Bank of Scotland plc

Half-Year Management Report

For the half-year to 30 June 2017

Member of the Lloyds Banking Group

FORWARD LOOKING STATEMENTS

This document contains certain forward looking statements with respect to the business, strategy and plans of the Bank of Scotland 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 Bank of Scotland Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future. Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Bank of Scotland Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates (including low or negative rates), exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the Bank of Scotland Group's or Lloyds Banking Group plc's, or Lloyds Bank plc's or HBOS plc's credit ratings; the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, instability as a result of the exit by the UK from the European Union (EU) and the potential for other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; natural, pandemic and other disasters, adverse weather and similar contingencies outside the Bank of Scotland Group's or Lloyds Banking Group plc's or Lloyds Bank plc's or HBOS plc's control; inadequate or failed internal or external processes or 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, accounting standards or taxation, including as a result of the exit by the UK from the EU, or a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside the Bank of Scotland Group's or Lloyds Banking Group plc's or Lloyds Bank plc's or HBOS plc's control; the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the US or elsewhere including the implementation and interpretation of key legislation and regulation; the ability to attract and retain senior management and other employees; actions or omissions by the Bank of Scotland Group's directors, management or employees including industrial action; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the Bank of Scotland Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Banking Group plc with the US Securities and Exchange Commission for a discussion of certain factors together with examples of forward looking statements. Except as required by any applicable law or regulation, the forward looking statements contained in this document are made as of today's date, and the Bank of Scotland Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements. The information, statements and opinions contained in this document do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

CONTENTS

FINANCIAL REVIEW

Principal activities

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

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

Review of results

During the half-year to 30 June 2017, the Group recorded a profit before tax of £1,627 million compared with a profit before tax in the half-year to 30 June 2016 of £1,964 million. However, the Group has incurred conduct charges of £482 million in the half-year to 30 June 2017 compared to £149 million in the half year to 30 June 2016. Excluding the conduct charges from both periods, the Group recorded a profit before tax of £2,109 million in the half-year to 30 June 2017, a decrease of £4 million from £2,113 million in the half-year to 30 June 2016.

Total income decreased by £150 million, or 4 per cent, to £3,600 million in the half-year to 30 June 2017 compared with £3,750 million in the half-year to 30 June 2016, comprising a £54 million increase in other income and a £204 million decrease in net interest income.

Net interest income was £3,027 million in the half-year to 30 June 2017; a decrease of £204 million, or 6 per cent, compared to £3,231 million in the half-year to 30 June 2016, reflecting the continuing run-off of assets outside of outside of the Group's risk appetite and changes in funding mix.

Other income was £54 million higher at £573 million in the half-year to 30 June 2017 compared to £519 million in the half-year to 30 June 2016. Net fee and commission income was £9 million or 4 per cent, lower at £194 million compared to £203 million in the half-year to 30 June 2016. Net trading income increased by £154 million to £215 million in the half-year to 30 June 2017 compared to £61 million in the half-year to 30 June 2016. Other operating income was £91 million, or 36 per cent, lower at £164 million in the half-year to 30 June 2017 compared to £255 million in the half-year to 30 June 2016. Other operating income in the half-year to 30 June 2016 included a gain of £112 million arising on a restructuring of capital instruments within the Lloyds Banking Group which was not repeated in 2017.

Operating expenses increased by £135 million, or 8 per cent to £1,897 million in the half-year to 30 June 2017 compared with £1,762 million in the half-year to 30 June 2016. A provision of £482 million was made in respect of conduct issues in the half-year to 30 June 2017 compared to a charge of £149 million in the same period in 2016. The charge in 2017 includes £216 million in respect of PPI, reflecting current claim levels, which remain above the Group's previous provision assumption. The remaining £266 million relates to other conduct matters including the HBOS Reading fraud, packaged bank accounts and arrears handling. Excluding all conduct charges from both years, operating expenses were £198 million, or 12 per cent, lower at £1,415 million in the half-year to 30 June 2017 compared to £1,613 million in the half-year to 30 June 2016. Staff costs were £53 million, or 7 per cent, lower at £713 million in the half-year to 30 June 2017 compared with £766 million in the half-year to 30 June 2016; annual pay rises have been offset by the impact of headcount reductions resulting from the Group's rationalisation programmes. Premises and equipment costs were £8 million or 7 per cent, higher at £129 million in the half-year to 30 June 2017 compared with £121 million in the half-year to 30 June 2016. Other expenses were £150 million, or 24 per cent, lower at £487 million in the half-year to 30 June 2017 compared to £637 million in the half-year to 30 June 2016. Depreciation and amortisation costs were £3 million, or 3 per cent, lower at £86 million in the half-year to 30 June 2017 compared to £89 million in the half-year to 30 June 2016.

FINANCIAL REVIEW (continued)

Impairment losses increased by £52 million to £76 million in the half-year to 30 June 2017 compared with £24 million in the half-year to 30 June 2016. Impairment losses in respect of loans and advances to customers were £43 million higher at £76 million in the half-year to 30 June 2017 compared with £33 million in the half-year to 30 June 2016; this reflects releases in relation to lending portfolios in run-off in 2016 which have not been repeated. There was a release of £2 million in respect of undrawn commitments in the half-year to 30 June 2017, compared to a credit of £9 million in the half-year to 30 June 2016.

In the half-year to 30 June 2017, the Group recorded a tax charge of £520 million compared to a charge of £540 million in the half-year to 30 June 2016, an effective tax rate of 32 per cent, compared to the standard UK corporation tax rate of 19.25 per cent, principally as a result of the banking surcharge and restrictions on the deductibility of conduct provisions.

Total assets were £35,534 million higher at £384,219 million at 30 June 2017 compared to £348,685 million at 31 December 2016. Amounts due from fellow Lloyds Banking Group undertakings were £39,175 million higher at £91,867 million at 30 June 2017 compared to £52,692 million at 31 December 2016. Loans and advances to customers were £148 million lower at £268,751 million at 30 June 2017 compared to £268,899 million at 31 December 2016; the impact of the reacquisition of a portfolio of mortgages has been offset by reductions in the larger corporate sector, as the Group focuses on optimising capital and returns, and in closed mortgage books.

Total liabilities were £35,723 million higher at £370,645 million at 30 June 2017 compared to £334,922 million at 31 December 2016. Deposits from banks were £10,101 million higher at £16,292 million at 30 June 2017 compared to £6,191 million at 31 December 2016 as a result of the use of repurchase agreements as a favourable form of funding. Customer deposits were £2,385 million lower at £176,932 million compared to £179,317 million at 31 December 2016 as reductions in non-relationship deposit balances have more than offset inflows from Commercial clients. Amounts due to fellow Lloyds Banking Group undertakings were £34,434 million higher at £140,297 million at 30 June 2017 compared to £105,863 million at 31 December 2016. Debt securities in issue were £4,767 million, or 29 per cent, lower at £11,912 million at 30 June 2017 compared to £16,679 million at 31 December 2016 following maturities of some tranches of securitisation notes and covered bonds.

Total equity was £189 million, or 1 per cent, lower at £13,574 million at 30 June 2017 compared to £13,763 million at 31 December 2016; the profit for the period was more than offset by dividends paid.

