Bank of Scotland plc

Report and Accounts
2021

Member of Lloyds Banking Group

Contents

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

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 and loans and other products to commercial and corporate customers.

Business review
Income statement
The Group's profit before tax for the year to 31 December 2021 was £2,316 million, whilst total profit for the year was £1,948 million. Both measures benefited from higher total income and an impairment credit due to the improved macroeconomic outlook for the UK.

Total income of £5,763 million was up 12 per cent on the prior year reflecting both higher net interest income and other income.

Net interest income of £5,324 million was up 2 per cent compared to 2020, benefiting from an increase in average interest-earning assets which was driven by growth in the Group's mortgage book.

Other income of £439 million was up on the prior year, reflecting net trading income in the year of £47 million compared to net trading losses of £369 million in 2020. Net trading income in 2021 benefited from the non-recurrence of losses incurred in 2020 on hedging arrangements entered into with fellow Lloyds Banking Group undertakings.

Operating expenses of £3,822 million were 45 per cent higher than in 2020, primarily as a result of a significantly higher charge for regulatory and legal provisions. The charge for regulatory and legal provisions increased to £982 million in the year which included redress and operational costs in respect of HBOS Reading and litigation costs and charges relating to other ongoing legacy programmes. During 2021, £790 million has been recognised in relation to HBOS Reading estimated future awards and operational costs, of which £600 million was recognised in the fourth quarter. This reflects the Group's estimate of its full liability and includes the expected future cost in relation to the independent Foskett Panel re-review, operational costs in relation to Dame Linda Dobbs' review which is considering whether the issues relating to HBOS Reading were investigated and appropriately reported by the Group during the period January 2009 to January 2017 and other programme costs. The final outcome could be significantly different once the re-review is concluded.

The impairment charge was a credit of £375 million in the year, compared to a charge of £1,622 million in 2020. The credit in 2021 was the result of the release of expected credit loss (ECL) allowances based upon improvements to the macroeconomic outlook for the UK. Overall the Group's loan portfolio continues to be well-positioned, reflecting a prudent through-the-cycle approach to credit risk with high levels of security. Observed credit performance has remained robust in the year, with the flow of assets into arrears, defaults and write-offs remaining at low levels. The Group's ECL allowance reduced over the 12 months to 31 December 2021 by £692 million to £2,639 million.

The Group recognised a tax expense of £368 million for the year, which included a credit of £439 million arising on the remeasurement of deferred tax assets following the announcement and subsequent substantive enactment by the UK Government that the corporation tax rate would increase from 19 per cent to 25 per cent on 1 April 2023.

Balance sheet
The Group's balance sheet reflects continued franchise growth throughout the year. Total assets of £310,560 million were up slightly compared to £310,328 million at 31 December 2020 as a result of an increase in loans and advances to customers which was partly offset by reductions in amounts due from fellow Lloyds Banking Group undertakings. Loans and advances to customers were 6 per cent higher at £279,409 million compared to £263,766 million at 31 December 2020 driven by growth in the Group's mortgage book. Amounts due from fellow Lloyds Banking Group undertakings reduced by £11,926 million from £28,988 million at 31 December 2020 due to increased settlement activity.

Total liabilities of £296,517 million were down slightly compared to £296,940 million at 31 December 2020 reflecting higher levels of customer deposits and repurchase agreements which were offset by reductions in amounts due to fellow Lloyds Banking Group undertakings and subordinated liability redemptions. Customer deposits of £170,777 million have increased by £7,776 million since the end of 2020, with continued inflows into the Group's trusted brands. This included personal current account growth, as a result of continued reduced levels of customer spending. Amounts due to fellow Lloyds Banking Group undertakings have fallen by £14,114 million in the year as the Group drew additional funds from the Term Funding Scheme with additional incentives for SMEs (TFSME) which were reflected in repurchase agreements present at the year-end.

Total equity increased by £655 million from £13,388 million at 31 December 2020 to £14,043 million at 31 December 2021 with total comprehensive income for the year of £1,929 million and capital contributions received of £36 million, partially offset by dividends paid of £1,201 million and distributions on other equity instruments of £109 million.

The post-tax return on average assets was 0.6 per cent compared to 0.2 per cent in 2020.

Capital
The Bank's common equity tier 1 (CET1) capital ratio increased to 15.7 per cent (31 December 2020: 15.5 per cent), largely reflecting profits for the year and a reduction in risk-weighted assets, partially offset by dividends paid and a release of IFRS 9 transitional relief which largely offset the impairment credit through profits.

The transitional total capital ratio reduced to 21.8 per cent (31 December 2020: 22.1 per cent) reflecting the net impact of calls on tier 2 capital instruments, partially offset by the issuance of a new tier 2 capital instrument and the reduction in risk-weighted assets.

Risk-weighted assets reduced by £497 million to £60,807 million at 31 December 2021 compared to £61,304 million at 31 December 2020, largely reflecting optimisation activity undertaken in the commercial lending book and a reduction in operational risk, partially offset by growth in the mortgage book. Credit migrations have had a limited impact on the risk-weighted asset position in part due to the increase in house prices.

Capital position at 31 December 2021
The capital position of Bank of Scotland plc is presented on an unconsolidated basis. The Bank's capital position as at 31 December 2021, applying transitional rules in respect of legacy capital securities that were subject to grandfathering provisions prior to 1 January 2022 and IFRS 9 transitional arrangements, is set out in the following section.

Capital resources of the Bank on a transitional basis (audited)	At 31 Dec 2021 £m	At 31 Dec 2020 £m
Common equity tier 1		
Shareholders' equity per balance sheet	**11,426**	10,770
Cash flow hedging reserve	**63**	45
Other adjustments[1]	**379**	771
	11,868	11,586
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	**(444)**	(470)
Prudent valuation adjustment	**(78)**	(79)
Removal of defined benefit pension surplus	**(39)**	(50)
Deferred tax assets	**(1,767)**	(1,477)
Common equity tier 1 capital	**9,540**	9,510
Additional tier 1		
Additional tier 1 instruments	**2,222**	2,221
Total tier 1 capital	**11,762**	11,731
Tier 2		
Tier 2 instruments	**1,500**	1,943
Eligible provisions and other adjustments	**(3)**	(97)
Total tier 2 capital	**1,497**	1,846
Total capital resources	**13,259**	13,577
Risk-weighted assets of the Bank (unaudited)	**60,807**	61,304
Capital ratios of the Bank (unaudited)		
Common equity tier 1 capital ratio[2]	**15.7%**	15.5%
Tier 1 capital ratio[2]	**19.3%**	19.1%
Total capital ratio[2]	**21.8%**	22.1%

1 Includes an adjustment applied to reserves to reflect the application of the IFRS 9 transitional arrangements for capital.

2 Reflecting the full impact of IFRS 9 at 31 December 2021, without the application of transitional arrangements, the Bank's common equity tier 1 capital ratio would be 15.0 per cent, the tier 1 capital ratio would be 18.7 per cent and the total capital ratio would be 21.6 per cent.

Risk-weighted assets of the Bank (unaudited)	At 31 Dec 2021 £m	At 31 Dec 2020 £m
Foundation Internal Ratings Based (IRB) Approach	**3,476**	4,245
Retail IRB Approach	**41,636**	39,137
Other IRB Approach	**1,557**	1,958
IRB Approach	**46,669**	45,340
Standardised Approach	**4,389**	5,815
Credit risk	**51,058**	51,155
Counterparty credit risk	**333**	473
Credit valuation adjustment risk	**46**	100
Operational risk	**8,488**	8,801
Market risk	**254**	220
Underlying risk-weighted assets	**60,179**	60,749
Threshold risk-weighted assets[1]	**628**	555
Total risk-weighted assets	**60,807**	61,304

1 Threshold risk-weighted assets reflect the element of deferred tax assets that are permitted to be risk-weighted instead of being deducted from CET1 capital.

Future developments
Information about future developments is provided with the principal risks and uncertainties section below.

Reflecting the needs of stakeholders in Board decisions
The Board is responsible for the long-term success of the Bank, setting and overseeing culture, purpose, values and strategy. The Board's understanding of stakeholders' interests is central to these responsibilities, and informs key aspects of Board decision-making.

Acknowledging the breadth of the Bank's stakeholders and the size of the organisation, stakeholder engagement takes place at a number of levels. In addition to direct engagement by members of the Board, the Board considers the stakeholder impacts of all proposals submitted to it from across the Bank. Stakeholder interests are central to the Board's delegation of the management of the business to the Executive.

In turn the Executive, including the Group Chief Executive and Chief Financial Officer, routinely provide the Board with details of non-Board stakeholder interaction and feedback through their regular business updates. Stakeholder interests are also identified by the Executive for consideration in all other proposals put to the Board.

Interaction has again mostly been undertaken virtually this year where necessary, in compliance with the government's COVID-19 requirements.

Section 172(1) Statement
In accordance with the Companies Act 2006 (the Act), the Directors provide this statement describing how they have had regard to the matters set out in section 172(1) of the Act, when performing their duty to promote the success of the Bank under section 172. Further details on key actions are also contained within the Corporate Governance Statement on page 6.

The Directors remain mindful in all their deliberations of the long-term consequences of their decisions, as well as the importance of the Bank maintaining a reputation for high standards of business conduct and the Board engaging with, and taking account of the views of, key stakeholders.

Key Stakeholder Engagement
The Non-Executive Directors undertook an engagement programme which allowed them to hear directly from customers, clients and colleagues, to help understand what matters in their lives, the role the Bank plays in supporting them and how the Bank is performing in that regard. A range of activities took place, which will extend into 2022, including meeting with customers, attending client visits and sitting with colleagues to understand the Bank's culture and discuss future ways of working. The Non-Executive Directors found these sessions to be of great benefit, giving many valuable insights which they take account of, as appropriate, in their decision-making.

Our Stakeholders

Customers
The Board remains committed to understanding and addressing our customers' needs, which is vital to setting and achieving the Bank's goals. Examples of Board engagement with customers included:

- Regular Board updates identifying key areas of customer concern, covering a range of internal and external measures including customer indices and market share updates
- These regular updates gave valuable insight into performance in delivering on customer-related objectives, on improving customer outcomes and in determining where further action was required
- The Group Chief Executive attended customer engagement events, an important opportunity for customers to raise any concerns directly

Shareholders
The Bank is a wholly owned subsidiary of Lloyds Banking Group. The Directors ensure that the strategy, priorities, processes and practices of the Bank are fully aligned where required to those of Lloyds Banking Group, ensuring that the interests of Lloyds Banking Group as the Bank's sole shareholder are duly acknowledged. Further information in respect of the relationship of Lloyds Banking Group with its shareholders is included within the Strategic Report within the Lloyds Banking Group Annual Report and Accounts for 2021, available on the Lloyds Banking Group website.

Society and environment
The Board places great importance on engagement and action to help these communities prosper, and to help build a more sustainable and inclusive future. Engagement with communities, and as relevant to environmental considerations included:

- Dedicated updates on climate, environmental, social and governance related matters, covering all aspects of the Bank's business, and the Board reviews progress against any action it considers is required
- The Board is supported in environmental matters by its Responsible Business Committee, which considers stakeholder views on all matters relating to the Group's goals to be a trusted, sustainable, inclusive and responsible business
- The Board continues to value the support of Lloyds Banking Group's regional colleague ambassadors, who help in establishing strong relationships with local politicians, councils and other community institutions across the UK

Regulators and government
The Board continues to maintain strong and open relationships with our regulators and government authorities, including key stakeholders such as HMRC and HM Treasury. Relevant engagement included:

- The Chair and individual Directors, in particular the Chairs of the Board's committees, held continuing discussions with the FCA and PRA on a number of aspects of the regulatory agenda
- The Board regularly reviewed updates on wider regulatory interaction, providing a view of key areas of regulatory focus, and also progress made in addressing key regulatory priorities
- A meeting was held between the Board and the PRA to discuss the outcome and progress of action relevant to the PRA's Periodic Summary Meeting letter

Suppliers
The Group relies on a number of partners for important aspects of our operations and customer service provision. The Board recognises the importance of these relationships, and engagement with suppliers included:

- The Board continues to have zero tolerance towards modern slavery in the supply chain, and receives updates on ongoing enhancements to the Group's supplier practices, including measures to address the risk of human trafficking and modern slavery in our wider supply chain

Key Decisions

Climate change
Investors, customers, regulators & government and society & environment

The Board remains committed to the ambitious climate change goals set for Lloyds Banking Group in 2020, including reducing the emissions we finance by more than 50 per cent by 2030 and achieving net zero by 2050 or sooner, with a number of key steps already having been taken in this regard, under the Board's supervision. The Board has also given much consideration to progress against these objectives, and during the year oversaw a number of additional commitments to further drive progress.

These included three new pledges specifically relevant to operations, ranging from further reducing our own carbon footprint with targets for reduced emissions and energy use in respect of buildings and colleague travel, and related collaboration with key stakeholders including our suppliers. Progress against all of related initiatives and activities continues to be closely monitored by the Board. Climate ambitions and related stakeholder interests have also been a key consideration for the Board during the course of the year in the development of purpose and strategy.

Further information on our progress in meeting climate ambitions can be found in Lloyds Banking Group's supplementary 2021 Climate Report.

Strategy
Investors, regulators & government and society & environment

As implementation of Strategic Review 2021 completed, and our new Group Chief Executive joined the organisation in August, the Board considered that this was the appropriate time to revisit the strategy for the coming years, ensuring that the focus remained on our central purpose of Helping Britain Prosper. To that end, under the Board's guidance, the Group Chief Executive led a process of reviewing the strategic priorities.

The development of the new strategy drew on the customer insights the Bank and Board gathers through regular surveys and interactions with our customers, feedback from bi-annual colleague surveys, and proactive regular engagement with our regulators and other stakeholders. The Bank also sought feedback on specific aspects of the strategy development, such as the new mission, through colleague surveys and interactive sessions, as well as targeted customer and client research.

In addition to regular sessions, the Board held a number of dedicated sessions with senior management during the development of the strategy, allowing both reflection on stakeholder feedback and input from Board members on key aspects of the development of the strategy.

This included the requirement for the strategy to be driven by our purpose, ensuring focus on meeting customer needs in a conduct-friendly manner, and moving the business to more sustainable growth.

The Board will continue to take the invaluable feedback and views of its stakeholders into consideration as the new strategy is implemented, ensuring we stay true to our commitments to meeting the needs of all our stakeholders.

Principal risks and uncertainties
The significant risks faced by the Group are detailed below.

Despite a resilient recovery, 2021 has been another year of significant uncertainty, with COVID-19 accelerating broad structural changes, including ways of working and impacts to global and domestic economies.

COVID-19 has continued to have a significant impact on all risk types in 2021. Understanding and managing its impacts dynamically has remained a major area of focus. The Group has responded quickly to the challenges faced, putting in place risk mitigation strategies and refining its investment and strategic plans.

Some of the emerging risk themes in 2021, that may require consideration as part of future strategic planning, include: technology; people, ways of working and skills; climate change and sustainability and future purpose and propositions.

The Group's principal risks and uncertainties are reviewed and reported regularly to the Board of Lloyds Banking Group in alignment with Lloyds Banking Group's enterprise risk management framework.

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

Credit
Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their financial obligations (both on and off-balance sheet).

Funding and liquidity
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.

Capital
Capital risk is defined as the risk that the Group has a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across Lloyds Banking Group.

Change/execution
Change/execution risk is defined as the risk that, in delivering its change agenda, the Group fails to ensure compliance with laws and regulation, maintain effective customer service and availability, and/or operate within Lloyds Banking Group's risk appetite.

Conduct
Conduct risk is defined as the risk of customer detriment across the customer lifecycle including: failures in product management, distribution and servicing activities; from other risks materialising, or other activities which could undermine the integrity of the market or distort competition, leading to unfair customer outcomes, regulatory censure, reputational damage or financial loss.

Data
Data risk is defined as the risk of the Group failing to effectively govern, manage and control its data (including data processed by third party suppliers), leading to unethical decisions, poor customer outcomes, loss of value to the Group and mistrust.

People
People risk is defined as the risk that the Group fails to provide an appropriate colleague and customer-centric culture, supported by robust reward and wellbeing policies and processes; effective leadership to manage colleague resources; effective talent and succession management; and robust control to ensure all colleague-related requirements are met.

Operational resilience
Operational resilience risk is defined as the risk that the Group fails to design resilience into business operations, underlying infrastructure and controls (people, process, technology) so that it is able to withstand external or internal events which could impact the continuation of operations, and fails to respond in a way which meets customer and stakeholder expectations and needs when the continuity of operations is compromised.

Operational
Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Model
Model risk is defined as the risk of financial loss, regulatory censure, reputational damage or customer detriment, as a result of deficiencies in the development, application or ongoing operation of models and rating systems.

Regulatory and legal
Regulatory and legal risk is defined as the risk of financial penalties, regulatory censure, criminal or civil enforcement action or customer detriment as a result of failure to identify, assess, correctly interpret, comply with, or manage regulatory and/or legal requirements.

Strategic
Strategic risk is defined as the risk which results from: incorrect assumptions about internal or external operating environments, failure to understand the potential impact of strategic responses and business plans on existing risk types and failure to respond or the inappropriate strategic response to material changes in the external or internal operating environments.

Climate
Climate risk is defined as the risk that the Group experiences losses and/or reputational damage as a result of physical events, transition risk, or as a consequence of the responses to managing these changes, either directly or through our customers.

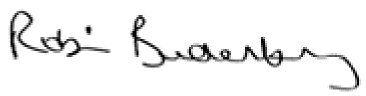
Financial risk management objectives and policies
Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in notes 33 and 36 to the accounts. The Group's approach to risk management including risk policies, risk appetite, measurement bases and sensitivities, in particular for credit risk, market risk and liquidity risk, is aligned to those of Lloyds Banking Group plc, the Bank's ultimate parent. Further information can be found in the Lloyds Banking Group plc Annual Report and Accounts.

The Group maintains risk management systems and internal controls relating to the financial reporting processes designed to:

– ensure that accounting policies are appropriately and consistently applied;
– enable the calculation, preparation and reporting of financial outcomes in line with applicable standards; and
– ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements.

The 2021 Strategic Report has been approved by the Board of Directors.

On behalf of the Board



Robin Budenberg
Chair
Bank of Scotland plc
8 March 2022

Results
The consolidated income statement on page 22 shows a statutory profit before tax for the year ended 31 December 2021 of £2,316 million (year ended 31 December 2020: £883 million).

Dividends
During the year the Bank paid an interim dividend of £1,200 million (2020: £nil). The Directors have not recommended a final dividend for the year ended 31 December 2021 (2020: £nil).

Post balance sheet events
There were no material post balance sheet events.

Going concern
The going concern of both the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have reviewed the Bank and the Group's operating plan and its funding and capital positions, including consideration of the short-term implications of the COVID-19 pandemic and climate change. The Directors have also taken into account the impact of further stress scenarios.

Accordingly, the Directors conclude that the Group has adequate resources to continue in operational existence for a period of at least 12 months from the date of the approval of the financial statements and therefore it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Corporate Governance Statement
In accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended by the Companies (Miscellaneous Reporting) Regulations 2018) (the 'Regulations'), for the year ended 31 December 2021, the Bank has in its corporate governance arrangements applied the Wates Corporate Governance Principles for Large Private Companies (the 'Principles'), which are available at www.frc.org.uk. The following section explains the Bank's approach to corporate governance, and its application of the Principles.

Fundamental to the Bank's strategy are high standards of corporate governance. A Corporate Governance Framework is in place for Lloyds Banking Group, the Bank, Lloyds Bank plc and HBOS plc, with all four companies sharing a common approach to governance. The framework is designed to meet the specific needs of each company, setting the wider approach and applicable standards in respect of the Bank's corporate governance practices, including addressing the matters set out in the Principles and the governance requirements of the operation of the Bank, as part of Lloyds Banking Group's Ring Fenced Bank.

This includes the matters reserved to the Board, and the matters the Board has chosen to delegate to management, including decision making on operational matters such as those relating to credit, liquidity, and the day-to-day management of risk. Governance arrangements, including the Corporate Governance Framework, are reviewed periodically to ensure they remain fit for purpose. The Board delegates further responsibilities to the Group Chief Executive, who is supported by the Group Executive Committee, the composition of which is detailed on pages 74 to 75 of the Lloyds Banking Group Annual Report and Accounts for 2021. The Corporate Governance Framework of the Bank further addresses the requirements of the Principles as discussed on pages 7 to 8.

Board and Committee Composition and Board Attendance in 2021[12]

Board Member	Board	Nomination Committee	Audit Committee	Board Risk Committee	Remuneration Committee
Robin Budenberg[1]	**10/10 (C)**	**6/6 (C)**		**2/2**	**6/6**
Charlie Nunn[2]	**4/4**				
Sir António Horta–Osório[3]	**3/3**				
William Chalmers[4]	**10/10**				
Alan Dickinson[5]	**10/10**	**6/6**	**6/6**	**8/8**	**6/6 (C)**
Sarah Bentley	**10/10**			**2/2**	**6/6**
Brendan Gilligan	**10/10**		**6/6**	**8/8**	
Nigel Hinshelwood	**10/10**	**6/6**	**6/6**	**8/8**	**6/6**
Sarah Legg	**10/10**		**6/6 (C)**	**8/8**	
Lord Lupton[1]	**10/10**			**2/2**	
Amanda Mackenzie[1,6]	**10/10**	**4/4**		**2/2**	**6/6**
Harmeen Mehta[7]	**2/2**				
Nick Prettejohn[8]	**7/7**	**4/4**	**5/5**	**6/6**	
Stuart Sinclair[1,5,9]	**8/10[11]**	**5/6[11]**		**2/2**	**4/6[11]**
Sara Weller[1,10]	**4/4**	**2/2**		**2/2**	**4/4**
Catherine Woods	**10/10**		**6/6**	**8/8 (C)**	**6/6**

(C) Chair
1 The Board Risk Committee was reconstituted with effect from 29 March 2021 to streamline that Committee's membership. With effect from 29 March 2021, the Committee comprised Catherine Woods (Chair), Alan Dickinson, Sarah Legg and, until his retirement from the Board, Nick Prettejohn.
2 Charlie Nunn joined the Board on 16 August 2021.
3 Sir António Horta-Osório retired from the Board on 30 April 2021.
4 William Chalmers, Chief Financial Officer, was acting Group Chief Executive from when Sir António Horta-Osório retired on 30 April 2021 and until Charlie Nunn's appointment to the Board on 16 August 2021.
5 Alan Dickinson succeeded Stuart Sinclair as Chair of the Remuneration Committee on 24 November 2021
6 Amanda Mackenzie joined the Nomination Committee on 23 June 2021
7 Harmeen Mehta joined the Board on 1 November 2021.
8 Nick Prettejohn retired from the Board on 30 September 2021
9 Stuart Sinclair plans to retire from the Board at the AGM in May 2022.
10 Sara Weller retired from the Board on 20 May 2021.
11 Unable to attend some meetings due to medical reasons
12 Where a Director is unable to attend a meeting he/she receives papers in advance and has the opportunity to provide comments to the Chair of the Board or to the relevant Committee Chair.

Principle One – Purpose and Leadership
The Board is collectively responsible for the long term success of the Bank. It achieves this by agreeing the Bank's strategy, within the wider strategy of Lloyds Banking Group, and overseeing delivery against it. The Bank's strategy is discussed further in the Strategic Report. The Board also assumes responsibility for the management of the culture, values and wider standards of the Bank, within the equivalent standards set by Lloyds Banking Group. The Board's understanding of stakeholders' interests is central to these responsibilities and informs key aspects of Board decision making.

Acknowledging the needs of all stakeholders is fundamental to the way the Bank operates, as is maintaining the highest standards of business conduct, which along with ensuring delivery for customers is a vital part of the corporate culture. The Bank's approach is further influenced by the need to build a culture in which everyone feels included, empowered and inspired to do the right thing for customers. To this end, the Board plays a lead role in establishing, promoting, and monitoring the Bank's corporate culture and values, with the Corporate Governance Framework ensuring such matters receive the level of prominence in Board and Executive decision making which they require. The Bank's corporate culture and values align to those of Lloyds Banking Group, which are discussed in more detail on page 80 of the Lloyds Banking Group Annual Report and Accounts for 2021.

Principle Two – Board Composition
The Bank is led by a Board comprising a Non-Executive Chair, independent Non-Executive Directors and Executive Directors; further details of the Directors can be found on page 10. The Board considers its composition regularly and is committed to ensuring it has the right balance of skills and experience. The Board considers its current size and composition is appropriate to the Bank's circumstances. The Board places great emphasis on ensuring its membership reflects diversity in its broadest sense. New appointments are made on merit, taking account of the specific skills and experience, independence and knowledge needed to ensure a rounded board and the diversity benefits each candidate can bring overall. There are a range of initiatives across Lloyds Banking Group to help ensure unbiased career progression opportunities. Progress on diversity objectives is monitored by the Board and built into its assessment of executive performance.

The Board is supported by its committees, the operation of which are discussed below, which make recommendations to the Board on matters delegated to them, in particular in relation to internal control, risk, financial reporting and remuneration matters. Each committee has written terms of reference setting out its delegated responsibilities. Each committee comprises Non-Executive Directors with appropriate skills and experience and is chaired by an experienced chairman. The committee Chairs report to the Board at the next Board meeting. The Board undertakes a periodic review of its effectiveness, which provides an opportunity to consider ways of identifying greater efficiencies, ways to maximise strengths and highlights areas of further development. Given the appointment of a new Group Chief Executive in August 2021 and the development of the Bank's ongoing strategy within the wider Lloyds Banking Group, the Board agreed that an evaluation of its effectiveness would be conducted in 2022 to allow the review to cover the Board's effectiveness in overseeing these developments.

