares are held by the Lloyds Bank Foundations (the Foundations). The holders of the limited voting ordinary shares, who held 0.1 per cent of the total ordinary share capital at 31 December 2014, are entitled to receive copies of every circular or other document sent out by the Company to the holders of other ordinary shares. These shares carry no rights to dividends but rank pari passu with the ordinary shares in respect of other distributions and in the event of winding up. These shares do not have any right to vote at general meetings other than on resolutions concerning acquisitions or disposals of such importance that they require shareholder consent, or for the winding up of the Company, or for a variation in the class rights of the limited voting ordinary shares. In the event of an offer for more than 50 per cent of the issued ordinary share capital of the

Notes to the consolidated financial statements continued

NOTE 42: SHARE CAPITAL (CONTINUED)

Company, each limited voting ordinary share will convert into an ordinary share and shall rank equally with the ordinary shares in all respects from the date of conversion.

The Company has entered into deeds of covenant with the Foundations under the terms of which the Company makes annual donations. The deeds of covenant can be cancelled by the Company at nine years notice, at which point the limited voting ordinary share capital would convert into ordinary shares. Such notice has been given to the Lloyds Bank Foundation for Scotland.

Preference shares

The Company has in issue various classes of preference shares which are all classified as liabilities under IFRS and details of which are shown in note 41.

NOTE 43: SHARE PREMIUM ACCOUNT

	2014 £m	2013 £m	2012 £m
At 1 January	**17,279**	16,872	16,541
Issued in relation to the settlement of coupons on certain hybrid capital securities[1]	**–**	279	123
Issued under employee share schemes	**2**	128	208
At 31 December	**17,281**	17,279	16,872

NOTE 44: OTHER RESERVES

	2014 £m	2013 £m	2012 £m
Other reserves comprise:			
Merger reserve[1]	**8,107**	8,107	8,107
Capital redemption reserve[1]	**4,115**	4,115	4,115
Revaluation reserve in respect of available-for-sale financial assets	**(67)**	(615)	399
Cash flow hedging reserve	**1,139**	(1,055)	350
Foreign currency translation reserve	**(78)**	(75)	(69)
At 31 December	**13,216**	10,477	12,902

[1] There were no movements in this reserve during 2014, 2013 or 2012.

The merger reserve primarily comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

The revaluation reserve in respect of available-for-sale financial assets represents the cumulative after tax unrealised change in the fair value of financial assets classified as available-for-sale since initial recognition; in the case of available-for-sale financial assets obtained on acquisitions of businesses, since the date of acquisition; and in the case of transferred assets that were previously held at amortised cost, by reference to that amortised cost.

The cash flow hedging reserve represents the cumulative after tax gains and losses on effective cash flow hedging instruments that will be reclassified to the income statement in the periods in which the hedged item affects profit or loss.

The foreign currency translation reserve represents the cumulative after-tax gains and losses on the translation of foreign operations and exchange differences arising on financial instruments designated as hedges of the Group's net investment in foreign operations.

NOTE 44: OTHER RESERVES (CONTINUED)

Movements in other reserves were as follows:

	2014 £m	2013 £m	2012 £m
Revaluation reserve in respect of available-for-sale financial assets			
At 1 January	**(615)**	399	1,326
Adjustment on transfer from held-to-maturity portfolio	**–**	–	1,168
Change in fair value of available-for-sale financial assets	**690**	(680)	900
Deferred tax	**(65)**	86	(516)
Current tax	**–**	3	(3)
	625	(591)	1,549
Income statement transfers:			
Disposals (note 9)	**(131)**	(629)	(3,547)
Deferred tax	**52**	191	848
	(79)	(438)	(2,699)
Impairment	**2**	18	42
Deferred tax	**–**	(3)	12
	2	15	54
Other transfers	**–**	–	169
Deferred tax	**–**	–	–
	–	–	169
At 31 December	**(67)**	(615)	399

	2014 £m	2013 £m	2012 £m
Cash flow hedging reserve			
At 1 January	**(1,055)**	350	325
Change in fair value of hedging derivatives	**3,896**	(1,229)	116
Deferred tax	**(765)**	320	(17)
Current tax	**–**	–	–
	3,131	(909)	99
Income statement transfers (note 5)	**(1,153)**	(550)	(92)
Deferred tax	**216**	54	18
	(937)	(496)	(74)
At 31 December	**1,139**	(1,055)	350

	2014 £m	2013 £m	2012 £m
Foreign currency translation reserve			
At 1 January	**(75)**	(69)	(55)
Currency translation differences arising in the year	**(25)**	(155)	(69)
Foreign currency gains (losses) on net investment hedges (tax: £nil)	**22**	149	55
At 31 December	**(78)**	(75)	(69)

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NOTE 45: RETAINED PROFITS

	2014 £m	2013 £m	2012 £m
At 1 January	**4,088**	5,080	8,266
Profit (loss) for the year	**1,412**	(838)	(1,471)
Issue costs of other equity instruments (net of tax) (note 46)	**(21)**	–	–
Distributions on other equity instruments (net of tax) (note 46)	**(225)**	–	–
Post-retirement defined benefit scheme remeasurements	**539**	(108)	(1,645)
Movement in treasury shares	**(286)**	(480)	(407)
Value of employee services:			
Share option schemes	**123**	142	81
Other employee award schemes	**233**	292	256
Adjustment on sale of non-controlling interest in TSB (note 56)	**(171)**	–	–
At 31 December	**5,692**	4,088	5,080

Retained profits are stated after deducting £565 million (2013: £480 million; 2012: £158 million) representing 648 million (2013: 578 million; 2012: 301 million) treasury shares held.

A number of Group entities and sub-groups, principally those with banking and insurance activities, are subject to various individual regulatory capital requirements. The payment of dividends by subsidiaries and the ability of members of the Group to lend money to other members of the Group may be subject to regulatory or legal restrictions, the availability of reserves and the financial and operating performance of the entity.

NOTE 46: OTHER EQUITY INSTRUMENTS

	2014 £m	2013 £m	2012 £m
At 1 January	**–**	–	–
Additional Tier 1 securities issued in the year:			
Sterling notes (£3,725 million nominal)	**3,725**	–	–
Euro notes (€750 million nominal)	**622**	–	–
US dollar notes ($1,675 million nominal)	**1,008**	–	–
At 31 December	**5,355**	–	–

On 6 March 2014 the Group announced concurrent Sterling, Euro and Dollar exchange offers for holders of certain series of its Enhanced Capital Notes (ECNs) to exchange them for new Additional Tier 1 (AT1) securities. The exchange offers completed in April 2014 and resulted in a total of £5,355 million of AT1 securities being issued; issue costs of £21 million, net of tax, have been charged to retained profits.

The AT1 securities are Fixed Rate Resetting Perpetual Subordinated Contingent Convertible Securities with no fixed maturity or redemption date.

The principal terms of the AT1 securities are described below:

- The securities rank behind the claims against Lloyds Banking Group plc of (a) unsubordinated creditors, (b) claims which are, or are expressed to be, subordinated to the claims of unsubordinated creditors of Lloyds Banking Group plc but not further or otherwise or (c) whose claims are, or are expressed to be, junior to the claims of other creditors of Lloyds Banking Group, whether subordinated or unsubordinated, other than those whose claims rank, or are expressed to rank, pari passu with, or junior to, the claims of the holders of the AT1 Securities in a winding-up occurring prior to the Conversion Trigger.
- The securities bear a fixed rate of interest until the first call date. After the initial call date, in the event that they are not redeemed, the AT1 securities will bear interest at rates fixed periodically in advance for five year periods based on market rates.
- Interest on the securities will be due and payable only at the sole discretion of Lloyds Banking Group plc, and Lloyds Banking Group plc may at any time elect to cancel any Interest Payment (or any part thereof) which would otherwise be payable on any Interest Payment Date. There are also certain restrictions on the payment of interest as specified in the terms.
- The securities are undated and are repayable, at the option of Lloyds Banking Group plc, in whole at the first call date, or on any fifth anniversary after the first call date. In addition, the AT1 securities are repayable, at the option of Lloyds Banking Group plc, in whole for certain regulatory or tax reasons. Any repayments require the prior consent of the PRA.
- The securities convert into ordinary shares of Lloyds Banking Group plc, at a pre-determined price, should the fully loaded Common Equity Tier 1 ratio of the Group fall below 7.0 per cent.

NOTE 47: ORDINARY DIVIDENDS

The directors have recommended a dividend, which is subject to approval by the shareholders at the Annual General Meeting, of 0.75 pence per share (2013: nil pence per share; 2012: nil pence per share) representing a total dividend of £535 million (2013: £nil; 2012: £nil), which will be paid on 19 May 2015. These financial statements do not reflect this recommended dividend.

The trustees of the following holdings of Lloyds Banking Group plc shares in relation to employee share schemes retain the right to receive dividends but have chosen to waive their entitlement to the dividends on those shares as indicated: the Lloyds Banking Group Share Incentive Plan (holding at 31 December 2014: 21,158,651 shares, 31 December 2013: 16,857,069 shares, waived rights to all dividends), the Lloyds Banking Group Employee Share Ownership Trust (holding at 31 December 2014: 18,704,412 shares, 31 December 2013: 52,150,441 shares, on which it waived rights to all dividends), Lloyds Group Holdings (Jersey) Limited (holding at 31 December 2014: 42,846 shares, 31 December 2013: 42,846 shares, waived rights to all but a nominal amount of one penny in total) and the Lloyds Banking Group Qualifying Employee Share Ownership Trust (holding at 31 December 2014: 1,398 shares, 31 December 2013: 1,398 shares, waived rights to all but a nominal amount of one penny in total).

NOTE 48: SHARE-BASED PAYMENTS

CHARGE TO THE INCOME STATEMENT

The charge to the income statement is set out below:

	2014 £m	2013 £m	2012 £m
Deferred bonus plan	**213**	276	248
Executive and SAYE plans:			
Options granted in the year	**29**	42	12
Options granted in prior years	**78**	74	65
	107	116	77
Share plans:			
Shares granted in the year	**14**	3	3
Shares granted in prior years	**6**	4	5
	20	7	8
Total charge to the income statement	**340**	399	333

During the year ended 31 December 2014 the Group operated the following share-based payment schemes, all of which are equity settled.

DEFERRED BONUS PLANS

The Group operates a number of deferred bonus plans that are equity settled. Bonuses in respect of employee performance in 2014 have been recognised in the charge in line with the proportion of the deferral period completed.

LLOYDS BANKING GROUP EXECUTIVE SHARE OPTION SCHEMES

The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between March 2004 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.

Performance conditions for executive options

For options granted in 2004

The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds Banking Group plc.

The performance condition was measured over a three year period which commenced at the end of the financial year preceding the grant of the option and continued until the end of the third subsequent year. If the performance condition was not then met, it was measured at the end of the fourth financial year. If the condition was not then met, the options would lapse.

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

Options granted to senior executives other than Executive Directors were not so highly leveraged and, as a result, different performance multipliers were applied to their options. For the majority of executives, options were granted with the performance condition but with no performance multiplier.

Notes to the consolidated financial statements continued

NOTE 48: SHARE-BASED PAYMENTS (CONTINUED)

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.

All options granted in 2004 lapsed on 18 March 2014 and 12 August 2014.

For options granted in 2005

The same conditions applied as for grants made in 2004, except that:

- the performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds Banking Group plc;
- if the performance condition was not met at the end of the third subsequent year, the options would lapse; and
- the full grant of options became exercisable only if the Group was ranked in the top four places of the comparator group. A sliding scale applied between fourth and eighth positions. If Lloyds Banking Group was ranked below the median (ninth or below) the options would lapse.

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

Movements in the number of share options outstanding under the executive share option schemes during 2014 and 2013 are set out below:

	2014		2013	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**6,052,593**	**224.04**	8,044,896	224.95
Forfeited	**–**	**–**	(1,992,303)	227.70
Lapsed	**(3,417,306)**	**215.39**	–	–
Outstanding at 31 December	**2,635,287**	**235.26**	6,052,593	224.04
Exercisable at 31 December	**2,635,287**	**235.26**	6,052,593	224.03

No options were exercised during 2014 or 2013. The weighted average remaining contractual life of options outstanding at the end of the year was 0.2 years (2013: 0.8 years). The fair values of the executive share options have been determined using a standard Black-Scholes model.

SAVE-AS-YOU-EARN SCHEMES

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £500 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 the Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

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

	2014		2013	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**500,969,617**	**41.16**	314,572,023	48.01
Granted	**326,565,564**	**60.02**	510,414,399	40.62
Exercised	**(7,287,899)**	**41.29**	(294,905,606)	46.78
Forfeited	**(18,949,167)**	**41.68**	(7,715,717)	43.08
Cancelled	**(15,561,144)**	**54.04**	(10,761,588)	45.61
Expired	**(2,110,588)**	**48.15**	(10,633,894)	56.28
Outstanding at 31 December	**783,626,383**	**48.73**	500,969,617	41.16
Exercisable at 31 December	**1,852**	**180.66**	2,255,239	120.76

The weighted average share price at the time that the options were exercised during 2014 was £0.77 (2013: £0.65). The weighted average remaining contractual life of options outstanding at the end of the year was 2.6 years (2013: 2.9 years).

The weighted average fair value of SAYE options granted during 2014 was £0.22 (2013: £0.24). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2014 or 2013. The options outstanding at 31 December 2014 had an exercise price of £1.8066 (2013: £1.8066) and a weighted average remaining contractual life of 1.4 years (2013: 1.1 years).

NOTE 48: SHARE-BASED PAYMENTS (CONTINUED)

OTHER SHARE OPTION PLANS

Lloyds Banking Group Executive Share Plan 2003

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

For options granted on 27 March 2014 under the Commercial Banking Transformation Plan (CBTP), the number of options that may be delivered in March 2017 may vary by a factor of 0-4 from the original 'on-target' award, depending on the degree to which the performance conditions have been met. An 'on-target' vesting is contingent upon Commercial Banking achieving £2.5 billion Underlying Profit and 2 per cent Return on Risk Weighted Assets ('RoRWA') on 31 December 2016. The Plan will pay out at between £1.9 billion and £3 billion underlying profit, and between 1.6 per cent and 2.5 per cent RoRWA.

Participants are not entitled to any dividends paid during the vesting period.

	2014		2013	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**37,354,979**	**Nil**	45,614,150	Nil
Granted	**225,424,109**	**Nil**	9,284,956	Nil
Exercised	**(21,870,649)**	**Nil**	(16,079,222)	Nil
Forfeited	**(7,114,199)**	**Nil**	(1,290,720)	Nil
Lapsed	**(405,156)**	**Nil**	(174,185)	Nil
Outstanding at 31 December	**233,389,084**	**Nil**	37,354,979	Nil
Exercisable at 31 December	**9,068,802**	**Nil**	4,275,432	Nil

The weighted average fair value of options granted in the year was £0.72 (2013: £0.56). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2014 was £0.75 (2013: £0.55). The weighted average remaining contractual life of options outstanding at the end of the year was 7.0 years (2013: 3.6 years).

Lloyds Banking Group Share Buy Out Awards

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

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

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

	2014		2013	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**11,172,600**	**Nil**	21,321,237	Nil
Exercised	**(5,173,429)**	**Nil**	(5,953,810)	Nil
Forfeited	**–**	**Nil**	(4,194,827)	Nil
Outstanding at 31 December	**5,999,171**	**Nil**	11,172,600	Nil
Exercisable at 31 December	**5,999,171**	**Nil**	11,083,749	Nil

No options were granted in 2014 or 2013. The weighted average remaining contractual life of options outstanding at the end of the year was 6.7 years (2013: 7.5 years).

The weighted average share price at the time the options were exercised during 2014 was £0.70 (2013: £0.75).

Participants are entitled to any dividends paid during the vesting period. This amount will be paid in cash unless the Remuneration Committee decides it will be paid in shares.

The fair values of the majority of options granted have been determined using a standard Black-Scholes model. The fair values of the remaining options have been determined by Monte Carlo simulation.

Notes to the consolidated financial statements continued

NOTE 48: SHARE-BASED PAYMENTS (CONTINUED)

HBOS share option plans

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

During 2013 the Group completed the sale of all of its holding in St James's Place plc. The participants of the St James's Place Share Option Plan remain entitled to the Lloyds Banking Group plc shares awarded under the terms of this Plan and these options are included in the table below.

Participants are not entitled to any dividends paid during the vesting period.

	2014		2013	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**13,119,584**	**369.76**	19,857,692	363.76
Exercised	**(5,222,260)**	**51.83**	(2,609,272)	51.83
Forfeited	**(103,007)**	**580**	(240,349)	568.80
Lapsed	**(321,138)**	**580**	(2,144,026)	546.43
Cancelled	**(7,473,179)**	**580**	(1,744,461)	532.39
Outstanding at 31 December	**–**	**–**	13,119,584	369.76
Exercisable at 31 December	**–**	**–**	13,119,584	369.76

The weighted average share price at the time the options were exercised during 2014 was £0.77 (2013: £0.72).

The options under the HBOS Share Option Plan and St James's Place Share Option Plan lapsed on 15 March 2014 and 20 April 2014 respectively.

OTHER SHARE PLANS

Lloyds Banking Group Long-Term Incentive Plan

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

Participants may be entitled to any dividends paid during the vesting period if the performance conditions are met. An amount equal in value to any dividends paid between the award date and the date the Remuneration Committee determine that the performance conditions were met may be paid, based on the number of shares that vest. The Remuneration Committee will determine if any dividends are to be paid in cash or in shares.

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

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

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

If adjusted EPS reaches 7.8p, 100 per cent of this element will vest.

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

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

If the adjusted EP reaches £567 million, 25 per cent of this element of the award, being the threshold, will vest. If the adjusted EP reaches £1,534 million, 100 per cent of this element will vest.

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

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

NOTE 48: SHARE-BASED PAYMENTS (CONTINUED)

At the end of the performance period for the EPS and EP measures, the targets had not been fully met and therefore these awards vested in 2014 at a rate of 68 per cent (54 per cent for members of the Group Executive Committee, including Executive Directors).

The performance conditions for awards made in March and September 2012 are as follows:

(i) **EP:** relevant to 30 per cent of the award. The performance target is based on 2014 adjusted EP outcome.

If the adjusted EP reaches £225 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £2,330 million, 100 per cent of this element will vest.

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

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2014.

If the ATSR reaches 12 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 30 per cent per annum, 100 per cent of this element will vest.

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

(iii) **Short-term funding as a percentage of total funding:** relevant to 10 per cent of the award. Performance will be measured relative to 2014 targets.

If the average percentage reaches 20 per cent, 25 per cent of this element of the award, being the threshold, will vest.

If the average percentage reaches 15 per cent, 100 per cent of this element will vest.

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

(iv) **Non-core assets at the end of 2014:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet non-core assets at 31 December 2014.

If non-core assets amount to £95 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If non-core assets amount to £80 billion or less, 100 per cent of this element will vest.

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

(v) **Net Simplification benefits:** relevant to 10 per cent of the award. Performance will be measured by reference to the run rate achieved by the end of 2014.

If a run rate of net Simplification benefits of £1.5 billion is achieved, 25 per cent of this element of the award, being the threshold, will vest.

If a run rate of net Simplification benefits of £1.8 billion is achieved, 100 per cent of this element will vest.

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

(vi) **FCA reportable complaints:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FSA reportable complaints per 1,000 customers (excluding PPI complaints) over the three year period to 31 December 2014.

If complaints per 1,000 customers average 1.5 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 1.3 per annum or less over three years, 100 per cent of this element will vest.

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

At the end of the performance period, it has been assessed that rewards will vest at 97 per cent of maximum.

The performance conditions for awards made in March and October 2013 are as follows:

(i) **EP:** relevant to 35 per cent of the award. The performance target is based on 2015 adjusted EP outcome.

If the adjusted EP reaches £1,254 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £1,881 million, 100 per cent of this element will vest.

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

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2015.

If the ATSR reaches 8 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 16 per cent per annum, 100 per cent of this element will vest.

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

(iii) **Adjusted total costs:** relevant to 10 per cent of the award. The performance target is based on 2015 adjusted total costs.

If adjusted total costs are £9,323 million or less, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted total costs are £8,973 million or less, 100 per cent of this element will vest.

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

Notes to the consolidated financial statements continued

NOTE 48: SHARE-BASED PAYMENTS (CONTINUED)

(iv) **Non-core assets excluding UK Retail at the end of 2015:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet non-core assets at 31 December 2015.

If non-core assets amount to £37 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If non-core assets amount to £28 billion or less, 100 per cent of this element will vest.

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

(v) **FCA reportable complaints:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FCA reportable complaints per 1,000 customers over the three year period to 31 December 2015.

If complaints per 1,000 customers average 1.05 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 0.95 per annum or less over three years, 100 per cent of this element will vest.

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

(vi) **SME lending:** relevant to 5 per cent of the award. Performance will be measured by reference to the movement in lending to SMEs relative to the market as reported by the Bank of England over the three year period ending 31 December 2015.

If the movement in SME lending equates to this market movement, 25 per cent of this element of the award, being the threshold, will vest.

If the movement in SME lending is 4 per cent or more greater than the market movement, 100 per cent of this element will vest.

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

In addition, short-term funding must remain within that stated in the Group's Risk Appetite throughout the three year period to 31 December 2015.

The weighted average fair value of the share awards granted in 2014 was £0.62 (2013: £0.34). The fair values of the majority of share awards granted have been determined using a standard Black-Scholes model. The fair values of the remaining share awards have been determined by Monte Carlo simulation.

The performance conditions for awards made in March and August 2014 are as follows:

(i) **EP:** relevant to 30 per cent of the award. The performance target is based on 2016 adjusted EP outcome.

If the adjusted EP reaches £2,154 million, 25 per cent of this element of the award, being the threshold will vest.

If the adjusted EP reaches £3,231 million, 100 per cent of this element will vest.

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

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2016.

If the ATSR reaches 8 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 16 per cent per annum, 100 per cent of this element will vest.

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

(iii) **Cost: income ratio:** relevant to 10 per cent of the award.

Performance will be measured against the adjusted total costs (total costs excluding FSCS costs and Bank Levy on underlying basis) as a percentage of total underlying income net of insurance claims based on full year 2016 figures.

If the adjusted total costs reaches:

– 48.9 per cent, 25 per cent of this element will vest.

– 46.5 per cent, 100 per cent of this element will vest.