The Group’s common equity tier 1 capital ratio increased to 12.5 per cent (31 December 2016: 12.0 per cent) and the tier 1 capital ratio increased to 15.0 per cent (31 December 2016: 14.5 per cent), largely driven by lower risk-weighted assets. The total capital ratio reduced to 21.4 per cent (31 December 2016: 23.2 per cent) reflecting an increase in regulatory adjustments applied to tier 2 instruments, partly offset by the reduction in risk-weighted assets.

Risk-weighted assets reduced by £2,264 million, or 3 per cent, to £73,297 million at 30 June 2017 compared to £75,561 million at 31 December 2016, largely relating to active portfolio management, disposals and yield curve movements.

FINANCIAL REVIEW (continued)

Capital ratios

Capital resources (transitional)	**At 30 June 2017 £m**	At 31 Dec 2016 £m
Common equity tier 1		
Shareholders' equity per balance sheet	**12,066**	12,255
Adjustment to retained earnings for foreseeable dividends	**(500)**	(500)
Cash flow hedging reserve	**(61)**	(90)
Other adjustments	**(4)**	(11)
	11,501	11,654
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	**(438)**	(424)
Prudent valuation adjustment	**(88)**	(165)
Excess of expected losses over impairment provisions and value adjustments	**(87)**	(132)
Securitisation deductions	**(186)**	(186)
Deferred tax assets	**(1,566)**	(1,650)
Common equity tier 1 capital	**9,136**	9,097
Additional tier 1		
Additional tier 1 instruments	**1,824**	1,827
Total tier 1 capital	**10,960**	10,924
Tier 2		
Tier 2 instruments	**4,421**	6,268
Eligible provisions	**300**	304
Total tier 2 capital	**4,721**	6,572
Total capital resources	**15,681**	17,496
Risk-weighted assets	**73,297**	75,561
Common equity tier 1 capital ratio	**12.5%**	12.0%
Tier 1 capital ratio	**15.0%**	14.5%
Total capital ratio	**21.4%**	23.2%

FINANCIAL REVIEW (continued)

	At 30 June 2017 £m	At 31 Dec 2016 £m
Risk-weighted assets		
Foundation Internal Ratings Based (IRB) Approach	**6,679**	7,626
Retail IRB Approach	**40,484**	40,295
Other IRB Approach	**2,885**	2,822
IRB Approach	**50,048**	50,743
Standardised Approach	**7,688**	8,150
Credit risk	**57,736**	58,893
Counterparty credit risk	**1,127**	1,574
Credit valuation adjustment risk	**107**	242
Operational risk	**12,059**	12,059
Market risk	**1,540**	1,980
Underlying risk-weighted assets	**72,569**	74,748
Threshold risk-weighted assets	**728**	813
Transitional risk-weighted assets	**73,297**	75,561

PRINCIPAL RISKS AND UNCERTAINTIES

The most significant risks faced by the Group which could impact the success of delivering against the Group's long-term strategic objectives and through which global macro-economic, regulatory developments and market liquidity dynamics could manifest, are detailed below. Except where noted, there has been no significant change to the description of these risks or key mitigating actions disclosed in the Group's 2016 Annual Report and Accounts, with any quantitative disclosures updated herein.

Credit risk − The risk that customers and/or other counterparties whom the Group has either lent money to or entered into a financial contract with, or other counterparties with whom the Group has contracted, fail to meet their financial obligations, resulting in loss to the Group. Adverse changes in the economic and market environment the Group operates in or the credit quality and/or behaviour of the Group's customers and counterparties could reduce the value of the Group's assets and potentially increase the Group's write downs and allowances for impairment losses, adversely impacting profitability.

Conduct risk − Conduct risk can arise from the failure to design products and services to ensure they are aligned to customer needs and to design and execute sales processes to ensure products and services are offered only to those customers who need and will benefit from them. Additionally, the failure to provide ongoing support and service to customers and to recognise and respond to customer complaints, providing appropriate rectification in a timely manner. Conduct risk can result from the failure to ensure that colleagues behave in line with conduct, regulatory and ethical standards. Additionally, market conduct risks exist where actions taken can disrupt the fair and effective operation of a market in which the Group is active.

Market risk − The risk that the Group's capital or earnings profile is affected by adverse market rates, in particular interest rates and credit spreads.

Operational risk − The Group faces significant operational risks, such as risk of cyber and terrorism, which may result in financial loss, disruption of services to customers, and damage to its reputation. These include the availability, resilience and security of the Group's core IT systems and the potential for failings in the Group's customer processes.

Capital risk − The risk that the Group has a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across the Group.

Funding and 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.

Regulatory and legal risk − The risks of changing legislation, regulation (including regulatory changes such as the Second Payment Services Directive and Open Banking), policies, voluntary codes of practice and their interpretation in the markets in which the Group operates can have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations.

Governance risk − Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from the requirement to improve the resolvability of the Group and to ring-fence core UK financial services and activities from January 2019, and from the further development of the Senior Managers and Certification Regime.

People risk − Key people risks include the risk that the Group fails to maintain organisational skills, capability, resilience and capacity levels in response to increasing volumes of organisational, political and external market change.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED INCOME STATEMENT

	Note	**Half-year to 30 June 2017 £ million**	Half-year to 30 June 2016 £ million
Interest and similar income		**4,488**	5,023
Interest and similar expense		**(1,461)**	(1,792)
Net interest income		**3,027**	3,231
Fee and commission income		**379**	400
Fee and commission expense		**(185)**	(197)
Net fee and commission income		**194**	203
Net trading income		**215**	61
Other operating income		**164**	255
Other income		**573**	519
Total income		**3,600**	3,750
Regulatory provisions		**(482)**	(149)
Operating expenses		**(1,415)**	(1,613)
Total operating expenses	2	**(1,897)**	(1,762)
Trading surplus		**1,703**	1,988
Impairment	3	**(76)**	(24)
Profit before tax		**1,627**	1,964
Taxation	4	**(520)**	(540)
Profit for the period		**1,107**	1,424
Profit attributable to ordinary shareholders		**1,056**	1,373
Profit attributable to other equity holders[1]		**51**	51
Profit attributable to equity holders		**1,107**	1,424
Profit attributable to non-controlling interests		**–**	–
Profit for the period		**1,107**	1,424

[1] The profit after tax attributable to other equity holders of £51 million (half-year to 30 June 2016: £51 million) is offset in reserves by a tax credit attributable to ordinary shareholders of £14 million (half-year to 30 June 2016: £14 million).