Principle Three – Director Responsibilities
The Directors assume ultimate responsibility for all matters, and along with senior management are committed to maintaining a robust control framework as the foundation for the delivery of good governance, including the effective management of delegation through the Corporate Governance Framework. Policies are also in place in relation to potential conflicts of interest which may arise. All Directors have access to the services of the Company Secretary, and independent professional advice is available to the Directors at the expense of Lloyds Banking Group, where they judge it necessary to discharge their duties as directors.

The Board is supported by its committees which make recommendations on matters delegated to them under the Corporate Governance Framework. The management of all committees is in keeping with the basis on which meetings of the Board are managed, with open debate, and adequate time for members to consider proposals which are put forward. The Chair of the Board and each Board committee assumes responsibility with support from the Company Secretary for the provision to each meeting of accurate and timely information.

Principle Four – Opportunity and Risk
The Board oversees the development and implementation of the Bank's strategy, within the context of the wider strategy of Lloyds Banking Group, which includes consideration of all strategic opportunities. The Board is also responsible for the long term sustainable success of the Bank, generating value for its shareholders and ensuring a positive contribution to society. The Board agrees the Bank's culture, purpose, values and strategy, within that of Lloyds Banking Group, and agrees the related standards of the Bank, again within the relevant standards of Lloyds Banking Group. Further specific aims and objectives of the Board are formalised within the Corporate Governance Framework, which also sets out the matters reserved for the Board.

Strong risk management is central to the strategy of the Bank, which along with a robust risk control framework acts as the foundation for the delivery of effective management of risk. The Board agrees the Bank's risk appetite and ensures the Bank manages risk effectively, delegating related authorities to individuals through the Corporate Governance Framework and the further management hierarchy. Board level engagement coupled with the direct involvement of senior management in risk issues ensures that escalated issues are promptly addressed, and remediation plans are initiated where required. The Bank's risk appetite, principles, policies, procedures, controls and reporting are managed in conjunction with those of Lloyds Banking Group, and as such are regularly reviewed to ensure they remain fully in line with regulations, law, corporate governance and industry best practice. The Bank's principal risks are discussed further on pages 4 and 5.

Principle Five – Remuneration
The Remuneration Committee of the Board, in conjunction with the Remuneration Committee of Lloyds Banking Group (the 'Remuneration Committees'), assume responsibility for the Bank's approach to remuneration. This includes reviewing and making recommendations on remuneration policy as relevant to the Bank, ranging from the remuneration of Directors and members of the Executive to that of all other colleagues where the regulators require the Bank to implement a specific approach to their remuneration, such as Senior Managers and other material risk takers. The activities of the Remuneration Committees extend to matters of remuneration relevant to subsidiaries of the Bank, where such subsidiary does not have its own remuneration committee. Certain members of the Lloyds Banking Group Executive, including the Group People and Property Director, are authorised to act upon the decisions made by the Remuneration Committees, and to undertake such other duties relevant to remuneration as delegated to them.

Principle Six – Stakeholders
The COVID-19 pandemic continued to have an effect on the way we live, including on the Bank's many stakeholders. The Board has monitored the impact of the pandemic on the Group's and Bank's business and its stakeholders, seeking to ensure that the challenges posed by the pandemic were addressed. The Board considered related updates from management as events unfolded, covering matters including the continued impact on customers, colleagues, suppliers and other stakeholders, approving suitable action as required.

The Bank as part of Lloyds Banking Group operates under Lloyds Banking Group's wider Responsible Business approach, which acknowledges that the Bank has a responsibility to help address the economic, social and environmental challenges which the UK faces, and as part of this understand the needs of the Bank's external stakeholders, including in the development and implementation of strategy. Central to this is Lloyds Banking Group's Helping Britain Prosper plan, in which the Bank participates. During the year there was a focus on the response to COVID, and Helping Britain Recover. This involved bringing together many of the Board's key stakeholders, to determine how the Bank could best support the recovery from the pandemic, the outcomes of this initiative being set out on pages 26 to 29 of the Lloyds Banking Group Annual Report and Accounts for 2021.

In 2021 the Responsible Business Committee of Lloyds Banking Group provided further oversight and support of Lloyds Banking Group's and the Bank's plans for embedding responsible business in the Banks' core purpose. The approach of the Board in respect of its key stakeholders is described further in a separate statement made in compliance with the Regulations on pages 3 to 4.

Directors

The names of the current Directors are shown on page 10. Changes to the composition of the Board since 1 January 2021 up to the date of this report are shown in the table below.

	Joined the Board	Left the Board
Charlie Nunn	16 August 2021	
Harmeen Mehta	1 November 2021	
Lord Blackwell		1 January 2021
Sir António Horta-Osório		30 April 2021
Sara Weller		20 May 2021
Nick Prettejohn		30 September 2021

Stuart Sinclair will retire as a director of the Bank at the forthcoming Lloyds Banking Group AGM.

Directors' indemnities

The Directors of the Bank, including the former Directors who retired during the year, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constitute '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. 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 2021. In addition, Lloyds Banking Group plc had appropriate Directors' and Officers' liability insurance cover in place throughout 2021. Deeds for existing Directors are available for inspection at the Bank's registered office.

Lloyds Banking Group plc has also granted deeds of indemnity by deed poll and by way of entering into individual deeds, which constitute 'qualifying third party indemnity provisions' to the Directors of the Group's subsidiary companies, including former Directors who retired during the year, and to colleagues subject to the provisions of the Senior Managers and Certification Regime. Such deeds were in force during the financial year ended 31 December 2021 and remain in force as at the date of this report. Qualifying pension scheme indemnities have also been granted to the Trustees of Lloyds Banking Group's Pension Schemes, including those schemes relevant to the Bank, which were in force for the whole of the financial year and remain in force as at the date of this report.

Information required under DTR 7.2

Certain information is incorporated into this report by reference. Information about internal control and risk management systems relating to the financial reporting process can be found on page 5.

Information about share capital is shown in note 25 on page 64. The Bank is a wholly owned subsidiary of HBOS plc, which holds all of the Bank's issued ordinary share capital.

The Directors manage the business of the Bank under the powers set out in the Companies Act 2006 and the Bank's articles of association, these powers include those in relation to the issue or buy back of the Bank's shares.

The appointment and retirement of Directors is governed by the Bank's articles of association and the Companies Act 2006. The Bank's articles of association may only be amended by a special resolution of the shareholders in a general meeting.

Conflicts of interest

The Board has a comprehensive procedure for reviewing, and as permitted by the Companies Act 2006 and the Bank's articles of association, approving actual and potential conflicts of interest. Directors have a duty to notify the Chair and Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to commitments of all Directors are reported to the Board and a register of directors' interests is regularly reviewed and authorised by the Board to ensure the authorisation status remains appropriate.

Lord Lupton is a senior adviser to Greenhill Europe, an investment bank focused on providing financial advice on significant mergers, acquisitions, restructurings, financings and capital raising to corporations, partnerships, institutions and governments. The Board has recognised that potential conflicts may arise as a result of these positions. The Board has authorised the potential conflicts and requires Lord Lupton to recuse himself from discussions, should the need arise.

Branches, future developments and financial risk management objectives and policies

The Bank provides a wide range of banking and financial services through branches and offices in the UK and overseas. Information regarding future developments and financial risk management objectives and policies of the Group in relation to the use of financial instruments that would otherwise be required to be disclosed in the Directors' report, and which is incorporated into this report by reference, can be found in the Strategic Report.

Share capital

Information about share capital is shown in note 25 on page 64. This information is incorporated into this report by reference. The Bank did not repurchase any of its shares during 2021 (2020: none). There are no restrictions on the transfer of shares in the Bank 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.

Change of control
The Bank is not party to any significant agreements which take effect, alter or terminate upon a change of control of the Bank following a takeover bid. There are no agreements between the Bank and its Directors or employees providing compensation for loss of office or employment that occurs because of a takeover bid.

Research and development activities
During the ordinary course of business the Bank develops new products and services.

Information incorporated by reference
The following additional information forms part of the Directors' Report, and is incorporated by reference.

Content		Pages
Disclosures required under the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008	Statement of stakeholder engagement	3 to 4

Significant contracts
Details of related party transactions are set out in note 31 on pages 68 to 70.

Streamlined Energy and Carbon Reporting
The Bank has taken advantage of the exemption from Streamlined Energy and Carbon Reporting (SECR) reporting requirements in its own Directors' Report as it is covered by the Lloyds Banking Group SECR report given in the Lloyds Banking Group plc 2021 Annual Report and Accounts, available at www.lloydsbankinggroup.com/investors/financial-downloads.html

Statement of directors' responsibilities
The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations. Company law requires the Directors to prepare financial statements for each financial year. Under that law, the Directors are required to prepare the Bank's financial statements in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006.

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 Bank and of the profit or loss of the Bank for that period. In preparing these financial statements, the Directors are required to properly select and apply accounting policies; present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; provide additional disclosures when compliance with the specific requirements in international accounting standards in conformity with the requirements of the Companies Act 2006 are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and make an assessment of the Bank's ability to continue as a going concern.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Bank and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Bank 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 the website www.lloydsbankinggroup.com/investors/financial-downloads.html. The Directors are responsible for the maintenance and integrity of all information relating to the Bank on that 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 as at the date of this report, and whose names and functions are listed on page 10 of this annual report, confirm that, to the best of his or her knowledge:

- The Bank's financial statements, which have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006 give a true and fair view of the assets, liabilities, financial position and profit or loss of the Bank
- 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 Bank together with a description of the principal risks and uncertainties they face
- The Annual Report and Accounts, taken as a whole, are fair, balanced and understandable and provides the information necessary for shareholders to assess the Bank's position, 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 Bank'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 Bank'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.

On behalf of the Board

Kate Cheetham

Kate Cheetham
Company Secretary
8 March 2022

Bank of Scotland plc
Registered in Scotland
Company Number SC327000

Current Directors

Executive Directors:

Charlie Nunn *Group Chief Executive*

William Chalmers *Chief Financial Officer*

Non-Executive Directors:

Robin Budenberg CBE *Chair*

Alan Dickinson *Deputy Chair*

Sarah Bentley

Brendan Gilligan

Nigel Hinshelwood

Sarah Legg

Lord Lupton CBE

Amanda Mackenzie OBE

Harmeen Mehta

Stuart Sinclair

Catherine Woods

Forward looking statements

This document contains certain forward looking statements within the meaning of Section 21E of the US Securities Exchange Act of 1934, as amended, and section 27A of the US Securities Act of 1933, as amended, with respect to the business, strategy, plans and/or results of Bank of Scotland plc together with its subsidiaries (the Group) and its current goals and expectations. Statements that are not historical or current facts, including statements about the Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as, without limitation, 'believes', 'achieves', 'anticipates', 'estimates', 'expects', 'targets', 'should', 'intends', 'aims', 'projects', 'plans', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'may', 'seek', 'estimate', 'probability', 'goal', 'objective', 'deliver', 'endeavour', 'prospects', 'optimistic' and similar expressions or variations on these expressions are intended to identify forward looking statements. These statements concern or may affect future matters, including but not limited to: projections or expectations of the Group's future financial position, including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; the Group's future financial performance; the level and extent of future impairments and write-downs; the Group's ESG targets and/or commitments; statements of plans, objectives or goals of the Group or its management and other statements that are not historical fact; expectations about the impact of COVID-19; and statements of assumptions underlying 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. Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from forward looking statements include, but are not limited to: general economic and business conditions in the UK and internationally; market related risks, trends and developments; risks concerning borrower and counterparty credit quality; fluctuations in interest rates, inflation, exchange rates, stock markets and currencies; volatility in credit markets; volatility in the price of our securities; any impact of the transition from IBORs to alternative reference rates; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the Group'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; inability to capture accurately the expected value from acquisitions; potential changes in dividend policy; the ability to achieve strategic objectives; insurance risks; management and monitoring of conduct risk; exposure to counterparty risk; credit rating risk; tightening of monetary policy in jurisdictions in which the Group operates; instability in the global financial markets, including within the Eurozone, and as a result of ongoing uncertainty following the exit by the UK from the European Union (EU) and the effects of the EU-UK Trade and Cooperation Agreement; political instability including as a result of any UK general election and any further possible referendum on Scottish independence; operational risks; conduct risk; 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 (including but not limited to the COVID-19 pandemic) and other disasters; inadequate or failed internal or external processes or systems; acts of hostility or terrorism and responses to those acts, or other such events; geopolitical unpredictability; risks relating to sustainability and climate change (and achieving climate change ambitions), including the Group's ability along with the government and other stakeholders to measure, manage and mitigate the impacts of climate change effectively; changes in laws, regulations, practices and accounting standards or taxation; changes to regulatory capital or liquidity requirements and similar contingencies; assessment related to resolution planning requirements; the policies and actions of governmental or regulatory authorities or courts together with any resulting impact on the future structure of the Group; failure to comply with anti-money laundering, counter terrorist financing, anti-bribery and sanctions regulations; failure to prevent or detect any illegal or improper activities; projected employee numbers and key person risk; increased labour costs; assumptions and estimates that form the basis of our financial statements; the impact of competitive conditions; and exposure to legal, regulatory or competition proceedings, investigations or complaints. A number of these influences and factors are beyond the Group's control. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Bank plc with the US Securities and Exchange Commission (the SEC), which is available on the SEC's website at www.sec.gov, for a discussion of certain factors and risks. Lloyds Banking Group plc may also make or disclose written and/or oral forward-looking statements in other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group plc to third parties, including financial analysts. 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 Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this document whether as a result of new information, future events or otherwise. 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.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF BANK OF SCOTLAND PLC

Report on the audit of the financial statements

1. Opinion

In our opinion:

- the financial statements of Bank of Scotland plc (the 'Bank') and its subsidiaries (the 'Group' or 'BOS') give a true and fair view of the state of the Group's and of the Bank's affairs as at 31 December 2021 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with United Kingdom adopted international accounting standards and International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB);
- the Bank's financial statements have been properly prepared in accordance with United Kingdom adopted international accounting standards 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.

We have audited the financial statements which comprise the:

Group	Bank
• Consolidated balance sheet as at 31 December 2021; • Consolidated income statement for the year then ended; • Consolidated statement of comprehensive income for the year then ended; • Consolidated statement of changes in equity for the year then ended; • Consolidated cash flow statement for the year then ended; and • Notes 1 to 38 to the financial statements, which include the accounting principles and policies.	• Balance sheet as at 31 December 2021; • Statement of comprehensive income for the year then ended; • Statement of changes in equity for the year then ended; • Cash flow statement for the year then ended; and • Notes 1 to 38 to the financial statements, which include the accounting principles and policies, as applicable to the Bank.

The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom adopted international accounting standards as applied in accordance with the provisions of the Companies Act 2006.

2. Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the Group and the Bank in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (the 'FRC's') Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. The non-audit services provided to the Group and the Bank for the year are disclosed in note 9 to the financial statements. We confirm that we have not provided any non-audit services prohibited by the FRC's Ethical Standard to the Group or the Bank.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

3. Audit scope, approach, and execution

Key audit matters	The key audit matters that we identified in the current year were: • Expected credit losses (Group and Bank) • Regulatory and litigation matters (Group and Bank) • IT systems that impact financial reporting (Group and Bank)
Materiality	Overall materiality used for the Group consolidated financial statements was £155 million, which was determined on the basis of profit before tax and net assets. Overall materiality used for the Bank's financial statements was £155 million, which was determined on the basis of net assets and capped at Group materiality.
Scoping	Our audit scope covers 92% of the Group's revenue, 98% of the Group's profit before tax and 98% of the Group's total assets.

First year audit transition

This is the first year we have been appointed as auditors to the Group. We undertook a number of transitional procedures to prepare for the audit including establishing our independence from the Group which involved ceasing a number of commercial relationships and banking arrangements and changing the financial arrangements for our partners and over 3,000 staff who are in the audit division at Deloitte, or who work on the Lloyds Banking Group audit including the BOS Group and Bank audit. We used the time prior to commencing our audit to meet with Group leadership and non-executive directors to gain an understanding of the business, its issues and the environment in which it operates.

We became independent of the Group and commenced our audit planning on 1 January 2020. From that date we attended all Audit Committee meetings, initially in an observer capacity, and continued to meet regularly with Group leadership, non-executive directors and the Group's main regulators. We worked alongside the former auditor, reviewed their working papers and shadowed some of their meetings to gain an understanding of the Group's processes, their audit risk assessment, and the controls on which they relied for the purposes of issuing their audit opinion.

Throughout 2020 we held regular meetings of audit partners and senior staff who would be responsible for undertaking the most significant areas of the Group audit. The main purpose of these meetings were to outline our audit approach, including discussing possible significant audit risks, the use of analytics in assessing significant and non-significant risks, to discuss testing approaches, and to brief our teams on the Group's key processes, systems and structure. During these meetings, we also heard directly from the Group on the changes impacting the business to inform our audit planning and risk assessment.

Our audit approach
We structured our approach to the audit to reflect how the Group is organised as well as ensuring our audit was both effective and risk focused. Our audit approach can be summarised into the following areas that enabled us to obtain the evidence required to form an opinion on the Group and the Bank's financial statements:

- **Risk assessment and audit planning.** We identified and instructed partners for the Group's and Bank audit, as well as identified partners to lead areas requiring significant audit judgement including expected credit losses and provisions for regulatory and litigation matters. These partners met regularly with management to understand business strategy, accounting judgements and estimations and other matters which arose during the year that could have impacted the Group's financial reporting. Our risk assessment was further informed by detailed analytics as well as other quantitative and qualitative audit procedures, including consideration of matters such as the impact of the global pandemic and climate change on the account balances, disclosures and company practices;
- **Audit procedures undertaken at a Group level and at the Bank.** In addition to the above, the Group and the Bank were subject to audit procedures. Government work-from-home orders and travel restrictions in force during the year required our team to work and communicate remotely. We were able to complete our audit work through increased videoconferencing and direct reviews of work completed, and continued to attend virtually the planning and clearance meetings with management. We also performed audit work on the Group and Bank financial statements, including the consolidation of the Group's results, the preparation of the financial statements, litigation provisions and exposures in addition to the Group's entity level and oversight controls relevant to financial reporting;
- **Internal controls testing approach.** We tested internal controls over financial reporting where our scoping and risk assessment determined those controls to be relevant to the audit. This included testing of general IT controls, process level controls and entity level controls at the Group level; and
- **The impact of climate change on our audit.** In planning our audit, we have considered the impact of climate change on the Group's operations and subsequent impact on its financial statements. The Group sets out its assessment of the potential impact in the Strategic Report on page 5 of the Annual Report.

  In conjunction with our climate risk specialists, we have held discussions with the Group to understand their:
  - process for identifying affected operations, including the governance and controls over this process, and the subsequent effect on the financial reporting for the Group; and
  - long-term strategy to respond to climate change risks as they evolve including the effect on the Group's forecasts.

  Our audit work has involved:
  - challenging the completeness of the physical and transition risks identified and considered in the Group's climate risk assessment and the conclusion that there is no material impact of climate change risk on the current year financial reporting;
  - assessing the Group's qualitative loan sector analysis, which supports the Group's conclusion that there is no material financial statement impact of climate risk on expected credit losses; and
  - assessing disclosures in the annual report, and challenging the consistency between the financial statements and the remainder of the annual report.

  As part of our audit procedures we read the Group's disclosures on page 5 and considered whether they are materially inconsistent with the financial statements or knowledge obtained in the audit and we did not identify any material inconsistencies as a result of these procedures.

4. Conclusions relating to going concern
In auditing the financial statements, we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate.

Our evaluation of the directors' assessment of the Group's and the Bank's ability to continue to adopt the going concern basis of accounting included:

- using our knowledge of the Group and the Bank, the financial services industry, the financial services regulatory environment and the general economic environment to identify inherent risks in the business model and how such risks might affect the financial resources or ability to continue operations over the going concern period;
- making enquiries of Group management about the assumptions, including climate risk considerations, used in their going concern models, and assessing the reasonableness of those assumptions and historical forecasting accuracy;
- evaluating the Group's strategic plans, short and longer term financial budgets, funding, liquidity and capital adequacy plans including internal stress tests;
- considering the Group's operational resilience;
- reading analyst reports, industry data, Bank of England reports and other external information to determine if it provided corroborative or contradictory evidence in relation to the Group's assumptions;
- reviewing correspondence and meeting with prudential and conduct regulators to assess whether there are any matters that may impact the going concern assessment;
- testing the underlying data generated to prepare the forecast scenarios and determined whether there was adequate support for the assumptions underlying the forecasts; and
- evaluating the Group's disclosures on going concern against the requirements of IAS 1.

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the Group's and the Bank's ability to continue as a going concern for a period of at least twelve months from when the financial statements are authorised for issue.

Our responsibilities and the responsibilities of the directors with respect to going concern are described in the relevant sections of this report.

5. Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit, and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Expected credit losses (Group and Bank)

Key audit matter description	How the scope of our audit responded to the key audit matter
Refer to notes 2, 3, 10, 13 and 36 in the financial statements The Group has recognised £2.6 billion of expected credit losses ("ECL") at 31 December 2021. The determination of ECL consists of a number of assumptions that require a high degree of judgement and involve complex impairment modelling. The key areas we identified as having the most significant level of management judgement were in respect of: • Multiple Economic Scenarios (MES); • Retail ECL; and • Commercial ECL.	
Multiple economic scenarios The measurement of expected credit losses is required to reflect an unbiased probability-weighted range of possible future outcomes. The Group's economics team develops the future economic scenarios. Firstly, a base case forecast is produced based on a set of conditioning assumptions, which are designed to reflect the Group's best view of future events. A full distribution of economic scenarios around this base case is produced using a Monte Carlo simulation and scenarios within that distribution are ranked using estimated relationships with industrywide historical loss data. Four scenarios are derived from the distribution as averages of constituent modelled scenarios around the 15th, 75th and 95th percentiles of the distribution corresponding to an upside, a downside and a severe downside, respectively. The upside, the base case and the downside scenarios are weighted at 30% and the severe downside at 10%. These four scenarios are then used as key assumptions in the determination of the ECL allowance. The development of these multiple economic scenarios is inherently uncertain, highly complex, and requires significant judgement. The global pandemic has increased the uncertainty of the conditioning assumptions used to develop the base case and, to account for this, the Group have recognised an adjustment to their multiple economic scenarios model to account for the significant downside uncertainties.	Working with our internal economic team and modelling specialists, we performed the following procedures: • Tested the controls over the generation of the multiple economic scenarios including those over the Group's governance processes to determine the base case, different scenarios and the weightings applied to each scenario; • Challenged and evaluated economic forecasts in the base scenario such as the unemployment rate, House Price Index and Gross Domestic Product through comparison to an independent economic outlook, external analysts and market data; • Challenged and evaluated the appropriateness of the methodology applied to generate alternative macroeconomic scenarios, including associated weightings, and assumptions within; • Tested whether the methodology has been appropriately reflected in the model code by producing an independent version of the model generating alternative macroeconomic scenarios and reconciling its outputs to the Group's model; • Tested the completeness and accuracy of the data used by the model; • Performed a stand back assessment of the appropriateness of the weightings applied to each of the scenarios based on publicly available data; and • Evaluated the adequacy of disclosures in respect of significant judgements and sources of estimation uncertainty including macroeconomic scenarios. In respect of the adjustment to the multiple economic scenarios model, we performed the following procedures: • Tested the controls over review, challenge, and approval of this central adjustment; • Tested the completeness and accuracy of the data used in the quantification of the model adjustment; and • Evaluated the adequacy of the disclosures of the adjustment, including the sensitivity analysis.

Key audit matter description	How the scope of our audit responded to the key audit matter
Retail ECL The ECL for the Retail division is determined on a collective basis using impairment models to calculate a probability weighted estimate by applying an appropriate probability of default, estimated exposure at default and taking account of collateral held or other loss mitigants, discounted using the effective interest rate. The key judgements and estimates in determining the ECL for the Retail division include: • model estimations, including model assumptions and data used such as statistical modelling triangulations, behavioral lives, and portfolio data; • the appropriate allocation of assets into the correct stage of 1, 2 or 3 under IFRS 9 'Financial Instruments' taking into account any significant deterioration in credit risk since inception; and • in-model and post-model adjustments (IMAs and PMAs) which are recognised to address identified model and data limitations.	We tested controls across the process to determine the ECL provisions including the following: • Model governance including model validation and monitoring; • In-model adjustments (IMA) and post-model adjustments (PMA); • Model assumptions; • The allocation of assets into stages; and • Data accuracy and completeness. Working with our internal modelling specialists, our audit procedures over the key areas of estimation included: • Model estimations, where we: – assessed and challenged the appropriateness of modelling approach and assumptions used; – independently replicated the models for the most material portfolios and compared outputs of our instances of the models to the Group's; – evaluated whether other models operate in line with their specification through inspecting and re-running the model code designed by the Group; – assessed model performance by evaluating variations between observed data and model predictions; – developed an understanding of and assessed model limitations and remedial actions; and – tested the completeness and accuracy of the data used in model execution and calibration. • Allocation of assets into stages, where we: – evaluated the appropriateness of quantitative and qualitative criteria used for allocation into IFRS 9 stages; – tested the appropriateness of the stage allocation for a sample of exposures; and – tested the data used by models in assigning IFRS 9 stages and evaluated the appropriateness of the model logic used. • In-model and post-model adjustments, where we: – challenged the methodology, approach and assumptions in developing IMAs and PMAs, and evaluated the Group's selection of approach for indications of bias; – tested the completeness and accuracy of the data used; – performed a recalculation of the IMAs and PMAs; and – evaluated the completeness of IMAs and PMAs based on our understanding of model and data limitations, including those highlighted by the COVID-19 pandemic. • Adequacy of disclosures, where we: – assessed whether the disclosures appropriately address the uncertainty which exists in determining the ECL.