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

(iv) **FCA reportable complaints:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FCA reportable complaints per 1,000 accounts (excluding PPI complaints) over the three year period to 31 December 2016. If complaints per 1,000 accounts average 1.15 per annum or less, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 accounts average 1.05 per annum or less, 100 per cent of this element will vest.

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

(v) **Net Promoter Score:** relevant to 10 per cent of the award. Performance will be measured against the Major Group Ranking position of Lloyds Banking Group, the position averaged over the final twelve months of the performance period.

If the final averaged ranking position of Lloyds Banking Group is third, 25 per cent of this element will vest.

If the final averaged ranking position of Lloyds Banking Group is first, 100 per cent of this element will vest.

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

(vi) **SME lending:** relevant to 5 per cent of the award. Performance will be measured by reference to the percentage increase in net lending to SMEs over the three year period ending 31 December 2016.

If there is a 14 per cent increase in net lending, 25 per cent of this element will vest.

If there is an 18 per cent increase in net lending, 100 per cent of this element will vest.

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

NOTE 48: SHARE-BASED PAYMENTS (CONTINUED)

(vii) **First Time Buyer Lending:** relevant to 5 per cent of the award. Performance will be measured against percentage market shares based on Council of Mortgage Lenders Volumes data. Calculated as three point average of year-end positions over the three year period ending 31 December 2016.

If the percentage market share reaches 20 per cent, 25 per cent of this element will vest.

If the percentage market share reaches 25 per cent, 100 per cent of this element will vest.

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

	2014 Number of shares	2013 Number of shares
Outstanding at 1 January	**548,885,895**	515,951,517
Granted	**120,952,253**	186,360,995
Vested	**(73,516,122)**	–
Forfeited	**(73,485,915)**	(153,426,617)
Outstanding at 31 December	**522,836,111**	548,885,895

Scottish Widows Investment Partnership Long-Term Incentive Plan

The Scottish Widows Investment Partnership (SWIP) Long-Term Incentive Plan applicable to senior executives and employees of SWIP, which had previously been a cash-only scheme, was amended in May 2012 for awards granted on or after that date. The amendment introduced the receipt of shares in Lloyds Banking Group plc as an element of the total award. For awards made in June 2012, the other element continued to be cash-based, with the split between cash-based and share-based determined by the Remuneration Committee. Awards made in June 2013 were fully share-based. The amendment was aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of SWIP over a three year period. Awards were made within limits set by the rules of the Plan, with the maximum limits for combined cash and shares awarded equating to 3.5 times annual salary. In exceptional circumstances this could increase to four times annual salary.

The 2012 and 2013 performance conditions were evaluated upon completion of the sale of SWIP to Aberdeen Asset Management PLC, and the awards were pro rated as appropriate. The 2012 award will vest at 155 per cent and 165.6 per cent for Code Staff in March 2015 and the 2013 award will vest at 165.7 per cent in March 2016.

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

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
At 31 December 2014									
Exercise price range									
£0 to £1	**–**	**–**	**–**	**48.63**	**2.57**	**783,025,625**	**–**	**–**	**–**
£1 to £2	**–**	**–**	**–**	**180.66**	**1.41**	**600,758**	**–**	**–**	**–**
£2 to £3	**235.26**	**0.2**	**2,635,287**	**–**	**–**	**–**	**–**	**–**	**–**
£3 to £4	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
£5 to £6	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
At 31 December 2013									
Exercise price range									
£0 to £1	–	–	–	40.63	2.91	499,088,383	5.25	4.1	51,528,728
£1 to £2	199.91	0.6	196,201	180.64	1.09	1,881,234	–	–	–
£2 to £3	224.85	0.8	5,856,392	–	–	–	–	–	–
£5 to £6	–	–	–	–	–	–	580.00	0.2	7,897,324

Notes to the consolidated financial statements continued

NOTE 48: SHARE-BASED PAYMENTS (CONTINUED)

The fair value calculations at 31 December 2014 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	Save-As-You-Earn	Executive Share Plan 2003	LTIP	Commercial Banking Transformation Program
Weighted average risk-free interest rate	1.30%	0.58%	1.03%	1.03%
Weighted average expected life	3.3 years	1.2 years	3.0 years	3.0 years
Weighted average expected volatility	35%	23%	41%	41%
Weighted average expected dividend yield	2.5%	2.5%	2.5%	2.5%
Weighted average share price	£0.75	£0.76	£0.79	£0.78
Weighted average exercise price	£0.60	Nil	Nil	Nil

Expected volatility is a measure of the amount by which the Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

Matching shares

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

The number of shares awarded relating to matching shares in 2014 was 16,248,562 (2013: 19,870,495), with an average fair value of £0.78 (2013: £0.63), based on market prices at the date of award.

Fixed Share Awards

Fixed share awards were introduced in 2014 in order to ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for certain Lloyds Banking Group employees, with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements. The Fixed Share Awards are delivered in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. The number of shares purchased in 2014 was 7,761,624.

The Fixed Share Award is not subject to any performance conditions, performance adjustment or clawback. On an employee leaving the Group, there is no change to the timeline for which shares will become unrestricted.

NOTE 49: RELATED PARTY TRANSACTIONS

KEY MANAGEMENT PERSONNEL

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

The table below details, on an aggregated basis, key management personnel compensation:

	2014 £m	2013 £m	2012 £m
Compensation			
Salaries and other short-term benefits	15	15	12
Post-employment benefits	1	–	–
Share-based payments	17	21	13
Total compensation	33	36	25

Aggregate contributions in respect of key management personnel to defined contribution pension schemes were £0.1 million (2013: £0.2 million; 2012: £0.1 million).

NOTE 49: RELATED PARTY TRANSACTIONS (CONTINUED)

	2014 million	2013 million	2012 million
Share option plans			
At 1 January	**14**	25	22
Granted, including certain adjustments (includes entitlements of appointed key management personnel)	**–**	5	8
Exercised/lapsed (includes entitlements of former key management personnel)	**(1)**	(16)	(5)
At 31 December	**13**	14	25

	2014 million	2013 million	2012 million
Share plans			
At 1 January	**105**	70	58
Granted, including certain adjustments (includes entitlements of appointed key management personnel)	**19**	42	45
Exercised/lapsed (includes entitlements of former key management personnel)	**(22)**	(7)	(33)
At 31 December	**102**	105	70

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:

	2014 £m	2013 £m	2012 £m
Loans			
At 1 January	**2**	2	3
Advanced (includes loans of appointed key management personnel)	**2**	2	3
Repayments (includes loans of former key management personnel)	**(1)**	(2)	(4)
At 31 December	**3**	2	2

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 0.5 per cent and 23.95 per cent in 2014 (2013: 2.5 per cent and 23.9 per cent; 2012: 2.5 per cent and 29.95 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2013 and 2012: £nil).

	2014 £m	2013 £m	2012 £m
Deposits			
At 1 January	**13**	10	6
Placed (includes deposits of appointed key management personnel)	**32**	29	39
Withdrawn (includes deposits of former key management personnel)	**(29)**	(26)	(35)
At 31 December	**16**	13	10

Deposits placed by key management personnel attracted interest rates of up to 4.7 per cent (2013: 2.9 per cent; 2012: 3.8 per cent).

At 31 December 2014, the Group did not provide any guarantees in respect of key management personnel (2013 and 2012: none).

At 31 December 2014, transactions, arrangements and agreements entered into by the Group's banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £1 million with six directors and six connected persons (2013: £1 million with six directors and five connected persons; 2012: £1 million with five directors and three connected persons).

SUBSIDIARIES
Details of the principal subsidiaries are given in note 9 to the parent company financial statements. In accordance with IFRS 10 *Consolidated financial statements*, transactions and balances with subsidiaries have been eliminated on consolidation.

UK GOVERNMENT
In January 2009, the UK Government through HM Treasury became a related party of the Company following its subscription for ordinary shares issued under a placing and open offer. At 31 December 2014, HM Treasury held more than 20 per cent of the Company's ordinary share capital and consequently HM Treasury remained a related party of the Company during the year ended 31 December 2014.

Notes to the consolidated financial statements continued

NOTE 49: RELATED PARTY TRANSACTIONS (CONTINUED)

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

During the year ended 31 December 2014, the Group participated in a number of schemes operated by the UK Government and central banks and made available to eligible banks and building societies.

National Loan Guarantee Scheme

The Group has participated in the UK government's National Loan Guarantee Scheme, which was launched on 20 March 2012. Through the scheme, the Group is providing eligible UK businesses with discounted funding, subject to continuation of the scheme and its financial benefits, and based on the Group's existing lending criteria. Eligible businesses who have taken up the funding benefit from a 1 per cent discount on their funding rate for a pre-agreed period of time.

Business Growth Fund

In May 2011 the Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to commit up to £300 million of equity investment by subscribing 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. At 31 December 2014, the Group had invested £118 million (31 December 2013: £64 million) in the Business Growth Fund and carried the investment at a fair value of £105 million (31 December 2013: £52 million).

Big Society Capital

In January 2012 the Group agreed, together with The Royal Bank of Scotland plc (and two other non-related parties), to commit up to £50 million each of equity investment into the Big Society Capital Fund. The Fund, which was created as part of the Project Merlin arrangements, is a UK social investment fund. The Fund was officially launched on 3 April 2012 and the Group had invested £23 million in the Fund by 31 December 2013 and invested a further £8 million during the year ended 31 December 2014.

Funding for Lending

In August 2012, the Group announced its support for the UK government's Funding for Lending Scheme and confirmed its intention to participate in the scheme. The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Group. The initiative supported a broad range of UK based customers, providing householders with more affordable housing finance and businesses with cheaper finance to invest and grow. In November 2013, the Group entered into extension letters with the Bank of England to take part in the extension of the Funding for Lending Scheme until the end of January 2015. The extension of the Funding for Lending Scheme focuses on providing businesses with cheaper finance to invest and grow. £10 billion has been drawn down under this extension. In December 2014, the Bank of England announced a further extension to the end of January 2016 with an increased focus on supporting small businesses. At 31 December 2014, the Group had drawn down £20 billion under the Funding for Lending Scheme.

Enterprise Finance Guarantee Scheme

The Group participates in the Enterprise Finance Guarantee Scheme which was launched in January 2009 as a replacement for the Small Firms Loan Guarantee Scheme. The scheme is a UK government-backed loan guarantee, which supports viable businesses with access to lending where they would otherwise be refused a loan due to a lack of lending security. The Department for Business, Innovation and Skills (formerly the Department for Business, Enterprise and Regulatory Reform) provides the lender with a guarantee of up to 75 per cent of the capital of each loan subject to the eligibility of the customer within the rules of the scheme. As at 31 December 2014, the Group had offered 6,250 loans to customers, worth over £500 million. The Group entities, Lloyds Bank plc, TSB Bank plc, Lloyds Commercial Finance Limited and Bank of Scotland plc contracted with The Secretary of State for Business, Innovation and Skills.

Help to Buy

On 7 October 2013, Bank of Scotland plc entered into an agreement with The Commissioners of Her Majesty's Treasury by which it agreed that the Halifax Division of Bank of Scotland plc would participate in the Help to Buy Scheme with effect from 11 October 2013 and that Lloyds Bank plc would participate from 3 January 2014. The Help to Buy Scheme is a scheme promoted by the UK government and is aimed to encourage participating lenders to make mortgage loans available to customers who require higher loan-to-value mortgages. Halifax and Lloyds are currently participating in the Scheme whereby customers borrow between 90 per cent and 95 per cent of the purchase price.

In return for the payment of a commercial fee, HM Treasury has agreed to provide a guarantee to the lender to cover a proportion of any loss made by the lender arising from a higher loan-to-value loan being made. £1,950 million of outstanding loans at 31 December 2014 had been advanced under this scheme.

HM Treasury expenses

During the year ended 31 December 2014, the Group paid for expenses amounting to £1 million incurred by or on behalf of HM Treasury in connection with the sale or proposed sale of shares by HM Treasury in the Company. The expenses were incurred in accordance with the Resale Rights Agreement and the Registration Rights Agreement entered into with HM Treasury in 2009. The performance by the Company of the Resale Rights Agreement and the Registration Rights Agreement was approved by shareholders of the Company at the 2014 Annual General Meeting.

Central bank facilities

In the ordinary course of business, the Group may from time to time access market-wide facilities provided by central banks.

NOTE 49: RELATED PARTY TRANSACTIONS (CONTINUED)

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

Pension funds

The Group provides banking and some investment management services to certain of its pension funds. At 31 December 2014, customer deposits of £129 million (2013: £145 million) and investment and insurance contract liabilities of £3,278 million (2013: £4,728 million) related to the Group's pension funds.

Collective investment vehicles

The Group manages 132 (2013: 210) collective investment vehicles, such as Open Ended Investment Companies (OEICs) and of these 80 (2013: 145) are consolidated. The Group invested £811 million (2013: £2,472 million) and redeemed £984 million (2013: £2,189 million) in the unconsolidated collective investment vehicles during the year and had investments, at fair value, of £2,243 million (2013: £3,291 million) at 31 December. The Group earned fees of £201 million from the unconsolidated collective investment vehicles during 2014 (2013: £277 million).

Joint ventures and associates

The Group provided both administration and processing services to Sainsbury's Bank plc, which was its principal joint venture up until the completion of the sale of the Group's investment in that company on 31 January 2014. The amounts receivable by the Group during January 2014 were £3 million (year ended 31 December 2013: £35 million, of which £10 million was outstanding at 31 December 2013). At 31 December 2013, Sainsbury's Bank plc had also had balances with the Group that were included in loans and advances to banks of £806 million and deposits by banks of £927 million.

At 31 December 2014 there were loans and advances to customers of £1,901 million (2013: £4,448 million) outstanding and balances within customer deposits of £24 million (2013: £70 million) relating to other joint ventures and associates.

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2014, these companies had total assets of approximately £5,553 million (2013: £6,913 million), total liabilities of approximately £6,312 million (2013: £7,084 million) and for the year ended 31 December 2014 had turnover of approximately £5,634 million (2013: £6,989 million) and made a net loss of approximately £272 million (2013: net loss of £16 million). In addition, the Group has provided £2,364 million (2013: £3,355 million) of financing to these companies on which it received £149 million (2013: £170 million) of interest income in the year.

On 25 June 2014, Lloyds Bank plc entered into an agreement for the exclusive provision of conveyancing panel services with United Legal Services Limited (ULS), which is a related party of the Company by virtue of ULS Technology plc, ULS's parent, being an investee company of Lloyds Development Capital, the UK regional equity provider which is part of the Group.

NOTE 50: CONTINGENT LIABILITIES AND COMMITMENTS

INTERCHANGE FEES

On 11 September 2014, the European Court of Justice (the ECJ) upheld the European Commission's 2007 decision that an infringement of EU competition law had arisen from arrangements whereby MasterCard issuers charged a uniform fallback multilateral interchange fee (MIF) in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card.

In parallel:

- the European Commission has proposed legislation to regulate interchange fees which continues through the EU legislative process. A political agreement has been reached between the European Parliament and the Council and the legislation is expected to be adopted and come into force in the second quarter of 2015 with certain articles applying six months or a year after that (the adoption and entry into force dates remain subject to change);
- the European Commission has adopted commitments proposed by VISA to settle an investigation into VISA's cross-border interchange arrangements and aspects of its scheme rules . VISA has, amongst other things, agreed to reduce the level of interchange fees for cross-border card transactions to: 30 basis points (for credit) and 20 basis points (for debit). VISA has also changed a number of its rules in relation to cross-border acquiring. MasterCard unilaterally undertook, amongst other things, to reduce the level of cross-border interchange fees to the same levels as agreed between the Commission and Visa;
- the Commission also continues to pursue other competition investigations into MasterCard and Visa probing, amongst other things, interchange paid in respect of cards issued outside the EEA;
- litigation continues in the English High Court against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly 'overpaid' MIFs;
- the new UK payments regulator may exercise its powers, when these come in to force (in April 2015), to regulate domestic interchange fees. In November 2014, the Competition and Markets Authority (the CMA) announced that it would not reopen the investigation into domestic interchange levels at this time following MasterCard's agreement to introduce a phased reduction of domestic interchange rates commencing in April 2015. In addition, the FCA has started a market study in relation to the UK credit cards market.

The ultimate impact on the Group of the above investigations, regulatory or legislative developments and the litigation against VISA and MasterCard can only be known at the conclusion of these matters.

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NOTE 50: CONTINGENT LIABILITIES AND COMMITMENTS (CONTINUED)

LIBOR AND OTHER TRADING RATES

As set out in more detail in note 40, on 28 July 2014, the Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The settlements in relation to LIBOR are part of an industry-wide investigation into the setting of interbank offered rates across a range of currencies.

The Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the European and Swiss Competition Commissions, and a number of US State Attorneys General, in conjunction with their investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

Certain Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar and Japanese Yen LIBOR. The claims have been asserted by plaintiffs claiming to have had an interest in various types of financial instruments linked to US Dollar and Japanese Yen LIBOR. The allegations in these cases, the majority of which have been coordinated for pre-trial purposes in multi-district litigation proceedings (MDL) in the US Federal Court for the Southern District of New York (the 'District Court'), are substantially similar to each other. The lawsuits allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act (RICO) and the Commodity Exchange Act (CEA), as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims have been dismissed by the District Court.

The Group is also reviewing its activities in relation to the setting of certain foreign exchange daily benchmark rates and related matters, following the FCA's publicised initiation of an investigation into other financial institutions in relation to this activity. The Group is co-operating with the FCA and other regulators and is providing information about the Group's review to those regulators. In addition, the Group, together with a number of other banks, was named as a defendant in several actions filed in the District Court between late 2013 and February 2014, in which the plaintiffs alleged that the defendants manipulated WM/Reuters foreign exchange rates in violation of US antitrust laws. On 31 March 2014, plaintiffs effectively withdrew their claims against the Group (but not against all defendants) by filing a superseding consolidated and amended pleading against a number of other defendants without naming any Group entity as a defendant.

It is currently not possible to predict the scope and ultimate outcome on the Group of the various outstanding regulatory investigations not encompassed by the settlements, any private lawsuits or any related challenges to the interpretation or validity of any of the Group's contractual arrangements, including their timing and scale.

UK SHAREHOLDER LITIGATION

In August 2014, the Group and a number of former directors were named as defendants in a claim filed in the English High Court by a number of claimants who held shares in Lloyds TSB Group plc (LTSB) prior to the acquisition of HBOS plc, alleging breaches of fiduciary and tortious duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. The claim is at an early stage and so it is currently not possible to determine the ultimate impact on the Group (if any), but it intends to defend the claim vigorously.

FINANCIAL SERVICES COMPENSATION SCHEME

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

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. At the end of the latest FSCS scheme year (31 March 2014), the principal balance outstanding on these loans was £16,591 million (31 March 2013: £17,246 million). Although the substantial majority of this loan 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, any shortfall will be funded by deposit-taking participants of the FSCS. The amount of future levies payable by the Group depends on a number of factors including the amounts recovered by the FSCS from asset sales, the Group's participation in the deposit-taking market at 31 December, the level of protected deposits and the population of deposit-taking participants.

INVESTIGATION INTO BANK OF SCOTLAND AND REPORT ON HBOS

The FSA's enforcement investigation into Bank of Scotland plc's Corporate division between 2006 and 2008 concluded with the publication of a Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. On 12 September 2012 the FSA confirmed it was starting work on a public interest report on HBOS. That report is now being produced as a joint PRA / FCA report. Although the Terms of Reference for the HBOS review (issued on 11 July 2014) stated an aim to publish the final report by the end of 2014, the report has not yet been published.

US-SWISS TAX PROGRAMME

The US Department of Justice (the DOJ) and the Swiss Federal Department of Finance announced on 29 August 2013 a programme (the Programme) for Swiss banks to obtain resolution concerning their status in connection with on-going investigations by the DOJ into individuals and entities that use foreign (i.e. non-US) bank accounts to evade US taxes and reporting requirements, and individuals and entities that facilitate or have facilitated the evasion of such taxes and reporting requirements. Swiss banks that chose to participate notified the DOJ of their election to categorise their relevant banking operations according to one of a number of defined categories under the Programme.

The Group carried out private banking operations in Switzerland with assets under management of approximately £7 billion. Those operations were sold in November 2013. Therefore, as a protective measure, in December 2013 the Group notified the DOJ of its intent to participate in the Programme. Having completed due diligence under the terms of the Programme, the Group has concluded that its further participation in the Programme is not warranted and it has communicated to the DOJ its decision to withdraw from the Programme.

NOTE 50: CONTINGENT LIABILITIES AND COMMITMENTS (CONTINUED)

TAX AUTHORITIES

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities. This includes open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law which might lead to additional tax. The Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In the second half of 2013 HMRC informed the Group that their interpretation of the UK rules, permitting the offset of such losses, denies the claim; if HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Group's deferred tax asset of approximately £400 million. The Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due.

RESIDENTIAL MORTGAGE REPOSSESSIONS

In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases, concerning certain aspects of the Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The Group is reviewing the issues raised by the judgment and will respond as appropriate to any investigations or proceedings that may in due course be instigated as a result of these issues.

OTHER LEGAL ACTIONS AND REGULATORY MATTERS

In addition, during the ordinary course of business the Group is subject to other complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of employees, customers, investors or other third parties, as well as regulatory reviews, challenges, investigations 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 at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed properly to assess the merits of the case, and no provisions are held in relation to 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, operations or cash flows.

	2014 £m	2013 £m
Contingent liabilities		
Acceptances and endorsements	59	204
Other:		
Other items serving as direct credit substitutes	330	710
Performance bonds and other transaction-related contingencies	2,293	1,966
	2,623	2,676
Total contingent liabilities	2,682	2,880

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

	2014 £m	2013 £m
Commitments		
Documentary credits and other short-term trade-related transactions	101	54
Forward asset purchases and forward deposits placed	162	440
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	8,809	9,559
Other commitments	64,015	55,002
	72,824	64,561
1 year or over original maturity	34,455	40,616
Total commitments	107,542	105,671

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £55,029 million (2013: £56,292 million) was irrevocable.