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Half-year to 30 June 2017 £ million	Half-year to 30 June 2016 £ million
Profit for the period	**1,107**	1,424
Other comprehensive income		
Items that may subsequently be classified to profit or loss:		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	**11**	80
Income statement transfers in respect of disposals	**(116)**	(48)
Income statement transfers in respect of impairments	**10**	1
Taxation	**11**	(17)
	(84)	16
Movement in cash flow hedging reserve:		
Effective portion of changes in fair value taken	**(54)**	302
Net income statement transfers	**15**	(165)
Taxation	**10**	(37)
	(29)	100
Currency translation differences (tax: nil)	**1**	(4)
Other comprehensive income for the period, net of tax	**(112)**	112
Total comprehensive income for the period	**995**	1,536
Total comprehensive income attributable to ordinary shareholders	**944**	1,485
Total comprehensive income attributable to other equity shareholders	**51**	51
Total comprehensive income attributable to equity shareholders	**995**	1,536
Total comprehensive income attributable to non-controlling interests	**–**	–
Total comprehensive income for the period	**995**	1,536

CONSOLIDATED BALANCE SHEET

	Note	**At 30 June 2017 £ million**	At 31 Dec 2016 £ million
Assets			
Cash and balances at central banks		**2,533**	2,840
Items in course of collection from banks		**285**	188
Trading and other financial assets at fair value through profit or loss	5	**165**	1,062
Derivative financial instruments		**12,885**	14,664
Loans and receivables:			
Loans and advances to banks		**2,104**	1,116
Loans and advances to customers	6	**268,751**	268,899
Debt securities		**177**	169
Due from fellow Lloyds Banking Group undertakings		**91,867**	52,692
		362,899	322,876
Available-for-sale financial assets		**1,494**	2,916
Goodwill		**325**	325
Other intangible assets		**113**	100
Property, plant and equipment		**986**	1,106
Current tax recoverable		**8**	7
Deferred tax assets		**1,834**	1,941
Other assets		**692**	660
Total assets		**384,219**	348,685
Equity and liabilities			
Liabilities			
Deposits from banks		**16,292**	6,191
Customer deposits		**176,932**	179,317
Due to fellow Lloyds Banking Group undertakings		**140,297**	105,863
Items in course of transmission to banks		**515**	248
Trading and other financial liabilities at fair value through profit or loss		**182**	945
Derivative financial instruments		**11,982**	13,725
Notes in circulation		**1,317**	1,402
Debt securities in issue	7	**11,912**	16,679
Other liabilities		**735**	824
Current tax liabilities		**1,200**	798
Other provisions		**2,239**	1,846
Subordinated liabilities		**7,042**	7,084
Total liabilities		**370,645**	334,922
Equity			
Share capital		**5,847**	5,847
Other reserves		**2,053**	2,165
Retained profits		**4,166**	4,243
Shareholders' equity		**12,066**	12,255
Other equity instruments		**1,500**	1,500
Total equity excluding non-controlling interests		**13,566**	13,755
Non-controlling interests		**8**	8
Total equity		**13,574**	13,763
Total equity and liabilities		**384,219**	348,685

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders						
	Share capital £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2017	**5,847**	**2,165**	**4,243**	**12,255**	**1,500**	**8**	**13,763**
Comprehensive income							
Profit for the period	**–**	**–**	**1,107**	**1,107**	**–**	**–**	**1,107**
Other comprehensive income							
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	**–**	**(84)**	**–**	**(84)**	**–**	**–**	**(84)**
Movements in cash flow hedging reserve, net of tax	**–**	**(29)**	**–**	**(29)**	**–**	**–**	**(29)**
Currency translation differences (tax: nil)	**–**	**1**	**–**	**1**	**–**	**–**	**1**
Total other comprehensive income	**–**	**(112)**	**–**	**(112)**	**–**	**–**	**(112)**
Total comprehensive income	**–**	**(112)**	**1,107**	**995**	**–**	**–**	**995**
Transactions with owners							
Dividends paid	**–**	**–**	**(1,200)**	**(1,200)**	**–**	**–**	**(1,200)**
Distributions on other equity instruments, net of tax	**–**	**–**	**(37)**	**(37)**	**–**	**–**	**(37)**
Capital contribution received	**–**	**–**	**53**	**53**	**–**	**–**	**53**
Total transactions with owners	**–**	**–**	**(1,184)**	**(1,184)**	**–**	**–**	**(1,184)**
Balance at 30 June 2017	**5,847**	**2,053**	**4,166**	**12,066**	**1,500**	**8**	**13,574**

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (continued)

	Attributable to equity shareholders						
	Share capital £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2016	5,847	2,268	5,496	13,611	1,500	8	15,119
Comprehensive income							
Profit for the period	–	–	1,424	1,424	–	–	1,424
Other comprehensive income							
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	16	–	16	–	–	16
Movements in cash flow hedging reserve, net of tax	–	100	–	100	–	–	100
Currency translation differences (tax: nil)	–	(4)	–	(4)	–	–	(4)
Total other comprehensive income	–	112	–	112	–	–	112
Total comprehensive income	–	112	1,424	1,536	–	–	1,536
Transactions with owners							
Capital contribution received	–	–	49	49	–	–	49
Dividends paid	–	–	(2,000)	(2,000)	–	–	(2,000)
Distributions on other equity instruments, net of tax	–	–	(37)	(37)	–	–	(37)
Total transactions with owners	–	–	(1,988)	(1,988)	–	–	(1,988)
Balance at 30 June 2016	5,847	2,380	4,932	13,159	1,500	8	14,667

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (continued)

	Attributable to equity shareholders						
	Share capital £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 July 2016	5,847	2,380	4,932	13,159	1,500	8	14,667
Comprehensive income							
Profit for the period	–	–	814	814	–	–	814
Other comprehensive income							
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(38)	–	(38)	–	–	(38)
Movements in cash flow hedging reserve, net of tax	–	(180)	–	(180)	–	–	(180)
Currency translation differences (tax: nil)	–	3	–	3	–	–	3
Total other comprehensive income	–	(215)	–	(215)	–	–	(215)
Total comprehensive income	–	(215)	814	599	–	–	599
Transactions with owners							
Capital contribution received	–	–	33	33	–	–	33
Dividends paid	–	–	(1,500)	(1,500)	–	–	(1,500)
Distributions on other equity instruments, net of tax	–	–	(36)	(36)	–	–	(36)
Total transactions with owners	–	–	(1,503)	(1,503)	–	–	(1,503)
Balance at 31 December 2016	5,847	2,165	4,243	12,255	1,500	8	13,763

CONSOLIDATED CASH FLOW STATEMENT

	Half-year to 30 June 2017 £ million	Half-year to 30 June 2016 £ million
Profit before tax	**1,627**	1,964
Adjustments for:		
Change in operating assets	**(36,024)**	(1,713)
Change in operating liabilities	**34,968**	4,353
Non-cash and other items	**103**	(1,863)
Tax received	**34**	95
Net cash provided by operating activities	**708**	2,836
Cash flows from investing activities		
Purchase of available-for-sale financial assets	**(194)**	(235)
Proceeds from sale and maturity of available-for-sale financial assets	**1,542**	1,455
Purchase of fixed assets	**(65)**	(56)
Proceeds from sale of fixed assets	**89**	24
Disposal of businesses, net of cash disposed	**26**	5
Net cash provided by investing activities	**1,398**	1,193
Cash flows from financing activities		
Dividends paid to equity shareholders	**(1,200)**	(2,000)
Distributions on other equity instruments	**(51)**	(51)
Interest paid on subordinated liabilities	**(128)**	(142)
Repayment of subordinated liabilities	**–**	(361)
Capital repayment to ultimate parent company	**–**	(1,350)
Net cash used in financing activities	**(1,379)**	(3,904)
Effects of exchange rate changes on cash and cash equivalents	**1**	13
Change in cash and cash equivalents	**728**	138
Cash and cash equivalents at beginning of period	**3,052**	2,389
Cash and cash equivalents at end of period	**3,780**	2,527

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

NOTES

1. Accounting policies, presentation and estimates

These condensed consolidated half-year financial statements as at and for the period to 30 June 2017 have been prepared in accordance with the Disclosure Guidance and Transparency Rules of the Financial Conduct Authority (FCA) and with International Accounting Standard 34 (IAS 34), *Interim Financial Reporting* as adopted by the European Union and comprise the results of Bank of Scotland plc (the Bank) together with its subsidiaries (the Group). They do not include all of the information required for full annual financial statements and should be read in conjunction with the Group's consolidated financial statements as at and for the year ended 31 December 2016 which were prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. Copies of the 2016 Annual Report and Accounts are available on the Lloyds Banking Group's website and are available upon request from Investor Relations, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN.