Key audit matter description	How the scope of our audit responded to the key audit matter
Commercial ECL The ECL in the Commercial Banking division is calculated on a collective basis for performing loans, being those in stage 1 and 2, and on an individual basis for larger impaired loans in stage 3. The collective provision is determined using impairment models. The models use a number of significant judgments to calculate a probability weighted ECL estimate applying an appropriate probability of default, estimated exposure at default and taking account of collateral held or other loss mitigants, discounted using the effective interest rate. The key driver of the probability of default and, therefore, the staging of Commercial Banking exposures is the credit risk rating. The determination of these credit risk ratings is performed on a counterparty basis for larger exposures by a credit officer and involves a high degree of judgement and consideration of multiple sources of information. Therefore, we focused our work on testing the credit risk ratings feeding the collective models and the appropriateness of the methodology. For individual assessments of larger exposures in Stage 3, the significant judgements in determining provisions and where we focused our work are the: • completeness and appropriateness of the potential workout and restructuring scenarios identified; • probability assigned to each identified potential workout and restructuring scenario through the use of best, likely or worst case flags; and • valuation assumptions used in determining the workout and restructuring scenarios.	We tested the controls across the process to determine the ECL provisions including: • the determination of credit risk ratings; • the allocation into stages, particularly the assessment of a significant change in credit risk; • model governance and arithmetical accuracy of provision calculations; • data accuracy and completeness; and • recognition and calculation of post-model adjustments. We performed the following audit procedures over: • Expected credit losses determined through impairment models: – Independently assessed the credit rating and tested whether a significant increase in credit risk had occurred to result in a stage 2 classification against IFRS 9 criteria; – Assessed and challenged the model methodologies, approach and assumptions, including those used in developing the IMAs and PMAs; – Tested the completeness and accuracy of data used; and – Performed a recalculation of the IFRS 9 collective provision. • Expected credit losses assessed individually: – Assessed the exposures to determine if they met the definition of credit impaired; – Performed independent assessments to determine the appropriateness of recovery scenarios and associated cash flows, including considerations of climate risks on recoveries; – Evaluated valuations, including the use of internal specialists for business valuations; and – Independently assessed and challenged the completeness of workout and restructuring scenarios identified and weightings applied. • Adequacy of disclosures, where we: – assessed whether the disclosures appropriately address the uncertainty which exists in determining the ECL.

Key observations communicated to the Audit Committee

We are satisfied that the ECL are reasonable and recognised in accordance with the requirements of IFRS 9. The calculations are based on appropriate methodologies using reasonable modelled assumptions, including IMAs and PMAs addressing model shortcomings. Where control deficiencies were identified, particularly in data linkage to models, compensating controls were identified and operated effectively. Overall ECL levels are reasonable compared to peer benchmarking information, although we did identify some prudence in our assessment of some of the model adjustments.

Regulatory and litigation matters (Group and Bank)	
Key audit matter description	**How the scope of our audit responded to the key audit matter**
Refer to notes 2, 3 and 23 in the financial statements.	
The Group operates in an environment where it is subject to regulatory investigations, litigation and customer remediation. The Group is currently exposed to a number of regulatory and litigation matters. The provision for these matters at both the Group and Bank is £0.8bn at 31 December 2021, the most significant of which is the HBOS Reading matter. Significant judgement is required by the Group in determining whether, under IAS 37 Provisions, Contingent Liabilities and Contingent Assets: • a reliable estimate can be made of the amount of the obligation, particularly where the information available is limited as is the case with HBOS Reading; and • any contingent liabilities and underlying significant estimation uncertainties are adequately disclosed.	We performed the following audit procedures: • Tested the Group's controls over the completeness of provisions, the robustness of the assessment of the provision against the requirements of IAS 37, the appropriateness of judgements used to determined a 'best estimate' and the completeness and accuracy of data used in the process; • evaluated the assessment of the provisions, associated probabilities, and potential outcomes in accordance with IAS 37; • verified and challenged whether the methodology, data and significant judgements and assumptions used in the valuation of the provisions are appropriate in the context of the applicable financial reporting framework; • In respect of HBOS Reading, we inspected information available for the limited number of awards made by the Foskett panel and tested the methodology applied to determine the provision; • inspected correspondence and, where appropriate, made direct enquiry with the Group's regulators and internal and external legal counsel; • where no provision was made, we critically assessed and challenged the conclusion in the context of the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and • evaluated whether the disclosures made in the financial statements appropriately reflect the facts and key sources of estimation uncertainty.

Key observations communicated to the Audit Committee

While there is significant judgement required in estimating the timing and value of future settlements, particularly in relation to the HBOS Reading matter, we are satisfied that the approach to the estimation of these provisions is consistent with the requirements of IAS 37.

IT systems that impact financial reporting (Group and Bank)	
Key audit matter description	**How the scope of our audit responded to the key audit matter**
The Group's IT environment is inherently complex as it supports a broad range of banking products and facilitates the processing of a significant volume of transactions. The IT systems within the Group form a critical component of the Group's financial reporting activities and impact all account balances with a reliance on automated and IT dependent manual controls. Due to the significant reliance on IT systems, effective General IT Controls (GITCs) are critical to allow reliance to be placed on the completeness and accuracy of financial data and the integrity of automated system functionality (e.g. system calculations). We identified the IT systems that impact financial reporting as a key audit matter because of the: • pervasive reliance on complex technology that is integral to the operation of key business processes and financial reporting; • reliance on technology which continues to develop in line with the business strategy, such as the increase in the use of automation across the Group and increasing reliance on third parties; and • importance of the IT controls in maintaining an effective control environment. A key interdependency exists between the ability to rely on IT controls and the ability to rely on financial data, system configured automated controls and system reports. IT controls, in the context of our audit scope, primarily relate to privileged access at the infrastructure level, user access security at the application level and change control.	Our IT audit scope tested the Group's IT controls over information systems deemed relevant to the audit based on the financial data, system configured automated controls and/or key financial reports that reside within it. We used IT specialists to support our evaluation of the risks associated with IT in the following areas: • General IT Controls, including user access and change management controls; • Key financial reports and system configured automated controls; and • Cyber security risk assessment. Where deficiencies in the IT control environment were identified, our risk assessment procedures included an assessment of those deficiencies to determine the impact on our audit plan. Where relevant, the audit plan was adjusted to mitigate the unaddressed IT risk. Where we were able to identify and test appropriate mitigating controls over affected financial statement line items, our testing approach remained unchanged. In a limited number of areas, we adopted a non-controls reliance approach and we therefore performed additional substantive procedures.

Key observations communicated to the Audit Committee

IT control deficiencies were identified in respect of privileged user access to IT infrastructure and in application user access management. The existence of these deficiencies in the year resulted in an increased risk in relation to data, reports and automated system functionality from the affected systems.

However, overall, in combination with business mitigating controls, we are satisfied that the Group's overall IT control environment appropriately supports the financial reporting process.

6. Our application of materiality

6.1 Materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Bank financial statements
Materiality	£155 million (2020: £120 million)	£155 million (2020: £120 million)
Basis for determining materiality	In determining our benchmark for materiality, we have considered the metrics used by investors and other users of the financial statements. We have determined the following benchmarks to be the most relevant to users of the financial statements: • Pre-tax profit; and • Net assets. The determined materiality represents 6.7% of pre-tax profit and 1.0% of net assets. The increase in materiality from the predecessor auditor's determination of £120 million in 2020 is primarily due to the increase in profit at 31 December 2021.	The Bank's materiality represents 0.6% of net assets, and is capped at Group materiality.
Rationale for the benchmark applied	Given the importance of these measures to investors and users of the financial statements, we have used pre-tax profit as the primary benchmark for our determination of materiality, and net assets as a supporting benchmark.	The users of the Bank's financial statements are primarily focused on the balance sheet since it is considered a key indicator of financial health. As such, we have used net assets as the benchmark for materiality. However, given the size of the entity's balance sheet, we have capped materiality at the Group's materiality.

6.2 Performance materiality

We set performance materiality at a level lower than materiality to reduce the probability that, in aggregate, uncorrected and undetected misstatements exceed the materiality for the financial statements as a whole.

	Group financial statements	Bank financial statements
Performance materiality	60% of Group materiality – £92 million	60% of Bank materiality – £92 million
Basis and rationale for determining performance materiality	In determining performance materiality, we considered the following factors: a. The current financial year being Deloitte LLP's first year auditing the Group and the Bank's financial statements; b. The quality of the control environment and whether we were able to rely on controls; c. Degree of centralisation and commonality of controls and processes; d. The uncertain economic environment arising from the COVID-19 pandemic; e. The nature, volume and size of uncorrected misstatements arising in the previous audit; and f. The nature, volume and size of uncorrected misstatements that remain uncorrected in the current period.	

6.3 Error reporting threshold

We agreed with the Audit Committee that we would report all audit differences in excess of £8 million (2020: £12 million), as well as any differences below this threshold, which in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

7. Other Information

The other information comprises the information included in the Annual Report, other than the financial statements and our auditor's report thereon. The Directors are responsible for the other information contained within the Annual Report. Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon. Our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in course of the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether this gives rise to a material misstatement in the financial statements themselves. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We summarise below our work in relation to areas of the other information including those areas upon which we are specifically required to report:	**We have nothing to report in this regard.**

	Our responsibility	Our reporting
Matters we are specifically required to report		
Strategic report and directors' report	Report whether they are consistent with the audited financial statements and are prepared in accordance with applicable legal requirements. Report if we have identified any material misstatements in either report in the light of the knowledge and understanding of the Group and of the Bank and their environment obtained in the course of the audit.	As set out in the section "Opinions on other matters prescribed by the Companies Act 2006", in our opinion, based on the work undertaken in the course of the audit, the information in these reports is consistent with the audited financial statements and has been prepared in accordance with applicable legal requirements.
Principal risks (within the Strategic Report)	Review the confirmation and description in the light of the knowledge gathered during the audit, such as through considering the directors' processes to support the statements made, challenging the Group's key judgements and estimates, consideration of historical forecasting accuracy and evaluating macro-economic assumptions.	We have nothing to report in respect of these matters.

8. Responsibilities of Directors

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the Bank's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the Bank or to cease operations, or have no realistic alternative but to do so.

9. Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

10. Extent to which the audit was considered capable of detecting irregularities, including fraud

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud is detailed below.

Identifying and assessing potential risks related to irregularities

In identifying and assessing the risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, we considered the following:

- The nature of the industry and sector, control environment and business performance including the design of the Group’s remuneration policies, key drivers for directors’ remuneration, bonus levels and performance targets;
- The Group’s own assessment of the risks that irregularities may occur either as a result of fraud or error that was approved by the board on 23 February 2022;
- Enquiring of management, in-house legal counsel, internal audit and the Audit Committee, including obtaining and reviewing supporting documentation, concerning the Group’s policies and procedures relating to:
  - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
  - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud; and
  - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations;
- Discussing among the engagement team including relevant internal specialists, including tax, valuations, pensions, IT and industry specialists regarding how and where fraud might occur in the financial statements and any potential indicators of fraud; and
- Obtaining an understanding of the legal and regulatory frameworks that the Group and the Bank operate in, focusing on those laws and regulations that had a direct effect on the financial statements, such as provisions of the UK Companies Act, pensions legislation and tax legislation or that had a fundamental effect on the operations of the Group, including regulation and supervisory requirements of the Prudential Regulation Authority, Financial Reporting Council and Financial Conduct Authority.

Audit response to risks identified

As a result of performing the above, we identified the Group’s and Bank’s determination of “expected credit losses” as a key audit matter related to the potential risk of fraud. The key audit matters section of our report explains the matter in more detail and also describes the specific procedures in response to those key audit matters. In common with all audits under ISAs (UK), we are also required to perform specific procedures to respond to the risk of management override.

In addition to the above, our procedures to respond to risks identified included the following:

- Reviewing the financial statement disclosures and testing to supporting documentation to assess compliance with provisions of relevant laws and regulations described as having a direct effect on the financial statements;
- Enquiring of management, the Audit Committee and in-house and external legal counsel concerning actual and potential litigation and claims;
- Performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- Reading minutes of meetings of those charged with governance, reviewing internal audit reports and correspondence with regulators; and
- In addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments; assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including specialists and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

Report on other legal and regulatory requirements

11. Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- 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 strategic report and the directors' report have been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the Group and of the Bank and their environment obtained in the course of the audit, we have not identified any material misstatements in the strategic report or the directors' report.

12. Matters on which we are required to report by exception

Adequacy of explanations received and accounting records 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 Bank, or returns adequate for our audit have not been received from branches not visited by us; or • The Bank's financial statements are not in agreement with the accounting records and returns.	**We have nothing to report in respect of these matters.**
Directors' remuneration Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of directors' remuneration have not been made or is not in agreement with the accounting records and returns.	**We have nothing to report in respect of these matters.**

13. Other matters which we are required to address

Auditor tenure

Following the recommendation of the Audit Committee, we were appointed by shareholders at its annual general meeting on 20 May 2021 to audit the financial statements of Lloyds Banking Group, including BOS plc for the year ended 31 December 2021 and subsequent financial periods. The period of total uninterrupted engagement of the firm is accordingly one year.

Consistency of the audit report with the additional report to the Audit Committee

Our audit opinion is consistent with the additional report to the Audit Committee we are required to provide in accordance with ISAs (UK).

14. Use of our report

This report is made solely to the Bank's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Bank's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank's members as a body, for our audit work, for this report, or for the opinions we have formed.

As required by the Financial Conduct Authority (FCA) Disclosure Guidance and Transparency Rule (DTR) 4.1.14R, these financial statements form part of the European Single Electronic Format (ESEF) prepared Annual Financial Report filed on the National Storage Mechanism of the UK FCA in accordance with the ESEF Regulatory Technical Standard ('ESEF RTS'). This auditor's report provides no assurance over whether the annual financial report has been prepared using the single electronic format specified in the ESEF RTS.

Michael Lloyd

Michael Lloyd (Senior Statutory Auditor)
For and on behalf of Deloitte LLP
Statutory Auditor
London, United Kingdom
8 March 2022

Consolidated income statement

for the year ended 31 December 2021

	Note	2021 £ million	2020 £ million
Interest income		**7,222**	7,565
Interest expense		**(1,898)**	(2,357)
Net interest income	4	**5,324**	5,208
Fee and commission income		**532**	468
Fee and commission expense		**(277)**	(269)
Net fee and commission income	5	**255**	199
Net trading income (losses)	6	**47**	(369)
Other operating income	7	**137**	109
Other income		**439**	(61)
Total income		**5,763**	5,147
Operating expenses	8	**(3,822)**	(2,642)
Impairment credit (charge)	10	**375**	(1,622)
Profit before tax		**2,316**	883
Tax (expense) credit	11	**(368)**	30
Profit for the year		**1,948**	913
Profit attributable to ordinary shareholders		**1,838**	749
Profit attributable to other equity holders		**109**	164
Profit attributable to equity holders		**1,947**	913
Profit attributable to non-controlling interests		**1**	—
Profit for the year		**1,948**	913

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

Statements of comprehensive income

for the year ended 31 December 2021

	The Group		The Bank	
	2021	2020	**2021**	2020
	£ million	£ million	**£ million**	£ million
Profit for the year	**1,948**	913	**1,962**	915
Other comprehensive income				
Items that will not subsequently be reclassified to profit or loss:				
Post-retirement defined benefit scheme remeasurements:				
Remeasurements before tax	**(12)**	22	**(12)**	22
Tax	**—**	(7)	**—**	(7)
	(12)	15	**(12)**	15
Items that may subsequently be reclassified to profit or loss:				
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income:				
Change in fair value	**(2)**	24	**(2)**	25
Income statement transfers in respect of disposals	**—**	(10)	**—**	(10)
Tax	**12**	(2)	**(1)**	(4)
	10	12	**(3)**	11
Movements in cash flow hedging reserve:				
Effective portion of changes in fair value taken to other comprehensive income	**(48)**	(3)	**(48)**	(3)
Net income statement transfers	**19**	(4)	**19**	(4)
Tax	**11**	3	**11**	3
	(18)	(4)	**(18)**	(4)
Movements in foreign currency translation reserve:				
Currency translation differences (tax: £nil)	**1**	(7)	**—**	(8)
Total other comprehensive income for the year, net of tax	**(19)**	16	**(33)**	14
Total comprehensive income for the year	**1,929**	929	**1,929**	929
Total comprehensive income attributable to ordinary shareholders	**1,819**	765	**1,820**	765
Total comprehensive income attributable to other equity holders	**109**	164	**109**	164
Total comprehensive income attributable to equity holders	**1,928**	929	**1,929**	929
Total comprehensive income attributable to non-controlling interests	**1**	—	**—**	—
Total comprehensive income for the year	**1,929**	929	**1,929**	929

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

Balance sheets

at 31 December 2021

	Note	The Group 2021 £ million	The Group 2020 £ million	The Bank 2021 £ million	The Bank 2020 £ million
Assets					
Cash and balances at central banks		**3,201**	2,841	**3,201**	2,841
Items in the course of collection from banks		**47**	42	**47**	42
Financial assets at fair value through profit or loss		**362**	477	**152**	158
Derivative financial instruments	12	**4,264**	7,423	**4,264**	7,423
Loans and advances to banks		**51**	207	**50**	205
Loans and advances to customers		**279,409**	263,766	**276,005**	259,697
Due from fellow Lloyds Banking Group undertakings		**17,062**	28,988	**23,919**	38,726
Financial assets at amortised cost	13	**296,522**	292,961	**299,974**	298,628
Financial assets at fair value through other comprehensive income		**2,047**	2,395	**2,047**	2,395
Goodwill	15	**325**	325	**325**	325
Current tax recoverable		**238**	356	**293**	395
Deferred tax assets	22	**2,007**	1,721	**1,991**	1,718
Investment in subsidiary undertakings	16	**—**	—	**84**	74
Retirement benefit assets		**58**	69	**58**	69
Other assets[1]	17	**1,489**	1,718	**1,476**	1,696
Total assets		**310,560**	310,328	**313,912**	315,764
Liabilities					
Deposits from banks[1]		**597**	1,015	**597**	1,014
Customer deposits		**170,777**	163,001	**170,776**	163,000
Repurchase agreements[1]		**30,028**	13,680	**30,028**	13,680
Due to fellow Lloyds Banking Group undertakings		**77,839**	91,953	**83,193**	99,612
Items in course of transmission to banks		**98**	98	**98**	98
Financial liabilities at fair value through profit or loss		**33**	45	**—**	—
Derivative financial instruments	12	**4,320**	8,672	**4,144**	8,360
Notes in circulation		**1,321**	1,305	**1,321**	1,305
Debt securities in issue	19	**7,353**	8,297	**6,140**	7,012
Other liabilities	21	**1,450**	1,389	**1,288**	1,220
Current tax liabilities		**—**	—	**—**	10
Other provisions	23	**1,057**	521	**1,057**	519
Subordinated liabilities	24	**1,644**	6,964	**1,644**	6,964
Total liabilities		**296,517**	296,940	**300,286**	302,794
Equity					
Share capital	25	**5,847**	5,847	**5,847**	5,847
Other reserves	26	**2,013**	2,020	**2,025**	2,046
Retained profits[2]	27	**3,975**	3,313	**3,554**	2,877
Ordinary shareholders' equity		**11,835**	11,180	**11,426**	10,770
Other equity instruments	28	**2,200**	2,200	**2,200**	2,200
Total equity excluding non-controlling interests		**14,035**	13,380	**13,626**	12,970
Non-controlling interests		**8**	8	**—**	—
Total equity		**14,043**	13,388	**13,626**	12,970
Total equity and liabilities		**310,560**	310,328	**313,912**	315,764

1 See note 1 regarding changes to presentation.

2 The Bank recorded a profit after tax for the year of £1,962 million (2020: £915 million).

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

The Directors approved the financial statements on 8 March 2022.

Robin Budenberg
Chair

Charlie Nunn
Chief Executive

William Chalmers
Chief Financial Officer

Statements of changes in equity

for the year ended 31 December 2021

	Attributable to ordinary shareholders						
The Group	**Share capital £ million**	**Other reserves £ million**	**Retained profits £ million**	**Total £ million**	**Other equity instruments £ million**	**Non-controlling interests £ million**	**Total £ million**
At 1 January 2020	5,847	2,019	2,516	10,382	2,700	8	13,090
Comprehensive income							
Profit for the year	—	—	749	749	164	—	913
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	—	—	15	15	—	—	15
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	—	12	—	12	—	—	12
Movements in cash flow hedging reserve, net of tax	—	(4)	—	(4)	—	—	(4)
Movements in foreign currency translation reserve, net of tax	—	(7)	—	(7)	—	—	(7)
Total other comprehensive income	—	1	15	16	—	—	16
Total comprehensive income[1]	—	1	764	765	164	—	929
Transactions with owners							
Distributions on other equity instruments	—	—	—	—	(164)	—	(164)
Issue of other equity instruments (note 28)	—	—	—	—	1,000	—	1,000
Redemption of other equity instruments (note 28)	—	—	—	—	(1,500)	—	(1,500)
Capital contributions received	—	—	33	33	—	—	33
Total transactions with owners	—	—	33	33	(664)	—	(631)
At 31 December 2020	5,847	2,020	3,313	11,180	2,200	8	13,388
Comprehensive income							
Profit for the year	**—**	**—**	**1,838**	**1,838**	**109**	**1**	**1,948**
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	**—**	**—**	**(12)**	**(12)**	**—**	**—**	**(12)**
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	**—**	**10**	**—**	**10**	**—**	**—**	**10**
Movements in cash flow hedging reserve, net of tax	**—**	**(18)**	**—**	**(18)**	**—**	**—**	**(18)**
Movements in foreign currency translation reserve, net of tax	**—**	**1**	**—**	**1**	**—**	**—**	**1**
Total other comprehensive income	**—**	**(7)**	**(12)**	**(19)**	**—**	**—**	**(19)**
Total comprehensive income[1]	**—**	**(7)**	**1,826**	**1,819**	**109**	**1**	**1,929**
Transactions with owners							
Dividends (note 29)	**—**	**—**	**(1,200)**	**(1,200)**	**—**	**(1)**	**(1,201)**
Distributions on other equity instruments	**—**	**—**	**—**	**—**	**(109)**	**—**	**(109)**
Capital contributions received	**—**	**—**	**36**	**36**	**—**	**—**	**36**
Total transactions with owners	**—**	**—**	**(1,164)**	**(1,164)**	**(109)**	**(1)**	**(1,274)**
At 31 December 2021	**5,847**	**2,013**	**3,975**	**11,835**	**2,200**	**8**	**14,043**

1 Total comprehensive income attributable to owners of the parent was £1,928 million (2020: £929 million).

Further details of movements in the Group's share capital and reserves are provided in notes 25, 26, 27 and 28.

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

Statements of changes in equity

for the year ended 31 December 2021

The Bank	Attributable to ordinary shareholders Share capital £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Total £ million
At 1 January 2020	5,847	2,047	2,078	9,972	2,700	12,672
Comprehensive income						
Profit for the year	—	—	751	751	164	915
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of tax	—	—	15	15	—	15
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	—	11	—	11	—	11
Movements in cash flow hedging reserve, net of tax	—	(4)	—	(4)	—	(4)
Movements in foreign currency translation reserve, net of tax	—	(8)	—	(8)	—	(8)
Total other comprehensive income	—	(1)	15	14	—	14
Total comprehensive income[1]	—	(1)	766	765	164	929
Transactions with owners						
Distributions on other equity instruments	—	—	—	—	(164)	(164)
Issue of other equity instruments (note 28)	—	—	—	—	1,000	1,000
Redemption of other equity instruments (note 28)	—	—	—	—	(1,500)	(1,500)
Capital contributions received	—	—	33	33	—	33
Total transactions with owners	—	—	33	33	(664)	(631)
At 31 December 2020	5,847	2,046	2,877	10,770	2,200	12,970
Comprehensive income						
Profit for the year	**—**	**—**	**1,853**	**1,853**	**109**	**1,962**
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of tax	**—**	**—**	**(12)**	**(12)**	**—**	**(12)**
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	**—**	**(3)**	**—**	**(3)**	**—**	**(3)**
Movements in cash flow hedging reserve, net of tax	**—**	**(18)**	**—**	**(18)**	**—**	**(18)**
Total other comprehensive income	**—**	**(21)**	**(12)**	**(33)**	**—**	**(33)**
Total comprehensive income[1]	**—**	**(21)**	**1,841**	**1,820**	**109**	**1,929**
Transactions with owners						
Dividends (note 29)	**—**	**—**	**(1,200)**	**(1,200)**	**—**	**(1,200)**
Distributions on other equity instruments	**—**	**—**	**—**	**—**	**(109)**	**(109)**
Capital contributions received	**—**	**—**	**36**	**36**	**—**	**36**
Total transactions with owners	**—**	**—**	**(1,164)**	**(1,164)**	**(109)**	**(1,273)**
At 31 December 2021	**5,847**	**2,025**	**3,554**	**11,426**	**2,200**	**13,626**

1 Total comprehensive income attributable to owners of the parent was £1,929 million (2020: £929 million).

Further details of movements in the Bank's share capital and reserves are provided in notes 25, 26, 27 and 28.