Notes to the consolidated financial statements continued

NOTE 50: CONTINGENT LIABILITIES AND COMMITMENTS (CONTINUED)

OPERATING LEASE COMMITMENTS

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

	2014 £m	2013 £m
Not later than 1 year	**301**	292
Later than 1 year and not later than 5 years	**945**	928
Later than 5 years	**1,141**	1,166
Total operating lease commitments	**2,387**	2,386

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

CAPITAL COMMITMENTS

Excluding commitments in respect of investment property (note 23), capital expenditure contracted but not provided for at 31 December 2014 amounted to £373 million (2013: £345 million). Of this amount, £368 million (2013: £344 million) related to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

NOTE 51: FINANCIAL INSTRUMENTS

(1) MEASUREMENT BASIS OF FINANCIAL ASSETS AND LIABILITIES

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
		Held for trading £m	Designated upon initial recognition £m					
At 31 December 2014								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	50,492	–	50,492
Items in the course of collection from banks	–	–	–	–	–	1,173	–	1,173
Trading and other financial assets at fair value through profit or loss	–	48,494	103,437	–	–	–	–	151,931
Derivative financial instruments	4,233	31,895	–	–	–	–	–	36,128
Loans and receivables:								
Loans and advances to banks	–	–	–	–	26,155	–	–	26,155
Loans and advances to customers	–	–	–	–	482,704	–	–	482,704
Debt securities	–	–	–	–	1,213	–	–	1,213
	–	–	–	–	510,072	–	–	510,072
Available-for-sale financial assets	–	–	–	56,493	–	–	–	56,493
Total financial assets	4,233	80,389	103,437	56,493	510,072	51,665	–	806,289
Financial liabilities								
Deposits from banks	–	–	–	–	–	10,887	–	10,887
Customer deposits	–	–	–	–	–	447,067	–	447,067
Items in course of transmission to banks	–	–	–	–	–	979	–	979
Trading and other financial liabilities at fair value through profit or loss	–	55,358	6,744	–	–	–	–	62,102
Derivative financial instruments	3,616	29,571	–	–	–	–	–	33,187
Notes in circulation	–	–	–	–	–	1,129	–	1,129
Debt securities in issue	–	–	–	–	–	76,233	–	76,233
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	86,918	86,918
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	27,248	27,248
Unallocated surplus within insurance businesses	–	–	–	–	–	–	320	320
Financial guarantees	–	–	51	–	–	–	–	51
Subordinated liabilities	–	–	–	–	–	26,042	–	26,042
Total financial liabilities	3,616	84,929	6,795	–	–	562,337	114,486	772,163

Notes to the consolidated financial statements continued

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

	Derivatives designated as hedging instruments £m	At fair value through profit or loss: Held for trading £m	At fair value through profit or loss: Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2013[1]								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	49,915	–	49,915
Items in the course of collection from banks	–	–	–	–	–	1,007	–	1,007
Trading and other financial assets at fair value through profit or loss	–	37,350	105,333	–	–	–	–	142,683
Derivative financial instruments	4,742	26,062	–	–	–	–	–	30,804
Loans and receivables:								
Loans and advances to banks	–	–	–	–	25,365	–	–	25,365
Loans and advances to customers	–	–	–	–	492,952	–	–	492,952
Debt securities	–	–	–	–	1,355	–	–	1,355
	–	–	–	–	519,672	–	–	519,672
Available-for-sale financial assets	–	–	–	43,976	–	–	–	43,976
Total financial assets	4,742	63,412	105,333	43,976	519,672	50,922	–	788,057
Financial liabilities								
Deposits from banks	–	–	–	–	–	13,982	–	13,982
Customer deposits	–	–	–	–	–	439,467	–	439,467
Items in course of transmission to banks	–	–	–	–	–	774	–	774
Trading and other financial liabilities at fair value through profit or loss	–	38,319	5,306	–	–	–	–	43,625
Derivative financial instruments	4,518	23,140	–	–	–	–	–	27,658
Notes in circulation	–	–	–	–	–	1,176	–	1,176
Debt securities in issue	–	–	–	–	–	87,102	–	87,102
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	82,777	82,777
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	27,590	27,590
Unallocated surplus within insurance businesses	–	–	–	–	–	–	391	391
Financial guarantees	–	–	50	–	–	–	–	50
Subordinated liabilities	–	–	–	–	–	32,312	–	32,312
Total financial liabilities	4,518	61,459	5,356	–	–	574,813	110,758	756,904

[1] See note 1.

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

(2) FAIR VALUE MEASUREMENT

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is a measure as at a specific date and may be significantly different from the amount which will actually be paid or received on maturity or settlement date.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

The Group manages valuation adjustments for its derivative exposures on a net basis; the Group determines their fair values on the basis of their net exposures. In all other cases, fair values of financial assets and liabilities measured at fair value are determined on the basis of their gross exposures.

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 are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group's consolidated balance sheet. 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.

Valuation control framework

The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

Valuation of financial assets and liabilities

Assets and liabilities carried at fair value or for which fair values are disclosed have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1

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

Level 2

Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

Level 3

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include the Group's venture capital and unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

Notes to the consolidated financial statements continued

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

Fair values of financial assets and liabilities

The following table summarises the carrying values of financial assets and liabilities presented on the Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

	2014		2013[1]	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets				
Trading and other financial assets at fair value through profit or loss	**151,931**	**151,931**	142,683	142,683
Derivative financial instruments	**36,128**	**36,128**	30,804	30,804
Loans and receivables:				
Loans and advances to banks	**26,155**	**26,031**	25,365	25,296
Loans and advances to customers: unimpaired	**473,947**	**471,961**	470,910	462,124
Loans and advances to customers: impaired	**8,757**	**8,670**	22,042	22,042
Debt securities	**1,213**	**1,100**	1,355	1,251
Available-for-sale financial assets	**56,493**	**56,493**	43,976	43,976
Reverse repurchase agreements included in above amounts:				
Loans and advances to customers	**5,148**	**5,148**	120	120
Loans and advances to banks	**1,899**	**1,899**	183	183
Financial liabilities				
Deposits from banks	**10,887**	**10,902**	13,982	14,101
Customer deposits	**447,067**	**450,038**	439,467	440,011
Trading and other financial liabilities at fair value through profit or loss	**62,102**	**62,102**	43,625	43,625
Derivative financial instruments	**33,187**	**33,187**	27,658	27,658
Debt securities in issue	**76,233**	**80,244**	87,102	90,803
Liabilities arising from non-participating investment contracts	**27,248**	**27,248**	27,590	27,590
Financial guarantees	**51**	**51**	50	50
Subordinated liabilities	**26,042**	**30,175**	32,312	34,449
Repurchase agreements included in the above amounts:				
Deposits from banks	**1,075**	**1,075**	1,874	1,874
Customer deposits	**–**	**–**	2,978	2,978

[1] See note 1.

The carrying amount of the following financial instruments is a reasonable approximation of fair value: cash and balances at central banks, items in the course of collection from banks, items in course of transmission to banks and notes in circulation.

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

(3) FINANCIAL ASSETS AND LIABILITIES CARRIED AT FAIR VALUE

(A) Financial assets, excluding derivatives

Valuation hierarchy

At 31 December 2014, the Group's financial assets carried at fair value, excluding derivatives, totalled £208,424 million (31 December 2013: £186,659 million). The table below analyses these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described on page 277). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

Valuation hierarchy

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2014				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	28,513	–	28,513
Loans and advances to banks	–	8,212	–	8,212
Debt securities:				
Government securities	23,950	1,523	–	25,473
Other public sector securities	–	781	1,389	2,170
Bank and building society certificates of deposit	–	554	–	554
Asset-backed securities:				
Mortgage-backed securities	24	963	47	1,034
Other asset-backed securities	1	849	–	850
Corporate and other debt securities	255	19,814	2,021	22,090
	24,230	24,484	3,457	52,171
Equity shares	59,607	322	1,647	61,576
Treasury and other bills	1,459	–	–	1,459
Total trading and other financial assets at fair value through profit or loss	85,296	61,531	5,104	151,931
Available-for-sale financial assets				
Debt securities:				
Government securities	47,402	–	–	47,402
Bank and building society certificates of deposit	–	298	–	298
Asset-backed securities:				
Mortgage-backed securities	–	674	–	674
Other asset-backed securities	–	685	–	685
Corporate and other debt securities	35	5,494	–	5,529
	47,437	7,151	–	54,588
Equity shares	45	727	270	1,042
Treasury and other bills	852	11	–	863
Total available-for-sale financial assets	48,334	7,889	270	56,493
Total financial assets carried at fair value, excluding derivatives	133,630	69,420	5,374	208,424

Notes to the consolidated financial statements continued

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2013				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	21,110	–	21,110
Loans and advances to banks	–	8,333	–	8,333
Debt securities:				
Government securities	20,191	498	–	20,689
Other public sector securities	–	1,312	885	2,197
Bank and building society certificates of deposit	–	1,491	–	1,491
Asset-backed securities:				
Mortgage-backed securities	30	768	–	798
Other asset-backed securities	171	756	–	927
Corporate and other debt securities	244	18,689	1,687	20,620
	20,636	23,514	2,572	46,722
Equity shares	64,690	53	1,660	66,403
Treasury and other bills	7	108	–	115
Total trading and other financial assets at fair value through profit or loss	85,333	53,118	4,232	142,683
Available-for-sale financial assets				
Debt securities:				
Government securities	38,262	28	–	38,290
Bank and building society certificates of deposit	–	208	–	208
Asset-backed securities:				
Mortgage-backed securities	–	1,263	–	1,263
Other asset-backed securities	–	841	74	915
Corporate and other debt securities	56	1,799	–	1,855
	38,318	4,139	74	42,531
Equity shares	48	147	375	570
Treasury and other bills	852	23	–	875
Total available-for-sale financial assets	39,218	4,309	449	43,976
Total financial assets carried at fair value, excluding derivatives	124,551	57,427	4,681	186,659

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

Movements in Level 3 portfolio

The table below analyses movements in level 3 financial assets, excluding derivatives, carried at fair value (recurring measurement).

	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Total level 3 assets carried at fair value, excluding derivatives (recurring basis) £m
At 1 January 2013	3,306	567	3,873
Exchange and other adjustments	21	15	36
Gains recognised in the income statement within other income	296	–	296
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	–	40	40
Purchases	582	43	625
Sales	(631)	(224)	(855)
Transfers into the level 3 portfolio	995	12	1,007
Transfers out of the level 3 portfolio	(337)	(4)	(341)
At 31 December 2013	4,232	449	4,681
Exchange and other adjustments	**5**	**(7)**	**(2)**
Gains recognised in the income statement within other income	**579**	**–**	**579**
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	**–**	**(61)**	**(61)**
Purchases	**552**	**229**	**781**
Sales	**(587)**	**(266)**	**(853)**
Transfers into the level 3 portfolio	**708**	**–**	**708**
Transfers out of the level 3 portfolio	**(385)**	**(74)**	**(459)**
At 31 December 2014	**5,104**	**270**	**5,374**
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December 2014	547	–	547
Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December 2013	70	–	70

Valuation methodology for financial assets, excluding derivatives

Loans and advances and debt securities

Loans and advances and debt securities measured at fair value and classified as level 2 are valued by discounting expected cash flows using an observable credit spread applicable to the particular instrument.

Where there is limited trading activity in debt securities, the Group uses valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes to determine an appropriate valuation. Debt securities are classified as level 3 if there is a significant valuation input that cannot be corroborated through market sources or where there are materially inconsistent values for an input. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

Equity investments

Unlisted equity and fund investments are valued using different techniques in accordance with the Group's valuation policy and International Private Equity and Venture Capital Guidelines.

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

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

Notes to the consolidated financial statements continued

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

Unlisted equity investments and investments in property partnerships held in the life assurance funds are valued using third party valuations. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

(B) Financial liabilities, excluding derivatives

Valuation hierarchy

At 31 December 2014, the Group's financial liabilities carried at fair value, excluding derivatives, totalled £62,153 million (31 December 2013: £43,675 million). The table below analyses these financial liabilities by balance sheet classification and valuation methodology (level 1, 2 or 3, as described on page 277). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2014				
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss	**–**	**6,739**	**5**	**6,744**
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	**–**	**50,007**	**–**	**50,007**
Short positions in securities	**2,700**	**519**	**–**	**3,219**
Other	**–**	**2,132**	**–**	**2,132**
	2,700	**52,658**	**–**	**55,358**
Total trading and other financial liabilities at fair value through profit or loss	**2,700**	**59,397**	**5**	**62,102**
Financial guarantees	**–**	**–**	**51**	**51**
Total financial liabilities carried at fair value, excluding derivatives	**2,700**	**59,397**	**56**	**62,153**
At 31 December 2013				
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss	–	5,267	39	5,306
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	28,902	–	28,902
Short positions in securities	6,473	417	–	6,890
Other	–	2,527	–	2,527
	6,473	31,846	–	38,319
Total trading and other financial liabilities at fair value through profit or loss	6,473	37,113	39	43,625
Financial guarantees	–	–	50	50
Total financial liabilities carried at fair value, excluding derivatives	6,473	37,113	89	43,675

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

The table below analyses movements in the level 3 financial liabilities portfolio, excluding derivatives.

	Trading and other financial liabilities at fair value through profit or loss £m	Financial guarantees £m	Total level 3 financial liabilities carried at fair value, excluding derivatives £m
At 1 January 2013	–	48	48
Losses (gains) recognised in the income statement within other income	10	3	13
Additions	29	–	29
Redemptions	–	(1)	(1)
At 31 December 2013	39	50	89
Exchange and other adjustments	**–**	**–**	**–**
Losses (gains) recognised in the income statement within other income	**(5)**	**1**	**(4)**
Additions	**–**	**–**	**–**
Redemptions	**(29)**	**–**	**(29)**
Transfers into the level 3 portfolio	**–**	**–**	**–**
Transfers out of the level 3 portfolio	**–**	**–**	**–**
At 31 December 2014	**5**	**51**	**56**
(Losses) gains recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2014	**–**	**1**	**1**
Gains recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2013	(10)	(3)	(13)

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

Valuation methodology for financial liabilities, excluding derivatives

Liabilities held at fair value through profit or loss

These principally comprise debt securities in issue which are classified as level 2 and their fair value is determined using techniques whose inputs are based on observable market data. The carrying amount of the securities is adjusted to reflect the effect of changes in own credit spreads. The resulting gain or loss is recognised in the income statement.

At 31 December 2014, the own credit adjustment arising from the fair valuation of £6,739 million (2013: £5,267 million) of the Group's debt securities in issue designated at fair value through profit or loss resulted in a gain of £33 million (2013: gain of £40 million).

(C) Derivatives

All of the Group's derivative assets and liabilities are carried at fair value. At 31 December 2014, such assets totalled £36,128 million (31 December 2013: £30,804 million) and liabilities totalled £33,187 million (31 December 2013: £27,658 million). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 277). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2014				
Derivative assets	**94**	**33,263**	**2,771**	**36,128**
Derivative liabilities	**(68)**	**(31,663)**	**(1,456)**	**(33,187)**
At 31 December 2013[1]				
Derivative assets	235	27,550	3,019	30,804
Derivative liabilities	(119)	(26,553)	(986)	(27,658)

[1] See note 1.

Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

– Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.

Notes to the consolidated financial statements continued

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

– Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
– Credit derivatives which are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.
– Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

The Group's level 3 derivative assets include £646 million (2013: £1,212 million) in respect of the value of the embedded equity conversion feature of the Enhanced Capital Notes issued in December 2009. The embedded equity conversion feature is valued by comparing the market price of the Enhanced Capital Notes with the market price of similar bonds without the conversion feature. The latter is calculated by discounting the expected Enhanced Capital Note cash flows in the absence of a conversion using prevailing market yields for similar capital securities without the conversion feature. The market price of the Enhanced Capital Notes was calculated with reference to multiple broker quotes.

The table below analyses movements in level 3 derivative assets and liabilities carried at fair value:

	Derivative assets £m	Derivative liabilities £m
At 1 January 2013	2,358	(543)
Exchange and other adjustments	2	(8)
Gains (losses) recognised in the income statement within other income	144	30
Purchases (additions)	271	(262)
(Sales) redemptions	(102)	29
Transfers into the level 3 portfolio	354	(233)
Transfers out of the level 3 portfolio	(8)	1
At 31 December 2013	3,019	(986)
Exchange and other adjustments	**(11)**	**4**
Gains recognised in the income statement within other income	**755**	**(375)**
Purchases (additions)	**68**	**(59)**
(Sales) redemptions	**(154)**	**66**
Derecognised pursuant to exchange and retail tender offers in respect of Enhanced Capital Notes (notes 9 and 40)	**(967)**	**–**
Transfers into the level 3 portfolio	**114**	**(110)**
Transfers out of the level 3 portfolio	**(53)**	**4**
At 31 December 2014	**2,771**	**(1,456)**
Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets or liabilities held at 31 December 2014	**755**	**(376)**
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets or liabilities held at 31 December 2013	159	20

Derivative valuation adjustments

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

(i) Uncollateralised derivative valuation adjustments, excluding monoline counterparties

The following table summarises the movement on this valuation adjustment account during 2014 and 2013:

	2014 £m	2013 £m
At 1 January	498	897
Income statement charge (credit)	95	(241)
Transfers	15	(158)
At 31 December	**608**	498

Represented by:

	2014 £m	2013 £m
Credit Valuation Adjustment	568	485
Debit Valuation Adjustment	(85)	(122)
Funding Valuation Adjustment	125	135
	608	498

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking division.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

The CVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised asset;

– expectations of future market volatility of the underlying asset; and

– expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £105 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. For these, the CVA is calculated on an add-on basis (in total contributing £2 million of the overall CVA balance at 31 December 2014).

The DVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised liability;

– expectations of future market volatility of the underlying liability; and

– the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £122 million to £207 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A 1 per cent rise in interest rates would lead to a £183 million fall in the overall valuation adjustment to £300 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding certain uncollateralised derivative positions where the Group considers that this cost is included in market pricing. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £7 million.

(ii) Market liquidity

The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2014, the Group's derivative trading business held mid to bid-offer valuation adjustments of £74 million (2013: £70 million).

Notes to the consolidated financial statements continued

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

(D) Sensitivity of level 3 valuations

	Valuation techniques	Significant unobservable inputs[1]	At 31 December 2014 Carrying value £m	At 31 December 2014 Effect of reasonably possible alternative assumptions[2] Favourable changes £m	At 31 December 2014 Effect of reasonably possible alternative assumptions[2] Unfavourable changes £m	At 31 December 2013 Carrying value £m	At 31 December 2013 Effect of reasonably possible alternative assumptions[2] Favourable changes £m	At 31 December 2013 Effect of reasonably possible alternative assumptions[2] Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss								
Debt securities	Discounted cash flows	Credit spreads (bps) n/a[3]	**35**	**5**	**(5)**	18	5	(2)
Asset-backed securities	Lead manager or broker quote	n/a	**65**	**–**	**(2)**	–	–	–
Equity and venture capital investments	Market approach	Earnings multiple (4/14)	**2,214**	**75**	**(75)**	2,132	70	(70)
	Underlying asset/ net asset value (incl. property prices)[4]	n/a	**173**	**26**	**(23)**	130	17	(16)
Unlisted equities and debt securities, property partnerships in the life funds	Underlying asset/ net asset value (incl. property prices)[4]	n/a	**2,617**	**4**	**(2)**	1,952	–	–
			5,104			4,232		
Available-for-sale financial assets								
Asset-backed securities	Lead manager or broker quote/consensus pricing	n/a	**–**	**–**	**–**	74	–	–
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[4]	n/a	**270**	**10**	**(18)**	375	28	(19)
			270			449		
Derivative financial assets								
Embedded equity conversion feature	Lead manager or broker quote	Equity conversion feature spread (175 bps/432 bps)	**646**	**21**	**(21)**	1,212	59	(58)
Interest rate derivatives	Discounted cash flow	Inflation swap rate – funding component (3 bps/167 bps)	**1,382**	**17**	**(16)**	1,461	66	(39)
	Option pricing model	Interest rate volatility (4%/120%)	**743**	**6**	**(6)**	346	6	(7)
			2,771			3,019		
Level 3 financial assets carried at fair value			**8,145**			7,700		
Trading and other financial liabilities at fair value through profit or loss			**5**	**–**	**–**	39	1	(1)
Derivative financial liabilities								
Interest rate derivatives	Discounted cash flow	Inflation swap rate – funding component (3 bps/167 bps)	**807**	**–**	**–**	754	–	–
	Option pricing model	Interest rate volatility (4%/120%)	**649**	**–**	**–**	232	–	–
			1,456			986		
Financial guarantees			**51**			50		
Level 3 financial liabilities carried at fair value			**1,512**			1,075		

[1] Ranges are shown where appropriate and represent the highest and lowest inputs used in the level 3 valuations.

[2] Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

[3] A single pricing source is used.

[4] Underlying asset/net asset values represent fair value.

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are as follows:

- Interest rates and inflation rates are referenced in some derivatives where the payoff that the holder of the derivative receives depends on the behaviour of those underlying references through time.
- Credit spreads represent the premium above the benchmark reference instrument required to compensate for lower credit quality; higher spreads lead to a lower fair value.
- Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes.
- Earnings multiples are used to value certain unlisted equity investments; a higher earnings multiple will result in a higher fair value.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships.

Debt securities

Reasonably possible alternative assumptions have been determined in respect of the Group's structured credit investment by flexing credit spreads.

Derivatives

Reasonably possible alternative assumptions have been determined in respect of the Group's derivative portfolios as follows:

- In respect of the embedded equity conversion feature of the Enhanced Capital Notes, the sensitivity was based on the absolute difference between the actual price of the enhanced capital note and the closest, alternative broker quote available plus the impact of applying a 10 bps increase/decrease in the market yield used to derive a market price for similar bonds without the conversion feature. The effect of interdependency of the assumptions is not material to the effect of applying reasonably possible alternative assumptions to the valuations of derivative financial instruments.
- Uncollateralised inflation swaps are valued using appropriate discount spreads for such transactions. These spreads are not generally observable for longer maturities. The reasonably possible alternative valuations reflect flexing of the spreads for the differing maturities to alternative values of between 3 bps and 167 bps (2013: 62 bps and 192 bps).
- Swaptions are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities have been flexed within a range of 4 per cent to 120 per cent (2013: 3 per cent and 112 per cent).

Unlisted equity, venture capital investments and investments in property partnerships

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

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

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NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

(4) FINANCIAL ASSETS AND LIABILITIES CARRIED AT AMORTISED COST

(A) Financial assets

Valuation hierarchy

The table below analyses the fair values of the financial assets of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 277). Loans and receivables are mainly classified as level 3 due to significant unobservable inputs used in the valuation models. Where inputs are observable, debt securities are classified as level 1 or 2.