The directors consider that it is appropriate to continue to adopt the going concern basis in preparing the condensed consolidated half-year financial statements. In reaching this assessment, the directors have considered projections for the Group's capital and funding position.

The accounting policies are consistent with those applied by the Group in its 2016 Annual Report and Accounts.

Future accounting developments

Details of those IFRS pronouncements which will be relevant to the Group but which will not be effective at 31 December 2017 and which have not been applied in preparing these condensed consolidated half-year financial statements are set out in note 13.

Critical accounting estimates and judgements

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions that impact the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may include 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. There have been no significant changes in the basis upon which estimates have been determined, compared to that applied at 31 December 2016.

2. Operating expenses

	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m
Administrative expenses:		
Staff costs	**713**	766
Premises and equipment	**129**	121
Other expenses	**487**	637
	1,329	1,524
Depreciation and amortisation	**86**	89
Total operating expenses, excluding regulatory provisions	**1,415**	1,613
Regulatory provisions:		
Payment protection insurance provision (note 8)	**216**	–
Other regulatory provisions (note 8)	**266**	149
	482	149
Total operating expenses	**1,897**	1,762

3. Impairment

	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m
Impairment losses on loans and receivables:		
Loans and advances to customers	**76**	33
Debt securities classified as loans and receivables	**(4)**	–
Impairment losses on loans and receivables	**72**	33
Impairment of available-for-sale financial assets	**6**	–
Other credit risk provisions	**(2)**	(9)
Total impairment charged to the income statement	**76**	24

4. Taxation

In accordance with IAS 34, the Group's income tax expense for the half-year to 30 June 2017 is based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. The tax effects of one-off items are not included in the weighted-average annual income tax rate, but are recognised in the relevant period.

An explanation of the relationship between tax expense and accounting profit is set out below:

	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m
Profit before tax	**1,627**	1,964
Tax thereon at UK corporation tax rate of 19.25 per cent (2016: 20 per cent)	**(313)**	(393)
Impact of bank surcharge	**(147)**	(151)
Impact of change in UK corporation tax rates	**(7)**	11
Disallowed items[1]	**(87)**	(38)
Non-taxable items	**2**	25
Overseas tax rate differences	**(5)**	(1)
Gains exempted	**18**	16
Adjustments in respect of previous years	**19**	(9)
Effect of results of joint ventures and associates	**1**	–
Other items	**(1)**	–
Tax expense	**(520)**	(540)

[1] The Finance (No. 2) Act 2015 introduced restrictions on the tax deductibility of provisions for conduct charges arising on or after 8 July 2015. This has resulted in an additional income tax charge of £79 million (half-year to 30 June 2016: £30 million).

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

	At 30 June 2017 £m	At 31 Dec 2016 £m
Trading assets	**35**	943
Other financial assets at fair value through profit or loss (equity shares)	**130**	119
Total trading and other financial assets at fair value through profit or loss	**165**	1,062

6. Loans and advances to customers

	At 30 June 2017 £m	At 31 Dec 2016 £m
Agriculture, forestry and fishing	**654**	616
Energy and water supply	**188**	207
Manufacturing	**321**	344
Construction	**1,330**	1,380
Transport, distribution and hotels	**1,966**	2,942
Information and communication	**240**	242
Property companies	**6,194**	6,534
Financial, business and other services	**2,420**	2,601
Personal:		
Mortgages	**246,330**	245,327
Other	**10,945**	10,667
Leasing	**275**	342
Hire purchase	**111**	82
Gross loans and advances to customers	**270,974**	271,284
Allowance for impairment losses on loans and advances to customers	**(2,223)**	(2,385)
Total loans and advances to customers	**268,751**	268,899

Loans and advances to customers include advances securitised under the Group's securitisation and covered bond programmes (see note 7).

7. Debt securities in issue

	At 30 June 2017 £m	At 31 Dec 2016 £m
Medium term notes issued	**1,336**	1,377
Covered bonds	**6,737**	9,689
Securitisation notes	**3,839**	5,562
	11,912	16,628
Amounts due to fellow Lloyds Banking Group undertakings	**–**	51
Total debt securities in issue	**11,912**	16,679

The notes issued by the Group's securitisation and covered bond programmes are held by external parties and by subsidiaries of the Group.

Securitisation programmes

At 30 June 2017, external parties held £3,839 million (31 December 2016: £5,562 million) and the Group's subsidiaries held £17,593 million (31 December 2016: £18,642 million) of total securitisation notes in issue of £21,432 million (31 December 2016: £24,204 million). The notes are secured on loans and advances to customers and debt securities classified as loans and receivables amounting to £31,648 million (31 December 2016: £34,218 million), the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. The structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet.

Covered bond programmes

At 30 June 2017, external parties held £6,737 million (31 December 2016: £9,689 million) and the Group's subsidiaries held £700 million (31 December 2016: £700 million) of total covered bonds in issue of £7,437 million (31 December 2016: £10,389 million). The bonds are secured on certain loans and advances to customers amounting to £10,227 million (31 December 2016: £11,032 million) that have yet to be assigned to bankruptcy remote limited liability partnerships. These loans are retained on the Group's balance sheet.

Cash deposits of £1,993 million (31 December 2016: £5,713 million) which support the debt securities issued by the structured entities, the term advances related to covered bonds and other legal obligations are held by the Group.

8. Provisions for liabilities and charges

Payment protection insurance

As at 30 June 2017, a provision of £974 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £172 million during the year to 30 June 2017.

The Group increased the provision for PPI costs by a further £216 million in the half-year to 30 June 2017, bringing the total amount provided to £5,003 million.

The charge is largely driven by a potentially higher total volume of complaints and associated operating costs due to higher reactive complaint volumes received over the past three quarters. This is in addition to the expected impact of the Financial Conduct Authority's (FCA) rules and guidance published on 2 March 2017 (Policy Statement 17/3), which confirmed an industry deadline of August 2019.

The total amount provided for PPI represents the Group's best estimate of the likely future cost. However a number of risks and uncertainties remain in particular with respect to future volumes. The cost could differ from the Group's estimates and the assumptions underpinning them, and could result in a further provision being required. There is significant uncertainty around the impact of the regulatory changes, FCA media campaign and Claims Management Companies and customer activity.

Key sensitivities are as follows[1]:

- the number of customer initiated complaints received: an increase of 50,000 from the level assumed would increase the provision by £100 million;

[1] All sensitivities are influenced by a proportion of complaints falling under the Plevin rules and guidance.