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

Cash flow statements

for the year ended 31 December 2021

		The Group		The Bank	
		2021	2020	**2021**	2020
	Note	**£ million**	£ million	**£ million**	£ million
Profit before tax		**2,316**	883	**2,305**	890
Adjustments for:					
Change in operating assets	37(A)	**47**	64,868	**2,094**	65,126
Change in operating liabilities	37(B)	**4,351**	(66,150)	**2,275**	(66,463)
Non-cash and other items	37(C)	**263**	1,052	**251**	1,036
Tax paid (net)		**(520)**	(313)	**(511)**	(282)
Net cash provided by operating activities		**6,457**	340	**6,414**	307
Cash flows from investing activities					
Purchase of financial assets		**(107)**	(745)	**(107)**	(745)
Proceeds from sale and maturity of financial assets		**399**	624	**399**	624
Dividends received from subsidiaries		**—**	—	**49**	45
Purchase of fixed assets		**(171)**	(179)	**(171)**	(170)
Proceeds from sale of fixed assets		**41**	20	**41**	1
Net cash provided by (used in) investing activities		**162**	(280)	**211**	(245)
Cash flows from financing activities					
Dividends paid to ordinary shareholders	29	**(1,200)**	—	**(1,200)**	—
Dividends paid to non-controlling interests		**(1)**	—	**—**	—
Distributions on other equity instruments		**(109)**	(164)	**(109)**	(164)
Interest paid on subordinated liabilities		**(88)**	(146)	**(94)**	(146)
Proceeds from issue of subordinated liabilities		**500**	1,000	**500**	1,000
Proceeds from issue of other equity instruments		**—**	1,000	**—**	1,000
Repayment of subordinated liabilities		**(5,714)**	(161)	**(5,714)**	(161)
Redemption of other equity instruments		**—**	(1,500)	**—**	(1,500)
Net cash (used in) provided by financing activities		**(6,612)**	29	**(6,617)**	29
Effect of exchange rate changes on cash and cash equivalents		**(1)**	1	**(1)**	1
Change in cash and cash equivalents		**6**	90	**7**	92
Cash and cash equivalents at beginning of year		**849**	759	**847**	755
Cash and cash equivalents at end of year	37(D)	**855**	849	**854**	847

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

Note 1: Basis of preparation

The consolidated financial statements of Bank of Scotland plc (the Bank) together with its subsidiary undertakings (the Group) have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006. The financial statements have also been prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IASB).

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, financial assets measured at fair value through other comprehensive income, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts. The Directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements. In reaching this assessment, the Directors have considered the implications of the short-term impacts of the COVID-19 pandemic and climate change upon the Group's performance and projected funding and capital position. The Directors have also taken into account the impact of further stress scenarios.

The IASB has issued a number of minor amendments to IFRSs effective 1 January 2022 and in later years (including IFRS 9 *Financial Instruments* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). These amendments are not expected to have a significant impact on the Group.

In 2019 the Group adopted IFRS 16 and amendments to IAS 12 and early-adopted the hedge accounting amendments *Interest Rate Benchmark Reform* issued by the IASB. In 2021, the Group has adopted the *Interest Rate Benchmark Reform* Phase 2 amendments issued by the IASB. These amendments require that changes to expected future cash flows that both arise as a direct result of IBOR Reform and are economically equivalent to the previous cash flows are accounted for as a change to the effective interest rate with no adjustment to the asset's or liability's carrying value; no immediate gain or loss is recognised. The new requirements also provide relief from the requirements to discontinue hedge accounting as a result of amending hedge documentation if the changes are required solely as a result of IBOR Reform. The amendments do not have a material impact on the Group's comparatives, which have not been restated.

IFRS 8 *Operating Segments* requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision-maker has been identified as the Group Executive Committee of Lloyds Banking Group. The Bank of Scotland Group is managed on an entity basis and not by segment. The Group Executive Committee does not assess the Bank of Scotland Group's performance and allocate resources across any segments, accordingly no segmental information is provided. A brief overview of the Group's sources of income is provided in the Business review. The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Lloyds Banking Group.

Property, plant and equipment and capitalised software enhancements, previously presented separately on the face of the balance sheet, are now both included within other assets (note 17). Repurchase agreements, previously reported within deposits from banks are now shown separately on the face of the balance sheet. There has been no change in the basis of accounting for any of the underlying transactions. Comparatives have been presented on a consistent basis for all of the above.

Note 2: Accounting policies

The 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. Details of the Group's subsidiaries and related undertakings are given on page 101.

(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.

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.

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)(4) below) or share capital (see (O) below). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

Note 2: Accounting policies (continued)

(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. Joint control is the contractually agreed sharing of control of an arrangement and only exists when decisions about the relevant activities require the unanimous consent of the parties sharing control. 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.

(B) Goodwill

Goodwill arises on business combinations and 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. 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.

(C) Other intangible assets

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: up to 7 years for capitalised software; 10 to 15 years for brands and other intangible assets.

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.

(D) Revenue recognition

(1) Net interest income

Interest income and expense are recognised in the income statement using the effective interest method for all interest-bearing financial instruments, 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 to the gross carrying amount of the financial asset (before adjusting for expected credit losses) or to the amortised cost of the financial liability, including early redemption fees, other fees, and premiums and discounts that are an integral part of the overall return. In the case of financial assets that are purchased or originated credit-impaired, the effective interest rate is the rate that discounts the estimated future cash flows to the amortised cost of the instrument. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account. Interest income from non-credit impaired financial assets is recognised by applying the effective interest rate to the gross carrying amount of the asset; for credit impaired financial assets, the effective interest rate is applied to the net carrying amount after deducting the allowance for expected credit losses. Impairment policies are set out in (H) below.

(2) Fee and commission income and expense

Fees and commissions receivable which are not an integral part of the effective interest rate are recognised as income as the Group fulfils its performance obligations. The Group's principal performance obligations arising from contracts with customers are in respect of value added current accounts, credit cards and debit cards. These fees are received, and the Group provides the service, monthly; the fees are recognised in income on this basis. The Group also receives certain fees in respect of its asset finance business where the performance obligations are typically fulfilled towards the end of the customer contract; these fees are recognised in income on this basis. Where it is unlikely that the loan commitments will be drawn, loan commitment fees are recognised in fee and commission income over the life of the facility, rather than as an adjustment to the effective interest rate for loans expected to be drawn. Incremental costs incurred to generate fee and commission income are charged to fees and commissions expense as they are incurred.

(3) Other

Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to trading income are set out in (E)(3) below; those relating to leases are set out in (J)(1) below.

(E) Financial assets and liabilities

On initial recognition, financial assets are classified as measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss, depending on the Group's business model for managing the financial assets and whether the cash flows represent solely payments of principal and interest. The Group assesses its business models at a portfolio level based on its objectives for the relevant portfolio, how the performance of the portfolio is managed and reported, and the frequency of asset sales. Financial assets with embedded derivatives are considered in their entirety when considering their cash flow characteristics. The Group reclassifies financial assets only when its business model for managing those assets changes. A reclassification will only take place when the change is significant to the Group's operations and will occur at a portfolio level and not for individual instruments; reclassifications are expected to be rare.

The Group initially recognises loans and advances, 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 the obligation is discharged, cancelled or expires.

Note 2: Accounting policies (continued)

(1) Financial instruments measured at amortised cost
Financial assets that are held to collect contractual cash flows where those cash flows represent solely payments of principal and interest are measured at amortised cost. A basic lending arrangement results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Where the contractual cash flows introduce exposure to risks or volatility unrelated to a basic lending arrangement such as changes in equity prices or commodity prices, the payments do not comprise solely principal and interest. Financial assets measured at amortised cost are predominantly loans and advances to customers and banks together with certain debt securities used by the Group to manage its liquidity. Loans and advances are initially recognised when cash is advanced to the borrower at fair value inclusive of transaction costs. Interest income is accounted for using the effective interest method (see (D) above).

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.

Where changes are made to the contractual cash flows of a financial asset or financial liability that are economically equivalent and arise as a direct consequence of interest rate benchmark reform, the Group updates the effective interest rate and does not recognise an immediate gain or loss.

(2) Financial assets measured at fair value through other comprehensive income
Financial assets that are held to collect contractual cash flows and for subsequent sale, where the assets' cash flows represent solely payments of principal and interest, are recognised in the balance sheet at their fair value, inclusive of transaction costs. Interest calculated using the effective interest method and foreign exchange gains and losses on assets denominated in foreign currencies are recognised in the income statement. All other gains and losses arising from changes in fair value are recognised directly in other comprehensive income, until the financial asset is either sold or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement other than in respect of equity shares, for which the cumulative revaluation amount is transferred directly to retained profits. The Group recognises a charge for expected credit losses in the income statement (see (H) below). As the asset is measured at fair value, the charge does not adjust the carrying value of the asset, it is reflected in other comprehensive income.

(3) Financial instruments measured at fair value through profit or loss
Financial assets are classified at fair value through profit or loss where they do not meet the criteria to be measured at amortised cost or fair value through other comprehensive income or where they are designated at fair value through profit or loss to reduce an accounting mismatch. All derivatives are carried at fair value through profit or loss. Derivatives are carried on the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 33(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

Derivatives embedded in a financial asset are not considered separately; the financial asset is considered in its entirety when determining whether its cash flows are solely payments of principal and interest. Derivatives embedded in financial liabilities 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.

Trading securities, which 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, do not meet these criteria and are also measured at fair value through profit or loss. Financial assets measured at fair value through profit or loss are recognised in the balance sheet at their fair value. Fair value gains and losses together with interest coupons and dividend income are recognised in the income statement within net trading income.

Financial liabilities are measured at fair value through profit or loss where they are trading liabilities or where they are designated at fair value through profit or loss in order to reduce an accounting mismatch; where the liabilities are part of a group of liabilities (or assets and liabilities) which is managed, and its performance evaluated, on a fair value basis; or where the 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. Financial liabilities measured at fair value through profit or loss are recognised in the balance sheet at their fair value. Fair value gains and losses are recognised in the income statement within net trading income in the period in which they occur.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices, respectively, which include the expected effects of potential changes to laws and regulations, risks associated with climate change and other factors. If the market is not active the Group establishes a fair value by using valuation techniques. The fair values of derivative financial instruments are adjusted where appropriate to reflect credit risk (via credit valuation adjustments (CVAs), debit valuation adjustments (DVAs) and funding valuation adjustments (FVAs)), market liquidity and other risks.

(4) 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 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.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the carrying value of the liability and the fair value of the new equity is recognised in profit or loss.

(5) 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 for repos carried at fair value are included within 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 measured at amortised cost or at fair value. Those measured at fair value are recognised within 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.

Note 2: Accounting policies (continued)

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 advance measured at amortised cost or customer deposit.

(F) Hedge accounting
As permitted by IFRS 9, the Group continues to apply the requirements of IAS 39 to its hedging relationships.

Changes in the fair value of all derivative instruments, other than those in effective cash flow and net investment hedging relationships, are recognised immediately in the income statement. As noted in (2) below, the change in fair value of a derivative in an effective cash flow hedging relationship is allocated between the income statement and other comprehensive income.

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, 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. Note 12 provides details of the types of derivatives held by the Group and presents separately those designated in hedge relationships.

Where there is uncertainty arising from interest rate benchmark reform, the Group assumes that the interest rate benchmark on which the hedged cash flows and/or the hedged risk are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of interest rate benchmark reform. The Group does not discontinue a hedging relationship during the period of uncertainty arising from the interest rate benchmark reform solely because the actual results of the hedge are not highly effective.

Where the contractual terms of a financial asset, financial liability or derivative are amended, on an economically equivalent basis, as a direct consequence of interest rate benchmark reform, the uncertainty arising from the reform is no longer present. In these circumstances, the Group amends the hedge documentation to reflect the changes required by the reform; these changes to the documentation do not in and of themselves result in the discontinuation of hedge accounting or require the designation of a new hedge relationship.

(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 a financial asset at fair value through other comprehensive income. 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 hedging 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.

(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 offset 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
The impairment charge in the income statement reflects the change in expected credit losses, including those arising from fraud. Expected credit losses are recognised for loans and advances to customers and banks, other financial assets held at amortised cost, financial assets (other than equity investments) measured at fair value through other comprehensive income, and certain loan commitments and financial guarantee contracts. Expected credit losses are calculated as an unbiased and probability-weighted estimate using an appropriate probability of default, adjusted to take into account a range of possible future economic scenarios, and applying this to the estimated exposure of the Group at the point of default after taking into account the value of any collateral held, repayments, or other mitigants of loss and including the impact of discounting using the effective interest rate.

At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is made for expected credit losses resulting from default events that are possible within the next 12 months (12-month expected credit losses). In the event of a significant increase in credit risk since origination, allowance (or provision) is made for expected credit losses resulting from all possible default events over the expected life of the financial instrument (lifetime expected credit losses). Financial assets where 12-month expected credit losses are recognised are considered to be Stage 1; financial assets which are considered to have experienced a significant increase in credit risk since initial recognition are in Stage 2; and financial assets which have defaulted or are otherwise considered to be credit-impaired are allocated to Stage 3. Some Stage 3 assets are subject to individual rather than collective assessment. Such cases are subject to a risk-based impairment sanctioning process, and these are reviewed and updated at least quarterly, or more frequently if there is a significant change in the credit profile. The collective assessment of impairment aggregates financial instruments with similar risk characteristics, such as whether the facility is revolving in nature or secured and the type of security against financial assets.

An assessment of whether credit risk has increased significantly since initial recognition considers the change in the risk of default occurring over the remaining expected life of the financial instrument. In determining whether there has been a significant increase in credit risk, the Group uses quantitative tests based on relative and absolute probability of default (PD) movements linked to internal credit ratings together with qualitative indicators such as watchlists and other indicators of historical delinquency, credit weakness or financial difficulty. The use of internal credit ratings and qualitative indicators ensures alignment between the assessment of staging and the Group's management of credit risk which utilises these internal metrics within distinct retail and commercial portfolio risk management practices. However, unless identified at an earlier

Note 2: Accounting policies (continued)

stage, the credit risk of financial assets is deemed to have increased significantly when more than 30 days past due. The use of a payment holiday in and of itself has not been judged to indicate a significant increase in credit risk, with the underlying long-term credit risk deemed to be driven by economic conditions and captured through the use of forward-looking models. These portfolio-level models are capturing the anticipated volume of increased defaults and therefore an appropriate assessment of staging and expected credit loss. Where the credit risk subsequently improves such that it no longer represents a significant increase in credit risk since initial recognition, the asset is transferred back to Stage 1.

Assets are transferred to Stage 3 when they have defaulted or are otherwise considered to be credit-impaired. Default is considered to have occurred when there is evidence that the customer is experiencing financial difficulty which is likely to affect significantly the ability to repay the amount due. IFRS 9 contains a rebuttable presumption that default occurs no later than when a payment is 90 days past due. The Group uses this 90 day backstop for all its products except for UK mortgages. For UK mortgages, the Group uses a backstop of 180 days past due as mortgage exposures more than 90 days past due, but less than 180 days, typically show high cure rates and this aligns with the Group's risk management practices. Key differences between Stage 3 balances and non-performing loans relate to the use of 180 days past due for Stage 3 mortgages and to the cure periods applied to forbearance exposures. The use of payment holidays is not considered to be an automatic trigger of regulatory default and therefore does not automatically trigger Stage 3. Days past due will also not accumulate on any accounts that have taken a payment holiday including those already past due.

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. In the latter circumstances, the loan will remain classified as either Stage 2 or Stage 3 until the credit risk has improved such that it no longer represents a significant increase since origination (for a return to Stage 1), or the loan is no longer credit-impaired (for a return to Stage 2). On renegotiation the gross carrying amount of the loan is recalculated as the present value of the renegotiated or modified contractual cash flows, which are discounted at the original effective interest rate. Renegotiation may also lead to the loan and associated allowance being derecognised and a new loan being recognised initially at fair value.

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 continuing attempts to recover are 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.

(I) Property, plant and equipment

Property, plant and equipment (other than investment property) is 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: the shorter of 50 years and the remaining period of the lease for freehold/long and short leasehold premises; the shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease for leasehold improvements; 10 to 20 years for fixtures and furnishings; and 2 to 8 years for other equipment and motor vehicles.

The assets' residual values and useful lives are reviewed, taking into account considerations such as potential changes to legislation, including those that are climate-related, as well as other factors, 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 assessing the recoverable amount of assets the Group considers the effects of potential or actual changes in legislation, customer behaviour, climate-related risks and other factors. 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.

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital accretion or both. In accordance with the guidance published by the Royal Institution of Chartered Surveyors, investment property is carried at fair value based on current prices for similar properties, adjusted for the specific characteristics of the property (such as location or condition). If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices in less active markets. These valuations are reviewed at least annually by independent professionally qualified valuers. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be valued at fair value.

(J) Leases

Under IFRS 16, a lessor is required to determine whether a lease is a finance or operating lease. A lessee is not required to make this determination.

(1) 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 allowances for expected credit losses and residual value impairment, 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 other 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.

(2) As lessee

Leases are recognised as a right-of-use asset and a corresponding liability at the date at which the leased asset is available for use by the Group. Assets and liabilities arising from a lease are initially measured on a present value basis. The lease payments are discounted using the interest rate implicit in the lease, if that rate can be determined, or the Group's incremental borrowing rate appropriate for the right-of-use asset arising from the lease and the liability recognised within other liabilities.

Note 2: Accounting policies (continued)

Lease payments are allocated between the liability and finance cost. The finance cost is charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. The right-of-use asset is depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis.

Payments associated with short-term leases and leases of low-value assets are recognised on a straight-line basis as an expense in profit or loss. Short-term leases are leases with a lease term of twelve months or less. Low-value assets comprise IT equipment and small items of office furniture.

(K) 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.

(1) Share-based compensation

Lloyds Banking 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.

(L) Taxation

Tax expense comprises current and deferred tax. Current and deferred tax are charged or credited in the income statement except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside the income statement (either in other comprehensive income, directly in equity, or through a business combination), in which case the tax appears in the same statement as the transaction that gave rise to it. The tax consequences of the Group's dividend payments (including distributions on other equity instruments), if any, are charged or credited to the statement in which the profit distributed originally arose.

Current tax is the amount of corporate income taxes expected to be payable or recoverable based on the profit for the period as adjusted for items that are not taxable or not deductible, and is calculated using tax rates and laws that were enacted or substantively enacted at the balance sheet date.

Current tax includes amounts provided in respect of uncertain tax positions when management expects that, upon examination of the uncertainty by Her Majesty's Revenue and Customs (HMRC) or other relevant tax authority, it is more likely than not that an economic outflow will occur. Provisions reflect management's best estimate of the ultimate liability based on their interpretation of tax law, precedent and guidance, informed by external tax advice as necessary. Changes in facts and circumstances underlying these provisions are reassessed at each balance sheet date, and the provisions are remeasured as required to reflect current information.

Deferred tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the balance sheet. Deferred tax is calculated using tax rates and laws that have been enacted or substantively enacted at the balance sheet date, and which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax liabilities are generally recognised for all taxable temporary differences but not recognised for taxable temporary differences arising on investments in subsidiaries where the reversal of the temporary difference can be controlled and it is probable that the difference will not reverse in the foreseeable future. Deferred tax liabilities are not recognised on temporary differences that arise from goodwill which is not deductible for tax purposes.

Deferred tax assets are recognised to the extent it is probable that taxable profits will be available against which the deductible temporary differences can be utilised, and are reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are not recognised in respect of temporary differences that arise on initial recognition of assets and liabilities acquired other than in a business combination. Deferred tax is not discounted.

(M) 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). Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on non-monetary financial assets measured at fair value through other comprehensive income, 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; and 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. On disposal or liquidation of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation is reclassified from equity and included in determining the profit or loss arising on disposal or liquidation.

Note 2: Accounting policies (continued)

(N) 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.

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 expected credit losses in respect of irrevocable undrawn loan commitments and financial guarantee contracts (see (H) above).

(O) Share capital

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. Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

(P) 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 an original maturity of less than three months.

(Q) Investment in subsidiaries

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

Note 3: Critical accounting judgements and key sources of estimation uncertainty

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. In preparing the financial statements, the Group has considered the impact of climate-related risks on its financial position and performance. While the effects of climate change represent a source of uncertainty, the Group does not consider there to be a material impact on its judgements and estimates from the physical, transition and other climate-related risks in the short to medium term.

The significant judgements, apart from those involving estimation, made by management in applying the Group's accounting policies in these financial statements (key judgements) and the key sources of estimation uncertainty that may have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year (key estimates), which together are considered critical to the Group's results and financial position, are as follows:

Allowance for expected credit losses

Key judgements:	Determining an appropriate definition of default against which a probability of default, exposure at default and loss given default parameter can be evaluated
	The appropriate lifetime of an exposure to credit risk for the assessment of lifetime losses, notably on revolving products
	Establishing the criteria for a significant increase in credit risk (SICR)
	The use of management judgement alongside impairment modelling processes to adjust inputs, parameters and outputs to reflect risks not captured by models
Key estimates:	Base case and multiple economic scenarios (MES) assumptions, including the rate of unemployment and the rate of change of house prices, required for creation of MES scenarios and forward-looking credit parameters

These judgements and estimates are subject to significant uncertainty.

The Group recognises an allowance for expected credit losses (ECLs) for loans and advances to customers and banks, other financial assets held at amortised cost, financial assets (other than equity investments) measured at fair value through other comprehensive income and certain loan commitment and financial guarantee contracts. At 31 December 2021, the Group's expected credit loss allowance was £2,639 million (2020: £3,331 million), of which £2,583 million (2020: £3,202 million) was in respect of drawn balances; and the Bank's expected credit loss allowance was £2,575 million (2020: £3,262 million), of which £2,519 million (2020: £3,133 million) was in respect of drawn balances.

The calculation of the Group's expected credit loss allowances and provisions against loan commitments and guarantees under IFRS 9 requires the Group to make a number of judgements, assumptions and estimates. The most significant are set out below.

Definition of default

The probability of default (PD) of an exposure, both over a 12-month period and over its lifetime, is a key input to the measurement of the ECL allowance. Default has occurred when there is evidence that the customer is experiencing significant financial difficulty which is likely to affect the ability to repay amounts due. The definition of default adopted by the Group is described in note 2(H) Impairment of financial assets. The Group has rebutted the presumption in IFRS 9 that default occurs no later than when a payment is 90 days past due for UK mortgages. As a result, at 31 December 2021, £0.8 billion of UK mortgages (2020: £1.0 billion) were classified as Stage 2 rather than Stage 3; the impact on the Group's ECL allowance was not material.

Lifetime of an exposure

A range of approaches, segmented by product type, has been adopted by the Group to estimate a product's expected life. These include using the full contractual life and taking into account behavioural factors such as early repayments, extensions and refinancing. For non-revolving retail assets, the Group has assumed the expected life for each product to be the time taken for all significant losses to be observed. For retail revolving products, the Group has considered the losses beyond the contractual term over which the Group is exposed to credit risk. For commercial overdraft facilities, the average behavioural life has been used. Changes to the assumed expected lives of the Group's assets could impact the ECL allowance recognised by the Group. The assessment of SICR and corresponding lifetime loss, and the PD, of a financial asset designated as Stage 2, or Stage 3, is dependent on its expected life.

Note 3: Critical accounting judgements and key sources of estimation uncertainty (continued)

Significant increase in credit risk

Performing assets are classified as either Stage 1 or Stage 2. An ECL allowance equivalent to 12 months' expected losses is established against assets in Stage 1; assets classified as Stage 2 carry an ECL allowance equivalent to lifetime expected losses. Assets are transferred from Stage 1 to Stage 2 when there has been a significant increase in credit risk since initial recognition. Credit-impaired assets are transferred to Stage 3 with a lifetime expected losses allowance. The Group uses both quantitative and qualitative indicators to determine whether there has been a SICR for an asset. For retail exposures, the following tables set out the retail master scale (RMS) grade triggers which result in a SICR for financial assets and the PD boundaries for each RMS grade. Loans and overdrafts SICR triggers have been refined in 2021 following a review of sensitivity to changes in economic assumptions, aligning to credit cards (refined in 2020). The impact of this has been £144 million of additional assets being classified as Stage 2 at 31 December 2021, with a corresponding increase in the ECL of £7 million resulting from the transfer to a lifetime expected loss.

SICR triggers for key retail portfolios

Origination grade	1	2	3	4	5	6	7
Mortgages SICR grade	5	5	6	7	8	9	10
Credit cards, loans and overdrafts SICR grade	4	5	6	7	8	9	10

RMS grade	1	2	3	4	5	6	7	8	9	10	11	12	13	14
PD boundary %[1]	0.10	0.40	0.80	1.20	2.50	4.50	7.50	10.00	14.00	20.00	30.00	45.00	99.99	100.00

1 Probability-weighted annualised lifetime probability of default.

For commercial exposures a doubling of PD with a minimum increase in PD of 1 per cent and a resulting change in the underlying grade is treated as a SICR.