		Valuation hierarchy		
	Fair value £m	Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2014				
Loans and receivables:				
Loans and advances to customers: unimpaired	**472,036**	**–**	**–**	**472,036**
Loans and advances to customers: impaired	**8,595**	**–**	**–**	**8,595**
Loans and advances to customers	**480,631**	**–**	**–**	**480,631**
Loans and advances to banks	**26,031**	**–**	**–**	**26,031**
Debt securities	**1,100**	**7**	**1,050**	**43**
Reverse repos included in above amounts:				
Loans and advances to customers	**5,148**	**–**	**–**	**5,148**
Loans and advances to banks	**1,899**	**–**	**–**	**1,899**
At 31 December 2013[1]				
Loans and receivables:				
Loans and advances to customers: unimpaired	462,124	–	–	462,124
Loans and advances to customers: impaired	22,042	–	–	22,042
Loans and advances to customers	484,166	–	–	484,166
Loans and advances to banks	25,296	–	–	25,296
Debt securities	1,251	157	42	1,052
Reverse repos included in above amounts:				
Loans and advances to customers	120	–	–	120
Loans and advances to banks	183	–	–	183

[1] See note 1.

Valuation methodology

Loans and advances to customers

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates due to their short term nature. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value.

To determine the fair value of loans and advances to customers, loans are segregated into portfolios of similar characteristics. A number of techniques are used to estimate the fair value of fixed rate lending; these take account of expected credit losses based on historic trends, prevailing market interest rates and expected future cash flows. For retail exposures, fair value is usually 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. 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 value of commercial 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. No adjustment is made to put it in place by the Group to manage its interest rate exposure.

Loans and advances to banks

The carrying value of short dated loans and advances to banks is assumed to be their fair value. The fair value of loans and advances to banks is estimated by discounting the anticipated cash flows at a market discount rate adjusted for the credit spread of the obligor or, where not observable, the credit spread of borrowers of similar credit quality.

Debt securities

The fair values of debt securities, which were previously within assets held for trading and were reclassified to loans and receivables, are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

Reverse repurchase agreements

The carrying amount is deemed a reasonable approximation of fair value given the short-term nature of these instruments.

NOTE 51: FINANCIAL INSTRUMENTS (CONTINUED)

(B) Financial liabilities

Valuation hierarchy

The table below analyses the fair values of the financial liabilities of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 277).

	Fair value £m	Valuation hierarchy Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2014				
Deposits from banks	**10,902**	**–**	**10,902**	**–**
Customer deposits	**450,038**	**–**	**435,073**	**14,965**
Debt securities in issue	**80,244**	**–**	**80,244**	**–**
Subordinated liabilities	**30,175**	**–**	**30,175**	**–**
Repos included in above amounts:				
Deposits from banks	**1,075**	**–**	**1,075**	**–**
Customer deposits	**–**	**–**	**–**	**–**
At 31 December 2013[1]				
Deposits from banks	14,101	–	13,957	144
Customer deposits	440,011	–	421,278	18,733
Debt securities in issue	90,803	–	90,628	175
Subordinated liabilities	34,449	–	34,449	–
Repos included in above amounts:				
Deposits from banks	2,112	–	2,112	–
Customer deposits	3,114	–	3,114	–

[1] See note 1.

Valuation methodology

Deposits from banks and customer deposits
The fair value of bank and customer deposits repayable on demand is assumed to be equal to their carrying value.

The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

Debt securities in issue
The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities is calculated based on quoted market prices where available. Where quoted market prices are not available, fair value is estimated using discounted cash flow techniques at a rate which reflects market rates of interest and the Group's own credit spread.

Subordinated liabilities
The fair value of subordinated liabilities is determined by reference to quoted market prices where available or by reference to quoted market prices of similar instruments. Subordinated liabilities are classified as level 2, since the inputs used to determine their fair value are largely observable.

Repurchase agreements
The carrying amount is deemed a reasonable approximation of fair value given the short term nature of these instruments.

(5) RECLASSIFICATION OF FINANCIAL ASSETS

No financial assets have been reclassified in 2014 or 2013.

During 2012 the Group reviewed its holding of government securities classified as held-to-maturity and in view of the fact that it was no longer the Group's intention to hold these to maturity, securities with a carrying amount of £10,811 million and a fair value of £11,979 million were reclassified as available-for-sale financial assets in December 2012. At 31 December 2014, the securities reclassified that were still retained by the Group were carried at their fair value of £1,284 million (2013: £1,117 million).

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NOTE 52: TRANSFERS OF FINANCIAL ASSETS

(1) TRANSFERRED FINANCIAL ASSETS THAT CONTINUE TO BE RECOGNISED IN FULL

The Group enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets covered as substantially all of the risks and rewards, including credit, interest rate, prepayment and other price risks are retained by the Group. In all cases, the transferee has the right to sell or repledge the assets concerned.

As set out in note 19, included within loans and receivables are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all of a majority of the risks and rewards associated with these loans, including credit, interest rate, prepayment and liquidity risk, they remain on the Group's balance sheet. Assets transferred into the Group's securitisation and covered bond programmes are not available to be used by the Group whilst the assets are within the programmes. However, the Group retains the right to remove loans from the covered bond programmes where they are in excess of the programme's requirements. In addition, where the Group has retained some of the notes issued by securitisation and covered bond programmes, the Group has the ability to sell or pledge these retained notes.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities lending transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 32). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

	2014		2013	
	Carrying value of transferred assets £m	Carrying value of associated liabilities £m	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
Repurchase and securities lending transactions				
Trading and other financial assets at fair value through profit or loss	16,803	6,673	10,832	927
Available-for-sale financial assets	18,835	10,301	6,093	3,726
Loans and receivables:				
Loans and advances to customers	2,353	908	19,074	3,936
Debt securities classified as loans and receivables	88	–	88	–
Securitisation programmes				
Loans and receivables:				
Loans and advances to customers	75,970	11,908	80,878	18,613[1]

[1] Excludes securitisation notes held by the Group of £38,149 million (31 December 2013: £38,288 million).

(2) TRANSFERRED FINANCIAL ASSETS DERECOGNISED IN THEIR ENTIRETY WITH ONGOING EXPOSURE

Transferred financial assets which were derecognised in their entirety, but with ongoing exposure, consisted of £33 million of debt securities (2013: £78 million) with a fair value of £33 million (2013: £76 million) and a maximum exposure to loss of £33 million (2013: £78 million).

NOTE 53: OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES

The following information relates to financial assets and liabilities which have been offset in the balance sheet and those which have not been offset but for which the Group has enforceable master netting agreements in place with counterparties.

At 31 December 2014	Gross amounts of assets and liabilities[1] £m	Amounts offset in the balance sheet[2] £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted[3]: Cash collateral received/ pledged £m	Related amounts where set off in the balance sheet not permitted[3]: Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	115,206	–	115,206	–	(6,670)	108,536
Reverse repos	42,640	(5,915)	36,725	–	(36,725)	–
	157,846	(5,915)	151,931	–	(43,395)	108,536
Derivative financial instruments	72,378	(36,250)	36,128	(3,651)	(22,336)	10,141
Loans and advances to banks:						
Excluding reverse repos	24,256	–	24,256	(2,133)	–	22,123
Reverse repos	1,899	–	1,899	–	(1,899)	–
	26,155	–	26,155	(2,133)	(1,899)	22,123
Loans and advances to customers:						
Excluding reverse repos	480,376	(2,820)	477,556	(1,254)	(4,967)	471,335
Reverse repos	5,148	–	5,148	–	(5,148)	–
	485,524	(2,820)	482,704	(1,254)	(10,115)	471,335
Debt securities	1,213	–	1,213	–	–	1,213
Available-for-sale financial assets	56,493	–	56,493	–	(10,299)	46,194
Financial liabilities						
Deposits from banks:						
Excluding repos	9,812	–	9,812	(3,119)	–	6,693
Repos	1,075	–	1,075	–	(1,075)	–
	10,887	–	10,887	(3,119)	(1,075)	6,693
Customer deposits:						
Excluding repos	449,361	(2,294)	447,067	(532)	(4,094)	442,441
Repos	–	–	–	–	–	–
	449,361	(2,294)	447,067	(532)	(4,094)	442,441
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	12,095	–	12,095	–	–	12,095
Repos	55,922	(5,915)	50,007	–	(50,007)	–
	68,017	(5,915)	62,102	–	(50,007)	12,095
Derivative financial instruments	69,963	(36,776)	33,187	(3,387)	(25,559)	4,241

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NOTE 53: OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES (CONTINUED)

At 31 December 2013	Gross amounts of assets and liabilities[1] £m	Amounts offset in the balance sheet[2] £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted[3]: Cash collateral received/ pledged £m	Related amounts where set off in the balance sheet not permitted[3]: Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	113,395	–	113,395	–	(903)	112,492
Reverse repos	33,725	(4,437)	29,288	–	(29,288)	–
	147,120	(4,437)	142,683	–	(30,191)	112,492
Derivative financial instruments	50,285	(19,481)	30,804	(2,702)	(19,703)	8,399
Loans and advances to banks:						
Excluding reverse repos	25,182	–	25,182	(2,180)	–	23,002
Reverse repos	183	–	183	–	(183)	–
	25,365	–	25,365	(2,180)	(183)	23,002
Loans and advances to customers:						
Excluding reverse repos	495,161	(2,329)	492,832	(782)	(10,698)	481,352
Reverse repos	120	–	120	–	(120)	–
	495,281	(2,329)	492,952	(782)	(10,818)	481,352
Debt securities	1,355	–	1,355	–	–	1,355
Available-for-sale financial assets	43,976	–	43,976	–	(3,725)	40,251
Financial liabilities						
Deposits from banks:						
Excluding repos	12,108	–	12,108	(2,280)	–	9,828
Repos	1,874	–	1,874	–	(1,874)	–
	13,982	–	13,982	(2,280)	(1,874)	9,828
Customer deposits:						
Excluding repos	438,333	(1,844)	436,489	(422)	(6,811)	429,256
Repos	2,978	–	2,978	–	(2,978)	–
	441,311	(1,844)	439,467	(422)	(9,789)	429,256
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	14,723	–	14,723	–	–	14,723
Repos	33,339	(4,437)	28,902	–	(28,902)	–
	48,062	(4,437)	43,625	–	(28,902)	14,723
Derivative financial instruments	47,624	(19,966)	27,658	(2,962)	(21,159)	3,537

[1] After impairment allowance.

[2] The amounts set off in the balance sheet as shown above represent derivatives and repurchase agreements with central clearing houses which meet the criteria for offsetting under IAS 32.

[3] The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respect of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over collateralisation have not been taken into account in the above table.

NOTE 54: FINANCIAL RISK MANAGEMENT

As a bancassurer, financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; liquidity risk; capital risk; and insurance risk. Information about the Group's exposure to each of the above risks and capital can be found on pages 107 to 170. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

MARKET RISK

The Group uses various market risk measures for risk reporting and setting risk appetite limits and triggers. These measures include Value at Risk and Stress Scenarios.

Interest rate risk

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

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

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt.

At 31 December 2014 the aggregate notional principal of interest rate swaps designated as fair value hedges was £115,394 million (2013: £154,657 million) with a net fair value asset of £1,511 million (2013: asset of £1,618 million) (note 16). The losses on the hedging instruments were £2,866 million (2013: losses of £933 million). The gains on the hedged items attributable to the hedged risk were £2,720 million (2013: gains of £872 million).

In addition the Group has cash flow hedges which are primarily used to hedge the variability in the cost of funding within the commercial business. Note 16 shows when the hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2014 was £518,746 million (2013: £559,690 million) with a net fair value liability of £930 million (2013: liability of £1,347 million) (note 16). In 2014, ineffectiveness recognised in the income statement that arises from cash flow hedges was a gain of £56 million (2013: loss of £60 million).

Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the market and liquidity risk function in London. Associated VaR and the closing, average, maximum and minimum are disclosed on page 139.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using currency borrowings. At 31 December 2014 the aggregate principal of these currency borrowings was £587 million (2013: £1,695 million). In 2014, an ineffectiveness loss of £1 million before and after tax (2013: ineffectiveness gain of £16 million before tax and £12 million after tax) was recognised in the income statement arising from net investment hedges.

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NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

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

Functional currency of Group operations

	2014 £m	2013 £m
Euro:		
Gross exposure	**286**	567
Net investment hedge	**(218)**	(464)
	68	103
US dollar:		
Gross exposure	**392**	379
Net investment hedge	**(342)**	(341)
	50	38
Swiss franc:		
Gross exposure	**(17)**	(7)
Net investment hedge	**–**	–
	(17)	(7)
Australian dollar:		
Gross exposure	**–**	853
Net investment hedge	**–**	(866)
	–	(13)
Japanese yen:		
Gross exposure	**–**	(1)
Net investment hedge	**–**	(1)
	–	(2)
Other non-sterling	**90**	106
Total structural foreign currency exposures, after net investment hedges	**191**	225

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

CREDIT RISK

The Group's credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems as inputs and measure the credit risk of loans and advances to customers and banks at a counterparty level using three components: (i) the probability of default by the counterparty on its contractual obligations; (ii) the current exposures to the counterparty and their likely future development, from which the Group derives the exposure at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default. The Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivative based transactions.

A. Maximum credit exposure

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

	At 31 December 2014			At 31 December 2013		
	Maximum exposure £m	Offset[2] £m	Net exposure £m	Maximum exposure £m	Offset[2] £m	Net exposure £m
At 31 December 2013						
Loans and receivables:						
Loans and advances to banks, net[1]	26,155	–	26,155	25,365	–	25,365
Loans and advances to customers, net[1]	482,704	(4,094)	478,610	492,952	(6,811)	486,141
Debt securities, net[1]	1,213	–	1,213	1,355	–	1,355
	510,072	(4,094)	505,978	519,672	(6,811)	512,861
Available-for-sale financial assets[3]	55,451	–	55,451	43,406	–	43,406
Trading and other financial assets at fair value through profit or loss:[3,4]						
Loans and advances	36,725	–	36,725	29,443	–	29,443
Debt securities, treasury and other bills	53,630	–	53,630	46,837	–	46,837
	90,355	–	90,355	76,280	–	76,280
Derivative assets	36,128	(21,929)	14,199	30,804	(19,479)	11,325
Assets arising from reinsurance contracts held	682	–	682	732	–	732
Financial guarantees	7,161	–	7,161	8,591	–	8,591
Off-balance sheet items:						
Acceptances and endorsements	59	–	59	204	–	204
Other items serving as direct credit substitutes	330	–	330	710	–	710
Performance bonds and other transaction-related contingencies	2,293	–	2,293	1,966	–	1,966
Irrevocable commitments	55,029	–	55,029	56,292	–	56,292
	57,711	–	57,711	59,172	–	59,172
	757,560	(26,023)	731,537	738,657	(26,290)	712,367

[1] Amounts shown net of related impairment allowances.

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

[3] Excluding equity shares.

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

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

B. Concentrations of exposure

The Group's management of concentration risk includes single name, industry sector and country limits as well as controls over the Group's overall exposure to certain products. Further information on the Group's management of this risk is included within Credit risk mitigation, Risk management on page 118.

At 31 December 2014 the most significant concentrations of exposure were in mortgages (comprising 68 per cent of total loans and advances to customers) and to financial, business and other services (comprising 9 per cent of the total). For further information on concentrations of the Group's loans, refer to note 18.

Following the continuing reduction in the Group's non-UK activities, an analysis of credit risk exposures by geographical region has not been provided.

C. Credit quality of assets

Loans and receivables

The disclosures in the table below and those on pages 297 and 298 are produced under the underlying basis used for the Group's segmental reporting. The Group believes that, for reporting periods following a significant acquisition such as the acquisition of HBOS in 2009, this underlying basis, which includes the allowance for loan losses at the acquisition date on a gross basis, more fairly reflects the underlying provisioning status of the loans. The remaining acquisition-related fair value adjustments in respect of this lending are therefore identified separately in this table.

The analysis of lending between retail and commercial 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 commercial are exposures to corporate customers and other large institutions.

Loans and advances

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	
At 31 December 2014						
Neither past due nor impaired	**26,003**	**320,324**	**37,886**	**106,768**	**464,978**	**36,725**
Past due but not impaired	**152**	**10,311**	**674**	**488**	**11,473**	**–**
Impaired – no provision required	**–**	**578**	**938**	**847**	**2,363**	**–**
– provision held	**–**	**3,766**	**1,109**	**7,070**	**11,945**	**–**
Gross	**26,155**	**334,979**	**40,607**	**115,173**	**490,759**	**36,725**
Allowance for impairment losses	**–**	**(1,702)**	**(577)**	**(5,373)**	**(7,652)**	**–**
Fair value adjustments	**–**				**(403)**	**–**
Net balance sheet carrying value	**26,155**				**482,704**	**36,725**
At 31 December 2013[1]						
Neither past due nor impaired	25,219	318,668	36,789	107,764	463,221	29,443
Past due but not impaired	146	12,329	580	786	13,695	–
Impaired – no provision required	–	637	1,284	1,824	3,745	–
– provision held	–	6,229	1,456	20,829	28,514	–
Gross	25,365	337,863	40,109	131,203	509,175	29,443
Allowance for impairment losses	–	(2,194)	(1,044)	(12,469)	(15,707)	–
Fair value adjustments	–				(516)	–
Net balance sheet carrying value	25,365				492,952	29,443

[1] See note 1.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2(H). All impaired loans which exceed certain thresholds, principally within the Group's Commercial Banking division, are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances which are individually determined to be impaired with a gross amount before impairment allowances of £8,522 million (31 December 2013: £22,390 million).

The table below sets out the reconciliation of the allowance for impairment losses of £6,414 million (2013: £11,966 million) shown in note 21 to the allowance for impairment losses on an underlying basis of £7,652 million (2013: £15,707 million) shown above:

	2014 £m	2013 £m
Allowance for impairment losses on loans and advances to customers	**6,414**	11,966
HBOS allowance at 16 January 2009[1]	**11,147**	11,147
HBOS charge covered by fair value adjustments[2]	**12,066**	11,815
Amounts subsequently written off	**(22,426)**	(19,674)
	787	3,288
Foreign exchange and other movements	**451**	453
Allowance for impairment losses on loans and advances to customers on an underlying basis	**7,652**	15,707

[1] Comprises an allowance held at 31 December 2008 of £10,693 million and a charge for the period from 1 January 2009 to 16 January 2009 of £454 million.

[2] This represents the element of the charge on loans and advances to customers in HBOS's results that was included within the Group's fair value adjustments in respect of the acquisition of HBOS on 16 January 2009.

Loans and advances which are neither past due nor impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2014						
Good quality	**25,654**	**318,967**	**30,993**	**65,106**		**36,482**
Satisfactory quality	**263**	**1,159**	**5,675**	**28,800**		**238**
Lower quality	**49**	**72**	**623**	**11,204**		**5**
Below standard, but not impaired	**37**	**126**	**595**	**1,658**		**–**
Total loans and advances which are neither past due nor impaired	**26,003**	**320,324**	**37,886**	**106,768**	**464,978**	**36,725**
At 31 December 2013[1]						
Good quality	25,044	314,749	29,129	66,345		29,432
Satisfactory quality	171	2,948	6,414	29,038		7
Lower quality	2	308	501	9,991		3
Below standard, but not impaired	2	663	745	2,390		1
Total loans and advances which are neither past due nor impaired	25,219	318,668	36,789	107,764	463,221	29,443

[1] See note 1.