Other provisions for legal actions and regulatory matters

Packaged bank accounts

In the half-year to 30 June 2017 the Group has provided an additional £26 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £117 million. As at 30 June 2017, £74 million of the provision remained unutilised. The total amount provided represents the Group's best estimate of the likely future cost, however a number of risks and uncertainties remain in particular with respect to future volumes.

Arrears handling related activities

The Group has provided an additional £68 million in the half-year to 30 June 2017 (bringing the total provision to £346 million), for the costs of identifying and rectifying certain arrears management fees and activities. Following a review of the Group's arrears handling activities, the Group has put in place a number of actions to improve further its handling of customers in these areas and the Lloyds Banking Group is reimbursing mortgage arrears fees to around 590,000 customers. As at 30 June 2017, the unutilised provision was £346 million.

HBOS Reading – customer review

The Group has commenced a review into a number of customer cases from the former HBOS Impaired Assets Office based in Reading. This review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Lloyds Banking Group in 2009. The review is ongoing, the Group has provided £100 million in the half-year to 30 June 2017 and is in the process of paying compensation to the victims of the fraud for economic losses, ex-gratia payments and awards for distress and inconvenience.

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 the half-year to 30 June 2017, the Group charged an additional £72 million in respect of matters across all divisions. At 30 June 2017, the Group held unutilised provisions totalling £489 million for these other legal actions and regulatory matters.

9. Contingent liabilities and commitments

Interchange fees

With respect to multi-lateral interchange fees (MIFs), the Lloyds Banking Group is not directly involved in the ongoing investigations and litigation (as described below) which involve card schemes such as Visa and MasterCard. However, the Lloyds Banking Group is a member of Visa and MasterCard and other card schemes.

- The European Commission continues to pursue certain competition investigations into MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA;
- Litigation continues in the English Courts against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly 'overpaid' MIFs. From publicly available information, it is understood these damages claims are running to different timescales with respect to the litigation process. It is also possible that new claims may be issued.
- Any ultimate impact on the Lloyds Banking Group of the above investigations and the litigation against Visa and MasterCard remains uncertain at this time.

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. The Lloyds Banking Group's share of the sale proceeds comprised cash consideration of approximately £330 million (of which approximately £300 million was received on completion of the sale and £30 million is deferred for three years) and preferred stock, which the Lloyds Banking Group measures at fair value. The preferred stock is convertible into Class A Common Stock of Visa Inc or its equivalent upon the occurrence of certain events. As part of this transaction, the Lloyds Banking Group and certain other UK banks also entered into a Loss Sharing Agreement (LSA) with Visa Inc, which clarifies the allocation of liabilities between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. The maximum amount of liability to which the Lloyds Banking Group may be subject under the LSA is capped at the cash consideration which was received by the Lloyds Banking Group at completion. Visa Inc may also have recourse to a general indemnity, previously in place under Visa Europe's Operating Regulations, for damages claims concerning inter or intra-regional MIF setting activities.

LIBOR and other trading rates

In July 2014, the Lloyds Banking 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 Lloyds Banking Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The Lloyds Banking Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the Swiss Competition Commission, 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 Lloyds Banking 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, Japanese Yen and Sterling LIBOR and the Australian BBSW Reference Rate. The lawsuits, which contain broadly similar allegations, allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act and the Commodity Exchange Act, as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims, including those in connection with USD and JPY LIBOR, have been dismissed by the US Federal Court for Southern District of New York. Appeals remain possible.

Certain Lloyds Banking Group companies are also named as defendants in UK based claims raising LIBOR manipulation allegations.

It is currently not possible to predict the scope and ultimate outcome on the Lloyds Banking 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 Lloyds Banking Group's contractual arrangements, including their timing and scale.

9. Contingent liabilities and commitments (continued)

UK shareholder litigation

In August 2014, the Lloyds Banking 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 duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. It is currently not possible to determine the ultimate impact on the Lloyds Banking Group (if any), but the Lloyds Banking Group intends to defend the claim vigorously.

Financial Services Compensation Scheme

Following the default of a number of deposit takers in 2008, the Financial Services Compensation Scheme (FSCS) borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. In June 2017, the FSCS announced that following the sale of certain Bradford & Bingley mortgage assets, the principal balance outstanding on these loans was £4,678 million (31 December 2016: £15,655 million). Although it is anticipated that 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, including the Group, of the FSCS. The amount of future levies payable by the Group depends on a number of factors, principally, the amounts recovered by the FSCS from asset sales.

Tax authorities

The Lloyds Banking 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 2013 HMRC informed the Lloyds Banking Group that their interpretation of the UK rules which allow 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 the Group’s current tax liabilities of approximately £150 million and a reduction in the Group’s deferred tax asset of approximately £50 million. The Lloyds Banking 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. There are a number of other open matters on which the Group is in discussion with HMRC, none of which is expected to have a material impact on the financial position of the Group.

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 Lloyds Banking Group’s practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The FCA is actively engaged with the industry in relation to these considerations and has recently published Guidance on the treatment of customers with mortgage payment shortfalls. The Guidance covers remediation for mortgage customers who may have been affected by the way firms calculate these customers’ monthly mortgage instalments. The Lloyds Banking Group is now determining its detailed approach to implementation of the Guidance and will contact affected customers next year.

Update following the Financial Conduct Authority’s publication of Policy Statement 17/3

On 2 August 2016, the Financial Conduct Authority (FCA) published a further consultation paper (CP16/20: Rules and guidance on payment protection insurance complaints: feedback on CP15/39 and further consultation), following on from the original consultation published in November 2015.

On 2 March 2017 the FCA confirmed that the deadline by which consumers would need to make their PPI complaints would be 29 August 2019, and new rules with respect to the UK Supreme Court’s decision in Plevin v Paragon Personal Finance Limited [2014] UKSC 61 would come into force on 29 August 2017.

On 31 May 2017 an application for judicial review of Policy Statement 17/3 was filed in the High Court of England and Wales, which subject to the Court’s determination may have an impact on the implementation of the FCA’s rules and guidance in Policy Statement 17/3.

9. Contingent liabilities and commitments (continued)

Mortgage arrears handling activities

On 26 May 2016, the Lloyds Banking Group was informed that an enforcement team at the FCA had commenced an investigation in connection with the Lloyds Banking Group's mortgage arrears handling activities. This investigation is ongoing and it is currently not possible to make a reliable assessment of the liability, if any, that may result from the investigation.

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 current or former employees, customers, investors or other third parties, as well as legal and 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. In these circumstances, specific disclosure in relation to a contingent liability will be made where material. 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.

Contingent liabilities and commitments arising from the banking business

	At 30 June 2017 £m	At 31 Dec 2016 £m
Contingent liabilities		
Acceptances and endorsements	**1**	1
Other:		
Other items serving as direct credit substitutes	**18**	19
Performance bonds and other transaction-related contingencies	**77**	83
	95	102
Total contingent liabilities	**96**	103
Commitments		
Documentary credits and other short-term trade-related transactions	**1**	–
Forward asset purchases and forward deposits placed	**29**	28
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	**10,711**	9,828
Other commitments	**22,036**	21,817
	32,747	31,645
1 year or over original maturity	**3,261**	3,651
Total commitments	**36,038**	35,324

Of the amounts shown above in respect of undrawn formal standby facilities and other commitments to lend, £14,652 million (2016: £14,431 million) was irrevocable.