The Group uses the internal credit risk classification and watchlist as qualitative indicators to identify a SICR. The Group does not use the low credit risk exemption in its staging assessments. The use of a payment holiday in and of itself has not been judged to indicate a significant increase in credit risk, nor forbearance, with the underlying long-term credit risk deemed to be driven by economic conditions and captured through the use of forward-looking models. These portfolio level models are capturing the anticipated volume of increased defaults and therefore an appropriate assessment of staging and expected credit loss.

All financial assets are assumed to have suffered a SICR if they are more than 30 days past due; credit cards, loans and overdrafts financial assets are also assumed to have suffered a SICR if they are in arrears on three or more separate occasions in a rolling 12-month period. Financial assets are classified as credit-impaired if they are 90 days past due, except for UK mortgages where a 180 days backstop is used.

A Stage 3 asset that is no longer credit-impaired is transferred back to Stage 2 as no cure period is applied to Stage 3. If an exposure that is classified as Stage 2 no longer meets the SICR criteria, which in some cases capture customer behaviour in previous periods, it is moved back to Stage 1.

The setting of precise trigger points combined with risk indicators requires judgement. The use of different trigger points may have a material impact upon the size of the ECL allowance. The Group monitors the effectiveness of SICR criteria on an ongoing basis.

Generation of multiple economic scenarios

The estimate of expected credit losses is required to be based on an unbiased expectation of future economic scenarios. The approach used to generate the range of future economic scenarios depends on the methodology and judgements adopted. The Group's approach is to start from a defined base case scenario, used for planning purposes, and to generate alternative economic scenarios around this base case. The base case scenario is a conditional forecast underpinned by a number of conditioning assumptions that reflect the Group's best view of key future developments. If circumstances appear likely to materially deviate from the conditioning assumptions, then the base case scenario is updated.

The base case scenario is central to a range of future economic scenarios generated by simulation of an economic model, for which the same conditioning assumptions apply as in the base case scenario. These scenarios are ranked by using estimated relationships with industry-wide historical loss data. With the base case already pre-defined, three other scenarios are identified as averages of constituent scenarios located around the 15th, 75th and 95th percentiles of the distribution. The full distribution is therefore summarised by a practical number of scenarios to run through ECL models representing an upside, the base case, and a downside scenario weighted at 30 per cent each, together with a severe downside scenario weighted at 10 per cent. The scenario weights represent the distribution of economic scenarios and not subjective views on likelihood. The inclusion of a severe downside scenario with a smaller weighting ensures that the non-linearity of losses in the tail of the distribution is adequately captured. The Group does not apply any reversion techniques within scenario generation, noting that data after the five-year forecast period shown has a relatively immaterial effect on the ECL provision.

A forum under the chairmanship of the Chief Economist meets at least quarterly to review and, if appropriate, recommend changes to the method by which economic scenarios are generated, for approval by the Chief Financial Officer and Chief Risk Officer. While no material changes were made to the model in 2021, the forum identified the need to consider an alternative approach to address interest rate risks not captured within the downside scenarios. The forum recommended that a non-modelled severe downside scenario was evaluated for potential incremental losses. This resulted in a management adjustment for UK mortgages which exhibited a sufficient uplift in ECL in a high rate scenario.

Note 3: Critical accounting judgements and key sources of estimation uncertainty (continued)

Base case and MES economic assumptions

The Group's base case economic scenario has been revised in light of the continuing impact of the coronavirus pandemic, intensifying global inflation pressures, and a shift towards a more restrictive stance of monetary policy by central banks. The Group's updated base case scenario built in three key conditioning assumptions. First, the current wave of coronavirus infections does not lead to a re-imposition of lockdown restrictions in the UK, although greater household caution is expected amid increased hospitalisation rates. Second, the rise in wholesale energy prices is passed on to consumers through a 50 per cent increase in retail energy prices in April 2022. Third, inflation expectations rise in response to increasing headline inflation but subsequently revert to levels consistent with the Bank of England's 2 per cent inflation target.

Based on these assumptions and incorporating the improved economic data in the fourth quarter, the Group's base case outlook is for a modest rise in the unemployment rate alongside a deceleration in residential and commercial property price growth, as the UK Bank Rate is raised in response to increasing inflationary pressures. Risks around this base case economic view lie in both directions and are partly captured by the generation of alternative economic scenarios described above. Uncertainties relating to key epidemiological developments, notably the possibility that a vaccine-resistant strain could emerge, are not specifically captured by these scenarios. These specific risks are recognised outside of the modelled scenarios with a central adjustment.

The Group has accommodated the latest available information at the reporting date in defining its base case scenario and generating alternative economic scenarios. The scenarios include forecasts for key variables in the fourth quarter of 2021, for which actuals may have since emerged prior to publication.

Scenarios by year

Key annual assumptions made by the Group are shown below. Gross domestic product is presented as an annual change, house price growth and commercial real estate price growth are presented as the growth in the respective indices within the period. UK Bank Rate and unemployment rate are averages for the period.

The key UK economic assumptions made by the Group averaged over a five-year period are also shown below. The five-year period reflects movements within the current reporting year such that 31 December 2021 reflects the five years 2021 to 2025. The prior year comparative data has been re-presented to align to the equivalent period, 2020 to 2024. The inclusion of the reporting year within the five-year period reflects the need to predict variables which remain unpublished at the reporting date, and recognises that credit models utilise both level and annual change in calculating ECL. The use of calendar years also maintains a comparability between tables disclosed.

At 31 December 2021	2021 %	2022 %	2023 %	2024 %	2025 %	2021-2025 average %
Upside						
Gross domestic product	7.1	4.0	1.4	1.3	1.4	3.0
UK Bank Rate	0.14	1.44	1.74	1.82	2.03	1.43
Unemployment rate	4.4	3.3	3.4	3.5	3.7	3.7
House price growth	10.1	2.6	4.9	4.7	3.6	5.1
Commercial real estate price growth	12.4	5.8	0.7	1.0	(0.6)	3.7
Base case						
Gross domestic product	7.1	3.7	1.5	1.3	1.3	2.9
UK Bank Rate	0.14	0.81	1.00	1.06	1.25	0.85
Unemployment rate	4.5	4.3	4.4	4.4	4.5	4.4
House price growth	9.8	0.0	0.0	0.5	0.7	2.1
Commercial real estate price growth	10.2	(2.2)	(1.9)	0.1	0.6	1.2
Downside						
Gross domestic product	7.1	3.4	1.3	1.1	1.2	2.8
UK Bank Rate	0.14	0.45	0.52	0.55	0.69	0.47
Unemployment rate	4.7	5.6	5.9	5.8	5.7	5.6
House price growth	9.2	(4.9)	(7.8)	(6.6)	(4.7)	(3.1)
Commercial real estate price growth	8.6	(10.1)	(7.0)	(3.4)	(0.3)	(2.6)
Severe downside						
Gross domestic product	6.8	0.9	0.4	1.0	1.4	2.1
UK Bank Rate	0.14	0.04	0.06	0.08	0.09	0.08
Unemployment rate	4.9	7.7	8.5	8.1	7.6	7.3
House price growth	9.1	(7.3)	(13.9)	(12.5)	(8.4)	(6.9)
Commercial real estate price growth	5.8	(19.6)	(12.1)	(5.3)	(0.5)	(6.8)
Probability-weighted						
Gross domestic product	7.0	3.4	1.3	1.2	1.3	2.8
UK Bank Rate	0.14	0.82	0.99	1.04	1.20	0.83
Unemployment rate	4.6	4.7	5.0	5.0	4.9	4.8
House price growth	9.6	(1.4)	(2.3)	(1.7)	(1.0)	0.6
Commercial real estate price growth	9.9	(3.9)	(3.7)	(1.2)	(0.1)	0.1

Note 3: Critical accounting judgements and key sources of estimation uncertainty (continued)

Base case scenario by quarter[1] At 31 December 2021	First quarter 2021 %	Second quarter 2021 %	Third quarter 2021 %	Fourth quarter 2021 %	First quarter 2022 %	Second quarter 2022 %	Third quarter 2022 %	Fourth quarter 2022 %
Gross domestic product	**(1.3)**	**5.4**	**1.1**	**0.4**	**0.1**	**1.5**	**0.5**	**0.3**
UK Bank Rate	**0.10**	**0.10**	**0.10**	**0.25**	**0.50**	**0.75**	**1.00**	**1.00**
Unemployment rate	**4.9**	**4.7**	**4.3**	**4.3**	**4.4**	**4.3**	**4.3**	**4.3**
House price growth	**6.5**	**8.7**	**7.4**	**9.8**	**8.4**	**6.1**	**3.2**	**(0.0)**
Commercial real estate price growth	**(2.9)**	**3.4**	**7.5**	**10.2**	**8.4**	**5.2**	**0.9**	**(2.2)**

1 Gross domestic product presented quarter-on-quarter, house price growth and commercial real estate growth presented year-on-year – i.e. from the equivalent quarter the previous year. UK Bank Rate and unemployment rate are presented as at end of quarter.

At 31 December 2020	2020 %	2021 %	2022 %	2023 %	2024 %	2020-2024 average %
Upside						
Gross domestic product	(10.5)	3.7	5.7	1.7	1.5	0.3
UK Bank Rate	0.10	1.14	1.27	1.20	1.21	0.98
Unemployment rate	4.3	5.4	5.4	5.0	4.5	5.0
House price growth	6.3	(1.4)	5.2	6.0	5.0	4.2
Commercial real estate price growth	(4.6)	9.3	3.9	2.1	0.3	2.1
Base case						
Gross domestic product	(10.5)	3.0	6.0	1.7	1.4	0.1
UK Bank Rate	0.10	0.10	0.10	0.21	0.25	0.15
Unemployment rate	4.5	6.8	6.8	6.1	5.5	5.9
House price growth	5.9	(3.8)	0.5	1.5	1.5	1.1
Commercial real estate price growth	(7.0)	(1.7)	1.6	1.1	0.6	(1.1)
Downside						
Gross domestic product	(10.6)	1.7	5.1	1.4	1.4	(0.4)
UK Bank Rate	0.10	0.06	0.02	0.02	0.03	0.05
Unemployment rate	4.6	7.9	8.4	7.8	7.0	7.1
House price growth	5.6	(8.4)	(6.5)	(4.7)	(3.0)	(3.5)
Commercial real estate price growth	(8.7)	(10.6)	(3.2)	(0.8)	(0.8)	(4.9)
Severe downside						
Gross domestic product	(10.8)	0.3	4.8	1.3	1.2	(0.8)
UK Bank Rate	0.10	0.00	0.00	0.01	0.01	0.02
Unemployment rate	4.8	9.9	10.7	9.8	8.7	8.8
House price growth	5.3	(11.1)	(12.5)	(10.7)	(7.6)	(7.5)
Commercial real estate price growth	(11.0)	(21.4)	(9.8)	(3.9)	(0.8)	(9.7)
Probability-weighted						
Gross domestic product	(10.6)	2.6	5.5	1.6	1.4	(0.1)
UK Bank Rate	0.10	0.39	0.42	0.43	0.45	0.36
Unemployment rate	4.5	7.0	7.3	6.7	6.0	6.3
House price growth	5.9	(5.2)	(1.5)	(0.2)	0.3	(0.2)
Commercial real estate price growth	(7.2)	(3.0)	(0.3)	0.3	(0.1)	(2.1)

Base case scenario by quarter[1] At 31 December 2020	First quarter 2020 %	Second quarter 2020 %	Third quarter 2020 %	Fourth quarter 2020 %	First quarter 2021 %	Second quarter 2021 %	Third quarter 2021 %	Fourth quarter 2021 %
Gross domestic product	(3.0)	(18.8)	16.0	(1.9)	(3.8)	5.6	3.6	1.5
UK Bank Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Unemployment rate	4.0	4.1	4.8	5.0	5.2	6.5	8.0	7.5
House price growth	2.8	2.6	7.2	5.9	5.5	4.7	(1.6)	(3.8)
Commercial real estate price growth	(5.0)	(7.8)	(7.8)	(7.0)	(6.1)	(2.9)	(2.2)	(1.7)

1 Gross domestic product presented quarter-on-quarter, house price growth and commercial real estate growth presented year-on-year – i.e. from the equivalent quarter the previous year. UK Bank Rate and unemployment rate are presented as at end of quarter.

Note 3: Critical accounting judgements and key sources of estimation uncertainty (continued)

Economic assumptions – start to peak[1]

	At 31 December 2021				At 31 December 2020			
	Upside %	**Base case %**	**Downside %**	**Severe downside %**	Upside %	Base case %	Downside %	Severe downside %
Gross domestic product	**12.6**	**12.3**	**11.4**	**7.6**	1.4	0.8	(1.7)	(3.0)
UK Bank Rate	**2.04**	**1.25**	**0.71**	**0.25**	1.44	0.25	0.10	0.10
Unemployment rate	**4.9**	**4.9**	**6.0**	**8.5**	6.5	8.0	9.3	11.5
House price growth	**28.5**	**11.0**	**9.2**	**9.1**	22.6	5.9	5.6	5.3
Commercial real estate price growth	**20.9**	**10.2**	**8.6**	**6.9**	11.0	(2.7)	(2.7)	(2.7)

1 Reflects five year period from 2021 to 2025.

Economic assumptions – start to trough[1]

	At 31 December 2021				At 31 December 2020			
	Upside %	**Base case %**	**Downside %**	**Severe downside %**	Upside %	Base case %	Downside %	Severe downside %
Gross domestic product	**(1.3)**	**(1.3)**	**(1.3)**	**(1.3)**	(21.2)	(21.2)	(21.2)	(21.2)
UK Bank Rate	**0.10**	**0.10**	**0.10**	**0.02**	0.10	0.10	0.01	0.00
Unemployment rate	**3.2**	**4.3**	**4.3**	**4.3**	4.0	4.0	4.0	4.0
House price growth	**1.2**	**1.2**	**(14.8)**	**(30.2)**	(0.5)	(0.5)	(16.4)	(32.4)
Commercial real estate price growth	**0.8**	**0.8**	**(12.8)**	**(30.0)**	(6.9)	(9.0)	(22.2)	(39.9)

1 Reflects five year period from 2021 to 2025.

ECL sensitivity to economic assumptions

The table below shows the Group's ECL for the upside, base case, downside and severe downside scenarios. The stage allocation for an asset is based on the overall scenario probability-weighted PD and, hence, the staging of assets is constant across all the scenarios. In each economic scenario the ECL for individual assessments and post-model adjustments is constant reflecting the basis on which they are evaluated. Judgements applied through changes to inputs are reflected in the scenario sensitivities. The probability-weighted view shows the extent to which a higher ECL allowance has been recognised to take account of multiple economic scenarios relative to the base case; the uplift being £126 million compared to £260 million at 31 December 2020, noting that if the impact of MES staging was also included, as shown in the table below, this would increase to £133 million compared to £298 million at 31 December 2020.

	At 31 December 2021					At 31 December 2020				
	Probability-weighted £m	**Upside £m**	**Base case £m**	**Downside £m**	**Severe downside £m**	Probability-weighted £m	Upside £m	Base case £m	Downside £m	Severe downside £m
ECL allowance	**2,639**	**2,385**	**2,513**	**2,799**	**3,295**	3,331	2,814	3,071	3,610	4,825

The table below shows the Group's ECL for the upside, base case, downside and severe downside scenarios, with staging of assets based on each specific scenario probability of default. ECL applied through individual assessments and post-model adjustments is reported flat against each economic scenario, reflecting the basis on which they are evaluated. Judgements applied through changes to inputs are reflected in the scenario sensitivities. A probability-weighted scenario is not shown as this does not reflect the basis on which ECL is reported.

	At 31 December 2021				At 31 December 2020			
	Upside £m	**Base case £m**	**Downside £m**	**Severe downside £m**	Upside £m	Base case £m	Downside £m	Severe downside £m
ECL allowance	**2,377**	**2,506**	**2,813**	**3,427**	2,768	3,033	3,651	5,105

The impact of changes in the UK unemployment rate and House Price Index (HPI) have also been assessed. Although such changes would not be observed in isolation, as economic indicators tend to be correlated in a coherent scenario, this gives insight into the sensitivity of the Group's ECL to gradual changes in these two critical economic factors. The assessment has been made against the base case with the reported staging unchanged.

The table below shows the impact on the Group's ECL resulting from a 1 percentage point (pp) increase or decrease in the UK unemployment rate. The increase or decrease is presented based on the adjustment phased evenly over the first 10 quarters of the base case scenario. An immediate increase or decrease would drive a more material ECL impact as it would be fully reflected in both 12-month and lifetime PDs.

	At 31 December 2021		At 31 December 2020	
	1pp increase in unemployment	**1pp decrease in unemployment**	1pp increase in unemployment	1pp decrease in unemployment
ECL impact, £m	**40**	**(35)**	96	(89)

Note 3: Critical accounting judgements and key sources of estimation uncertainty (continued)

The table below shows the impact on the Group's ECL in respect of UK mortgages of an increase or decrease in loss given default for a 10 percentage point (pp) increase or decrease in the UK House Price Index (HPI). The increase or decrease is presented based on the adjustment phased evenly over the first 10 quarters of the base case scenario.

	At 31 December 2021		At 31 December 2020	
	10pp increase in HPI	**10pp decrease in HPI**	10pp increase in HPI	10pp decrease in HPI
ECL impact, £m	**(106)**	**154**	(189)	259

Individual assessments

The Stage 3 ECL relating to commercial clients is largely assessed on an individual basis using bespoke assessment of loss for each specific client. These assessments are carried out by the Business Support Unit based on detailed reviews and expected recovery strategies. While these assessments are based on the Group's latest economic view, the use of Group-wide multiple economic scenarios and weightings is not considered appropriate for these cases due to their individual characteristics. In place of this, a range of case-specific outcomes are considered with any alternative better or worse outcomes that carry a 25 per cent likelihood taken into account in establishing a probability-weighted ECL.

Application of judgement in adjustments to modelled ECL

Impairment models fall within the Group's model risk framework with model monitoring, periodic validation and back testing performed on model components (i.e. probability of default, exposure at default and loss given default). Limitations in the Group's impairment models or data inputs may be identified through the ongoing assessment and validation of the output of the models. In these circumstances, management make appropriate adjustments to the Group's allowance for impairment losses to ensure that the overall provision adequately reflects all material risks. These adjustments are determined by considering the particular attributes of exposures which have not been adequately captured by the impairment models and range from changes to model inputs and parameters, at account level, through to more qualitative post-model adjustments.

Judgements are not typically assessed under each distinct economic scenario used to generate ECL, but instead are applied on the basis of final modelled ECL which reflects the probability-weighted view of all scenarios. All adjustments are reviewed quarterly and are subject to internal review and challenge, including by the Lloyds Banking Group Audit Committee, to ensure that amounts are appropriately calculated and that there are specific release criteria identified.

The coronavirus pandemic and the various support measures that have been put in place have resulted in an economic environment which differs significantly from the historical economic conditions upon which the impairment models have been built. As a result there has been a greater need for management judgements to be applied alongside the use of models. At 31 December 2021 management judgement resulted in additional ECL allowances totalling £1,060 million (2020: £1,120 million). This comprises judgements added due to COVID-19 and other judgements not directly linked to COVID-19 but which have increased in size during the pandemic. The table below analyses total ECL allowance, separately identifying the amounts that have been modelled, those that have been individually assessed and those arising through the application of management judgement.

	Modelled ECL £m	**Individually assessed £m**	**Judgements due to COVID-19[1] £m**	**Other judgements £m**	**Total ECL £m**
At 31 December 2021	**870**	**709**	**390**	**670**	**2,639**
At 31 December 2020	1,434	777	339	781	3,331

1 Judgements introduced to address the impact that COVID-19 and resulting interventions have had on the Group's economic outlook and observed loss experience, which have required additional model limitations to be addressed.

Judgements due to COVID-19

These adjustments principally comprise:

Increase in time to repossession: £76 million (2020: £46 million)
This reflects an adjustment made to allow for an increase in the time assumed between default and repossession as a result of the Group temporarily suspending the repossession of properties to support customers during the pandemic.

Recognition of impact of support measures: £56 million (2020: £63 million)
Government support and subdued levels of consumer spending are judged to have contributed to the reduced flow of accounts into default and to improved average credit scores across portfolios. Management believes that the resulting position does not fully reflect the underlying credit risk in the portfolios although there is no longer an expectation that the reduced level of defaults experienced in 2020 was temporary. Adjustments continue to be made to increase expected future rates of default and predicted exposures at default relative to modelled ECL.

Adjustment to economic variables used as inputs to models: £10 million (2020: £14 million)
Observed reductions in the rate of UK corporate insolvencies, used as an input to commercial default models, continue to be substituted with an increase proportionate to that seen in unemployment to generate a level of predicted defaults. As anticipated, the rate of recoveries has returned to pre-pandemic levels towards the end of 2021 and, with model outputs based on 12 months observed insolvency data, management believe the historically low levels of insolvencies seen during early 2021 do not reflect the underlying credit risk.

Specific sector risks: £10 million (2020: £nil)
At 31 December 2020 modelled ECL incorporated an economic outlook containing a material reduction in corporate profits. This is no longer assumed, which generates a reduction in modelled ECL and therefore leaves potential risk on specific sectors. An updated assessment of risks including COVID-driven restrictions, inflation and interest rate pressures has been undertaken which continues to suggest that a number of specific industries remain more exposed. Judgement has therefore been raised in place of this to ensure a more targeted stress on likelihood and severity of loss in sectors which are considered to face an elevated risk incorporating any impact on SICR through the increased likelihood of loss.

Note 3: Critical accounting judgements and key sources of estimation uncertainty (continued)

COVID risk to base case conditioning assumptions: £240 million (2020: £200 million)
An important element of the methodology used to calculate the Group's ECL allowance is the determination of a base case economic scenario, predicated on certain conditioning assumptions, which is then used to derive alternative economic scenarios using stochastic shocks. While the base case outlook has improved throughout the year, unexpected and adverse COVID-19 mutations may partially invalidate the base case conditioning assumptions and therefore the potential range of losses considered. The base case represents the Groups most likely view, however management believes that in the context of the pandemic, the possibility that the conditioning assumptions are invalidated is firmly to the downside. In particular, the possibility that a future virus mutation has vaccine resistance leading to serious social and economic disruption. Such a possibility lies outside of the Group's current methodology because it would invalidate one of the key assumptions behind the base case forecast. The likelihood and impact of a vaccine resistant mutation is difficult to estimate with any precision therefore the Group has considered a number of approaches to create a reasonable estimate of this additional downside risk.

An adjustment of £240 million (31 December 2020: £200 million) has been made to increase the Group's ECL allowances to reflect the increased downside risk and the potential for the severity of losses to stretch beyond the Group's severe scenario. One approach used to quantify this amount is to apply a 15 per cent re-weighting from the stated upside to the stated severe downside scenario, a larger re-weight than at 31 December 2020 given that the current severe scenario reflects the improved conditioning assumptions of the base case, whereas the downside risk remains constant. Another approach is to apply a 1 percentage point increase in unemployment allied with a 10 per cent lower HPI in 2022, reflecting a broader assessment of a more immediate and therefore greater ECL impact than the gradual increase reflected in the stated univariate sensitivities. Such an increase is proportionate to the level of volatility seen in forecasts every six months as the pandemic has unfolded.

As the adjustment has been calculated centrally it has not been allocated to specific portfolios, however the increase in 2021 reflects a more granular assessment of the risk. It has therefore been allocated against Stage 1 assets given that the downside risks are largely considered to relate to non-defaulted exposures, the majority of which are in Stage 1. Detailed level disclosures continue to reflect the Group's economic assumptions at the Group's stated weightings.

Other judgements

These adjustments principally comprise:

Adjustment to modelled forecast parameters: £79 million (2020: £277 million)
Adjustments to the estimated defaults used within the ECL calculation for UK mortgages were introduced in 2020 following the adoption of new default forecast models. Work has progressed through the year to embed the new model, including updates to model design choices through the implementation of formal model changes or through in-model adjustments, which are considered judgemental pending final evaluation and model governance. These remaining in-model adjustments now target a combination of specific enhancements which will continue to be progressed through to model changes. The reduction in the adjustment is also partly due to the improved economic outlook which reduces the impact of adopting the new forecast model.

End-of-term interest-only: £211 million (2020: £225 million)
The current definition of default used in the UK mortgages impairment model excludes past term interest-only accounts that continue to make interest payments but have missed their capital payment upon maturity of the loan. This adjustment therefore mitigates the risk that the model understates the credit losses associated with interest-only accounts which have missed, or will potentially miss, their final capital payment. For those accounts that have reached end of term this adjustment manually overwrites PDs to 70 per cent or 100 per cent, thereby moving them into Stage 2, or Stage 3, depending on whether they are considered performing or non-performing respectively. For interest-only accounts with six years or less to maturity an appropriate incremental PD uplift is made to PDs based on the probability of missing a future capital payment, assessed through segmentation of behaviour score, debt-to-value and worst ever arrears status.