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and commercial are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Commercial lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models. Further information about the Group's internal probabilities of default rating models can be found on page 117.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Loans and advances which are past due but not impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2014						
0-30 days	**152**	**4,854**	**453**	**198**	**5,505**	**–**
30-60 days	**–**	**2,309**	**110**	**51**	**2,470**	**–**
60-90 days	**–**	**1,427**	**90**	**139**	**1,656**	**–**
90-180 days	**–**	**1,721**	**5**	**38**	**1,764**	**–**
Over 180 days	**–**	**–**	**16**	**62**	**78**	**–**
Total loans and advances which are past due but not impaired	**152**	**10,311**	**674**	**488**	**11,473**	**–**
At 31 December 2013						
0-30 days	146	5,596	489	347	6,432	–
30-60 days	–	2,639	87	102	2,828	–
60-90 days	–	1,734	4	57	1,795	–
90-180 days	–	2,360	–	41	2,401	–
Over 180 days	–	–	–	239	239	–
Total loans and advances which are past due but not impaired	146	12,329	580	786	13,695	–

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

Debt securities classified as loans and receivables

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

	Investment grade[1] £m	Sub-investment grade £m	Not rated £m	Total £m
At 31 December 2014				
Asset-backed securities:				
Mortgage-backed securities	**190**	**–**	**–**	**190**
Other asset-backed securities	**780**	**198**	**7**	**985**
	970	**198**	**7**	**1,175**
Corporate and other debt securities	**–**	**–**	**164**	**164**
Gross exposure	**970**	**198**	**171**	**1,339**
Allowance for impairment losses				**(126)**
Total debt securities classified as loans and receivables				**1,213**
At 31 December 2013				
Asset-backed securities:				
Mortgage-backed securities	333	–	–	333
Other asset-backed securities	605	117	18	740
	938	117	18	1,073
Corporate and other debt securities	175	–	232	407
Gross exposure	1,113	117	250	1,480
Allowance for impairment losses				(125)
Total debt securities classified as loans and receivables				1,355

[1] Credit ratings equal to or better than 'BBB'.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

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

An analysis of the Group's available-for-sale financial assets is included in note 22. The credit quality of the Group's available-for-sale financial assets (excluding equity shares) is set out below:

	Investment grade[1] £m	Sub-investment grade £m	Not rated £m	Total £m
At 31 December 2014				
Debt securities:				
Government securities	**47,402**	**–**	**–**	**47,402**
Bank and building society certificates of deposit	**298**	**–**	**–**	**298**
Asset-backed securities:				
Mortgage-backed securities	**674**	**–**	**–**	**674**
Other asset-backed securities	**681**	**4**	**–**	**685**
	1,355	**4**	**–**	**1,359**
Corporate and other debt securities	**5,490**	**16**	**23**	**5,529**
Total debt securities	**54,545**	**20**	**23**	**54,588**
Treasury bills and other bills	**863**	**–**	**–**	**863**
Total held as available-for-sale financial assets	**55,408**	**20**	**23**	**55,451**
At 31 December 2013				
Debt securities:				
Government securities	38,290	–	–	38,290
Bank and building society certificates of deposit	208	–	–	208
Asset-backed securities:				
Mortgage-backed securities	1,181	82	–	1,263
Other asset-backed securities	890	25	–	915
	2,071	107	–	2,178
Corporate and other debt securities	1,799	37	19	1,855
Total debt securities	42,368	144	19	42,531
Treasury bills and other bills	875	–	–	875
Total held as available-for-sale financial assets	43,243	144	19	43,406

[1] Credit ratings equal to or better than 'BBB'.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

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

An analysis of the Group's trading and other financial assets at fair value through profit or loss is included in note 15. The credit quality of the Group's debt securities, treasury and other bills held at fair value through profit or loss is set out below:

	Investment grade[1] £m	Sub-investment grade £m	Not rated £m	Total £m
At 31 December 2014				
Debt securities, treasury and other bills held at fair value through profit or loss				
Trading assets:				
Government securities	7,976	–	–	7,976
Bank and building society certificates of deposit	554	–	–	554
Asset-backed securities:				
Mortgage-backed securities	187	–	–	187
Other asset-backed securities	117	3	9	129
	304	3	9	316
Corporate and other debt securities	1,288	43	155	1,486
Total debt securities held as trading assets	10,122	46	164	10,332
Treasury bills and other bills	1,437	–	–	1,437
Total held as trading assets	11,559	46	164	11,769
Other assets held at fair value through profit or loss:				
Government securities	17,496	1	–	17,497
Other public sector securities	2,170	–	–	2,170
Asset-backed securities:				
Mortgage-backed securities	845	–	2	847
Other asset-backed securities	699	3	19	721
	1,544	3	21	1,568
Corporate and other debt securities	18,119	579	1,906	20,604
Total debt securities held at fair value through profit or loss	39,329	583	1,927	41,839
Treasury bills and other bills	22	–	–	22
Total other assets held at fair value through profit or loss	39,351	583	1,927	41,861
Total held at fair value through profit or loss	50,910	629	2,091	53,630

[1] Credit ratings equal to or better than 'BBB'.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

	Investment grade[1] £m	Sub-investment grade £m	Not rated £m	Total £m
At 31 December 2013				
Debt securities, treasury and other bills held at fair value through profit or loss				
Trading assets:				
Government securities	4,259	–	–	4,259
Other public sector securities	14	–	–	14
Bank and building society certificates of deposit	1,491	–	–	1,491
Asset-backed securities:				
Mortgage-backed securities	–	5	–	5
Other asset-backed securities	158	13	–	171
	158	18	–	176
Corporate and other debt securities	1,886	29	14	1,929
Total debt securities held as trading assets	7,808	47	14	7,869
Treasury bills and other bills	61	–	–	61
Total held as trading assets	7,869	47	14	7,930
Other assets held at fair value through profit or loss:				
Government securities	16,415	1	14	16,430
Other public sector securities	2,183	–	–	2,183
Asset-backed securities:				
Mortgage-backed securities	793	–	–	793
Other asset-backed securities	755	1	–	756
	1,548	1	–	1,549
Corporate and other debt securities	16,350	617	1,724	18,691
Total debt securities held at fair value through profit or loss	36,496	619	1,738	38,853
Treasury bills and other bills	54	–	–	54
Total other assets held at fair value through profit or loss	36,550	619	1,738	38,907
Total held at fair value through profit or loss	44,419	666	1,752	46,837

[1] Credit ratings equal to or better than 'BBB'.

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

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Derivative assets

An analysis of derivative assets is given in note 16. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's maximum credit risk relating to derivative assets of £14,199 million (2013: £11,325 million), cash collateral of £3,651 million (2013: £2,702 million) was held and a further £2,043 million was due from OECD banks (2013: £2,372 million).

	Investment grade[1] £m	Sub-investment grade £m	Not rated £m	Total £m
At 31 December 2014				
Trading and other	**26,574**	**1,849**	**3,472**	**31,895**
Hedging	**4,185**	**47**	**1**	**4,233**
Total derivative financial instruments	**30,759**	**1,896**	**3,473**	**36,128**
At 31 December 2013[2]				
Trading and other	22,250	2,554	1,258	26,062
Hedging	4,705	32	5	4,742
Total derivative financial instruments	26,955	2,586	1,263	30,804

[1] Credit ratings equal to or better than 'BBB'.

[2] See note 1.

Assets arising from reinsurance contracts held

Of the assets arising from reinsurance contracts held at 31 December 2014 of £682 million (2013: £732 million), £363 million (2013: £383 million) were due from insurers with a credit rating of AA or above.

Financial guarantees and irrevocable loan commitments

Financial guarantees 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.

D. Collateral held as security for financial assets

A general description of collateral held as security in respect of financial instruments is provided on page 119. The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

Loans and receivables

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

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

Loans and advances to banks

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

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £1,899 million (2013: £183 million), against which the Group held collateral with a fair value of £1,886 million (2013: £183 million), all of which the Group is able to repledge.

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

Loans and advances to customers

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

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Retail lending

Mortgages

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

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
At 31 December 2014				
Less than 70 per cent	**202,789**	**4,895**	**1,601**	**209,285**
70 per cent to 80 per cent	**58,837**	**1,998**	**726**	**61,561**
80 per cent to 90 per cent	**32,771**	**1,526**	**702**	**34,999**
90 per cent to 100 per cent	**15,858**	**1,005**	**486**	**17,349**
Greater than 100 per cent	**10,069**	**887**	**829**	**11,785**
Total	**320,324**	**10,311**	**4,344**	**334,979**
At 31 December 2013				
Less than 70 per cent	161,105	4,294	1,743	167,142
70 per cent to 80 per cent	64,954	2,296	970	68,220
80 per cent to 90 per cent	46,581	2,224	1,080	49,885
90 per cent to 100 per cent	24,592	1,720	1,027	27,339
Greater than 100 per cent	21,436	1,795	2,046	25,277
Total	318,668	12,329	6,866	337,863

Other

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

The majority of non-mortgage retail lending is unsecured. At 31 December 2014, impaired non-mortgage lending amounted to £1,470 million, net of an impairment allowance of £577 million (2013: £1,696 million, net of an impairment allowance of £1,044 million). The fair value of the collateral held in respect of this lending was £110 million (2013: £144 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £38,560 million (2013: £37,369 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are thereafter monitored in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is reassessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

Commercial lending

Reverse repurchase transactions

There were reverse repurchase agreements which are accounted for as collateralised loans with a carrying value of £5,148 million (2013: £120 million), against which the Group held collateral with a fair value of £5,155 million (2013: £112 million), all of which the Group is able to repledge. Included in these amounts are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £35 million (2013: £49 million). These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Impaired secured lending

The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt.

At 31 December 2014, impaired secured commercial lending amounted to £2,539 million, net of an impairment allowance of £3,799 million (2013: £9,845 million, net of an impairment allowance of £11,063 million). The fair value of the collateral held in respect of impaired secured commercial lending was £2,517 million (2013: £6,915 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured commercial lending,

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

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

Unimpaired secured lending

Unimpaired secured commercial lending amounted to £57,647 million (2013: £69,108 million). Commercial lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination. The types of collateral taken and the frequency with which collateral is required at origination is dependent upon the size and structure of the borrower. For exposures to corporate customers and other large institutions, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a mortgage debenture over the company's undertaking and one or more of its assets, and keyman insurance. The Group maintains policies setting out acceptable collateral, maximum loan-to-value ratios and other criteria to be considered when reviewing a loan application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the customer. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, the provision of collateral will not determine the outcome of a credit application. The fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay debt.

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

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

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

Trading and other financial assets at fair value through profit or loss (excluding equity shares)

Included in trading and other financial assets at fair value through profit or loss are repurchase agreements treated as collateralised loans with a carrying value of £36,725 million (2013: £29,288 million). Collateral is held with a fair value of £42,858 million (2013: £32,434 million), all of which the Group is able to repledge. At 31 December 2014, £10,319 million had been repledged (2013: £8,195 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £33,721 million (2013: £46,552 million). Of this amount, £32,686 million (2013: £45,277 million) had been resold or repledged as collateral for the Group's own transactions.

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

Derivative assets, after offsetting of amounts under master netting arrangements

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £14,199 million (2013: £11,325 million), cash collateral of £3,651 million (2013: £2,702 million) was held.

Irrevocable loan commitments and other credit-related contingencies

At 31 December 2014, the Group held irrevocable loan commitments and other credit-related contingencies of £57,711 million (2013: £59,172 million). Collateral is held as security, in the event that lending is drawn down, on £8,673 million (2013: £19,123 million) of these balances.

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

Collateral repossessed

During the year, £828 million of collateral was repossessed (2013: £902 million), consisting primarily of residential property.

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

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

E. COLLATERAL PLEDGED AS SECURITY

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

Repurchase transactions

Deposits from banks

Included in deposits from banks are deposits held as collateral for facilities granted, with a carrying value of £1,075 million (2013: £1,874 million) and a fair value of £1,075 million (2013: £1,874 million).

Customer deposits

Included in customer deposits in 2013 were deposits held as collateral for facilities granted, with a carrying value of £2,978 million and a fair value of £3,114 million. In addition, collateral balances in the form of cash provided in respect of repurchase agreements amounted to £6 million (2013: £416 million).

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

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secure borrowing, where the secured party is permitted by contract or custom to repledge was £56,696 million (2013: £37,999 million).

Securities lending transactions

The following financial assets on the balance sheet have been pledged as collateral as part of securities lending transactions:

	2014 £m	2013 £m
Trading and other financial assets at fair value through profit or loss	9,955	9,928
Loans and advances to customers	1,393	14,927
Debt securities classified as loans and receivables	88	89
Available-for-sale financial assets	8,363	2,311
	19,799	27,255

Securitisations and covered bonds

In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 19 and 20.

F. TREATMENT OF CUSTOMERS EXPERIENCING FINANCIAL STRESS

The Group operates a number of schemes to assist borrowers who are experiencing financial stress. The material elements of these schemes are described in the Risk Management report on pages 120 and 121 and further details relating to those cases where the Group has granted a concession, whether temporarily or permanently, are set out below.

Retail customers

Forbearance activities

The Group classifies the treatments offered to retail customers who have experienced financial difficulty into the following categories:

– *Reduced contractual monthly payment:* a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments, for example temporary interest only arrangements and short-term payment holidays granted in collections. Any arrears existing at the commencement of the arrangement are retained;
– *Reduced payment arrangements:* a temporary arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay;
– *Term extensions:* a permanent account change for customers in financial distress where the overall term of the mortgage is extended resulting in a lower contractual monthly payment; and
– *Repair:* a permanent account change used to repair a customer's position where they have emerged from financial difficulty, for example capitalisation of arrears.

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Customers receiving support from UK Government sponsored programmes

The Group participates in a number of UK Government sponsored programmes designed to support households, which are described on page 121. Where these schemes provide borrowers with a state benefit that is used to service the loan, there is no change in the reported status of the loan which is managed and reported in accordance with its original terms.

The Group assesses whether a loan benefiting from a UK Government sponsored programme is impaired using the same accounting policies and practices as it does for loans not benefiting from such a programme. There is no direct impact on the impairment status of a loan benefiting from the Mortgage Rescue schemes, as these schemes involve the purchase, and eventual sale, of the property. The loans included within the Income Support for Mortgage Interest scheme may be impaired, in accordance with the normal definition of impairment.

The Income Support for Mortgage Interest scheme remains the most successful of the Government backed schemes. It is the longest-running, is the most widely known and provides both the customer and the Group with an assurance as to the maintenance of at least two years' worth of interest payments. The Group estimates that customers representing approximately £2.3 billion of its mortgage exposures are receiving this benefit. This includes those who are also receiving other treatments for financial difficulty.

Customers in financial difficulty receiving support under other schemes

The Group measures the success of a forbearance scheme based upon the proportion of customers maintaining or improving their arrears position over the 24 months following the exit from a forbearance treatment. For temporary treatments, 90 per cent of customers who have accepted temporary interest-only concessions and 76 per cent of customers accepting reduced payment arrangements have maintained or improved their arrears position. For permanent treatments, 80 per cent of customers who have accepted capitalisations of arrears and 84 per cent of customers who have accepted term extensions have maintained or improved their arrears position.

Forbearance identification and classification

The Group classifies a retail account as forborne at the time a customer in financial difficulty is granted a concession. Accounts are classified as forborne only for the period of time which the exposure is known to be, or may still be, in financial difficulty. Where temporary forbearance is granted, exit criteria are applied to include accounts until they are known to no longer be in financial difficulty. Details of the exit criteria are shown in the analysis below. Where the treatment involves a permanent change to the contractual basis of the customer's account such as a capitalisation of arrears or term extension, the Group classifies the balance as forborne for a period of 24 months, after which no distinction is made between these accounts and others where no change has been made.

Collective impairment assessment of retail loans subject to forbearance

Secured

Loans which are forborne are grouped with other assets with similar risk characteristics and assessed collectively for impairment as described below. The loans are not considered as impaired loans unless they meet the Group's definition of an impaired asset.

The Group's approach is to ensure that provisioning models, supported by management judgement, appropriately reflect the underlying loss risk of exposures. The Group uses sophisticated behavioural scoring to assess customers' credit risk. The underlying behavioural scorecards consider many different characteristics of customer behaviour, both static and dynamic, from internal sources and also from credit bureaux data, including characteristics that may identify when a customer has been in arrears on products held with other firms. Hence, these models take a range of potential indicators of customer financial distress into account.

The performance of such models is monitored and challenged on an ongoing basis, in line with the Group's model governance policies. The models are also regularly recalibrated to reflect up to date customer behaviour and market conditions. Specifically, regular detailed analysis of modelled provision outputs is undertaken to demonstrate that the risk of forbearance or other similar activities is recognised, that the outcome period adequately captures the risk and that the underlying risk is appropriately reflected. Where this is not the case, additional provisions are applied to capture the risk.

Unsecured

Credit risk provisioning for the retail unsecured portfolio is undertaken on a purely collective basis. The approach used is based on segmented cash flow models, divided into two primary streams for loans judged to be impaired and those that are not. Accounts subject to repayment plans and collections refinance loans are among those considered to be impaired.

For exposures that are judged to be impaired, provisions are determined through modelling the expected cure rates, write-off propensity and cash flows with segments explicitly relating to repayment plans and refinance loans treatments. Payments of less than the monthly contractual amount are reflected in reduced cash flow forecasts when calculating the impairment allowance for these accounts.

The outputs of the models are monitored and challenged on an ongoing basis. The models are run monthly meaning that current market conditions and customer processes are reflected in the output. Where the risks identified are not captured in the underlying models, appropriate additional provisions are made.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Forborne loans

Retail lending

At 31 December 2014, UK retail secured loans and advances currently or recently subject to forbearance were 1.4 per cent (31 December 2013: 2.0 per cent) of total UK retail secured loans and advances. The Group no longer offers temporary interest-only as a forbearance treatment to secured lending customers in financial difficulty, and this is the primary driver of the reduction in forbearance balances in 2014.

At 31 December 2014, unsecured retail loans and advances currently or recently subject to forbearance were 1.6 per cent (31 December 2013: 1.8 per cent) of total UK retail unsecured loans and advances.

Further analysis of the forborne loan balances is set out below:

	Total loans and advances which are currently or recently forborne		Total current and recent forborne loans and advances which are impaired[1]		Impairment provisions as % of loans and advances which are currently or recently forborne	
	2014 £m	2013[6] £m	2014 £m	2013[6] £m	2014 %	2013[6] %
UK secured lending:						
Temporary forbearance arrangements						
Reduced contractual monthly payment[2]	146	957	29	221	6.0	4.1
Reduced payment arrangements[3]	552	1,336	69	157	3.4	3.2
	698	2,293	98	378	4.0	3.6
Permanent treatments						
Repair and term extensions[4]	3,696	3,860	168	296	3.5	3.4
Total	4,394	6,153	266	674	3.5	3.5
UK unsecured lending:						
Loans and overdrafts[5]	162	191	139	169	39.4	45.8

[1] £4,128 million of current and recent forborne secured loans and advances were not impaired at 31 December 2014 (31 December 2013: £5,479 million). £23 million of current and recent forborne unsecured loans and overdrafts were not impaired at 31 December 2014 (31 December 2013: £22 million).

[2] Includes temporary interest-only arrangements and short-term payment holidays granted in collections where the customer is currently benefiting from the treatment and where the concession has ended within the previous six months (temporary interest-only) and previous twelve months (short-term payment holidays).

[3] Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous three months.

[4] Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and where the borrowers remain as customers at 31 December.

[5] Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the previous six months. Permanent changes which commenced during the last 24 months for existing customers as at 31 December are also included.

[6] See note 4.

Secured forborne loans have reduced by £1,759 million in 2014 to £4,394 million, driven primarily by an improvement in the underlying quality of the portfolio, with a greater value exiting forbearance than entering forbearance. Unsecured forborne loans have reduced by £29 million in 2014.

Further analysis of the movements in UK retail lending forborne loans and advances during the year is as follows:

	Secured lending £m	Unsecured lending £m
At 1 January 2014[1]	6,153	191
Classified as forborne during the year	1,805	123
Written-off/sold	(93)	(77)
Good exit from forbearance	(2,957)	(35)
Redeemed or repaid	(462)	(10)
Exchange and other movements	(52)	(30)
At 31 December 2014	4,394	162

[1] See note 4.

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Consumer Finance

At 31 December 2014, Consumer credit card advances currently or recently subject to forbearance were 2.6 per cent (31 December 2013: 3.7 per cent) of total Consumer credit card advances. At 31 December 2014, Asset Finance retail loans and advances on open portfolios currently or recently subject to forbearance were 2.1 per cent (31 December 2013: 4.0 per cent) of total Asset Finance loans and advances. Further analysis of the forborne loans and advances is set out below:

	Total loans and advances which are currently or recently forborne		Total current and recent forborne loans and advances which are impaired[1]		Impairment provisions as % of loans and advances which are currently or recently forborne	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 %	2013 %
Consumer Credit Cards[2]	234	326	140	188	29.1	21.9
Asset Finance[2]	109	149	53	75	20.5	24.0

[1] £150 million of forborne loans and advances (consumer credit cards: £94 million, Asset Finance: £56 million) were not impaired at 31 December 2014 (31 December 2013: consumer credit cards: £138 million, Asset Finance: £74 million).

[2] Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months. Permanent changes which commenced during the last 24 months for existing customers as at 31 December are also included. Asset Finance UK previously reported accounts on a temporary concession as forborne for the period of the concession only and accounts on a permanent concession for 12 months after the concession had ended. 2013 balances have been restated.

Consumer Credit Cards and Asset Finance forborne loans have reduced in 2014 by £92 million and £40 million respectively, driven primarily by improvements in the underlying quality of the portfolios. The movements in forborne loans and advances during the year were as follows:

	Consumer credit cards £m	Asset Finance[1] £m
At 1 January 2014	326	149
Classified as forborne during the year	128	56
Written off/sold	(93)	(25)
Good exit from forbearance	(92)	(19)
Redeemed or repaid	(14)	(26)
Exchange and other movements	(21)	(26)
At 31 December 2014	234	109

[1] Restated.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Run-off: Ireland secured retail lending

At 31 December 2014, Irish secured loans and advances subject to current or recent forbearance were 6.3 per cent (31 December 2013: 12.2 per cent) of total Irish retail secured loans and advances. Further analysis of the forborne loan balances is set out below:

	Total loans and advances which are currently or recently forborne		Total current and recent forborne loans and advances which are impaired[1]		Impairment provisions as % of loans and advances which are currently or recently forborne	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 %	2013 %
Ireland secured lending:						
Temporary forbearance arrangements						
Reduced payment arrangements[2]	41	254	28	227	34.0	49.8
Permanent treatments						
Repair and term extensions[3]	239	473	13	102	9.1	14.4
Total	**280**	727	**41**	329	**12.7**	26.7

[1] £239 million of current and recent forborne loans and advances were not impaired at 31 December 2014 (31 December 2013: £398 million).
[2] Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous three months.
[3] Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and where the borrowers remain as customers at 31 December.

Forborne loans have decreased by £447 million in 2014, to £280 million, driven by the disposal of impaired assets during 2014. The movements during the year for forborne loans and advances in the Irish secured retail lending portfolio was as follows:

	£m
At 1 January 2014	727
Classified as forborne during the year	261
Written off/sold	(348)
Good exit from forbearance	(324)
Redeemed or repaid	(13)
Exchange and other movements	(23)
At 31 December 2014	**280**

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Commercial customers

Forbearance

A key factor in determining whether the Group treats a commercial customer as forborne is the granting of a concession to a borrower who experiences, or is believed to be about to experience, financial difficulty and which is outside the Group's current risk appetite. Where a concession is granted to a customer that is not in financial difficulty or the risk profile is considered within the Group's current risk appetite, the concession would not be considered to be an act of forbearance. The Group does not believe forbearance reporting is appropriate for derivatives, available for sale assets and the trading book where assets are marked to market daily.

The Group recognises that forbearance alone is not necessarily an indicator of impaired status but it is a trigger for the review of the customer's credit profile. If there is any concern over future cash flows and the Group incurring a loss, then forborne loans will be classified as impaired in accordance with the Group's impairment policy.

Recovery can sometimes be through improvement in market or economic conditions, or the customer may benefit from access to alternative sources of liquidity such as an equity injection. These can be especially relevant in real estate or other asset backed transactions where a fire sale of assets in a weak market may be unattractive.

Depending on circumstances and when operated within robust parameters and controls, the Group believes forbearance can help support the customer in the short to medium-term. The Group expects to have unimpaired forborne assets within its portfolios, although the majority of these cases will be managed in the Business Support Unit, where more intensive management and monitoring is available.

Unimpaired forborne assets are included in calculating the overall collective unimpaired provision, which uses the historical observed default rate and loss emergence period of the relevant portfolio as a whole as part of its calculation.

Whilst the material portfolios have been reviewed for forbearance, some non-retail loans and advances in Commercial Banking and Run-off divisions have not been reviewed on the basis that the level is relatively immaterial or because the concept of forbearance is not relevant.

Types of forbearance

The Group's strategy and offer of forbearance is largely dependent on the individual situation and early identification, control and monitoring are key to supporting the customer and protecting the Group. Concessions are often provided to help the customer with their day to day liquidity and working capital.

A number of options are available to the Group where a customer is facing financial difficulty, and each case is treated depending on its own specific circumstances.