10. Fair values of financial assets and liabilities

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine those fair values. Note 42 to the Group's 2016 financial statements describes the definitions of the three levels in the fair value hierarchy.

Valuation control framework

Key elements of the valuation control framework, which covers processes for all levels in the fair value hierarchy including level three portfolios, include model validation (incorporating pre-trade and post-trade testing), product implementation review and independent price verification. Formal committees meet quarterly to discuss and approve valuations in more judgemental areas.

Transfers into and out of level 3 portfolios

Transfers out of level three portfolios arise when inputs that could have a significant impact on the instrument's valuation become market observable; conversely, transfers into the portfolios arise when consistent sources of data cease to be available.

Valuation methodology

For level two and level three portfolios, there is no significant change to what was disclosed in the Group's 2016 Annual Report and Accounts in respect of the valuation methodology (techniques and inputs) applied to such portfolios.

The table below 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.

	30 June 2017		31 December 2016	
	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	**165**	**165**	1,062	1,062
Derivative financial instruments	**12,885**	**12,885**	14,664	14,664
Loans and receivables:				
Loans and advances to banks	**2,104**	**2,105**	1,116	1,115
Loans and advances to customers	**268,751**	**270,940**	268,899	270,153
Debt securities	**177**	**167**	169	152
Due from fellow Lloyds Banking Group undertakings	**91,867**	**91,867**	52,692	52,692
	362,899	**365,079**	322,876	324,112
Available-for-sale financial instruments	**1,494**	**1,494**	2,916	2,916
Financial liabilities				
Deposits from banks	**16,292**	**16,292**	6,191	6,191
Customer deposits	**176,932**	**176,817**	179,317	179,420
Due to fellow Lloyds Banking Group undertakings	**140,297**	**140,297**	105,863	105,863
Trading and other financial liabilities at fair value through profit or loss	**182**	**182**	945	945
Derivative financial instruments	**11,982**	**11,982**	13,725	13,725
Debt securities in issue	**11,912**	**11,943**	16,679	16,621
Subordinated liabilities	**7,042**	**7,123**	7,084	7,118

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.

10. Fair values of financial assets and liabilities (continued)

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.

The following tables provide an analysis of the financial assets and liabilities of the Group that are carried at fair value in the Group's consolidated balance sheet, grouped into levels one to three based on the degree to which the fair value is observable.

Financial assets

	Level 1 £m	**Level 2 £m**	**Level 3 £m**	**Total £m**
At 30 June 2017				
Trading and other financial assets at fair value through profit or loss:				
Loans and advances to customers	**–**	**35**	**–**	**35**
Equity shares	**–**	**–**	**130**	**130**
Total trading and other financial assets at fair value through profit or loss	**–**	**35**	**130**	**165**
Available-for-sale financial assets:				
Debt securities	**–**	**1,116**	**–**	**1,116**
Equity shares	**–**	**7**	**371**	**378**
Total available-for-sale financial assets	**–**	**1,123**	**371**	**1,494**
Derivative financial instruments	**–**	**12,470**	**415**	**12,885**
Total financial assets carried at fair value	**–**	**13,628**	**916**	**14,544**

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2016				
Trading and other financial assets at fair value through profit or loss:				
Loans and advances to customers	–	943	–	943
Equity shares	–	–	119	119
Total trading and other financial assets at fair value through profit or loss	–	943	119	1,062
Available-for-sale financial assets:				
Debt securities	–	2,439	–	2,439
Equity shares	–	8	469	477
Total available-for-sale financial assets	–	2,447	469	2,916
Derivative financial instruments	–	14,081	583	14,664
Total financial assets carried at fair value	–	17,471	1,171	18,642

10. Fair values of financial assets and liabilities (continued)

Financial liabilities

	Level 1 £m	**Level 2 £m**	**Level 3 £m**	**Total £m**
At 30 June 2017				
Trading and other financial liabilities at fair value through profit or loss:				
Trading liabilities	**–**	**182**	**–**	**182**
Total trading and other financial liabilities at fair value through profit or loss	**–**	**182**	**–**	**182**
Derivative financial instruments	**–**	**11,932**	**50**	**11,982**
Total financial liabilities carried at fair value	**–**	**12,114**	**50**	**12,164**

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2016				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	–	–	2	2
Trading liabilities	–	943	–	943
Total trading and other financial liabilities at fair value through profit or loss	–	943	2	945
Derivative financial instruments	–	13,668	57	13,725
Total financial liabilities carried at fair value	–	14,611	59	14,670

Financial guarantees are recognised at fair value on initial recognition and are classified as level 3; the balance is not material.

10. Fair values of financial assets and liabilities (continued)

Movements in level 3 portfolio

The tables below analyse movements in the level 3 financial assets portfolio.

	Trading and other financial assets at fair value through profit or loss £m	**Available-for-sale financial assets £m**	**Derivative assets £m**	**Total financial assets carried at fair value £m**
At 1 January 2017	**119**	**469**	**583**	**1,171**
Exchange and other adjustments	**–**	**(1)**	**13**	**12**
Gains (losses) recognised in the income statement within other income	**17**	**–**	**(137)**	**(120)**
Losses recognised in other comprehensive income within the revaluations reserve in respect of available-for-sale financial assets	**–**	**(101)**	**–**	**(101)**
Purchases	**–**	**24**	**–**	**24**
Sales	**(6)**	**(20)**	**–**	**(26)**
Transfers out of the level 3 portfolio	**–**	**–**	**(44)**	**(44)**
At 30 June 2017	**130**	**371**	**415**	**916**
Gains (losses) recognised in the income statement within other income relating to those assets held at 30 June 2017	**19**	**–**	**(137)**	**(118)**

	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale financial assets £m	Derivative assets £m	Total financial assets carried at fair value £m
At 1 January 2016	226	339	342	907
Exchange and other adjustments	1	6	42	49
Gains (losses) recognised in the income statement within other income	(15)	–	296	281
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	–	39	–	39
Purchases	–	48	–	48
Sales	(93)	(4)	–	(97)
Transfers into the level 3 portfolio	–	31	–	31
At 30 June 2016	119	459	680	1,258
Gains (losses) recognised in the income statement within other income relating to those assets held at 30 June 2016	(12)	–	296	284

10. Fair values of financial assets and liabilities (continued)

Movements in level 3 portfolio

The tables below analyse movements in the level 3 financial liabilities portfolio.

	Trading and other financial liabilities at fair value through profit or loss £m	**Derivative liabilities £m**	**Total financial liabilities carried at fair value £m**
At 1 January 2017	**2**	**57**	**59**
Gains recognised in the income statement within other income	**(2)**	**(7)**	**(9)**
At 30 June 2017	**–**	**50**	**50**
Gains recognised in the income statement within other income relating to those liabilities held at 30 June 2017	**–**	**(7)**	**(7)**

	Trading and other financial liabilities at fair value through profit or loss £m	Derivative liabilities £m	Total financial liabilities carried at fair value £m
At 1 January 2016	1	38	39
Exchange and other adjustments	–	2	2
Losses recognised in the income statement within other income	1	24	25
At 30 June 2016	2	64	66
Losses recognised in the income statement within other income relating to those liabilities held at 30 June 2016	1	24	25

10. Fair values of financial assets and liabilities (continued)

The tables below set out the effects of reasonably possible alternative assumptions for categories of level 3 financial assets and financial liabilities.