Long-term defaults: £144 million (2020: £145 million)
The Group suspended mortgage litigation activity between late 2014 and mid 2018 as changes were implemented to the treatment of amounts in arrears, interrupting the natural flow of accounts to possession. An adjustment is made to ensure adequate provision coverage considering the resulting build-up of accounts in long-term default. Coverage is uplifted to the equivalent levels of those accounts already in repossession on an estimated shortfall of balances expected to flow to possession. A further adjustment is made to mitigate for the risk that credit model provision understates the probability of possession for accounts which have been in default for more than 24 months, with an arrears balance increase in the last 6 months. These accounts have their probability of possession set to 95 per cent based on observed historical losses incurred on accounts that were of an equivalent status.

Adjustment for specific segments: £78 million (2020: £46 million)
The Group monitors risks across specific UK mortgage segments of its portfolios which may not be fully captured through wider collective models. Along with continued judgemental increases to probability of default on forborne accounts of £36 million (2020: £46 million), the Group has taken an additional £42 million judgement for fire safety and cladding uncertainty. This captures risks within the assessment of affordability and asset valuations, not captured by underlying models. Though experience remains limited the risk is now considered sufficiently material to address through judgement, given that more cases have been assessed as having defective cladding, or other fire safety issues, together with emerging evidence of higher arrears and weaker sales values relative to the wider portfolio.

Inflation and interest rate risk: £57 million (2020: £nil)
The Group's approach to MES modelling incorporates a range of interest rate scenarios, however it is recognised that given current inflationary pressures the risk of a very rapid increase in interest rates may not be fully captured in the range of economic assumptions used to assess credit losses. Therefore an additional management judgement for the mortgage portfolio, for which default rates are most sensitive to interest rates, has been taken to reflect this heightened risk. The quantification of this risk adopts an alternative severe downside scenario which leverages the Group's internal stress testing exercise. The increase in ECL therefore reflects the incremental losses from adopting a severe downside scenario with interest rates increasing to 4 per cent, with peak unemployment and house price falls broadly consistent with the Group's stated severe downside scenario. The Group will continue to reassess inflationary risks and whether this additional judgement is required.

Lifetime extension on revolving products: £16 million (2020: £28 million)
Unsecured revolving products use a model lifetime definition of three years based on historic data which shows that substantially all accounts resolve in this time. An adjustment is made to extend the lifetime used for Stage 2 exposures to six years by increasing default probabilities through the extrapolation of the default trajectory observed throughout the three years and beyond. The resulting additional ECL allowance is added to Stage 2 accounts proportionate to the modelled three-year PD. The decrease in this judgement during 2021 is primarily due to the Group's improved economic outlook, meaning that the model view of lifetime three year losses is lower and therefore this extrapolation to six years is proportionally lower.

Note 3: Critical accounting judgements and key sources of estimation uncertainty (continued)

Uncertain tax positions

Key judgement:	Interpreting tax rules on the Group's open tax matters

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 its interpretation of the UK rules means that the group relief is not available. In 2020, HMRC concluded their enquiry into the matter and issued a closure notice. The Lloyds Banking Group's interpretation of the UK rules has not changed and hence it has appealed to the First Tier Tax Tribunal, with a hearing expected in 2022. If the final determination of the matter by the judicial process is that HMRC's position is correct, management estimate that this would result in an increase in current tax liabilities of the Group of approximately £180 million (including interest). The Lloyds Banking Group, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due.

The Group makes other estimates in relation to tax which do not require significant judgements, see further discussion in note 22.

Regulatory and legal provisions

Key judgements:	Determining the scope of reviews required by regulators
	The impact of legal decisions that may be relevant to claims received
	Determining whether a reliable estimate is available for obligations arising from past events
Key estimates:	The number of future complaints
	The proportion of complaints that will be upheld
	The average cost of redress

At 31 December 2021, the Group carried provisions of £835 million (2020: £230 million) and the Bank £835 million (2020: £229 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches.

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 and estimation. It will often be necessary to form a view on matters which are inherently uncertain, such as the scope of reviews required by regulators, and to estimate the number of future complaints, the extent to which they will be upheld, the average cost of redress and the impact of decisions reached by legal and other review processes that may be relevant to claims received. 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.

Management has applied significant judgement in determining the provision required for HBOS Reading; further details are provided in note 23.

Fair value of financial instruments

Key estimate:	Interest rate spreads, earnings multiples and interest rate volatility

At 31 December 2021, the carrying value of the Group's financial instrument assets held at fair value was £6,673 million (2020: £10,295 million), and its financial instrument liabilities held at fair value was £4,353 million (2020: £8,717 million). The carrying value of the Bank's financial instrument assets held at fair value was £6,463 million (2020: £9,976 million) and financial instrument liabilities held at fair value was £4,144 million (2020: £8,360 million).

The Group's valuation control framework and a description of level 1, 2 and 3 financial assets and liabilities is set out in note 33(2). The valuation techniques for level 3 financial instruments involve management judgement and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information. In addition, in line with market practice, the Group applies credit, debit and funding valuation adjustments in determining the fair value of its uncollateralised derivative positions. A description of these adjustments is set out in note 33.

Note 4: Net interest income

	Weighted average effective interest rate 2021 %	2020 %	2021 £m	2020 £m
Interest income:				
Financial assets held at amortised cost	**2.40**	2.13	**7,204**	7,539
Financial assets at fair value through other comprehensive income	**0.82**	0.97	**18**	26
Total interest income[1]	**2.39**	2.13	**7,222**	7,565
Interest expense:				
Deposits from banks, customer deposits, repurchase agreements and other liabilities	**0.75**	0.76	**(1,748)**	(2,243)
Debt securities in issue[2]	**0.44**	(0.48)	**(30)**	44
Lease liabilities	**2.29**	2.19	**(15)**	(16)
Subordinated liabilities	**2.07**	2.29	**(105)**	(142)
Total interest expense	**0.77**	0.76	**(1,898)**	(2,357)
Net interest income			**5,324**	5,208

1 Includes £12 million (2020: £8 million) in respect of interest income on finance leases.

2 The impact of the Group's hedging arrangements is included on this line; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.69 per cent (2020: 2.58 per cent).

Included within interest income is £119 million (2020: £105 million) in respect of credit-impaired financial assets. Net interest income also includes a debit of £19 million (2020: credit of £4 million) transferred from the cash flow hedging reserve (see note 26).

Note 5: Net fee and commission income

	2021 £m	2020 £m
Fee and commission income:		
Current accounts	**196**	203
Credit and debit card fees	**245**	206
Other	**91**	59
Total fee and commission income	**532**	468
Fee and commission expense	**(277)**	(269)
Net fee and commission income	**255**	199

Fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 4. 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 6.

In determining the disaggregation of fees and commissions the Group has considered how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors, including those that are impacted by climate-related factors. It has determined that the above disaggregation by product type provides useful information that does not aggregate items that have substantially different characteristics and is not too detailed.

At 31 December 2021, the Group held on its balance sheet £22 million (31 December 2020: £22 million) in respect of services provided to customers. There were no unsatisfied performance obligations at 31 December 2020 or 31 December 2021.

The most significant performance obligations undertaken by the Group are in respect of current accounts, the provision of other banking services for commercial customers and credit and debit card services.

In respect of current accounts, the Group receives fees for the provision of bank account and transaction services such as ATM services, fund transfers, overdraft facilities and other value-added offerings.

For commercial customers, alongside its provision of current accounts, the Group provides other corporate banking services including factoring and commitments to provide loan financing. Loan commitment fees are included in fees and commissions where the loan is not expected to be drawn down by the customer.

The Group receives interchange and merchant fees, together with fees for overseas use and cash advances, for provision of card services to cardholders and merchants.

Note 6: Net trading income

	2021 £m	2020 £m
Foreign exchange	**12**	36
Investment property losses	**—**	(20)
Hedging and other gains (losses)	**35**	(385)
Net trading income (losses)	**47**	(369)

Note 7: Other operating income

	2021 £m	2020 £m
Gains less losses on disposal of financial assets at fair value through other comprehensive income (note 26)	—	10
Liability management	**112**	(5)
Intercompany recharges and other	**25**	104
Total other operating income	**137**	109

Note 8: Operating expenses

	2021 £m	2020 £m
Staff costs:		
Salaries	**841**	887
Social security costs	**94**	81
Pensions and other post-retirement benefit schemes	**196**	194
	1,131	1,162
Premises and equipment:		
Rent and rates	**57**	63
Repairs and maintenance	**44**	37
Other	**39**	83
	140	183
Other expenses:		
Communications and data processing	**94**	118
Advertising and promotion	**44**	54
Professional fees	**14**	10
Regulatory and legal provisions (note 23)	**982**	107
Amounts payable to fellow Lloyds Banking Group undertakings and other	**1,133**	776
	2,267	1,065
Depreciation and amortisation:		
Depreciation of property, plant and equipment[1]	**187**	199
Amortisation of other intangible assets	**97**	33
	284	232
Total operating expenses	**3,822**	2,642

1 Comprising depreciation in respect of premises £49 million (2020: £54 million), equipment £53 million (2020: £53 million) and right-of-use assets £85 million (2020: £92 million).

The average number of persons on a headcount basis employed by the Group during the year was as follows:

	2021	2020
UK	**25,123**	26,869
Overseas	**410**	389
Total	**25,533**	27,258

The majority of the Group's staff are contractually employed by the Bank's parent company, HBOS plc.

Note 9: Auditors' remuneration

Fees payable to the Bank's auditors[1] are as follows:

	2021 £m	2020 £m
Fees payable for the:		
– the audit of the Bank's current year Annual Report	**3.6**	3.5
– the audits of the Bank's subsidiaries	**1.2**	1.0
– total audit fees in respect of the statutory audit of Group entities[2]	**4.8**	4.5
– services normally provided in connection with statutory and regulatory filings or engagements	**0.1**	0.4
Total audit fees[3]	**4.9**	4.9

Other audited-related fees[3]	**—**	—
All other fees[3]	**0.1**	—
Total non-audit services[4]	**0.1**	—
Total fees payable to the Bank's auditors by the Group	**5.0**	4.9

1 Deloitte LLP became the Group's statutory auditor in 2021. PricewaterhouseCoopers LLP was the statutory auditor during 2020.

2 As defined by the Financial Reporting Council (FRC).

3 As defined by the Securities and Exchange Commission (SEC).

4 As defined by the SEC. Total non-audit services as defined by the FRC include all fees other than audit fees in respect of the statutory audit of Group entities. These fees totalled £0.2 million (2020 £0.4 million).

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 costs incurred in connection with client asset assurance and with the Sarbanes-Oxley Act requirements associated with the audit of Lloyds Banking Group's financial statements filed on its Form 20-F.

Other 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 debt prospectuses required by the Listing Rules.

All other fees: This category includes other assurance services not related to the performance of the audit or review of the financial statements, for example, the review of controls operated by the Group on behalf of a third party. The auditors are not engaged to provide tax services.

It is the Group's policy to use the auditors only 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.

The Group has procedures that are designed to ensure auditor independence, including prohibiting certain non-audit services. All audit and non-audit assignments must be pre-approved by the Lloyds Banking Group Audit Committee on an individual engagement basis; for certain types of non-audit engagements where the fee is 'de minimis' the Lloyds Banking Group Audit Committee has pre-approved all assignments subject to confirmation by management. On a quarterly basis, the Lloyds Banking Group Audit Committee receives and reviews a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

Note 10: Impairment

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Year ended 31 December 2021				
Impact of transfers between stages	**25**	**(128)**	**142**	**39**
Other changes in credit quality	**(107)**	**(124)**	**69**	**(162)**
Additions and repayments	**(42)**	**(125)**	**(88)**	**(255)**
Other items	**2**	**1**	**—**	**3**
	(147)	**(248)**	**(19)**	**(414)**
Total impairment (credit) charge	**(122)**	**(376)**	**123**	**(375)**

In respect of:				
Loans and advances to customers	**(94)**	**(336)**	**128**	**(302)**
Due from fellow Lloyds Banking Group undertakings	**(1)**	**—**	**—**	**(1)**
Financial assets at amortised cost	**(95)**	**(336)**	**128**	**(303)**
Loan commitments and financial guarantees	**(27)**	**(40)**	**(5)**	**(72)**
Total impairment (credit) charge	**(122)**	**(376)**	**123**	**(375)**

Note 10: Impairment (continued)

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Year ended 31 December 2020				
Impact of transfers between stages	(49)	348	267	566
Other changes in credit quality	387	102	596	1,085
Additions and repayments	31	(13)	(42)	(24)
Other items	—	—	(5)	(5)
	418	89	549	1,056
Total impairment charge	369	437	816	1,622
In respect of:				
Loans and advances to customers	339	396	812	1,547
Due from fellow Lloyds Banking Group undertakings	1	—	—	1
Financial assets at amortised cost	340	396	812	1,548
Loan commitments and financial guarantees	29	41	4	74
Total impairment charge	369	437	816	1,622

The Group's impairment charge comprises the following items:

Impact of transfers between stages
The net impact on the impairment charge of transfers between stages.

Other changes in credit quality
Changes in loss allowance as a result of movements in risk parameters that reflect changes in customer quality, but which have not resulted in a transfer to a different stage. This also contains the impact on the impairment charge as a result of write-offs and recoveries, where the related loss allowances are reassessed to reflect ultimate realisable or recoverable value.

Additions and repayments
Expected loss allowances are recognised on origination of new loans or further drawdowns of existing facilities. Repayments relate to the reduction of loss allowances resulting from the repayments of outstanding balances that have been provided against.

Movements in the Group's impairment allowances are shown in note 13.

Note 11: Tax expense

(A) Analysis of tax (expense) credit for the year

	2021 £m	2020 £m
UK corporation tax:		
Current tax on profit for the year	**(655)**	(109)
Adjustments in respect of prior years	**16**	50
	(639)	(59)
Foreign tax:		
Current tax on profit for the year	**—**	12
Adjustments in respect of prior years	**8**	2
	8	14
Current tax expense	**(631)**	(45)
Deferred tax:		
Current year	**282**	109
Adjustments in respect of prior years	**(19)**	(34)
Deferred tax credit	**263**	75
Tax (expense) credit	**(368)**	30

Note 11: Tax expense (continued)

(B) Factors affecting tax (expense) credit for the year

The UK corporation tax rate for the year was 19.0 per cent (2020: 19.0 per cent). An explanation of the relationship between tax (expense) credit and accounting profit is set out below:

	2021 **£m**	2020 £m
Profit before tax	**2,316**	883
UK corporation tax thereon	**(440)**	(168)
Impact of surcharge on banking profits	**(235)**	(59)
Non-deductible costs: conduct charges	**(155)**	13
Non-deductible costs: bank levy	**(8)**	(11)
Other non-deductible costs	**(21)**	(18)
Non-taxable income	**26**	39
Tax relief on coupons on other equity instruments	**21**	31
Remeasurement of deferred tax due to rate changes	**439**	182
Differences in overseas tax rates	**—**	3
Adjustments in respect of prior years	**5**	18
Tax (expense) credit	**(368)**	30

The tax expense in 2021 included the impact of non-deductible conduct charges which were significantly greater than in 2020, reflecting the Group's best estimate of tax-deductibility of provisions made in the year.

Note 12: Derivative financial instruments

The fair values and notional amounts of derivative instruments are set out in the following table:

	2021			2020		
The Group	**Contract/ notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading and other						
Exchange rate contracts:						
Spot, forwards and futures	**273**	**3**	**5**	794	14	49
Currency swaps	**10,044**	**85**	**326**	32,733	630	697
Options purchased	**5**	**—**	**—**	2	—	—
Options written	**5**	**—**	**—**	2	—	—
	10,327	**88**	**331**	33,531	644	746
Interest rate contracts:						
Interest rate swaps	**66,190**	**3,957**	**3,750**	93,427	5,467	6,649
Forward rate agreements	**—**	**—**	**—**	2,940	—	—
Options purchased	**100**	**1**	**—**	135	12	—
Options written	**119**	**—**	**1**	250	—	1
	66,409	**3,958**	**3,751**	96,752	5,479	6,650
Credit derivatives	**2,017**	**9**	**24**	2,132	15	21
Equity and other contracts	**44**	**11**	**166**	47	—	257
Total derivative assets/liabilities - trading and other	**78,797**	**4,066**	**4,272**	132,462	6,138	7,674
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**2,306**	**198**	**48**	4,235	533	106
Derivatives designated as cash flow hedges:						
Interest rate swaps	**—**	**—**	**—**	9,993	752	892
Total derivative assets/liabilities - hedging	**2,306**	**198**	**48**	14,228	1,285	998
Total recognised derivative assets/liabilities	**81,103**	**4,264**	**4,320**	146,690	7,423	8,672

The notional amount of the contract does not represent the Group’s 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; a large proportion of the Group's derivatives are held through exchanges such as London Clearing House and are collateralised through those exchanges. Further details are provided in note 36 Credit risk.

Note 12: Derivative financial instruments (continued)

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 36

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
- 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

Details of the Group's hedging instruments are set out below:

	Maturity					
The Group	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Total**
At 31 December 2021	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	**85**	**28**	**1,095**	**792**	**306**	**2,306**
Average fixed interest rate	**4.25%**	**4.38%**	**4.69%**	**4.71%**	**5.67%**	
Cash flow hedges						
Interest rate						
Interest rate swap						
Notional	**—**	**—**	**—**	**—**	**—**	**—**
Average fixed interest rate	**—**	**—**	**—**	**—**	**—**	
At 31 December 2020						
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	—	27	1,560	1,868	780	4,235
Average fixed interest rate	—	5.06%	4.56%	4.56%	5.58%	
Cash flow hedges						
Interest rate				.		
Interest rate swap						
Notional	49	637	1,084	4,918	3,305	9,993
Average fixed interest rate	4.07%	2.19%	0.82%	1.67%	3.65%	

Note 12: Derivative financial instruments (continued)

The carrying amounts of the Group's hedging instruments are as follows:

The Group At 31 December 2021	Carrying amount of the hedging instrument: Contract/ notional amount £m	Assets £m	Liabilities £m	Changes in fair value used for calculating hedge ineffectiveness £m
Fair value hedges				
Interest rate				
Interest rate swaps	**2,306**	**198**	**48**	**(151)**
Cash flow hedges				
Interest rate				
Interest rate swaps	**—**	**—**	**—**	**(43)**
At 31 December 2020				
Fair value hedges				
Interest rate				
Interest rate swaps	4,235	533	106	(23)
Cash flow hedges				
Interest rate				
Interest rate swaps	9,993	752	892	(2)

All amounts are held within derivative financial instruments.

The Group's hedged items are as follows:

The Group At 31 December 2021	Carrying amount of the hedged item: Assets £m	Liabilities £m	Accumulated amount of fair value adjustment on the hedged item: Assets £m	Liabilities £m	Change in fair value of hedged item for ineffectiveness assessment £m	Cash flow hedging reserve: Continuing hedges £m	Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	**—**	**3,315**	**—**	**525**	**173**		
Fixed rate bonds[2]	**660**	**—**	**(2)**	**—**	**(22)**		
Cash flow hedges							
Interest rate							
Customer loans[3]					**53**	**—**	**(113)**
Customer deposits[4]					**(11)**	**—**	**23**
At 31 December 2020							
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	—	5,143	—	711	8		
Fixed rate bonds[2]	872	—	20	—	15		
Cash flow hedges							
Interest rate							
Customer loans[3]					2	48	(117)
Customer deposits[4]					—	(5)	13

1 Included within debt securities in issue.

2 Included within financial assets at fair value through other comprehensive income.

3 Included within loans and advances to customers.

4 Included within customer deposits.

The accumulated amount of fair value hedge adjustments remaining in the balance sheet for hedged items that have ceased to be adjusted for hedging gains and losses is a liability of £56 million (2020: liability of £391 million).

Note 12: Derivative financial instruments (continued)

Gains and losses arising from hedge accounting are summarised as follows:

The Group At 31 December 2021	Gain (loss) recognised in other comprehensive income[1] £m	Hedge ineffectiveness recognised in the income statement[2] £m	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Income statement line item that includes reclassified amount
Cash flow hedges				
Interest rate				
Customer loans	**(44)**	**(4)**	**24**	**Interest income**
Customer deposits	**15**	**1**	**(5)**	**Interest expense**
At 31 December 2020				
Cash flow hedges				
Interest rate				
Customer loans	(8)	—	(5)	Interest income
Customer deposits	(1)	—	(1)	Interest expense

1 Comprising the change in fair value of the hedging derivatives (a loss of £48 million; 2020: loss of £3 million) and the amounts reclassified from reserves to the income statement (positive £19 million; 2020: negative £4 million).

2 Hedge ineffectiveness is included in the income statement within net trading income.

There were no amounts reclassified from the cash flow hedging reserve in 2020 or 2021 for which hedge accounting had previously been used but for which the hedged future cash flows are no longer expected to occur.

At 31 December 2021 £4,155 million of total recognised derivative assets of the Group and £4,188 million of total recognised derivative liabilities of the Group (2020: £7,139 million of assets and £8,337 million of liabilities) had a contractual residual maturity of greater than one year.

	2021			2020		
The Bank	**Contract/ notional amount** **£m**	**Fair value assets** **£m**	**Fair value liabilities** **£m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading and other						
Exchange rate contracts:						
Spot, forwards and futures	**273**	**3**	**5**	591	14	28
Currency swaps	**10,044**	**85**	**326**	32,714	630	678
Options purchased	**5**	**—**	**—**	2	—	—
Options written	**5**	**—**	**—**	2	—	—
	10,327	**88**	**331**	33,309	644	706
Interest rate contracts:						
Interest rate swaps	**66,189**	**3,957**	**3,740**	93,553	5,504	6,655
Forward rate agreements	**—**	**—**	**—**	2,940	—	—
Options purchased	**100**	**1**	**—**	135	12	—
Options written	**119**	**—**	**1**	250	—	1
	66,408	**3,958**	**3,741**	96,878	5,516	6,656
Credit derivatives	**2,017**	**9**	**24**	2,132	15	21
Equity and other contracts	**11**	**11**	**—**	—	—	—
Total derivative assets/liabilities - trading and other	**78,763**	**4,066**	**4,096**	132,319	6,175	7,383
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**2,306**	**198**	**48**	4,108	496	85
Derivatives designated as cash flow hedges:						
Interest rate swaps	**—**	**—**	**—**	9,993	752	892
Total derivative assets/liabilities - hedging	**2,306**	**198**	**48**	14,101	1,248	977
Total recognised derivative assets/liabilities	**81,069**	**4,264**	**4,144**	146,420	7,423	8,360

Note 12: Derivative financial instruments (continued)

Details of the Bank's hedging instruments are set out below:

The Bank At 31 December 2021	Maturity Up to 1 month £m	 1-3 months £m	 3-12 months £m	 1-5 years £m	 Over 5 years £m	 Total £m
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	**85**	**28**	**1,095**	**792**	**306**	**2,306**
Average fixed interest rate	**4.25%**	**4.38%**	**4.69%**	**4.71%**	**5.67%**	
Cash flow hedges						
Interest rate						
Interest rate swap						
Notional	**—**	**—**	**—**	**—**	**—**	**—**
Average fixed interest rate	**—**	**—**	**—**	**—**	**—**	
At 31 December 2020						
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	—	27	1,560	1,868	653	4,108
Average fixed interest rate	—	5.06%	4.56%	4.56%	5.67%	
Cash flow hedges						
Interest rate						
Interest rate swap						
Notional	49	637	1,084	4,918	3,305	9,993
Average fixed interest rate	4.07%	2.19%	0.82%	1.67%	3.65%	

The carrying amounts of the Bank's hedging instruments are as follows:

The Bank At 31 December 2021	Carrying amount of the hedging instrument Contract/ notional amount £m	 Assets £m	 Liabilities £m	 Changes in fair value used for calculating hedge ineffectiveness £m
Fair value hedges				
Interest rate				
Interest rate swaps	**2,306**	**198**	**48**	**(151)**
Cash flow hedges				
Interest rate				
Interest rate swaps	**—**	**—**	**—**	**(43)**
At 31 December 2020				
Fair value hedges				
Interest rate				
Interest rate swaps	4,108	496	85	(23)
Cash flow hedges				
Interest rate				
Interest rate swaps	9,993	752	892	(2)

All amounts are held within derivative financial instruments.

Note 12: Derivative financial instruments (continued)

The Bank's hedged items are as follows:

The Bank At 31 December 2021	Carrying amount of the hedged item Assets £m	Carrying amount of the hedged item Liabilities £m	Accumulated amount of fair value adjustment on the hedged item Assets £m	Accumulated amount of fair value adjustment on the hedged item Liabilities £m	Change in fair value of hedged item for ineffectiveness assessment £m	Cash flow hedging reserve Continuing hedges £m	Cash flow hedging reserve Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	**—**	**3,315**	**—**	**525**	**173**		
Fixed rate bonds[2]	**660**	**—**	**(2)**	**—**	**(22)**		
Cash flow hedges							
Interest rate							
Customer loans[3]					**53**	**—**	**(113)**
Customer deposits[4]					**(11)**	**—**	**23**
At 31 December 2020							
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	—	5,185	—	723	8		
Fixed rate bonds[2]	872	—	20	—	15		
Cash flow hedges							
Interest rate							
Customer loans[3]					2	48	(117)
Customer deposits[4]					—	(5)	13

1 Included within debt securities in issue.

2 Included within financial assets at fair value through other comprehensive income.

3 Included within loans and advances to customers.

4 Included within customer deposits.

The accumulated amount of fair value hedge adjustments remaining in the balance sheet for hedged items that have ceased to be adjusted for hedging gains and losses is a liability of £56 million (2020: liability of £391 million).