Forbearance treatments may include changes to:

- Contractual payment terms (for example loan extensions, or changes to debt servicing terms), and
- Non-payment contractual terms (for example covenant amendments or waivers) where the modifications enable default to be avoided.
- The four main types of forbearance concessions to commercial customers in financial difficulty are set out below:
  - Covenants: This includes temporary and permanent waivers, amendment or resetting of non-payment contractual covenants (including LTV and interest cover). The granting of this type of concession in itself would not result in the loan being classified as impaired;
  - Extensions/Alterations: This includes extension and/or alteration of repayment terms to a level outside of market or the Group's risk appetite due to the customer's inability to make existing contractual repayment terms; amendments to an interest rate to a level considered outside of market or the Group's risk appetite, or other amendments such as changes to debt servicing arrangements;
  - Forgiveness: This includes debt for equity swaps or partial debt forgiveness. This type of forbearance will always give rise to impairment; and
  - Multiple type of forbearance (a combination of the above three).

Forbearance identification and classification

All non-retail loans and advances in Commercial Banking and Run-off Divisions are reviewed at least annually by the independent Risk Division. As part of the Group's long established Credit Risk Classification system for commercial customers, every loan and advance in the good book is categorised as either 'good' or 'watchlist'.

The watchlist is further categorised depending on the current and expected credit risk attaching to the customer and the transaction. All watchlist names are reviewed by the Business and independent Risk function regularly, and the classification is updated if required.

Any concession granted to a customer is reviewed and must be approved by Risk. If Risk determine that the customer is in, or about to be in, financial difficulty, then any concession granted outside the Group's current risk appetite is treated as forbearance and in most cases, the obligor is transferred to Business Support Unit (BSU).

Any event that causes concern over future payments from the customer is likely to result in the asset being assessed for impairment and, if required, an impairment allowance recognised. If impairment is identified, the customer is immediately transferred to Business Support Unit (if not already managed there) and the lending will be treated as an impaired asset.

All non-retail impaired assets are considered as having been granted some form of forbearance. Impaired loans and advances exist only in the BSU within Commercial Banking Division; and Run-off Division.

A portfolio approach is taken for SME customers with exposures below £1 million managed in BSU. All customers with exposures below £1 million are reported as forborne whilst they are managed by BSU (whether impaired or unimpaired).

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

All reviews performed in the good book, Business Support Unit within Commercial Banking or in the Run-off division include analysis of latest financial information, a consideration of the market and sector the customer operates in, performance against plan and revised terms and conditions granted as part of the forbearance concession.

The Group no longer reports as forborne non-payment concessions to unimpaired obligors if the revised terms are within the Group's risk appetite and the overall risk is acceptable, taking into account the overall structure of facilities together with the current state and expectations of financial strength. There is no significant impact as a result of this change.

Exit from forbearance classification

A customer where forbearance has been granted will remain treated and recorded as forborne until it evidences acceptable performance over a period of time. This period will depend on a number of factors such as whether the customer is trading in line with its revised plan, it is operating within the new terms and conditions (including observation to revised covenants and contractual payments), its financial performance is stable or improving, and there are no undue concerns over its future performance. As a minimum, this period is currently expected to be at least 12 months following a forbearance event. However, notwithstanding this, the overriding requirement is that the financial difficulty previously seen has been removed, and the performance has stabilised.

The exception to this 12 month minimum period is where a permanent structure cure is made (for example, an injection of new collateral security or a partial repayment of debt to restore an LTV back to within a covenant). In this case, the obligor may be removed from the forbearance category once the permanent cure has been made.

Once a customer evidences acceptable performance over a period of time (of not less than the minimum cure period), the customer may be returned to the mainstream good classification and would no longer be considered forborne. It is important to note that such a decision can be made only by the independent Risk Division.

Forborne loans

Commercial Banking

	Total loans and advances which are forborne		Impairment provisions as % of loans and advances which are forborne	
	2014 £m	2013[1] £m	**2014 %**	2013[1] %
Impaired	**3,241**	5,047	**49.2**	47.2
Unimpaired	**1,896**	2,432	**–**	–
Total	**5,137**	7,479	**31.0**	31.8

[1] See note 4.

All impaired assets are considered forborne.

Impaired loans and advances

The movements in Commercial Banking impaired forborne loans and advances were as follows:

	£m
At 1 January 2014[1]	**5,047**
Classified as impaired during the year:	
UK exposures >£5 million	**775**
Exposures <£5 million and other non-UK	**188**
	963
Transferred to unimpaired but still reported as forborne during the year:	
UK exposures >£5 million	**(268)**
Exposures <£5 million and other non-UK	**(477)**
	(745)
Written-off	**(719)**
Asset disposal/sales of impaired assets	**(357)**
Drawdowns/repayments	**(732)**
Exchange and other movements	**(216)**
At 31 December 2014	**3,241**

[1] See note 4.

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Unimpaired loans and advances

The table below sets out the largest unimpaired forborne loans and advances to Commercial Banking customers (exposures over £5 million) as at 31 December 2014 by type of forbearance, together with a breakdown of exposures classified as Direct Real Estate:

	Direct Real Estate £m	Other industry sector £m	Total £m
At 31 December 2014			
Type of unimpaired forbearance			
UK exposures[1] > £5 million			
Covenants	**153**	**865**	**1,018**
Extensions	**–**	**426**	**426**
Multiple	**–**	**6**	**6**
	153	**1,297**	**1,450**
Exposures < £5 million and other non-UK			**446**
Total			**1,896**
At 31 December 2013[2]			
Type of unimpaired forbearance			
UK exposures[1] > £5 million			
Covenants	527	488	1,015
Extensions	69	254	323
Multiple	–	316	316
	596	1,058	1,654
Exposures < £5 million and other non-UK			778
Total			2,432

[1] Based on the location of the office recording the transaction.
[2] See note 4.

The movements in UK Commercial Banking unimpaired forborne exposures over £5 million were:

	£m
At 1 January 2014[1]	**1,654**
Classified as impaired during the year	**(147)**
Cured no longer forborne	**(1,004)**
Classified as forborne during the year	**709**
Transferred from impaired but still reported as forborne[2]	**743**
Asset disposal/sales	**(451)**
Net drawdowns/repayments	**(6)**
Exchange and other movements	**(48)**
At 31 December 2014	**1,450**

[1] See note 4.
[2] Includes £475 million in respect of two loans transferred from Run-off.

Run-off: Corporate real estate, other corporate and Specialist Finance

At 31 December 2014, £1,998 million (31 December 2013: £12,051 million, restated following a reassessment of the unimpaired exposure breakdown) of total loans and advances were forborne of which £1,912 million (31 December 2013: £9,499 million) were impaired. The coverage ratio for forborne loans increased from 32.2 per cent at 31 December 2013 to 58.3 per cent at 31 December 2014.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Impaired loans and advances

The movements in Run-off corporate real estate, other corporate and Specialist Finance impaired forborne loans and advances were as follows:

	£m
At 1 January 2014	9,499
Classified as impaired during the year:	
UK exposures >£5 million	557
Exposures <£5 million and other non-UK	46
	603
Transferred to unimpaired but still reported as forborne during the year:	
UK exposures >£5 million[1]	(961)
Exposures <£5 million and other non-UK	(12)
	(973)
Write offs	(2,565)
Asset disposal/sales of impaired assets	(4,363)
Drawdowns/repayments	(248)
Exchange and other movements	(41)
At 31 December 2014	**1,912**

[1] Includes £475 million in respect of two loans classified as impaired during the year and subsequently transferred to Commercial Banking.

Unimpaired loans and advances

Unimpaired forborne loans and advances were £86 million at 31 December 2014 (31 December 2013: £2,552 million, restated). The Group previously assumed that all lower quality unimpaired exposures under £5 million were forborne, as were a number of non-material portfolios. As part of the Group's ongoing review and refinement of forbearance reporting, exposures below £5 million, and non-material portfolios, were subject to more granular review which led to a reduction in the level of forbearance previously reported.

The reduction also related to unimpaired loans and advances over £5 million and reflects the curing of a limited number of high value transactions where forbearance was granted some time ago and the obligor is no longer considered in financial difficulty.

The table below sets out the largest unimpaired forborne loans and advances to customers in Run-off corporate real estate, other corporate and Specialist Finance (exposures over £5 million) as at 31 December 2014 by type of forbearance, together with a breakdown of exposures classified as Direct Real Estate:

	Direct Real Estate £m	Other industry sector £m	Total £m
At 31 December 2014			
Type of unimpaired forbearance			
UK exposures[1] > £5 million			
Covenants	–	–	–
Extensions	–	47	47
Multiple	24	–	24
	24	47	71
Exposures < £5 million and other non-UK			15
Total			**86**

[1] Based on the location of the office recording the transaction.

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Run off: Ireland commercial real estate and corporate

All loans and advances in (whether impaired or unimpaired) are treated as forborne.

	Total loans and advances which are forborne		Impairment provisions as % of loans and advances which are forborne	
	2014 £m	2013 £m	2014 %	2013 %
Impaired	3,052	8,322	81.3	73.1
Unimpaired	384	1,108	–	–
Total	3,436	9,430	72.2	64.5

The movements in forborne loans and advances were:

	£m
At 1 January 2014	9,430
Write-offs	(2,589)
Asset disposal/sales	(1,444)
Drawdowns/repayments	(1,413)
Exchange and other movements	(548)
At 31 December 2014	3,436

LIQUIDITY RISK

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturity. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses assets and liabilities of the Group into relevant maturity groupings based on the remaining contractual period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Maturities of assets and liabilities

	Up to 1 month £m	1-3 months £m	3-6 months £m	6-9 months £m	9-12 months £m	1-2 years £m	2-5 years £m	Over 5 years £m	Total £m
At 31 December 2014									
Assets									
Cash and balances at central banks	**50,476**	**1**	**13**	**2**	**–**	**–**	**–**	**–**	**50,492**
Trading and other financial assets at fair value through profit or loss	**31,766**	**10,523**	**6,818**	**2,982**	**1,526**	**1,880**	**5,976**	**90,460**	**151,931**
Derivative financial instruments	**1,460**	**1,562**	**1,096**	**867**	**562**	**2,326**	**4,627**	**23,628**	**36,128**
Loans and advances to banks	**10,709**	**4,926**	**3,107**	**1,274**	**1,170**	**1,107**	**2,579**	**1,283**	**26,155**
Loans and advances to customers	**20,072**	**11,026**	**10,860**	**10,216**	**11,332**	**27,292**	**80,257**	**311,649**	**482,704**
Debt securities held as loans and receivables	**–**	**–**	**–**	**–**	**–**	**32**	**4**	**1,177**	**1,213**
Available-for-sale financial assets	**963**	**1,533**	**724**	**28**	**203**	**939**	**6,085**	**46,018**	**56,493**
Other assets	**4,684**	**1,284**	**1,347**	**1,933**	**1,393**	**4,801**	**9,490**	**24,848**	**49,780**
Total assets	**120,130**	**30,855**	**23,965**	**17,302**	**16,186**	**38,377**	**109,018**	**499,063**	**854,896**
Liabilities									
Deposits from banks	**4,270**	**1,711**	**603**	**530**	**176**	**93**	**2,840**	**664**	**10,887**
Customer deposits	**364,040**	**13,852**	**14,051**	**12,706**	**11,517**	**20,845**	**9,528**	**528**	**447,067**
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	**34,690**	**14,446**	**5,078**	**3,708**	**846**	**3,867**	**6,461**	**26,193**	**95,289**
Debt securities in issue	**8,862**	**5,678**	**2,850**	**5,024**	**3,409**	**7,257**	**17,330**	**25,823**	**76,233**
Liabilities arising from insurance and investment contracts	**1,439**	**1,699**	**2,443**	**2,295**	**2,312**	**8,266**	**21,049**	**74,983**	**114,486**
Other liabilities	**4,686**	**4,467**	**304**	**1,779**	**2,416**	**484**	**2,749**	**18,104**	**34,989**
Subordinated liabilities	**74**	**1,241**	**1,331**	**10**	**192**	**3,174**	**5,428**	**14,592**	**26,042**
Total liabilities	**418,061**	**43,094**	**26,660**	**26,052**	**20,868**	**43,986**	**65,385**	**160,887**	**804,993**
At 31 December 2013[1]									
Assets									
Cash and balances at central banks	49,823	5	78	–	–	–	–	9	49,915
Trading and other financial assets at fair value through profit or loss	15,874	6,966	5,868	3,892	2,630	5,601	2,989	98,863	142,683
Derivative financial instruments	475	928	858	780	365	2,420	6,298	18,680	30,804
Loans and advances to banks	11,853	5,980	3,310	553	1,038	344	1,827	460	25,365
Loans and advances to customers	32,677	6,720	9,699	10,269	11,886	25,191	56,156	340,354	492,952
Debt securities held as loans and receivables	–	150	10	–	–	41	66	1,088	1,355
Available-for-sale financial assets	139	642	26	390	142	1,933	2,932	37,772	43,976
Other assets	6,265	9,083	1,491	663	1,610	2,665	7,900	25,653	55,330
Total assets	117,106	30,474	21,340	16,547	17,671	38,195	78,168	522,879	842,380
Liabilities									
Deposits from banks	9,984	612	291	788	116	1,548	113	530	13,982
Customer deposits	335,286	16,034	18,659	13,562	11,224	26,749	16,592	1,361	439,467
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	19,209	12,344	3,974	2,165	1,152	5,029	8,408	19,002	71,283
Debt securities in issue	5,427	5,771	6,399	3,644	4,081	12,184	18,857	30,739	87,102
Liabilities arising from insurance and investment contracts	1,486	6,579	2,317	2,244	3,046	8,430	21,300	65,356	110,758
Other liabilities	7,679	6,043	1,230	374	1,045	1,146	1,814	28,809	48,140
Subordinated liabilities	363	238	800	718	645	2,710	5,813	21,025	32,312
Total liabilities	379,434	47,621	33,670	23,495	21,309	57,796	72,897	166,822	803,044

[1] See note 1.

The above tables are provided on a contractual basis. The Group's assets and liabilities may be repaid or otherwise mature earlier or later than implied by their contractual terms and readers are, therefore, advised to use caution when using this data to evaluate the Group's liquidity position. In particular, amounts in respect of customer deposits are usually contractually payable on demand or at short notice. However, in practice, these deposits are not usually withdrawn on their contractual maturity.

Notes to the consolidated financial statements continued

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

The table below analyses financial instrument liabilities of the Group, excluding those arising from insurance and participating investment contracts, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2014						
Deposits from banks	**4,288**	**1,734**	**1,427**	**2,895**	**954**	**11,298**
Customer deposits	**365,261**	**13,672**	**38,520**	**31,614**	**578**	**449,645**
Trading and other financial liabilities at fair value through profit or loss	**32,209**	**15,145**	**1,316**	**3,658**	**7,508**	**59,836**
Debt securities in issue	**11,070**	**6,163**	**15,186**	**34,028**	**31,116**	**97,563**
Liabilities arising from non-participating investment contracts	**17,136**	**–**	**–**	**–**	**–**	**17,136**
Subordinated liabilities	**757**	**1,433**	**2,842**	**12,908**	**19,784**	**37,724**
Total non-derivative financial liabilities	**430,721**	**38,147**	**59,291**	**85,103**	**59,940**	**673,202**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**39,616**	**32,166**	**34,932**	**42,416**	**41,128**	**190,258**
Gross settled derivatives – inflows	**(37,928)**	**(30,408)**	**(32,999)**	**(39,883)**	**(35,858)**	**(177,076)**
Gross settled derivatives – net flows	**1,688**	**1,758**	**1,933**	**2,533**	**5,270**	**13,182**
Net settled derivatives liabilities	**21,959**	**114**	**341**	**1,150**	**3,650**	**27,214**
Total derivative financial liabilities	**23,647**	**1,872**	**2,274**	**3,683**	**8,920**	**40,396**
At 31 December 2013[1]						
Deposits from banks	9,944	636	1,254	1,710	738	14,282
Customer deposits	321,087	15,576	38,689	43,011	34,510	452,873
Trading and other financial liabilities at fair value through profit or loss	18,811	9,906	4,416	7,382	3,616	44,131
Debt securities in issue	7,427	5,069	15,805	40,928	24,514	93,743
Liabilities arising from non-participating investment contracts	27,590	–	–	–	–	27,590
Subordinated liabilities	180	424	2,503	15,019	24,538	42,664
Total non-derivative financial liabilities	385,039	31,611	62,667	108,050	87,916	675,283
Derivative financial liabilities:						
Gross settled derivatives – outflows	4,880	81,612	35,369	56,857	33,767	212,485
Gross settled derivatives – inflows	(4,115)	(79,256)	(34,321)	(55,396)	(32,625)	(205,713)
Gross settled derivatives – net flows	765	2,356	1,048	1,461	1,142	6,772
Net settled derivatives liabilities	21,730	179	438	1,202	541	24,090
Total derivative financial liabilities	22,495	2,535	1,486	2,663	1,683	30,862

[1] See note 1.

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £7,161 million at 31 December 2014 (2013: £8,591 million) with £4,133 million expiring within one year; £1,823 million between one and three years; £674 million between three and five years; and £531 million over five years (2013: £4,233 million expiring within one year; £837 million between one and three years; £2,039 million between three and five years; and £1,482 million over five years).

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

The principal amount for undated subordinated liabilities with no redemption option is included within the over five years column; interest of approximately £80 million (2013: £85 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

NOTE 54: FINANCIAL RISK MANAGEMENT (CONTINUED)

Further information on the Group's liquidity exposures is provided on pages 146 to 150.

Liabilities arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2014	**1,036**	**1,276**	**5,100**	**20,916**	**58,590**	**86,918**
At 31 December 2013	1,088	1,391	5,231	21,468	53,599	82,777

For insurance and participating investment contracts which are neither unit-linked nor in the Group's with-profit funds, in particular annuity liabilities, the aim is to invest in assets such that the cash flows on investments match those on the projected future liabilities.

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

	Up to 1 month £m	1-3 months £m	3-6 months £m	6-9 months £m	9-12 months £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2014									
Acceptances and endorsements	**51**	**6**	**1**	**–**	**–**	**–**	**–**	**1**	**59**
Other contingent liabilities	**432**	**415**	**217**	**80**	**162**	**504**	**130**	**683**	**2,623**
Total contingent liabilities	**483**	**421**	**218**	**80**	**162**	**504**	**130**	**684**	**2,682**
Lending commitments	**49,773**	**2,576**	**4,738**	**3,397**	**12,209**	**13,750**	**15,733**	**5,103**	**107,279**
Other commitments	**38**	**32**	**–**	**31**	**–**	**162**	**–**	**–**	**263**
Total commitments	**49,811**	**2,608**	**4,738**	**3,428**	**12,209**	**13,912**	**15,733**	**5,103**	**107,542**
Total contingents and commitments	**50,294**	**3,029**	**4,956**	**3,508**	**12,371**	**14,416**	**15,863**	**5,787**	**110,224**

	Up to 1 month £m	1-3 months £m	3-6 months £m	6-9 months £m	9-12 months £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2013									
Acceptances and endorsements	59	56	9	–	10	15	13	42	204
Other contingent liabilities	256	501	207	145	464	377	118	608	2,676
Total contingent liabilities	315	557	216	145	474	392	131	650	2,880
Lending commitments	30,918	11,857	15,452	4,632	7,519	14,886	17,064	2,849	105,177
Other commitments	–	–	–	–	494	–	–	–	494
Total commitments	30,918	11,857	15,452	4,632	8,013	14,886	17,064	2,849	105,671
Total contingents and commitments	31,233	12,414	15,668	4,777	8,487	15,278	17,195	3,499	108,551

CAPITAL RISK

Capital risk is defined as the risk that the Group has a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Capital risk appetite is set by the Board, reflecting the Group's strategic plans, regulatory capital constraints and market expectations. It includes a number of minimum capital ratios in normal and stressed conditions as well as a specific measure for the Insurance business, set by the Insurance Board, taking account of the need to maintain regulatory solvency including appropriate management buffers. The Board and the Group Chief Executive, assisted by the Group Asset and Liability Committee and the Group Risk Committee, regularly review performance against the risk appetite. A key metric is the Group's common equity tier 1 (CET1) capital ratio for which the Group is now assuming a steady state ratio requirement of around 12 per cent.

Additionally, a series of stress analyses is undertaken during the year to determine the adequacy of the Group's capital resources in adverse economic scenarios including those provided by the PRA.

INSURANCE RISK

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

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

Notes to the consolidated financial statements continued

NOTE 55: CONSOLIDATED CASH FLOW STATEMENT

(A) CHANGE IN OPERATING ASSETS

	2014 £m	2013[1] £m	2012[1] £m
Change in loans and receivables	**12,852**	29,909	51,234
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**(11,767)**	(5,078)	1,447
Change in other operating assets	**(1,957)**	(4,448)	(3,492)
Change in operating assets	**(872)**	20,383	49,189

(B) CHANGE IN OPERATING LIABILITIES

	2014 £m	2013 £m	2012 £m
Change in deposits from banks	**(3,029)**	(25,529)	(1,325)
Change in customer deposits	**7,745**	15,599	12,696
Change in debt securities in issue	**(11,089)**	(29,032)	(66,968)
Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss	**24,020**	(8,376)	809
Change in investment contract liabilities	**(342)**	3,171	7,421
Change in other operating liabilities	**(5,313)**	(3,520)	(170)
Change in operating liabilities	**11,992**	(47,687)	(47,537)

[1] See note 1.