				At 30 June 2017		
					Effect of reasonably possible alternative assumptions[1]	
	Valuation technique(s)	**Significant unobservable inputs**	**Range[2]**	**Carrying value £m**	**Favourable changes £m**	**Unfavourable changes £m**
Trading and other financial assets at fair value through profit or loss:						
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[3]	n/a	**n/a**	**130**	**14**	**(14)**
				130		
Available for sale financial assets				**371**	**31**	**(36)**
Derivative financial assets:						
Interest rate derivatives	Option pricing model	Interest rate volatility	**0%/136%**	**415**	**1**	**(3)**
				415		
Financial assets carried at fair value				**916**		
Derivative financial liabilities:						
Interest rate derivatives	Option pricing model	Interest rate volatility	**0%/136%**	**50**	**–**	**–**
				50		
Financial liabilities carried at fair value				**50**		

[1] Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

[2] The range represents the highest and lowest inputs used in the level 3 valuations.

[3] Underlying asset/net asset values represent fair value.

10. Fair values of financial assets and liabilities (continued)

	Valuation technique(s)	Significant unobservable inputs	Range[2]	At 31 December 2016 Carrying value £m	Effect of reasonably possible alternative assumptions[1] Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss:						
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[3]	n/a	n/a	119	6	(10)
				119		
Available for sale financial assets				469	30	(35)
Derivative financial assets:						
Interest rate derivatives	Option pricing model	Interest rate volatility	0%/115%	583	2	(8)
				583		
Financial assets carried at fair value				1,171		
Trading and other financial liabilities at fair value through profit or loss				2	–	–
Derivative financial liabilities:						
Interest rate derivatives	Option pricing model	Interest rate volatility	0%/115%	57	–	–
				57		
Financial liabilities carried at fair value				59		

[1] Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

[2] The range represents the highest and lowest inputs used in the level 3 valuations.

[3] Underlying asset/net asset values represent fair value.

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are unchanged from those described in the Group's 2016 financial statements.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level three 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 and are unchanged from those described in the Group's 2016 financial statements.

11. Related party transactions

Balances and transactions with Lloyds Banking Group plc and fellow Lloyds Banking Group undertakings

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

	At 30 June 2017 £m	At 31 Dec 2016 £m
Assets		
Derivative financial instruments	**7,458**	8,502
Loans and receivables: Due from fellow Lloyds Banking Group undertakings	**91,867**	52,692
Trading and other financial assets at fair value through profit or loss	**34**	943
Liabilities		
Due to fellow Lloyds Banking Group undertakings	**140,297**	105,863
Trading and other financial liabilities at fair value through profit or loss	**182**	943
Derivative financial instruments	**8,884**	10,121
Debt securities in issue	**84**	139
Subordinated liabilities	**5,585**	5,601

During the half-year ended 30 June 2017 the Group earned £181 million (half-year ended 30 June 2016: £178 million) of interest income and incurred £993 million (half-year ended 30 June 2016: £1,085 million) of interest expense on balances and transactions with Lloyds Banking Group plc and fellow Lloyds Banking Group undertakings.

In addition, during the half-year to 30 June 2017 the Group incurred expenditure of £39 million (half-year ended 30 June 2016: £41 million) on behalf of fellow Lloyds Banking Group undertakings which was recharged to those undertakings; and fellow Lloyds Banking Group undertakings incurred expenditure of £277 million (half-year ended 30 June 2016: £409 million) on behalf of the Group which has been recharged to the Group.

Other related party transactions

Other related party transactions for the half-year to 30 June 2017 are similar in nature to those for the year ended 31 December 2016.

12. Dividends on ordinary shares

The Bank paid a dividend of £1,200 million on 11 May 2017; the Bank paid dividends of £2,000 million on 12 May 2016 and a further £1,500 million on 23 September 2016.

13. Future accounting developments

The following pronouncements are not applicable for the year ending 31 December 2017 and have not been applied in preparing these interim financial statements. Save as disclosed below, the impact of these accounting changes is still being assessed by the Group and reliable estimates cannot be made at this stage.

With the exception of IFRS 9 'Financial Instruments', and IFRS 15 'Revenue from Contracts with Customers', as at 26 July 2017 these pronouncements are awaiting EU endorsement.

IFRS 9 Financial Instruments

IFRS 9 replaces IAS 39 'Financial Instruments: Recognition and Measurement' and is effective for annual periods beginning on or after 1 January 2018.

The Group has an established IFRS 9 programme to ensure a high quality implementation in compliance with the standard and additional regulatory guidance that has been issued. The programme involves Finance and Risk functions across the Group with Divisional and Group steering committees providing oversight. The key responsibilities of the programme include defining IFRS 9 methodology and accounting policy, development of Expected Credit Loss ('ECL') models, identifying and implementing data and system requirements, and establishing an appropriate operating model and governance framework.

The programme is progressing in line with delivery plans and is currently completing credit risk model development and embedding the IFRS 9 operating model into the business. All core models are expected to be operational by September 2017 and outputs will be reviewed and validated ahead of implementation.

Classification 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 or amortised cost. Financial assets will be measured at amortised cost if they are held within a business model the objective of which is to hold financial assets in order to collect contractual cash flows, and their contractual cash flows represent solely payments of principal and interest. Financial assets will be measured at fair value through other comprehensive income if they are held within a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets and their contractual cash flows represent solely payments of principal and interest. Financial assets not meeting either of these two business models; and all equity instruments (unless designated at inception to fair value through other comprehensive income); and all derivatives are measured at fair value through profit or loss. An entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch.

The Group has undertaken an assessment of the classification and measurement of financial assets and, whilst certain portfolios will need to be reclassified, including from amortised cost to fair value through profit or loss, the overall impact on the Group is not expected to be significant.

IFRS 9 retains most of the existing requirements for financial liabilities. However, for financial liabilities designated at fair value through profit or loss, gains or losses attributable to changes in own credit risk may be presented in other comprehensive income. The Group has elected to early adopt this presentation of gains and losses on financial liabilities from 1 January 2017.

13. Future accounting developments (continued)

Impairment

The IFRS 9 impairment model will be applicable to all financial assets at amortised cost, debt instruments measured at fair value through other comprehensive income, lease receivables, loan commitments and financial guarantees not measured at fair value through profit or loss.

IFRS 9 replaces the existing 'incurred loss' impairment approach with an expected credit loss model, resulting in earlier recognition of credit losses compared with IAS 39. Expected credit losses are the unbiased probability weighted average credit losses determined by evaluating a range of possible outcomes and future economic conditions.

The ECL model has three stages. Entities are required to recognise a 12 month expected loss allowance on initial recognition (stage 1) and a lifetime expected loss allowance when there has been a significant increase in credit risk since initial recognition (stage 2). Stage 3 requires objective evidence that an asset is credit-impaired, which is similar to the guidance on incurred losses in IAS 39.