Gains and losses arising from hedge accounting are summarised as follows:

The Bank At 31 December 2021	Gain (loss) recognised in other comprehensive income[1] £m	Hedge ineffectiveness recognised in the income statement[2] £m	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Amounts reclassified from reserves to income statement as: Income statement line item that includes reclassified amount
Fair value hedges				
Interest rate				
Fixed rate issuance		**—**		
Fixed rate bonds		**—**		
Cash flow hedges				
Interest rate				
Customer loans	**(44)**	**(4)**	**24**	**Interest income**
Customer deposits	**15**	**1**	**(5)**	**Interest expense**
At 31 December 2020				
Fair value hedges				
Interest rate				
Fixed rate issuance		(1)		
Fixed rate bonds		1		
Cash flow hedges				
Interest rate				
Customer loans	(8)	—	(5)	Interest income
Customer deposits	1	—	1	Interest expense

1 Comprising the change in fair value of the hedging derivatives (a loss of £48 million; 2020: loss of £3 million) and the amounts reclassified from reserves to the income statement (positive £19 million; 2020: negative £4 million).

2 Hedge ineffectiveness is included in the income statement within net trading income.

Note 12: Derivative financial instruments (continued)

There were no amounts reclassified from the cash flow hedging reserve in 2020 or 2021 for which hedge accounting had previously been used but for which the hedged future cash flows are no longer expected to occur.

At 31 December 2021 £4,154 million of total recognised derivative assets of the Bank and £4,010 million of total recognised derivative liabilities of the Bank (2020: £7,139 million of assets and £8,046 million of liabilities) had a contractual residual maturity of greater than one year.

Note 13: Financial assets at amortised cost

Year ended 31 December 2021

	Gross carrying amount				Allowance for expected credit losses			
The Group	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**
Loans and advances to banks								
At 31 December 2021	**51**	**—**	**—**	**51**	**—**	**—**	**—**	**—**
Allowance for impairment losses	**—**	**—**	**—**	**—**				
Net carrying amount	**51**	**—**	**—**	**51**				
Loans and advances to customers								
At 1 January 2021	**226,746**	**34,437**	**5,775**	**266,958**	**486**	**1,146**	**1,560**	**3,192**
Exchange and other adjustments	**(32)**	**—**	**(31)**	**(63)**	**—**	**—**	**9**	**9**
Transfers to Stage 1	**9,790**	**(9,779)**	**(11)**	**—**	**210**	**(206)**	**(4)**	**—**
Transfers to Stage 2	**(6,399)**	**7,171**	**(772)**	**—**	**(19)**	**108**	**(89)**	**—**
Transfers to Stage 3	**(309)**	**(1,356)**	**1,665**	**—**	**(6)**	**(118)**	**124**	**—**
Impact of transfers between stages	**3,082**	**(3,964)**	**882**	**—**	**(160)**	**100**	**110**	**50**
					25	**(116)**	**141**	**50**
Other changes in credit quality					**(83)**	**(107)**	**75**	**(115)**
Additions and repayments	**20,211**	**(4,053)**	**(745)**	**15,413**	**(36)**	**(113)**	**(88)**	**(237)**
(Credit) charge to the income statement					**(94)**	**(336)**	**128**	**(302)**
Advances written off			**(382)**	**(382)**			**(382)**	**(382)**
Recoveries of advances written off in previous years			**62**	**62**			**62**	**62**
At 31 December 2021	**250,007**	**26,420**	**5,561**	**281,988**	**392**	**810**	**1,377**	**2,579**
Allowance for impairment losses	**(392)**	**(810)**	**(1,377)**	**(2,579)**				
Net carrying amount	**249,615**	**25,610**	**4,184**	**279,409**				
Due from fellow Lloyds Banking Group undertakings								
At 31 December 2021	**17,065**	**—**	**—**	**17,065**	**3**	**—**	**—**	**3**
Allowance for impairment losses	**(3)**	**—**	**—**	**(3)**				
Net carrying amount	**17,062**	**—**	**—**	**17,062**				
Total financial assets at amortised cost	**266,728**	**25,610**	**4,184**	**296,522**				

Movements in allowance for expected credit losses in respect of undrawn balances were as follows:

	Allowance for expected credit losses			
The Group	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**
Undrawn balances				
At 1 January 2021	**54**	**69**	**6**	**129**
Exchange and other adjustments	**(1)**	**—**	**—**	**(1)**
Transfers to Stage 1	**20**	**(20)**	**—**	**—**
Transfers to Stage 2	**(3)**	**3**	**—**	**—**
Transfers to Stage 3	**—**	**(2)**	**2**	**—**
Impact of transfers between stages	**(17)**	**7**	**(1)**	**(11)**
	—	**(12)**	**1**	**(11)**
Other items credited to the income statement	**(27)**	**(28)**	**(6)**	**(61)**
Credit to the income statement	**(27)**	**(40)**	**(5)**	**(72)**
At 31 December 2021	**26**	**29**	**1**	**56**

Note 13: Financial assets at amortised cost (continued)

The Group's total impairment allowances were as follows:

	Allowance for expected credit losses			
	Stage 1	**Stage 2**	**Stage 3**	**Total**
The Group	**£m**	**£m**	**£m**	**£m**
In respect of:				
Loans and advances to customers	**392**	**810**	**1,377**	**2,579**
Other assets	**—**	**—**	**1**	**1**
Due from fellow Lloyds Banking Group undertakings	**3**	**—**	**—**	**3**
Drawn balances	**395**	**810**	**1,378**	**2,583**
Provisions in relation to loan commitments and financial guarantees	**26**	**29**	**1**	**56**
Total	**421**	**839**	**1,379**	**2,639**

Year ended 31 December 2020

	Gross carrying amount				Allowance for expected credit losses			
	Stage 1	Stage 2	Stage 3	Total	Stage 1	Stage 2	Stage 3	Total
The Group	£m	£m	£m	£m	£m	£m	£m	£m
Loans and advances to banks								
At 31 December 2020	207	—	—	207	—	—	—	—
Allowance for impairment losses	—	—	—	—				
Net carrying amount	207	—	—	207				
Loans and advances to customers								
At 1 January 2020	229,741	24,996	5,663	260,400	149	749	1,187	2,085
Exchange and other adjustments	94	1	(2)	93	(2)	1	15	14
Transfers to Stage 1	3,011	(3,004)	(7)	—	52	(51)	(1)	—
Transfers to Stage 2	(15,009)	15,731	(722)	—	(63)	120	(57)	—
Transfers to Stage 3	(401)	(1,598)	1,999	—	(6)	(108)	114	—
Impact of transfers between stages	(12,399)	11,129	1,270	—	(33)	372	197	536
					(50)	333	253	536
Other changes in credit quality					367	88	587	1,042
Additions and repayments	10,106	(1,665)	(702)	7,739	22	(25)	(28)	(31)
Charge to the income statement					339	396	812	1,547
Disposal of business	(796)	(24)	—	(820)	—	—	—	—
Advances written off			(552)	(552)			(552)	(552)
Recoveries of advances written off in previous years			98	98			98	98
At 31 December 2020	226,746	34,437	5,775	266,958	486	1,146	1,560	3,192
Allowance for impairment losses	(486)	(1,146)	(1,560)	(3,192)				
Net carrying amount	226,260	33,291	4,215	263,766				
Due from fellow Lloyds Banking Group undertakings								
At 31 December 2020	28,997	—	—	28,997	9	—	—	9
Allowance for impairment losses	(9)	—	—	(9)				
Net carrying amount	28,988	—	—	28,988				
Total financial assets at amortised cost	255,455	33,291	4,215	292,961				

Note 13: Financial assets at amortised cost (continued)

Movements in allowance for expected credit losses in respect of undrawn balances were as follows:

The Group	Allowance for expected credit losses Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Undrawn balances				
At 1 January 2020	26	28	1	55
Exchange and other adjustments	(1)	—	1	—
Transfers to Stage 1	8	(8)	—	—
Transfers to Stage 2	(3)	3	—	—
Transfers to Stage 3	—	(3)	3	—
Impact of transfers between stages	(4)	23	11	30
	1	15	14	30
Other items charged (credited) to the income statement	28	26	(10)	44
Charge to the income statement	29	41	4	74
At 31 December 2020	54	69	6	129

The Group's total impairment allowances were as follows:

The Group	Allowance for expected credit losses Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of:				
Loans and advances to customers	486	1,146	1,560	3,192
Other assets	—	—	1	1
Due from fellow Lloyds Banking Group undertakings	9	—	—	9
Drawn balances	495	1,146	1,561	3,202
Provisions in relation to loan commitments and financial guarantees	54	69	6	129
Total	549	1,215	1,567	3,331

Year ended 31 December 2021

The Bank	**Gross carrying amount Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	**Allowance for expected credit losses Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**
Loans and advances to banks								
At 31 December 2021	**50**	**—**	**—**	**50**	**—**	**—**	**—**	**—**
Allowance for impairment losses	**—**	**—**	**—**	**—**				
Net carrying amount	**50**	**—**	**—**	**50**				
Loans and advances to customers								
At 1 January 2021	**224,337**	**32,974**	**5,421**	**262,732**	**482**	**1,066**	**1,487**	**3,035**
Exchange and other adjustments	**(27)**	**—**	**(32)**	**(59)**	**(1)**	**—**	**6**	**5**
Transfers to Stage 1	**9,404**	**(9,393)**	**(11)**	**—**	**191**	**(187)**	**(4)**	**—**
Transfers to Stage 2	**(6,189)**	**6,887**	**(698)**	**—**	**(19)**	**96**	**(77)**	**—**
Transfers to Stage 3	**(303)**	**(1,268)**	**1,571**	**—**	**(6)**	**(112)**	**118**	**—**
Impact of transfers between stages	**2,912**	**(3,774)**	**862**	**—**	**(142)**	**101**	**102**	**61**
					24	**(102)**	**139**	**61**
Other changes in credit quality					**(80)**	**(112)**	**82**	**(110)**
Additions and repayments	**20,632**	**(3,837)**	**(691)**	**16,104**	**(36)**	**(104)**	**(79)**	**(219)**
(Credit) charge to the income statement					**(92)**	**(318)**	**142**	**(268)**
Advances written off			**(371)**	**(371)**			**(371)**	**(371)**
Recoveries of advances written off in previous years			**62**	**62**			**62**	**62**
At 31 December 2021	**247,854**	**25,363**	**5,251**	**278,468**	**389**	**748**	**1,326**	**2,463**
Allowance for impairment losses	**(389)**	**(748)**	**(1,326)**	**(2,463)**				
Net carrying amount	**247,465**	**24,615**	**3,925**	**276,005**				

Note 13: Financial assets at amortised cost (continued)

	Gross carrying amount				Allowance for expected credit losses			
	Stage 1	**Stage 2**	**Stage 3**	**Total**	**Stage 1**	**Stage 2**	**Stage 3**	**Total**
The Bank	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Due from fellow Lloyds Banking Group undertakings								
At 31 December 2021	**23,926**	**—**	**48**	**23,974**	**7**	**—**	**48**	**55**
Allowance for impairment losses	**(7)**	**—**	**(48)**	**(55)**				
Net carrying amount	**23,919**	**—**	**—**	**23,919**				
Total financial assets at amortised cost	**271,434**	**24,615**	**3,925**	**299,974**				

Movements in allowance for expected credit losses in respect of undrawn balances were as follows:

	Allowance for expected credit losses			
	Stage 1	**Stage 2**	**Stage 3**	**Total**
The Bank	**£m**	**£m**	**£m**	**£m**
Undrawn balances				
At 1 January 2021	**54**	**69**	**6**	**129**
Exchange and other adjustments	**(1)**	**—**	**—**	**(1)**
Transfers to Stage 1	**20**	**(20)**	**—**	**—**
Transfers to Stage 2	**(3)**	**3**	**—**	**—**
Transfers to Stage 3	**—**	**(2)**	**2**	**—**
Impact of transfers between stages	**(17)**	**7**	**(1)**	**(11)**
	—	**(12)**	**1**	**(11)**
Other items credited to the income statement	**(27)**	**(28)**	**(6)**	**(61)**
Credit to the income statement	**(27)**	**(40)**	**(5)**	**(72)**
At 31 December 2021	**26**	**29**	**1**	**56**

The Bank's total impairment allowances were as follows:

	Allowance for expected credit losses			
	Stage 1	**Stage 2**	**Stage 3**	**Total**
The Bank	**£m**	**£m**	**£m**	**£m**
In respect of:				
Loans and advances to customers	**389**	**748**	**1,326**	**2,463**
Other assets	**—**	**—**	**1**	**1**
Due from fellow Lloyds Banking Group undertakings	**7**	**—**	**48**	**55**
Drawn balances	**396**	**748**	**1,375**	**2,519**
Provisions in relation to loan commitments and financial guarantees	**26**	**29**	**1**	**56**
Total	**422**	**777**	**1,376**	**2,575**

Year ended 31 December 2020

	Gross carrying amount				Allowance for expected credit losses			
	Stage 1	Stage 2	Stage 3	Total	Stage 1	Stage 2	Stage 3	Total
The Bank	£m	£m	£m	£m	£m	£m	£m	£m
Loans and advances to banks								
At 31 December 2020	205	—	—	205	—	—	—	—
Allowance for impairment losses	—	—	—	—				
Net carrying amount	205	—	—	205				

Note 13: Financial assets at amortised cost (continued)

The Bank	Gross carrying amount Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Allowance for expected credit losses Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Loans and advances to customers								
At 1 January 2020	225,703	23,857	5,307	254,867	147	682	1,107	1,936
Exchange and other adjustments	58	—	(2)	56	1	2	11	14
Transfers to Stage 1	2,930	(2,923)	(7)	—	50	(49)	(1)	—
Transfers to Stage 2	(14,422)	15,081	(659)	—	(62)	113	(51)	—
Transfers to Stage 3	(389)	(1,478)	1,867	—	(6)	(99)	105	—
Impact of transfers between stages	(11,881)	10,680	1,201	—	(31)	357	184	510
					(49)	322	237	510
Other changes in credit quality					360	81	602	1,043
Additions and repayments	10,457	(1,563)	(640)	8,254	23	(21)	(25)	(23)
Charge to the income statement					334	382	814	1,530
Advances written off			(536)	(536)			(536)	(536)
Recoveries of advances written off in previous years			91	91			91	91
At 31 December 2020	224,337	32,974	5,421	262,732	482	1,066	1,487	3,035
Allowance for impairment losses	(482)	(1,066)	(1,487)	(3,035)				
Net carrying amount	223,855	31,908	3,934	259,697				
Due from fellow Lloyds Banking Group undertakings								
At 31 December 2020	38,735	—	88	38,823	9	—	88	97
Allowance for impairment losses	(9)	—	(88)	(97)				
Net carrying amount	38,726	—	—	38,726				
Total financial assets at amortised cost	262,786	31,908	3,934	298,628				

Movements in allowance for expected credit losses in respect of undrawn balances were as follows:

The Bank	Allowance for expected credit losses Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Undrawn balances				
At 1 January 2020	26	28	1	55
Exchange and other adjustments	(1)	—	1	—
Transfers to Stage 1	8	(8)	—	—
Transfers to Stage 2	(3)	3	—	—
Transfers to Stage 3	—	(3)	3	—
Impact of transfers between stages	(4)	22	11	29
	1	14	14	29
Other items charged (credited) to the income statement	28	27	(10)	45
Charge to the income statement	29	41	4	74
At 31 December 2020	54	69	6	129

The Bank's total impairment allowances were as follows:

The Bank	Allowance for expected credit losses Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of:				
Loans and advances to customers	482	1,066	1,487	3,035
Other assets	—	—	1	1
Due from fellow Lloyds Banking Group undertakings	9	—	88	97
Drawn balances	491	1,066	1,576	3,133
Provisions in relation to loan commitments and financial guarantees	54	69	6	129
Total	545	1,135	1,582	3,262

Note 13: Financial assets at amortised cost (continued)

The movement tables are compiled by comparing the position at 31 December to that at the beginning of the year. Transfers between stages are deemed to have taken place at the start of the reporting period, with all other movements shown in the stage in which the asset is held at 31 December.

Additions and repayments comprise new loans originated and repayments of outstanding balances throughout the reporting period. Loans which are written off in the period are first transferred to Stage 3 before acquiring a full allowance and subsequent write-off.

At 31 December 2021 £42 million (2020: £56 million) of loans and advances to banks of the Group and £42 million (2020: £56 million) of the Bank had a contractual residual maturity of greater than one year.

At 31 December 2021 £262,405 million (2020: £248,314 million) of loans and advances to customers of the Group and £259,388 million (2020: £244,626 million) of the Bank had a contractual residual maturity of greater than one year.

Note 14: Finance lease receivables

The Group's finance lease receivables are classified as loans and advances to customers and accounted for at amortised cost. The balance is analysed as follows:

	The Group	
	2021	2020
	£m	£m
Not later than 1 year	**31**	31
Later than 1 year and not later than 2 years	**41**	32
Later than 2 years and not later than 3 years	**30**	50
Later than 3 years and not later than 4 years	**27**	26
Later than 4 years and not later than 5 years	**27**	30
Later than 5 years	**149**	172
Gross investment in finance leases	**305**	341
Unearned future finance income on finance leases	**(92)**	(105)
Rentals received in advance	**—**	(1)
Net investment in finance leases	**213**	235

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

	The Group	
	2021	2020
	£m	£m
Not later than 1 year	**10**	10
Later than 1 year and not later than 2 years	**27**	17
Later than 2 years and not later than 3 years	**18**	37
Later than 3 years and not later than 4 years	**16**	14
Later than 4 years and not later than 5 years	**18**	19
Later than 5 years	**124**	138
Net investment in finance leases	**213**	235

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. There was an allowance for uncollectable finance lease receivables included in the allowance for impairment losses for the Group of £1 million (2020: £nil).

Note 15: Goodwill

	The Group and the Bank	
	2021	2020
	£m	£m
At 1 January and 31 December	**325**	325

The goodwill held in the Group's balance sheet is tested at least annually for impairment. This compares the estimated recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; the entire balance of £325 million has been allocated to the Bank of Scotland cash generating unit.

The recoverable amount of goodwill carried at 31 December 2021 has been based upon value in use. This calculation uses cash flow projections based upon the Group's business plan where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. The discount rate used in discounting the projected cash flows is 10.25 per cent (post-tax) and a future growth rate of 3.5 per cent, reflecting the perceived risks within those businesses. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount to fall below the balance sheet carrying value.

Note 16: Investment in subsidiary undertakings of the Bank

	2021 £m	2020 £m
At 1 January	**74**	74
Additions	**10**	—
At 31 December	**84**	74

Details of the subsidiaries and related undertakings are given on page 101 and are incorporated by reference.

Certain subsidiary companies currently have insufficient distributable reserves to make dividend payments, however, there were no further significant restrictions on any of the Bank's subsidiaries in paying dividends or repaying loans and advances.

Note 17: Other assets

	The Group		The Bank	
	2021 £m	2020 £m	2021 £m	2020 £m
Property, plant and equipment:				
Investment properties	**4**	4	**—**	—
Premises	**287**	317	**287**	317
Equipment	**244**	261	**244**	261
Right-of-use assets (note 18)	**573**	648	**573**	648
	1,108	1,230	**1,104**	1,226
Capitalised software enhancements	**224**	224	**224**	224
Settlement balances	**—**	92	**—**	86
Prepayments	**100**	95	**100**	99
Other assets	**57**	77	**48**	61
Total other assets	**1,489**	1,718	**1,476**	1,696

Note 18: Lessee disclosures

The table below sets out the movement in the Group's right-of-use assets, which are primarily in respect of premises, and are recognised within other assets (note 17).

The Group and the Bank	2021 £m	2020 £m
At 1 January	**648**	730
Additions	**17**	18
Disposals	**(7)**	(8)
Depreciation charge for the year	**(85)**	(92)
At 31 December	**573**	648

The Group's lease liabilities are recognised within other liabilities (note 21). The maturity analysis of the Group's lease liabilities on an undiscounted basis is set out in the liquidity risk section of note 36.

The total cash outflow for leases in the year ended 31 December 2021 was £105 million. The amount recognised within interest expense in respect of lease liabilities is disclosed in note 4.

Note 19: Debt securities in issue

	The Group		The Bank	
	2021 £m	2020 £m	2021 £m	2020 £m
Medium-term notes issued	**4,048**	2,065	**4,048**	2,065
Covered bonds (note 20)	**1,651**	3,243	**1,651**	3,243
Securitisation notes (note 20)	**1,654**	2,989	**—**	—
	7,353	8,297	**5,699**	5,308
Other amounts due to fellow Group undertakings	**—**	—	**441**	1,704
Total debt securities in issue	**7,353**	8,297	**6,140**	7,012

At 31 December 2021 £4,705 million (2020: £5,898 million) of debt securities in issue of the Group and £3,352 million (2020: £3,543 million) of the Bank had a contractual residual maturity of greater than one year.

Note 20: Structured entities

The Group's interests in structured entities are consolidated. Details of the Group's interests in these structured entities are set out below for securitisations and covered bond vehicles.

Securitisation programmes
The Group's balance sheet includes loans securitised under the Group's securitisation programmes, the majority of which have been sold by Group 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 Group company, 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 and financial liabilities at fair value through profit or loss.

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 19 and on the balance sheet within financial liabilities at fair value through profit or loss.

	2021		2020	
	Loans and advances securitised £m	**Notes in issue £m**	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	**18,300**	**16,215**	23,504	21,119
Commercial loans	**388**	**388**	774	774
Credit card receivables	**3,413**	**4,121**	3,226	4,340
	22,101	**20,724**	27,504	26,233
Less held by the Group		**(19,037)**		(23,199)
Total securitisation programmes (note 19)[1]		**1,687**		3,034
Covered bond programmes				
Residential mortgage-backed	**2,574**	**1,151**	3,076	2,743
Social housing loan-backed	**833**	**500**	980	600
	3,407	**1,651**	4,056	3,343
Less held by the Group		**—**		(100)
Total covered bond programmes (note 19)		**1,651**		3,243
Total securitisation and covered bond programmes		**3,338**		6,277

1 Includes £33 million (2020: £45 million) of securitisation notes held at fair value through profit or loss.

Cash deposits of £1,286 million (2020: £1,485 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. Additionally, the Group has certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2021 these obligations had not been triggered; the maximum exposure under these facilities was £4 million (2020: £4 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 and financial liabilities at fair value through profit or loss, although the obligations of the Group in respect of its securitisation issuances 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 or as otherwise required by the transaction documents.

Note 21: Other liabilities

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Settlement balances	**58**	24	**58**	24
Lease liabilities	**627**	699	**627**	699
Accruals and other creditors	**765**	666	**603**	497
Total other liabilities	**1,450**	1,389	**1,288**	1,220

The maturity analysis of the lease liabilities on an undiscounted basis is set out in the liquidity risk section of note 36.

Note 22: Deferred tax

The Group's and the Bank's deferred tax assets and liabilities are as follows:

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Statutory position				
Deferred tax assets	**2,007**	1,721	**1,991**	1,718
Deferred tax liabilities	**—**	—	**—**	—
Net deferred tax asset at 31 December	**2,007**	1,721	**1,991**	1,718
Tax disclosure				
Deferred tax assets	**2,082**	1,786	**2,065**	1,782
Deferred tax liabilities	**(75)**	(65)	**(74)**	(64)
Net deferred tax asset at 31 December	**2,007**	1,721	**1,991**	1,718

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes into account the ability of the Group and the Bank to net assets and liabilities where there is a legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the tables below which splits the deferred tax assets and liabilities by type, before such netting.

Finance Act 2021, which was substantively enacted on 24 May 2021, increases the rate of corporation tax from 19 per cent to 25 per cent with effect from 1 April 2023. The impact of this rate change is an increase in the Group's net deferred tax asset as at 31 December 2021 of £438 million, comprising a £439 million credit included in the income statement and a £1 million charge included in equity. The tax credit in 2020 included an uplift in deferred tax assets following the announcement by the UK Government that it would maintain the corporation tax rate at 19 per cent.

On 27 October 2021, the UK Government announced its intention to decrease the rate of banking surcharge from 8 per cent to 3 per cent with effect from 1 April 2023. This change was substantively enacted on 2 February 2022 and its impact on deferred tax is therefore not included in these financial statements. Had this change in banking surcharge rate been substantively enacted at 31 December 2021, the impact would have been to recognise a £22 million deferred tax charge in the income statement and a £1 million charge within other comprehensive income, reducing the Group's net deferred tax asset by £23 million.