NOTE 55: CONSOLIDATED CASH FLOW STATEMENT (CONTINUED)

(C) NON-CASH AND OTHER ITEMS

	2014 £m	2013 £m	2012 £m
Depreciation and amortisation	**1,935**	1,940	2,126
Revaluation of investment properties	**(513)**	(156)	264
Provision for impairment of disposal groups	**–**	382	26
Allowance for loan losses	**737**	2,726	5,121
Write-off of allowance for loan losses	**(5,761)**	(5,858)	(7,922)
Impairment of available-for-sale financial assets	**2**	15	37
Change in insurance contract liabilities	**4,070**	5,300	3,929
Payment protection insurance provision	**2,200**	3,050	3,575
Other regulatory provisions	**925**	405	650
Other provision movements	**222**	153	(101)
Net (credit) charge in respect of defined benefit schemes	**(478)**	503	110
Impact of consolidation and deconsolidation of OEICs[1]	**(5,277)**	6,303	(829)
Unwind of discount on impairment allowances	**(126)**	(351)	(374)
Foreign exchange impact on balance sheet[2]	**770**	89	(219)
Liability management losses (gains) within other income[3]	**–**	80	(59)
Loss on ECN exchange transaction	**1,336**	–	–
Interest expense on subordinated liabilities	**2,374**	2,956	2,783
(Profit) loss on disposal of businesses	**(208)**	(362)	7
Net gain on sale of available-for-sale financial assets	**(131)**	(629)	(3,547)
Hedging valuation adjustments on subordinated debt	**559**	(1,083)	225
Value of employee services	**340**	434	337
Issue of shares (non-cash)	**–**	160	322
Transactions in own shares	**(286)**	(480)	(407)
Accretion of discounts and amortisation of premiums and issue costs	**122**	286	12
Share of post-tax results of associates and joint ventures	**(32)**	(43)	(28)
Transfers to income statement from reserves	**(1,153)**	(550)	198
Profit on disposal of tangible fixed assets	**(44)**	(43)	(75)
Other non-cash items	**(8)**	(26)	(101)
Total non-cash items	**1,575**	15,201	6,060
Contributions to defined benefit schemes	**(538)**	(811)	(675)
Payments in respect of payment protection insurance provision	**(2,458)**	(2,674)	(3,299)
Payments in respect of other regulatory provisions	**(1,104)**	(360)	(20)
Other	**29**	26	15
Total other items	**(4,071)**	(3,819)	(3,979)
Non-cash and other items	**(2,496)**	11,382	2,081

[1] These OEICs (Open-ended investment companies) are mutual funds which are consolidated if the Group manages the funds and also has a majority beneficial interest. The population of OEICs to be consolidated varies at each reporting date as external investors acquire and divest holdings in the various funds. The consolidation of these funds is effected by the inclusion of the fund investments and a matching liability to the unitholders; and changes in funds consolidated represent a non-cash movement on the balance sheet.

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

[3] A number of capital transactions entered into by the Group involved the exchange of existing securities for new issues and as a result there was no related cash flow.

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NOTE 55: CONSOLIDATED CASH FLOW STATEMENT (CONTINUED)

(D) ANALYSIS OF CASH AND CASH EQUIVALENTS AS SHOWN IN THE BALANCE SHEET

	2014 £m	2013 £m	2012 £m
Cash and balances at central banks	**50,492**	49,915	80,298
Less: mandatory reserve deposits[1]	**(980)**	(937)	(580)
	49,512	48,978	79,718
Loans and advances to banks	**26,155**	25,365	32,757
Less: amounts with a maturity of three months or more	**(10,520)**	(7,546)	(11,417)
	15,635	17,819	21,340
Total cash and cash equivalents	**65,147**	66,797	101,058

[1] Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

Included within cash and cash equivalents at 31 December 2014 is £12,855 million (2013: £14,058 million; 2012: £17,889 million) held within the Group's life funds, which is not immediately available for use in the business.

(E) DISPOSAL AND CLOSURE OF GROUP UNDERTAKINGS AND BUSINESSES

	2014 £m	2013 £m	2012 £m
Trading and other assets at fair value through profit or loss	**11**	35,159	–
Loans and advances to customers	**256**	2,612	15
Loans and advances to banks	**55**	1,701	16
Investment property	**–**	582	–
Value of in-force business	**–**	831	–
Other intangible assets	**–**	251	–
Tangible fixed assets	**–**	67	–
	322	41,203	31
Customer deposits	**(266)**	(1,923)	–
Debt securities in issue	**–**	(264)	–
Liabilities arising from insurance contracts and participating investment contracts	**–**	(451)	–
Liabilities arising from non-participating investment contracts	**–**	(29,953)	–
Non-controlling interests	**–**	(357)	(38)
Other net assets (liabilities)	**802**	(6,160)	51
	536	(39,108)	13
Net assets	**858**	2,095	44
Cash and cash equivalents disposed	**(5)**	(1,702)	–
Non-cash consideration received	**(518)**	(59)	–
Profit (loss) on sale	**208**	362	(7)
Net cash inflow (outflow)	**543**	696	37

NOTE 56: DISPOSAL OF A NON-CONTROLLING INTEREST IN TSB BANKING GROUP PLC

During the year ended 31 December 2014, the Group disposed of three tranches of TSB Banking Group plc (TSB) shares:

(i) in June 2014, the Group disposed of a 35 per cent interest in TSB for a consideration of £430 million, after directly attributable costs of £25 million, through an initial public offering (IPO);

(ii) in July 2014, the Group sold 3.5 per cent of TSB for £44 million, after directly attributable costs of £1 million, through an over-allotment option which was exercised by the underwriters of the IPO; and

(iii) in September 2014, the Group disposed of a further 11.5 per cent for a consideration of £160 million, after directly attributable costs of £1 million.

At 31 December 2014, the Group retained an interest of approximately 50 per cent in TSB, which continues to be consolidated by the Group.

As none of these transactions resulted in the Group ceding control of TSB, no gain or loss has been recognised in the Group's income statement. The shortfall of £171 million between the net proceeds of the three sales and the share of TSB's net assets (at book value) disposed of has been deducted from the Group's retained earnings.

NOTE 57: FUTURE ACCOUNTING DEVELOPMENTS

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2014 and have not been applied in preparing these financial statements. Save as disclosed below, the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
IFRS 9 *Financial Instruments*[1]	Replaces IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments. The requirements for derecognition are broadly unchanged from IAS 39. The standard retains most of the existing requirements for financial liabilities except for those designated at fair value through profit or loss whereby that part of the fair value change attributable to the entity's own credit risk is recorded in other comprehensive income. These changes are not expected to have a significant impact on the Group. IFRS 9 also replaces the existing 'incurred loss' impairment approach with an expected credit loss approach. This change is likely to result in an increase in the Group's balance sheet provisions for credit losses although the extent of any increase will depend upon, amongst other things, the composition of the Group's lending portfolios and prevailing and forecast economic conditions at the date of implementation. The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The revised requirements are not expected to have a significant impact on the Group.	Annual periods beginning on or after 1 January 2018
IFRS 15 *Revenue from Contracts with Customers*[1]	Replaces IAS 18 *Revenue* and IAS 11 *Construction Contracts*. IFRS 15 establishes principles for reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognised at an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods and services. Financial instruments, leases and insurance contracts are out of scope and so this standard is not expected to have a significant impact on the Group.	Annual periods beginning on or after 1 January 2017

[1] As at 26 February 2015, these pronouncements are awaiting EU endorsement.

Parent company balance sheet

	Note	2014 £ million	2013 £ million
Assets			
Non-current assets:			
Investment in subsidiaries	9	41,102	40,933
Loans to subsidiaries	9	13,848	11,043
Deferred tax asset	2	19	4
		54,969	51,980
Current assets:			
Derivative financial instruments		752	1,452
Other assets		791	1,171
Amounts due from subsidiaries	3	67	67
Cash and cash equivalents		195	511
Current tax recoverable		–	19
		1,805	3,220
Total assets		56,774	55,200
Equity and liabilities			
Capital and reserves:			
Share capital	4	7,146	7,145
Share premium account	4	17,281	17,279
Merger reserve	5	7,764	7,764
Capital redemption reserve	5	4,115	4,115
Retained profits	6	1,720	1,414
Shareholders' equity		38,026	37,717
Other equity instruments	4	5,355	–
Total equity		43,381	37,717
Non-current liabilities:			
Debt securities in issue	8	561	535
Subordinated liabilities	7	1,688	1,669
		2,249	2,204
Current liabilities:			
Current tax liabilities		107	–
Other liabilities		11,037	15,279
		11,144	15,279
Total liabilities		13,393	17,483
Total equity and liabilities		56,774	55,200

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

The directors approved the parent company financial statements on 26 February 2015.

Lord Blackwell
Chairman

António Horta-Osório
Group Chief Executive

George Culmer
Chief Financial Officer

Parent company statement of changes in equity

	Share capital and premium £ million	Merger reserve £ million	Capital redemption reserve £ million	Retained profits[1] £ million	Total shareholders' equity £ million	Other equity instruments £ million	Total equity £ million
Balance at 1 January 2012	23,422	7,764	4,115	2,198	37,499	–	37,499
Total comprehensive income[1]	–	–	–	(224)	(224)	–	(224)
Issue of ordinary shares	492	–	–	–	492	–	492
Movement in treasury shares	–	–	–	(282)	(282)	–	(282)
Value of employee services:							
Share option schemes	–	–	–	69	69	–	69
Other employee award schemes	–	–	–	256	256	–	256
Balance at 31 December 2012	23,914	7,764	4,115	2,017	37,810	–	37,810
Total comprehensive income[1]	–	–	–	(846)	(846)	–	(846)
Issue of ordinary shares	510	–	–	–	510	–	510
Movement in treasury shares	–	–	–	(165)	(165)	–	(165)
Value of employee services:							
Share option schemes	–	–	–	116	116	–	116
Other employee award schemes	–	–	–	292	292	–	292
Balance at 31 December 2013	24,424	7,764	4,115	1,414	37,717	–	37,717
Total comprehensive income[1]	–	–	–	379	379	–	379
Distributions on other equity instruments, net of tax	–	–	–	(225)	(225)	–	(225)
Issue of ordinary shares	3	–	–	–	3	–	3
Issue of other equity instruments	–	–	–	(21)	(21)	5,355	5,334
Movement in treasury shares	–	–	–	(182)	(182)	–	(182)
Value of employee services:							
Share option schemes, net of tax	–	–	–	122	122	–	122
Other employee award schemes	–	–	–	233	233	–	233
Balance at 31 December 2014	**24,427**	**7,764**	**4,115**	**1,720**	**38,026**	**5,355**	**43,381**

[1] Total comprehensive income comprises only the profit (loss) for the year; no statement of comprehensive income has been shown for the parent company, as permitted by section 408 of the Companies Act 2006.

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

Parent company cash flow statement

	2014 £ million	2013 £ million	2012 £ million
Profit (loss) before tax	**273**	(1,090)	(259)
Fair value and exchange adjustments and other non-cash items	**1,118**	137	245
Change in other assets	**558**	124	14
Change in other liabilities and other items	**(4,242)**	4,699	750
Tax (paid) received	**301**	(35)	290
Net cash provided by (used in) operating activities	**(1,992)**	3,835	1,040
Cash flows from investing activities			
Return of capital contribution	**198**	–	–
Amounts advanced to subsidiaries	**(7,892)**	(3,082)	–
Redemption of loans to subsidiaries	**4,420**	197	209
Net cash (used in) provided by investing activities	**(3,274)**	(2,885)	209
Cash flows from financing activities			
Distributions on other equity instruments	**(287)**	–	–
Issue of other equity instruments	**5,329**	–	–
Issue of subordinated liabilities	**629**	–	–
Interest paid on subordinated liabilities	**(128)**	(253)	(293)
Repayment of subordinated liabilities	**(596)**	(2,767)	–
Proceeds from issue of ordinary shares	**3**	350	170
Net cash used in financing activities	**4,950**	(2,670)	(123)
Change in cash and cash equivalents	**(316)**	(1,720)	1,126
Cash and cash equivalents at beginning of year	**511**	2,231	1,105
Cash and cash equivalents at end of year	**195**	511	2,231

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

Notes to the parent company financial statements

NOTE 1: ACCOUNTING POLICIES

The Company has applied International Financial Reporting Standards as adopted by the European Union in its financial statements for the year ended 31 December 2014. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Company has not taken advantage of this relaxation, and therefore there is no difference in application to the Company between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of all derivative contracts.

The accounting policies of the Company are the same as those of the Group which are set out in note 2 to the consolidated financial statements, except that it has no policy in respect of consolidation and investments in subsidiaries are carried at historical cost, less any provisions for impairment.

NOTE 2: DEFERRED TAX ASSET

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

	2014 £m	2013 £m
At 1 January	**4**	9
Income statement charge	**(1)**	(5)
Amount credited to equity in respect of share-based compensation	**16**	–
At 31 December	**19**	4

The deferred tax asset relates to temporary differences.

NOTE 3: AMOUNTS DUE FROM SUBSIDIARIES

These comprise short-term lending to subsidiaries, repayable on demand. The fair values of amounts owed by subsidiaries are equal to their carrying amounts. No provisions have been recognised in respect of amounts owed by subsidiaries.

NOTE 4: SHARE CAPITAL, SHARE PREMIUM AND OTHER EQUITY INSTRUMENTS

Details of the Company's share capital, share premium account and other equity instruments are as set out in notes 42, 43 and 46 to the consolidated financial statements.

NOTE 5: OTHER RESERVES

The merger reserve comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

There were no movements in other reserves in 2014, 2013 or 2012.

Notes to the parent company financial statements continued

NOTE 6: RETAINED PROFITS

	£m
At 1 January 2012	2,198
Loss for the year	(224)
Movement in treasury shares	(282)
Value of employee services:	
Share option schemes	69
Other employee award schemes	256
At 31 December 2012	2,017
Loss for the year	(846)
Movement in treasury shares	(165)
Value of employee services:	
Share option schemes	116
Other employee award schemes	292
At 31 December 2013	1,414
Profit for the year	**379**
Issue costs of other equity instruments, net of tax	**(21)**
Distributions on other equity instruments, net of tax	**(225)**
Movement in treasury shares	**(182)**
Value of employee services:	
Share option schemes	**122**
Other employee award schemes	**233**
At 31 December 2014	**1,720**

Details of the Company's dividends are as set out in note 47 to the consolidated financial statements.

NOTE 7: SUBORDINATED LIABILITIES

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer. Any repayments of subordinated liabilities require the consent of the Prudential Regulation Authority.

	Note	2014 £m	2013 £m
Preference shares			
6% Non-Cumulative Redeemable Preference Shares	a	–	–
6.0884% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2015 (£745 million)	a	11	10
5.92% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2015 (US$750 million)	a	135	123
6.267% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million)	a	279	274
6.3673% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2019 (£335 million)	a	2	2
6.475% Non-Cumulative Preference Shares callable 2024 (£186 million)	a	43	39
6.413% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2035 (US$750 million)	a	115	108
6.657% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2037 (US$750 million)	a	134	125
9.25% Non-Cumulative Irredeemable Preference Shares (£300 million)	a	266	266
9.75% Non-Cumulative Irredeemable Preference Shares (£100 million)	a	54	54
Total preference shares		1,039	1,001
Undated subordinated liabilities			
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	b	10	10
Total undated subordinated liabilities		10	10
Dated subordinated liabilities			
5.875% Subordinated Guaranteed Bonds 2014 (€750 million)		–	658
4.5% Fixed Rate Subordinated Debt Securities due 2024 (US$1,000 million)		639	–
Total dated subordinated liabilities		639	658
Total subordinated liabilities		1,688	1,669

a Further information regarding these issues can be found in note 41 to the consolidated financial statements.

b In certain circumstances, these bonds would acquire the characteristics of preference share capital. They are accounted for as liabilities as coupon payments are mandatory as a consequence of the terms of the 6 per cent non-cumulative redeemable preference shares. At the callable date the coupon on these bonds will be reset by reference to the applicable five year benchmark gilt rate. Further information regarding this can be found in note 41 to the consolidated financial statements.

NOTE 8: DEBT SECURITIES IN ISSUE

These comprise US$862.5 million 7.75% Public Income Notes due 2050 issued by the Company in July 2010.

NOTE 9: RELATED PARTY TRANSACTIONS

In January 2009 HM Treasury became a related party of the Company and has remained so during 2013 and 2014. From 1 January 2011, in accordance with IAS 24, UK Government-controlled entities also became related parties of the Group. Further information on the relationship and transactions with HM Treasury and UK Government-controlled entities is given in note 49 to the consolidated financial statements.

KEY MANAGEMENT PERSONNEL

The key management personnel of the Group and the Company are the same. The relevant disclosures are given in note 49 to the consolidated financial statements.

The Company has no employees (2013: nil).

As discussed in note 2 to the consolidated financial statements, the Group provides share-based compensation to employees through a number of schemes; these are all in relation to shares in the Company and the cost of providing those benefits is recharged to the employing companies in the Group.

INVESTMENT IN SUBSIDIARIES

	2014 £m	2013 £m
At 1 January	40,933	40,534
Capital contribution	367	399
Return of capital contribution	(198)	–
At 31 December	41,102	40,933

Notes to the parent company financial statements continued

NOTE 9: RELATED PARTY TRANSACTIONS (CONTINUED)

The principal subsidiaries, all of which have prepared accounts to 31 December and whose results are included in the consolidated accounts of Lloyds Banking Group plc, are:

	Share class	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Lloyds Bank plc	Ordinary	England	100%	Banking and financial services
Scottish Widows plc	Ordinary	Scotland	100%[1]	Life assurance
HBOS plc	Ordinary	Scotland	100%[1]	Holding company
Bank of Scotland plc	Ordinary	Scotland	100%[1]	Banking and financial services
TSB Bank plc	Ordinary	Scotland	50%[1]	Banking and financial services
St. Andrew's Insurance plc	Ordinary	England	100%[1]	General insurance
Clerical Medical Investment Group Limited	Ordinary	England	100%[1]	Life assurance
Clerical Medical Managed Funds Limited	Ordinary	England	100%[1]	Life assurance

[1] Indirect interest.

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

A full list of subsidiaries will be included in the Company's next annual return, the Company having made use of the exemption in section 410 of the Companies Act 2006.

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Group, Lloyds Banking Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. The Group also agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra group. Consequently, in accordance with the terms of some of these instruments, subsidiaries could have been prevented from making dividend payments on ordinary shares during this period. In addition, certain subsidiary companies currently have insufficient distributable reserves to make dividend payments.

Subject to the foregoing, there were no further significant restrictions on any of the Company's subsidiaries in paying dividends or repaying loans and advances. All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

LOANS TO SUBSIDIARIES

	2014 £m	2013 £m
At 1 January	**11,043**	8,123
Exchange and other adjustments	**19**	35
New issues	**7,849**	3,082
Redemptions	**(5,063)**	(197)
At 31 December	**13,848**	11,043

In addition the Company carries out banking activities through its subsidiary, Lloyds Bank plc. At 31 December 2014, the Company held deposits of £195 million with Lloyds Bank plc (2013: £511 million). Given the volume of transactions flowing through the account, it is not meaningful to provide gross inflow and outflow information. Included within subordinated liabilities is £nil (2013: £nil) and within other liabilities is £10,944 million (2013: £14,821 million) due to subsidiary undertakings. In addition, at 31 December 2014 the Company had interest rate and currency swaps with Lloyds Bank plc with an aggregate notional principal amount of £1,446 million and a net positive fair value of £752 million (2013: notional principal amount of £2,454 million and a net positive fair value of £1,452 million). Of this amount an aggregate notional principal amount of £449 million and a net positive fair value of £43 million (2013: notional principal amount of £1,854 million and a net positive fair value of £226 million) were designated as fair value hedges to manage the Company's issuance of subordinated liabilities and debt securities in issue.

A further notional principal amount of £nil and a net fair value of £nil (2013: notional principal amount of £600 million and a net positive fair value of £13 million) of this amount were designated as cash flow hedges.

GUARANTEES

The Company guarantees certain of its subsidiaries' liabilities to the Bank of England.

OTHER RELATED PARTY TRANSACTIONS

Related party information in respect of other related party transactions is given in note 49 to the consolidated financial statements.

NOTE 10: FINANCIAL INSTRUMENTS

MEASUREMENT BASIS OF FINANCIAL ASSETS AND LIABILITIES

The accounting policies in note 2 to the consolidated financial statements describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the Company's financial assets and liabilities by category and by balance sheet heading.

	Derivatives designated as hedging instruments, held at fair value through profit or loss £m	Held for trading at fair value through profit or loss £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2014					
Financial assets:					
Cash and cash equivalents	**–**	**–**	**–**	**195**	**195**
Derivative financial instruments	**106**	**646**	**–**	**–**	**752**
Loans to subsidiaries	**–**	**–**	**13,848**	**–**	**13,848**
Amounts due from subsidiaries	**–**	**–**	**67**	**–**	**67**
Total financial assets	**106**	**646**	**13,915**	**195**	**14,862**
Financial liabilities:					
Debt securities in issue	–	**–**	**–**	**561**	**561**
Subordinated liabilities	–	**–**	**–**	**1,688**	**1,688**
Total financial liabilities	–	**–**	**–**	**2,249**	**2,249**
At 31 December 2013					
Financial assets:					
Cash and cash equivalents	–	–	–	511	511
Derivative financial instruments	240	1,212	–	–	1,452
Loans to subsidiaries	–	–	11,043	–	11,043
Amounts due from subsidiaries	–	–	67	–	67
Total financial assets	240	1,212	11,110	511	13,073
Financial liabilities:					
Debt securities in issue	–	–	–	535	535
Subordinated liabilities	–	–	–	1,669	1,669
Total financial liabilities	–	–	–	2,204	2,204

Note 51 to the consolidated financial statements outlines the valuation hierarchy into which financial instruments measured at fair value are categorised.

The derivative assets designated as hedging instruments represent level 2 portfolios. The derivative assets classified as held for trading (not being designated as hedging instruments) shown above represent level 3 portfolios. The level 3 derivatives reflect the value of the equity conversion feature of the Enhanced Capital Notes issued in December 2009 as part of Lloyds Banking Group's recapitalisation and exit from the Government Asset Protection Scheme.

The following reconciliation shows the movements in derivative financial instrument assets within level 3 portfolios:

	2014 £m	2013 £m
At 1 January	**1,212**	1,421
Derecognised following completion of the Group's ECN exchange and retail offers[1]	**(967)**	–
Gains (losses) recognised in the income statement	**401**	(209)
At 31 December	**646**	1,212

[1] See note 10 to the consolidated financial statements.

Notes to the parent company financial statements continued

NOTE 10: FINANCIAL INSTRUMENTS (CONTINUED)

INTEREST RATE RISK AND CURRENCY RISK

The Company is exposed to interest rate risk and currency risk on its debt securities in issue and its subordinated debt.

As discussed in note 9, the Company has entered into interest rate and currency swaps with its subsidiary, Lloyds Bank plc, to manage these risks.

CREDIT RISK

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

LIQUIDITY RISK

The table below analyses financial instrument liabilities of the Company, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2014						
Debt securities in issue	**10**	**–**	**30**	**165**	**1,810**	**2,015**
Subordinated liabilities	**–**	**14**	**258**	**468**	**4,055**	**4,795**
Total financial instrument liabilities	**10**	**14**	**288**	**633**	**5,865**	**6,810**
At 31 December 2013						
Debt securities in issue	10	–	30	562	–	602
Subordinated liabilities	–	2	128	697	1,509	2,336
Total financial instrument liabilities	10	2	158	1,259	1,509	2,938

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £1 million (2013: £1 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES

The valuation techniques for the Company's financial instruments are as discussed in note 51 to the consolidated financial statements.