IFRS 9 requires the use of more forward looking information including reasonable and supportable forecasts of future economic conditions. The need to consider a range of economic scenarios and how they could impact the loss allowance is a subjective feature of the IFRS 9 ECL model. The Group has developed the capability to model a number of economic scenarios and capture the impact on credit losses to ensure the overall ECL reflects an appropriate distribution of economic outcomes.

For all material portfolios, IFRS 9 ECL calculation will leverage the systems, data and methodology used to calculate regulatory 'expected losses'. The definition of default for IFRS 9 purposes will be aligned to the Basel definition of default to ensure consistency across the Group. IFRS 9 models will use three key input parameters for the computation of expected loss, being probability of default ('PD'), loss given default ('LGD') and exposure at default ('EAD'). However, given the conservatism inherent in the regulatory expected losses calculation and some differences in the period over which risk parameters are measured, some adjustments to these components have been made to ensure compliance with IFRS 9.

The new impairment requirements will result in an increase in the Group's balance sheet provisions for credit losses and may have a negative impact on the Group's regulatory capital position. The extent of any increase in provisions will depend upon a number of factors including the composition of the Group's lending portfolios and forecast economic conditions at the date of implementation. It is not possible to conclude on the capital impact as the interaction with IFRS 9 and the capital rules, including possible transitional arrangements, is still being finalised.

Whilst the Group is still running and testing the new credit risk models, it is not possible to provide a reliable estimate of the increase in impairment provisions on 1 January 2018. The ongoing impact on the financial results will only become clearer after running the IFRS 9 models over a period of time and under different economic environments, however, it could result in impairment charges being more volatile when compared to the current IAS 39 impairment model, due to the forward looking nature of expected credit losses.

Hedge accounting

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 standard does not address macro hedge accounting, which is being considered in a separate IASB project. There is an option to retain the existing IAS 39 hedge accounting requirements until the IASB completes its project on macro hedging. The Group expects to continue applying IAS 39 hedge accounting in accordance with this accounting policy choice.

13. Future accounting developments (continued)

IFRS 15 Revenue from Contracts with Customers

IFRS 15 replaces IAS 18 'Revenue' and IAS 11 'Construction Contracts' and is effective for annual periods beginning on or after 1 January 2018.

The core principle of IFRS 15 is that revenue reflects the transfer of goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled. The recognition of such revenue is in accordance with five steps to: identify the contract; identify the performance obligations; determine the transaction price; allocate the transaction price to the performance obligations; and recognise revenue when the performance obligations are satisfied.

Revenue relating to financial instruments, leases and insurance contracts are out of scope, however, the Group does recognise fee income that is within scope, for example on added value accounts, interchange and service fees, certain mortgage fees, factoring and commitment fees. A substantial proportion of the current revenue recognition policy for fee and commission income is not expected to change. The standard is therefore not expected to have a significant impact on the Group's profitability.

Upon transition, any adjustments can be recognised either retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying the standard recognised at the date of initial application as an adjustment to the opening balance retained earnings. The Group anticipates adopting the second approach to transition.

IFRS 16 Leases

IFRS 16 replaces IAS 17 'Leases' and is effective for annual periods beginning on or after 1 January 2019.

IFRS 16 requires lessees to recognise a right of use asset and a liability for future payments arising from a lease contract. Lessees will recognise a finance charge on the liability and a depreciation charge on the asset which could affect the timing of the recognition of expenses on leased assets. This change will mainly impact the properties that the Group currently accounts for as operating leases. Finance systems will need to be changed to reflect the new accounting rules and disclosures. Lessor accounting requirements remain aligned to the current approach under IAS 17.

Minor amendments to other accounting standards

The IASB has issued a number of minor amendments to IFRSs effective 1 January 2018 (including IFRS 2 'Share-based Payment' and IAS 40 'Investment Property') and IFRIC 23 'Uncertainty over Income Tax Treatments' effective 1 January 2019. These revised requirements are not expected to have a significant impact on the Group.

14. Ultimate parent undertaking

Bank of Scotland plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Lloyds Banking Group plc has published consolidated accounts for the year ended 31 December 2016 and copies may be obtained from Investor Relations, Lloyds Banking Group, 25 Gresham Street, London EC2V 7HN and are available for download from www.lloydsbankinggroup.com

15. Other information

The financial information included in these condensed consolidated interim financial statements does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006. Statutory accounts for the year ended 31 December 2016 have been delivered to the Registrar of Companies. The auditors' report on those accounts was unqualified, did not include an emphasis of matter paragraph and did not include a statement under section 498 of the Companies Act 2006.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

- an indication of important events that have occurred during the six months ended 30 June 2017 and their impact on the condensed consolidated half-year financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year; and
- material related party transactions in the six months ended 30 June 2017 and any material changes in the related party transactions described in the last annual report.

Signed on behalf of the board by

António Horta-Osório
Group Chief Executive
26 July 2017

Bank of Scotland plc board of directors:
António Horta-Osório (Group Chief Executive)
George Culmer (Chief Financial Officer)
Juan Colombás (Chief Risk Officer)
Lord Blackwell (Chairman)
Anita Frew (Deputy Chairman)
Alan Dickinson
Simon Henry
Lord Lupton CBE
Deborah McWhinney
Nicholas Prettejohn
Stuart Sinclair
Sara Weller CBE

INDEPENDENT REVIEW REPORT TO BANK OF SCOTLAND PLC

Report on the condensed consolidated half-year financial statements

Our conclusion

We have reviewed Bank of Scotland plc's condensed consolidated half-year financial statements (the 'interim financial statements') in the 2017 half-year management report of Bank of Scotland plc for the six month period ended 30 June 2017. Based on our review, nothing has come to our attention that causes us to believe that the interim financial statements are not prepared, in all material respects, in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union and the Disclosure Guidance and Transparency Rules sourcebook of the United Kingdom's Financial Conduct Authority.

What we have reviewed

The interim financial statements comprise:

- the consolidated balance sheet as at 30 June 2017;
- the consolidated income statement for the period then ended;
- the consolidated statement of comprehensive income for the period then ended;
- the consolidated cash flow statement for the period then ended;
- the consolidated statement of changes in equity for the period then ended; and
- the explanatory notes to the interim financial statements.

The interim financial statements included in the 2017 half-year management report have been prepared in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union and the Disclosure Guidance and Transparency Rules sourcebook of the United Kingdom's Financial Conduct Authority.

As disclosed in note one to the interim financial statements, the financial reporting framework that has been applied in the preparation of the full annual financial statements of the Group is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Responsibilities for the interim financial statements and the review

Our responsibilities and those of the directors

The 2017 half-year management report, including the interim financial statements, is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the 2017 half-year management report in accordance with the Disclosure Guidance and Transparency Rules sourcebook of the United Kingdom's Financial Conduct Authority.

Our responsibility is to express a conclusion on the interim financial statements in the 2017 half-year management report based on our review. This report, including the conclusion, has been prepared for and only for the Bank for the purpose of complying with the Disclosure Guidance and Transparency Rules sourcebook of the United Kingdom's Financial Conduct Authority and for no other purpose. We do not, in giving this conclusion, 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 a review of interim financial statements involves

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity' issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and, consequently, does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

We have read the other information contained in the 2017 half-year management report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the interim financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants
London
26 July 2017

Notes:

(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 interim financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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