	2014		2013	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets:				
Cash and cash equivalents	**195**	**195**	511	511
Derivative financial instruments	**752**	**752**	1,452	1,452
Loans to subsidiaries	**13,848**	**14,053**	11,043	10,988
Amounts due from subsidiaries	**67**	**67**	67	67
Financial liabilities:				
Debt securities in issue	**561**	**580**	535	535
Subordinated liabilities	**1,688**	**2,040**	1,669	1,959

NOTE 10: FINANCIAL INSTRUMENTS (CONTINUED)

VALUATION HIERARCHY

The table below analyses the assets and liabilities of the Company. With the exception of derivatives all assets and liabilities are held at amortised cost. They are categorised into levels 1 to 3 based on the degree to which their fair value is observable.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2014				
Derivative financial instruments	–	**106**	**646**	**752**
Loans to subsidiaries	–	**13,848**	–	**13,848**
Amounts due from subsidiaries	–	**67**	–	**67**
Total financial assets	–	**14,021**	**646**	**14,667**
Debt securities in issue	–	**561**	–	**561**
Subordinated liabilities	–	**1,688**	–	**1,688**
Total financial liabilities	–	**2,249**	–	**2,249**

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2013				
Derivative financial instruments	–	240	1,212	1,452
Loans to subsidiaries	–	11,043	–	11,043
Amounts due from subsidiaries	–	67	–	67
Total financial assets	–	11,350	1,212	12,562
Debt securities in issue	–	535	–	535
Subordinated liabilities	–	1,669	–	1,669
Total financial liabilities	–	2,204	–	2,204

The carrying amount of cash and cash equivalents is a reasonable approximation of fair value.

SENSITIVITY OF LEVEL 3 VALUATIONS

				Effect of reasonably possible alternative assumptions	
	Valuation technique(s)	Significant unobservable inputs[1]	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Financial assets carried at fair value at December 2014					
Derivative financial assets					
Embedded equity conversion feature	Lead manager or broker quote	Equity conversion feature spread (175 bps/432 bps)	**646**	**21**	**(21)**
			646		
Financial assets carried at fair value at December 2013					
Derivative financial assets					
Embedded equity conversion feature	Lead manager or broker quote	Equity conversion feature spread (199 bps/420 bps)	1,212	59	(58)
			1,212		

[1] Ranges represent the highest and lowest inputs used in the level 3 valuations.

NOTE 11: OTHER INFORMATION

Lloyds Banking Group plc was incorporated as a public limited company and registered in Scotland under the UK Companies Act 1985 on 21 October 1985 with the registered number 95000. Lloyds Banking Group plc's registered office is The Mound, Edinburgh EH1 1YZ, Scotland, and its principal executive offices in the UK are located at 25 Gresham Street, London EC2V 7HN.

OTHER INFORMATION

Shareholder information

ANNUAL GENERAL MEETING (AGM)

The AGM will be held at the Edinburgh International Conference Centre, The Exchange, Edinburgh EH3 8EE on Thursday 14 May 2015 at 11.00 am. Further details about the meeting, including the proposed resolutions, can be found in our Notice of AGM which will be available shortly on our website at www.lloydsbankinggroup.com

REPORTS AND COMMUNICATIONS

The Group issues regulatory announcements through the Regulatory News Service (RNS); shareholders can subscribe for free via the 'Investors & Performance' section of our website at www.lloydsbankinggroup.com, where you can also find our statutory reports and shareholder communications. A summary of these are listed below:

		Available format			
Report/Communication	Month	Online	RNS	Paper	Email
Preliminary results	Feb	✔	✔		
Annual Report and Accounts, Annual Review or Performance Summary	Mar	✔		✔	✔
Pillar 3 report	Mar	✔			
Notice of AGM and voting materials	Mar	✔		✔	✔
Country-by-country reporting[1]	Jun/Jul	✔			
Q1 interim management statement[2]	May	✔	✔		
Interim results	Jul	✔	✔		
Group Chief Executive letter to shareholders	Mar/Aug	✔		✔	✔
Q3 interim management statement[2]	Oct	✔	✔		

[1] To be published on the Group's website by 1 July 2015 in accordance with the Capital Requirements (country-by-country) Regulations 2013.

[2] Despite changes to regulations which remove the requirement to issue interim management statements, Lloyds Banking Group still intends to issue these reports in May and October.

SHARE DEALING FACILITIES

We offer a choice of three share dealing services for our UK shareholders and customers. To see the full range of services available for each, please use the contact details below:

Service Provider	Telephone Dealing	Internet Dealing
Bank of Scotland Share Dealing	0845 606 1188	www.bankofscotlandsharedealing.co.uk
Halifax Share Dealing	08457 22 55 25	www.halifaxsharedealing.co.uk
Lloyds Bank Direct Investments	0845 60 60 560	www.lloydsbank.com/shares

Note:

All internet services are available 24/7. Telephone dealing services are available between 8.00 am and 9.15 pm, Monday to Friday and 9.00 am to 1.00 pm on Saturday. To open a share dealing account with any of these services, you must be 18 years of age or over and be resident in the UK, Jersey, Guernsey or the Isle of Man.

SHARE DEALING FOR THE LLOYDS BANKING GROUP SHAREHOLDER ACCOUNT

Share dealing services for the Lloyds Banking Group Shareholder Account are provided by Equiniti Shareview Dealing, operated by Equiniti Financial Services Limited. Details of the services provided can be found either on the Shareholder Information page of our website at www.lloydsbankinggroup.com, or by contacting Equiniti using the contact details provided on the next page.

SHARE PRICE INFORMATION

Shareholders can access both the latest and historical share prices via our website at www.lloydsbankinggroup.com as well as listings in most national newspapers. For a real time buying or selling price, you will need to contact a stockbroker, or you can contact the share dealing providers detailed above.

INDIVIDUAL SAVINGS ACCOUNTS (ISAs)

There are a number of options for investing in Lloyds Banking Group shares through an ISA. For details of services and products provided by the Group please contact: Bank of Scotland Share Dealing, Halifax Share Dealing or Lloyds Bank Direct Investments using the contact details above.

Shareholder information continued

AMERICAN DEPOSITARY RECEIPTS (ADRs)

Our shares are traded in the USA through a New York Stock Exchange-listed sponsored ADR facility with The Bank of New York Mellon as the depositary. The ADRs are traded on the New York Stock Exchange under the symbol LYG. The CUSIP number is 539439109 and the ratio of ADRs to ordinary shares is 1:4.

For details contact: BNY Mellon Depositary Receipts, PO Box 30170, College Station, TX 77842-3170. Telephone: 1-866-259-0336 (US toll free), international callers: +1 201-680-6825. Alternatively visit www.adrbnymellon.com or email shrrelations@cpushareownerservices.com

ANALYSIS OF SHAREHOLDERS

At 31 December 2014

Size of shareholding	Share Number	Share %	Number of ordinary shares Millions	Number of ordinary shares %
1 – 999	2,141,483	81.54	649.6	0.91
1,000 – 9,999	423,780	16.14	1,111.5	1.56
10,000 – 99,999	57,515	2.19	1,360.5	1.91
100,000 – 999,999	2,403	0.09	576.4	0.81
1,000,000 – 4,999,999	474	0.02	1,145.9	1.60
5,000,000 – 9,999,999	173	0.01	1,223.7	1.71
10,000,000 – 49,999,999	272	0.01	6,452.0	9.04
50,000,000 – 99,999,999	53	0.00	3,571.1	5.00
100,000,000 – 499,999,999	64	0.00	12,551.2	17.59
500,000,000 – 999,999,999	12	0.00	8,353.2	11.70
1,000,000,000 and over	14	0.00	34,378.6	48.17
	2,626,243	100.00	71,373.7	100.00

SECURITY – SHARE FRAUD AND SCAMS

Shareholders should exercise caution when unsolicited callers offer the chance to buy or sell shares with promises of huge returns. If it sounds too good to be true, it usually is and we would ask that shareholders take steps to protect themselves. We strongly recommend seeking advice from an independent financial adviser authorised by the Financial Conduct Authority (FCA). Shareholders can verify whether a firm is authorised via the Financial Services Register which is available at www.fca.org.uk

If a shareholder is concerned that they may have been targeted by such a scheme, please contact the FCA Consumer Helpline on 0800 111 6768 or use the online 'Share Fraud Reporting Form' available from their website (see above). We would also recommend contacting the Police through Action Fraud on 0300 123 2040 or visiting www.actionfraud.org.uk for further information.

KEY CONTACT INFORMATION

Company information
www.lloydsbankinggroup.com

Shareholder information
www.shareview.co.uk
help.shareview.co.uk

Registrar
Equiniti Limited
Aspect House, Spencer Road, Lancing
West Sussex BN99 6DA

Shareholder helpline
0871 384 2990* from within the UK,
0871 384 2255 Textphone
+44 121 415 7066 from outside the UK

*Lines are open 8.30 am to 5.30 pm, Monday to Friday, Calls cost 8p per minute plus network extras. Calls to +44 121 415 7066 from outside the UK are charged at applicable international rates.

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Forward looking statements

This Annual Report contains certain forward looking statements with respect to the business, strategy and plans of the Lloyds Banking Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the Lloyds Banking Group or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

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

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

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

Glossary

Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency and the entire outstanding balance is delinquent.
Asset quality ratio	The impairment charge for the year in respect of loans and advances to customers expressed as a percentage of average loans and advances to customers.
Basel II	The capital adequacy framework issued by the Basel Committee on Banking Supervision in June 2006 in the form of the 'International Convergence of Capital Measurement and Capital Standards'.
Basel III	The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in, through CRD IV, from 1 January 2014 onward.
Basis point	One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates or yields on securities.
Central counterparty (CCP)	An institution mediating between the buyer and seller in a financial transaction, such as a derivative contract or repurchase agreement. Where a CCP is used, a single bilateral contract between the buyer and the seller is replaced with two contracts, one between the buyer and the CCP and one between the CCP seller.
Collectively assessed loan impairment provision	A provision established following an impairment assessment on a collective basis for homogeneous groups of loans, such as credit card receivables and personal loans, that are not considered individually significant and for loan losses that have been incurred but not separately identified at the balance sheet date.
Commercial paper	Commercial paper is an unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date. Commercial paper can be issued as an unsecured obligation of the Group or, for example when issued by the Group's conduits, as an asset-backed obligation (in such case it is referred to as **asset-backed commercial paper**). Commercial paper is usually issued for periods from as little as a week up to nine months.
Commercial Real Estate	Includes office buildings, industrial property, medical centres, hotels, malls, retail stores, shopping centres, farm land, multifamily housing buildings, warehouses, garages, and industrial properties.
Common equity tier 1 capital (CET1)	The highest quality form of regulatory capital under CRD IV that comprises common shares issued and related share premium, retained earnings and other reserves excluding the cash flow hedging reserve, less specified regulatory adjustments.
Conduits	A financial vehicle that holds asset-backed securities which are financed with short-term deposits (generally **commercial paper**) that use the asset-backed securities as collateral. The conduit will often have a liquidity line provided by a bank that it can draw down on in the event that it is unable to issue funding to the market.
Contractual maturities	Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.
Cost:income ratio	Operating expenses compared to total income net of insurance claims. The Group calculates this ratio using the 'underlying basis' which is the basis on which financial information is reported internally to management.
Coverage ratio	Impairment provisions as a percentage of impaired loans.
CRD IV	On 27 June 2013, the European Commission published, through the Official Journal of the European Union, its legislation for a Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR), which together form the CRD IV package. Amendments published on 30 November 2013 were made to the Regulation. The package implements the Basel III reforms in addition to the inclusion of new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. CRD IV rules apply from 1 January 2014 onwards, with certain requirements set to be phased in.
Credit default swap	A credit default swap is a type of credit derivative. It is an arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection. The entity selling protection receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.
Credit derivatives	A credit derivative is a financial instrument that derives its value from the credit rating of an underlying instrument carrying the credit risk of the issuing entity. The principal type of credit derivatives are **credit default swaps**, which are used by the Group as part of its trading activity and to manage its own exposure to credit risk.
Credit valuation adjustments	These are adjustments to the fair values of derivative assets to reflect the creditworthiness of the counterparty. Further details are given in note 51.
Debt restructuring	This is when the terms and provisions of outstanding debt agreements are changed. This is often done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as reducing the debt or interest charged on the loan.
Debt securities	Debt securities are assets held by the Group representing certificates of indebtedness of credit institutions, public bodies or other undertakings, excluding those issued by Central Banks.

Delinquency	See **Arrears**.
Embedded equity conversion feature	An embedded equity conversion feature is a derivative contained within the terms and conditions of a debt instrument that enables or requires the instrument to be converted into equity under a particular set of circumstances. The Group's Enhanced Capital Notes (ECNs) contain such a feature whereby these notes convert to ordinary shares in the event that the consolidated core tier 1 ratio of the Group falls below 5 per cent.
Enhanced Capital Notes (ECNs)	The Group's ECNs are subordinated notes issued by the Group that contain an embedded equity conversion feature. Further details of these are given in note 41.
Expected loss	This is the amount of loss that can be expected by the Group calculated in accordance with PRA rules. In broad terms it is calculated by multiplying the Default Frequency by the **Loss Given Default** by the **Exposure at Default**.
Exposure at default	An estimate of the amount expected to be owed by a customer at the time of the customer's default.
Fair value adjustment	Fair value adjustments arise on acquisition when assets and liabilities are acquired at fair values that are different from the carrying values in the acquired company. In respect of the Group's acquisition of HBOS the principal adjustments were write-downs in respect of loans and advances to customers and debt issued.
Forbearance	Forbearance takes place when a concession is made on the contractual terms of a loan in response to an obligor's financial difficulties.
Full time equivalent	A full time employee works a standard five day week. The hours or days worked by part time employees are measured against this standard and accumulated along with the number of full time employees and counted as full time equivalents. This is a more consistent measure of the amount of time worked than employee numbers which will fluctuate as the mix of part-time and full-time employees changes.
Funded/unfunded exposures	Exposures where the notional amount of the transaction is either funded or unfunded.
Funding risk	The risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.
Impaired loans	Impaired loans are loans where the Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
Impairment allowances	Impairment allowances are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.
Impairment losses	An impairment loss is the reduction in value that arises following an impairment review of an asset that determines that the asset's value is lower than it's carrying value. For impaired financial assets measured at amortised cost, impairment losses are the difference between the carrying value and the present value of estimated future cash flows, discounted at the asset's original effective interest rate. Impairment losses can be difficult to assess and the critical accounting estimates and judgements in note 3 detail the key assessments made when determining impairment losses.
Individually/collectively assessed	Impairment is measured individually for assets that are individually significant, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available.
Individually assessed loan impairment provisions	Impairment loss provisions for individually significant impaired loans are assessed on a case-by-case basis, taking into account the financial condition of the counterparty, any guarantor and the realisable value of any collateral held.
Interest rate risk	Interest rate risk in arises from the different repricing characteristics of the Group's non-trading assets, liabilities and off-balance sheet positions of the Group. Interest rate risk arises predominantly from the mismatch between interest rate sensitive assets and liabilities, but also to the investment term of capital and reserves, and the need to minimise income volatility.
Internal Capital Adequacy Assessment Process (ICAAP)	The Group's own assessment, based on Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events as they apply on a solo level and on a consolidated level.
Internal Ratings-Based approach (IRB)	A methodology of estimating the credit risk within a portfolio by utilising internal risk parameters to calculate credit risk regulatory capital requirements. There are two approaches to IRB: Foundation IRB and Advanced IRB.
Investment grade	This refers to the highest range of credit ratings, from 'AAA' to 'BBB' as measured by external credit rating agencies.
ISDA (International Swaps and Derivatives Association) master agreement	A standardised contract developed by the ISDA which is used as an umbrella contract for bilateral derivative contracts.

Glossary continued

Liquidity Coverage Ratio (LCR)	The ratio of the stock of high quality liquid assets to expected net cash outflows over the following 30 days. High quality liquid assets should be unencumbered, liquid in markets during a time of stress and ideally, be central bank eligible.
Liquidity risk	The risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.
Loan to deposit ratio	The ratio of loans and advances to customers net of allowance for impairment losses and excluding reverse repurchase agreements divided by customer deposits excluding repurchase agreements.
Loan-to-value ratio (LTV)	The loan-to-value ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.
Loans past due	Loans are past due when a counterparty has failed to make a payment when contractually due.
Loss emergence period	The loss emergence period is the estimated period between impairment occurring and the loss being specifically identified and evidenced by the establishment of an appropriate impairment allowance.
Loss Given Default	The estimated loss that will arise if a customer defaults. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.
Master netting agreement	An agreement between two counterparties that have multiple derivative contracts with each other that provides for the net settlement of all contracts through a single payment, in a single currency, in the event of default on, or termination of, any one contract.
Medium Term Notes	Medium term notes are a form of corporate borrowing covering maturity periods ranging from nine months to 30 years. Details of the notes issued under the Group's medium term notes programmes are given in note 32.
Negative equity mortgages	Negative equity occurs when the value of the property purchased using the mortgage is below the balance outstanding on the loan. Negative equity is the value of the asset less the outstanding balance on the loan.
Net asset value per ordinary share	Shareholders' equity divided by the number of ordinary shares and limited voting ordinary shares in issue, adjusted to exclude shares held under certain employee share ownership plans.
Net Stable Funding Ratio (NSFR)	The ratio of available stable funding to required stable funding over a one year time horizon, assuming a stressed scenario. The ratio is required to be over 100% with effect from 2018. Available stable funding would include such items as equity capital, preferred stock with a maturity of over 1 year, or liabilities with a maturity of over 1 year.
Net interest income	The difference between interest received on assets and interest paid on liabilities.
Net interest margin	Net interest margin is net interest income as a percentage of average interest-earning assets.
Over-the-counter derivatives	Over-the-counter derivatives are derivatives for which the terms and conditions can be freely negotiated by the counterparties involved, unlike exchange traded derivatives which have standardised terms.
Probability of default	The likelihood that a customer will default on their obligation within the next year.
Regulatory capital	The amount of capital that the Group holds, determined in accordance with rules established by the PRA for the consolidated Group and by local regulators for individual Group companies.
Repurchase agreements or 'repos'	Short-term funding agreements which allow a borrower to sell a financial asset, such as ABS or Government bonds as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.
Risk appetite	The amount and type of risk that the Group is prepared to seek, accept or tolerate.
Risk-weighted assets	A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with the Basel Capital Accord as implemented by the PRA.
Securitisation	Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities.
Sovereign exposures	Exposures to central governments and central government departments, central banks and entities owned or guaranteed by the aforementioned.
Specialist mortgages	Specialist mortgages include those mortgage loans provided to customers who have self-certified their income (normally as a consequence of being self-employed) or who are otherwise regarded as a sub-prime credit risk. New mortgage lending of this type has not been offered by the Group since early 2009.
Standardised Approach	In relation to credit risk, a method for calculating credit risk capital requirements using External Credit Assessment Institutions (ECAI) ratings of obligors (where available) and supervisory risk weights. In relation to operational risk, a method of calculating the operational risk capital requirement by the application of a supervisory defined percentage charge to the gross income of specified business lines.
Stress testing	Stress and scenario testing is the term used to describe techniques where plausible events are considered as vulnerabilities to ascertain how this will impact the capital resources which are required to be held.

Structured entities (SEs)	SEs are entities that have been designed so that voting or similar rights are not the dominant factor in determining who controls the entity, such as when voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. SEs often have specific restrictions around their ongoing activities and are created to accomplish a narrow and well-defined objective.
Sub-investment grade	This refers to credit ratings issued by external credit rating agencies that are below 'BBB' grade or its equivalent.
Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer. Details of the Group's subordinated liabilities are set out in note 41.
Trading book	Positions in financial instruments and commodities held for trading purposes or to hedge other elements of the trading book.
Value-at-Risk	Value-at-Risk is an estimate of the potential loss in earnings which might arise from market movements under normal market conditions, if the current positions were to be held unchanged for one business day. It is measured to specified level of confidence, often 95 per cent or 99 per cent.
Write downs	The depreciation or lowering of the value of an asset in the books to reflect a decline in their value, or expected cash flows.

Abbreviations

ADRs	American Depositary Receipts
BoE	Bank of England
BSU	Business Support Unit
CDS	Credit Default Swap
CET1	Common Equity Tier 1
CMIG	Clerical Medical Investment Group Limited
CRD IV	Capital Requirements Directive IV
CVA	Credit Valuation Adjustment
DVA	Debit Valuation Adjustment
EBA	European Banking Authority
EC	European Commission
ECNs	Enhanced Capital Notes
EEI	Employee Engagement Index
EEV	European Embedded Value
EFG	Enterprise Finance Guarantee Scheme
EP	Economic Profit
EPS	Earnings Per Share
EU	European Union
FCA	Financial Conduct Authority
FLS	Funding for Lending Scheme
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
HMRC	Her Majesty's Revenue & Customs
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICG	Individual Capital Guidance
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
LCR	Liquidity Coverage Ratio
LIBOR	London Inter-Bank Offered Rate
LMI	Line Manager Index
LTIP	Long-Term Incentive Plan
NPS	Net Promoter Score
NSFR	Net Stable Funding Ratio
OEICs	Open Ended Investment Companies
OFT	Office of Fair Trading
PEI	Performance Excellence Index
PFI	Private Finance Initiative
PPI	Payment Protection Insurance
PPP	Public Private Partnership
PRA	Prudential Regulation Authority
PVNBP	Present Value of New Business Premiums
RDR	Retail Distribution Review
SAYE	Save-As-You-Earn
SEC	Securities and Exchange Commission
SWIP	Scottish Widows Investment Partnership
TSR	Total Shareholder Return
UKFI	UK Financial Investments Limited
VaR	Value-at-Risk

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DISCLOSURES ARISING FROM ENHANCED DISCLOSURE TASK FORCE (EDTF) RECOMMENDATIONS

The 32 recommendations listed below are made in the report 'Enhancing the Risk Disclosures of Banks' issued by the Enhanced Disclosure Task Force of the Financial Stability Board on 29 October 2012.

The Group's Pillar 3 Report can be found at www.lloydsbankinggroup.com

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