Movements in deferred tax assets and liabilities (before taking into consideration the offsetting of balances within the same taxing jurisdiction) can be summarised as follows:

The Group **Deferred tax assets**	**Tax losses** **£m**	**Property, plant and equipment** **£m**	**Provisions** **£m**	**Share-based payments** **£m**	**Derivatives** **£m**	**Asset revaluations[1]** **£m**	**Other temporary differences** **£m**	**Total** **£m**
At 1 January 2020	1,402	144	92	11	14	2	24	1,689
Credit (charge) to the income statement	145	(41)	(4)	(5)	—	(2)	1	94
Credit to other comprehensive income	—	—	—	—	3	—	—	3
At 31 December 2020	1,547	103	88	6	17	—	25	1,786
Credit (charge) to the income statement	**280**	**—**	**2**	**(2)**	**—**	**—**	**5**	**285**
Credit to other comprehensive income	**—**	**—**	**—**	**—**	**11**	**—**	**—**	**11**
At 31 December 2021	**1,827**	**103**	**90**	**4**	**28**	**—**	**30**	**2,082**

1 Financial assets at fair value through other comprehensive income.

Note 22: Deferred tax (continued)

The Group Deferred tax liabilities	Capitalised software enhancements £m	Derivatives £m	Asset revaluations[1] £m	Other temporary differences £m	Total £m
At 1 January 2020	(2)	—	—	(35)	(37)
Charge to the income statement	(14)	—	(4)	(1)	(19)
Charge to other comprehensive income	—	—	(2)	(7)	(9)
At 31 December 2020	(16)	—	(6)	(43)	(65)
Charge to the income statement	**(4)**	**(1)**	**(13)**	**(4)**	**(22)**
Credit to other comprehensive income	**—**	**—**	**12**	**—**	**12**
At 31 December 2021	**(20)**	**(1)**	**(7)**	**(47)**	**(75)**

The Bank Deferred tax assets	Tax losses £m	Property, plant and equipment £m	Provisions £m	Share-based payments £m	Derivatives £m	Other temporary differences £m	Total £m
At 1 January 2020	1,382	165	88	11	14	24	1,684
Credit (charge) to the income statement	143	(38)	(3)	(5)	—	(2)	95
Credit to other comprehensive income	—	—	—	—	3	—	3
At 31 December 2020	1,525	127	85	6	17	22	1,782
Credit (charge) to the income statement	**274**	**(2)**	**2**	**(2)**	**—**	**—**	**272**
Credit to other comprehensive income	**—**	**—**	**—**	**—**	**11**	**—**	**11**
At 31 December 2021	**1,799**	**125**	**87**	**4**	**28**	**22**	**2,065**

The Bank Deferred tax liabilities	Capitalised software enhancements £m	Asset revaluations[1] £m	Other temporary differences £m	Total £m
At 1 January 2020	(2)	(2)	(33)	(37)
Charge to the income statement	(14)	—	(3)	(17)
Charge to other comprehensive income	—	(4)	(7)	(11)
Exchange and other adjustments	—	—	1	1
At 31 December 2020	(16)	(6)	(42)	(64)
Charge to the income statement	**(4)**	**—**	**(5)**	**(9)**
Charge to other comprehensive income	**—**	**(1)**	**—**	**(1)**
At 31 December 2021	**(20)**	**(7)**	**(47)**	**(74)**

1 Financial assets at fair value through other comprehensive income.

At 31 December 2021 the Group carried net deferred tax assets on its balance sheet of £2,007 million (2020: £1,721 million) and the Bank carried deferred tax assets of £1,991 million (2020: £1,718 million) principally relating to tax losses carried forward.

Estimation of income taxes includes the assessment of recoverability of deferred tax assets. Deferred tax assets are only recognised to the extent that they are considered more likely than not to be recoverable based on existing tax laws and forecasts of future taxable profits against which the underlying tax deductions can be utilised. The Group has recognised a deferred tax asset of £1,827 million (2020: £1,547 million), and the Bank £1,799 million (2020: £1,525 million) in respect of trading losses carried forward. Substantially all of these losses have arisen in the Bank, and will be utilised as taxable profits arise in future periods.

The Group's expectations of future UK taxable profits require management judgement, and 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 Board-approved operating plan and the expected future economic outlook as set out in the strategic report, as well as the risks associated with future regulatory, climate-related and other change, in order to produce a base case forecast of future UK taxable profits. Under current law there is no expiry date for UK trading losses not yet utilised, and given the forecast of future profitability and the Group's commitment to the UK market, in management's judgement it is more likely than not that the value of the losses will be recovered by the Group while still operating as a going concern. Banking tax losses that arose before 1 April 2015 can only be used against 25 per cent of taxable profits arising after 1 April 2016, and they cannot be used to reduce the surcharge on banking profits. These restrictions in utilisation mean that the value of the deferred tax asset in respect of tax losses is only expected to be fully recovered by 2034 (2020: 2034) in the base case forecast. It is possible that future tax law changes could materially affect the timing of recovery and the value of these losses ultimately realised by the Group. The value of the deferred tax asset in respect of tax losses increased by £414 million in 2021 as a result of the change in UK tax rates.

Note 22: Deferred tax (continued)

Deferred tax not recognised
Deferred tax assets of £31 million (2020: £11 million) for the Group and the Bank have not been recognised in respect of £126 million of UK tax losses and other temporary differences which can only be used to offset future capital gains. UK capital losses can be carried forward indefinitely.

No deferred tax asset was recognised in 2020 in respect of unrelieved foreign tax credits of £40 million for the Group and the Bank, as there were no expected profits against which the credits could be utilised. The formal closure of the branches in respect of which these credits means that the credits have now been extinguished

No deferred tax has been recognised in respect of foreign trade losses where it is not more likely than not that we will be able to utilise them in future periods. Of the asset not recognised, £34 million for the Group and £nil for the Bank (2020: £33 million for the Group and £nil for the Bank) relates to losses that will expire if not used within 20 years, and £2 million for the Group and £nil for the Bank (2020: £37 million for the Group and £36 million for the Bank) relates to losses with no expiry date.

As a result of parent company exemptions on dividends from subsidiaries and on capital gains on disposal there are no significant taxable temporary differences associated with investments in subsidiaries, branches, associates and joint arrangements.

Note 23: Other provisions

	The Group				The Bank			
	Provisions for financial commitments and guarantees	Regulatory and legal provisions	Other	Total	Provisions for financial commitments and guarantees	Regulatory and legal provisions	Other	Total
	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2021	**129**	**230**	**162**	**521**	**129**	**229**	**161**	**519**
Exchange and other adjustments	**(1)**	**—**	**1**	**—**	**(1)**	**—**	**1**	**—**
Provisions applied	**—**	**(377)**	**(31)**	**(408)**	**—**	**(377)**	**(30)**	**(407)**
(Release) charge for the year	**(72)**	**982**	**34**	**944**	**(72)**	**983**	**34**	**945**
At 31 December 2021	**56**	**835**	**166**	**1,057**	**56**	**835**	**166**	**1,057**

Provisions for financial commitments and guarantees
Provisions are recognised for expected credit losses on undrawn loan commitments and financial guarantees. See also note 13.

Regulatory and legal provisions
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 in connection with its past conduct and claims brought by or on behalf of current and former employees, customers, investors and other third parties and is subject to legal proceedings and other legal actions. Where significant, provisions are held against the costs expected to be incurred in relation to these matters and matters arising from related internal reviews. During the year ended 31 December 2021 the Group charged a further £982 million in respect of legal actions and other regulatory matters, including a charge in respect of HBOS Reading and charges for other legacy programmes.

The unutilised balance at 31 December 2021 was £835 million (31 December 2020: £230 million). The most significant items are as follows.

HBOS Reading – review
The Group completed its compensation assessment for those within the Customer Review in 2019 with more than £109 million of compensation paid, in addition to £15 million for ex-gratia payments and £6 million for the reimbursement of legal fees. The Group is now applying the recommendations from Sir Ross Cranston's review, issued in December 2019, including a reassessment of direct and consequential losses by an independent panel (the Foskett Panel), an extension of debt relief and a wider definition of de facto directors. The appeal process for the further assessment of debt relief and de facto director status is now nearing completion. Further details of the Foskett Panel were announced on 3 April 2020 and the Foskett Panel's full scope and methodology was published on 7 July 2020. The Foskett Panel's stated objective is to consider cases via a non-legalistic and fair process and to make their decisions in a generous, fair and common sense manner, assessing claims against an expanded definition of the fraud and on a lower evidential basis.

Following the emergence of the first outcomes of the Foskett Panel through 2021, the Group has charged a further £790 million in the year ended 31 December 2021, of which £600 million was recognised in the fourth quarter. This includes operational costs in relation to Dame Linda Dobbs' review, which is considering whether the issues relating to HBOS Reading were investigated and appropriately reported by the Group during the period from January 2009 to January 2017, and other programme costs. A significant proportion of the fourth quarter charge relates to the estimated future awards from the Foskett Panel. To date the Foskett Panel has shared outcomes on a limited subset of the total population which covers a wide range of businesses and different claim characteristics. The estimated awards provision recognised is therefore materially dependent on the assumption that the limited number of awards to date are representative of the full population of cases. The 2021 charge increases the lifetime cost to £1,225 million. The final outcome could be significantly different from the current provision once the re-review is concluded by the Foskett Panel. There is no confirmed timeline for the completion of the Foskett Panel re-review process. The Group is committed to implementing Sir Ross's recommendations in full.

Payment protection insurance
The Group has made provisions for PPI costs over a number of years totalling £6,356 million. Good progress continues to be made towards ensuring operational completeness, ahead of an orderly programme close. At 31 December 2021, a provision of £2 million remained outstanding, with total cash payments of £54 million during the year.

In addition to the above provision, the Group continues to challenge PPI litigation cases, with mainly legal fees and operational costs associated with litigation activity recognised within regulatory and legal provisions, including a charge in the fourth quarter. PPI litigation remains inherently uncertain, with a number of key Court judgments due to be delivered in 2022.

Arrears handling related activities
To date the Group has provided a total of £679 million for arrears handling activities. The unutilised balance at 31 December 2021 was £10 million.

Note 24: Subordinated liabilities

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

	The Group				The Bank			
	Preferred securities £m	Undated £m	Dated £m	Total £m	Preferred securities £m	Undated £m	Dated £m	Total £m
At 1 January 2020	323	4,571	1,207	6,101	172	4,722	1,207	6,101
Issued during the year[1]:								
SONIA 105 NC 5.5 Subordinated Floating Rate Notes due 2026 (£1,000 million)	—	—	1,000	1,000	—	—	1,000	1,000
Repurchases and redemptions during the year[1]:								
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)	(154)	—	—	(154)	(154)	—	—	(154)
Foreign exchange movements	—	24	—	24	—	24	—	24
Other movements (cash and non-cash)	3	(2)	(8)	(7)	3	(2)	(8)	(7)
At 31 December 2020	172	4,593	2,199	6,964	21	4,744	2,199	6,964
Issued during the year[1]:								
Subordinated Floating Rate Note 24 September 2026 (£500 million)	**—**	**—**	**500**	**500**	**—**	**—**	**500**	**500**
Repurchases and redemptions during the year[1]:								
7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million)	**(156)**	**—**	**—**	**(156)**	**—**	**—**	**—**	**—**
7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B) (£150 million)	**—**	**—**	**—**	**—**	**—**	**(156)**	**—**	**(156)**
Floating Rate Subordinated Notes (£150 million)	**—**	**(151)**	**—**	**(151)**	**—**	**(151)**	**—**	**(151)**
Floating Rate Subordinated Notes (€500 million)	**—**	**(429)**	**—**	**(429)**	**—**	**(429)**	**—**	**(429)**
Floating Rate Subordinated Notes 30 April 2004 (£500 million)	**—**	**(502)**	**—**	**(502)**	**—**	**(502)**	**—**	**(502)**
Floating Rate Subordinated Notes 31 October 2003 (£500 million)	**—**	**(502)**	**—**	**(502)**	**—**	**(502)**	**—**	**(502)**
Floating Rate Subordinated Notes 30 January 2004 (£300 million)	**—**	**(302)**	**—**	**(302)**	**—**	**(302)**	**—**	**(302)**
Floating Rate Subordinated Notes 30 June 2003 (£300 million)	**—**	**(302)**	**—**	**(302)**	**—**	**(302)**	**—**	**(302)**
Floating Rate Subordinated Notes (£250 million)	**—**	**(251)**	**—**	**(251)**	**—**	**(251)**	**—**	**(251)**
Floating Rate Subordinated Notes (£2,000 million)	**—**	**(2,007)**	**—**	**(2,007)**	**—**	**(2,007)**	**—**	**(2,007)**
Floating Rate Primary Capital Notes (US$250 million)	**—**	**(24)**	**—**	**(24)**	**—**	**(24)**	**—**	**(24)**
9.375% Subordinated Bonds 2021 (£500 million)	**—**	**—**	**(200)**	**(200)**	**—**	**—**	**(200)**	**(200)**
Floating Rate Subordinated Notes 2014 (£1,000 million)	**—**	**—**	**(1,002)**	**(1,002)**	**—**	**—**	**(1,002)**	**(1,002)**
	(156)	**(4,470)**	**(1,202)**	**(5,828)**	**—**	**(4,626)**	**(1,202)**	**(5,828)**
Foreign exchange movements	**—**	**1**	**—**	**1**	**—**	**1**	**—**	**1**
Other movements (cash and non-cash)	**6**	**(5)**	**6**	**7**	**1**	**—**	**6**	**7**
At 31 December 2021	**22**	**119**	**1,503**	**1,644**	**22**	**119**	**1,503**	**1,644**

1 Issuances in the year generated cash inflows for the Group and for the Bank of £500 million (2020: £1,000 million); the repurchases and redemptions resulted in cash outflows for the Group and the Bank of £5,714 million (2020: £161 million). Cash payments in respect of interest on subordinated liabilities in the year amounted to £88 million for the Group and £94 million for the Bank (2020: £146 million for the Group and the Bank).

Certain of the above securities were issued or redeemed under exchange offers, which did not result in an extinguishment of the original financial liability for accounting purposes.

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. Neither the Group nor the Bank has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during 2021 (2020: none).

Note 25: Share capital

(1) Authorised share capital

	The Group and the Bank			
	2021	2020	**2021**	2020
	Number of shares	Number of shares	**£m**	£m
Sterling				
Ordinary shares of 25p each	**24,085,301,755**	24,085,301,755	**6,021**	6,021
8.117% non-cumulative perpetual preference shares class "A" of £10 each	**250,000**	250,000	**3**	3
7.754% non-cumulative perpetual preference shares class "B" of £10 each	**150,000**	150,000	**2**	2
			6,026	6,026

(2) Issued and fully paid share capital

	The Group and the Bank			
	2021	2020	**2021**	2020
	Number of shares	Number of shares	**£m**	£m
Issued and fully paid ordinary shares				
Ordinary shares of 25p each				
At 1 January	**23,388,340,553**	23,388,340,552	**5,847**	5,847
Issued in the year	**—**	1	**—**	—
At 31 December	**23,388,340,553**	23,388,340,553	**5,847**	5,847
Issued and fully paid preference shares				
Preferences shares of 25p each				
At 1 January and 31 December	**400**	400	**—**	—
Total share capital at 31 December			**5,847**	5,847

(3) Share capital and control

There are no limitations on voting rights or restrictions on the transfer of shares in the Bank 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).

Ordinary shares
The holders of ordinary shares are entitled to receive the Bank's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares may also receive a dividend (subject to the provisions of the Bank's articles of association) and on a winding up may share in the assets of the Bank.

Issued and fully paid preference shares
The Bank has in issue preference shares which are all classified as liabilities under accounting standards.

Note 26: Other reserves

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Merger reserve and other reserves[1]	**1,600**	1,600	**1,600**	1,600
Capital redemption reserve[1]	**482**	482	**482**	482
Revaluation reserve in respect of debt securities held at fair value through other comprehensive income	**15**	5	**14**	17
Cash flow hedging reserve	**(63)**	(45)	**(63)**	(45)
Foreign currency translation reserve	**(21)**	(22)	**(8)**	(8)
At 31 December	**2,013**	2,020	**2,025**	2,046

1 There have been no movements in these reserves in 2021 or 2020.

Movements in other reserves were as follows:

	The Group		The Bank	
Revaluation reserve in respect of debt securities held at fair value through other comprehensive income	**2021**	2020	**2021**	2020
	£m	£m	**£m**	£m
At 1 January	**5**	(7)	**17**	6
Change in fair value	**(2)**	24	**(2)**	25
Deferred tax	**(1)**	(5)	**(1)**	(7)
	(3)	19	**(3)**	18
Income statement transfers in respect of disposals (note 7)	**—**	(10)	**—**	(10)
Deferred tax	**13**	3	**—**	3
	13	(7)	**—**	(7)
At 31 December	**15**	5	**14**	17

Note 26: Other reserves (continued)

	The Group and the Bank	
	2021	2020
Cash flow hedging reserve	**£m**	£m
At 1 January	**(45)**	(41)
Change in fair value of hedging derivatives	**(48)**	(3)
Deferred tax	**16**	2
	(32)	(1)
Net income statement transfers	**19**	(4)
Deferred tax	**(5)**	1
	14	(3)
At 31 December	**(63)**	(45)

	The Group		The Bank	
	2021	2020	**2021**	2020
Foreign currency translation reserve	**£m**	£m	**£m**	£m
At 1 January	**(22)**	(15)	**(8)**	—
Currency translation differences arising in the year	**1**	(7)	**—**	(8)
At 31 December	**(21)**	(22)	**(8)**	(8)

Note 27: Retained profits

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
At 1 January	**3,313**	2,516	**2,877**	2,078
Profit attributable to ordinary shareholders[1]	**1,838**	749	**1,853**	751
Dividends paid (note 29)	**(1,200)**	—	**(1,200)**	—
Capital contributions received	**36**	33	**36**	33
Post-retirement defined benefit scheme remeasurements	**(12)**	15	**(12)**	15
At 31 December	**3,975**	3,313	**3,554**	2,877

1 No income statement has been shown for the Bank, as permitted by Section 408 of the Companies Act 2006.

Note 28: Other equity instruments

	The Group and the Bank	
	2021	2020
	£m	£m
At 1 January	**2,200**	2,700
Issued in the year	**—**	1,000
Redemption	**—**	(1,500)
Profit for the year attributable to other equity holders	**109**	164
Distributions on other equity instruments	**(109)**	(164)
At 31 December	**2,200**	2,200

The Bank has in issue £2,200 million of Additional Tier 1 (AT1) securities to Lloyds Banking Group plc. The AT1 securities are fixed rate resetting or floating rate Perpetual Subordinated Permanent Write-Down 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 the Bank of unsubordinated creditors on a winding-up
– The fixed rate reset 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 fixed rate reset AT1 securities will bear interest at rates fixed periodically in advance. The floating rate AT1 securities will be reset quarterly both prior to and following the first call date
– Interest on the securities will be due and payable only at the sole discretion of the Bank and the Bank 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 the Bank, in whole at the first call date, or at any interest payment date thereafter. In addition, the AT1 securities are repayable, at the option of the Bank, in whole for certain regulatory or tax reasons. Any repayments require the prior consent of the PRA
– The securities will be subject to a Permanent Write Down should the Common Equity Tier 1 ratio of the Bank fall below 7.0 per cent

Note 29: Dividends on ordinary shares

Dividends paid during the year were as follows:

	2021 £m	2020 £m
Interim dividends	**1,200**	—

Note 30: Share-based payments

During the year ended 31 December 2021 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the Bank of Scotland Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group are set out below; these are managed and operated on a Lloyds Banking Group-wide basis. The amount charged to the Group's income statement in respect of Lloyds Banking Group share-based payment schemes, and which is included within staff costs (note 8), was £45 million (2020: £48 million).

During the year ended 31 December 2021 the Lloyds Banking Group operated the following share-based payment schemes, all of which are equity settled.

Lloyds Banking Group Performance Share plan
The Lloyds Banking Group operates a Group Performance Share plan that is equity settled. Bonuses in respect of employee service in 2021 have been recognised in the charge in line with the proportion of the deferral period completed.

Save-As-You-Earn schemes
Eligible employees may enter into contracts through the Save-As-You-Earn (SAYE) schemes to save up to £500 per month and, at the expiry of a fixed term of three years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Lloyds Banking Group at a discounted price of no less than 80 per cent (90 per cent for the 2020 and 2021 plans) 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:

	2021		2020	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**1,120,138,915**	**30.39**	1,068,094,073	44.55
Granted	**236,923,744**	**39.40**	779,229,797	24.25
Exercised	**(6,924,434)**	**30.57**	(255,706,663)	47.51
Forfeited	**(22,815,078)**	**28.78**	(6,938,102)	43.30
Cancelled	**(51,479,310)**	**32.57**	(389,767,675)	42.24
Expired	**(95,280,546)**	**49.03**	(74,772,515)	47.26
Outstanding at 31 December	**1,180,563,291**	**30.63**	1,120,138,915	30.39
Exercisable at 31 December	**336,561**	**51.03**	792,741	47.49

The weighted average share price at the time that the options were exercised during 2021 was £0.47 (2020: £0.61). The weighted average remaining contractual life of options outstanding at the end of the year was 2.46 years (2020: 2.98 years).

The weighted average fair value of SAYE options granted during 2021 was £0.09 (2020: £0.05). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

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 (to compensate new recruits for any lost share awards), and also to make grants to key individuals for retention purposes. In some instances, grants may be made subject to individual performance conditions.

Participants are not entitled to any dividends paid during the vesting period.

	2021		2020	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**6,666,372**	**Nil**	7,634,638	Nil
Granted	**5,308,496**	**Nil**	1,990,449	Nil
Exercised	**(5,129,115)**	**Nil**	(2,122,302)	Nil
Vested	—	**Nil**	(47,337)	Nil
Forfeited	**(385,184)**	**Nil**	(111,100)	Nil
Lapsed	**(558,679)**	**Nil**	(677,976)	Nil
Outstanding at 31 December	**5,901,890**	**Nil**	6,666,372	Nil
Exercisable at 31 December	**708,939**	**Nil**	3,150,407	Nil

Note 30: Share-based payments (continued)

The weighted average fair value of options granted in the year was £0.45 (2020: £0.33). 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 2021 was £0.44 (2020: £0.36). The weighted average remaining contractual life of options outstanding at the end of the year was 4.3 years (2020: 4.1 years).

Other share plans

Lloyds Banking Group Executive Group Ownership Share Plan

The plan, introduced in 2006, is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Lloyds Banking Group over a three-year period. Awards are made within limits set by the rules of the plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

At the end of the performance period for the 2018 grant, the targets had not been fully met and therefore these awards vested in 2021 at a rate of 33.75 per cent.

	2021 Number of shares	2020 Number of shares
Outstanding at 1 January	**533,987,527**	459,904,745
Granted	**—**	211,214,605
Vested	**(39,621,415)**	(47,775,806)
Forfeited	**(144,437,243)**	(96,015,542)
Dividend award	**944,758**	6,659,525
Outstanding at 31 December	**350,873,627**	533,987,527

Awards in respect of the 2019 grant are due to vest in 2022 at a rate of 41.80 per cent. In previous years participants were entitled to any dividends paid in the vesting period. However, following a regulatory change prohibiting the payment of dividend on such awards, the number of shares awarded has been determined by applying a share price adjusted to exclude the value of estimated future dividends.

The weighted average fair value of the awards granted in 2020 was £0.28.

Lloyds Banking Group Long Term Share Plan

The plan, introduced in 2021, which replaced the Lloyds Banking Group Executive Group Ownership Share Plan, is intended to provide alignment to our aim of delivering sustainable returns to shareholders, supported by our values and behaviours.

	2021 Number of shares
Granted	**83,456,304**
Forfeited	**(5,573,236)**
Outstanding at 31 December	**77,883,068**

The weighted average fair value of awards granted in the year was £0.36.

Chief Financial Officer buyout

William Chalmers joined the Lloyds Banking Group on 3 June 2019 and was appointed as Chief Financial Officer on 1 August 2019 on the retirement of George Culmer. He was granted deferred share awards over 4,086,632 shares, to replace unvested awards from his former employer, Morgan Stanley, that were forfeited as a result of him joining the Lloyds Banking Group.

	2021 Number of shares	2020 Number of shares
Outstanding at 1 January	**1,810,712**	3,268,460
Exercised	**(1,124,627)**	(1,457,748)
Outstanding at 31 December	**686,085**	1,810,712

Group Chief Executive buyout

Charlie Nunn joined the Lloyds Banking Group on 16 August 2021 as Group Chief Executive. He was granted deferred share awards over 8,301,708 shares to replace unvested awards from his former employer, HSBC, that were forfeited as a result of him joining the Lloyds Banking Group.

	2021 Number of shares
Granted	**8,301,708**
Exercised	**(856,921)**
Outstanding at 31 December	**7,444,787**

The weighted average fair value of awards granted in 2021 was £0.40.

Note 30: Share-based payments (continued)

Assumptions at 31 December 2021

The fair value calculations at 31 December 2021 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	SAYE	Executive Share Plan 2003	Long Term Share Plan	Group Chief Executive buyout
Weighted average risk-free interest rate	**0.49%**	**0.12%**	**0.16%**	**0.26%**
Weighted average expected life	**3.3 years**	**1.3 years**	**3.4 years**	**2.8 years**
Weighted average expected volatility	**28%**	**30%**	**31%**	**31%**
Weighted average expected dividend yield	**3.1%**	**3.2%**	**3.1%**	**3.1%**
Weighted average share price	**£0.45**	**£0.47**	**£0.40**	**£0.44**
Weighted average exercise price	**£0.39**	**Nil**	**Nil**	**Nil**

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

Share Incentive Plan
Free shares
An award of shares may be made annually to employees up to a maximum of £3,600. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition. If an employee leaves the Lloyds Banking Group within this three-year period for other than a 'good' reason, all of the shares awarded will be forfeited.

On 25 March 2021, the Lloyds Banking Group made an award of 1,017 (2020: 676) shares to all eligible employees. The number of shares awarded was 67,658,976 (2020: 45,612,424), with an average fair value of £0.42 (2020: £0.30) based on the market price at the date of award.

Matching shares
The Lloyds Banking Group undertakes to match shares purchased by employees up to the value of £45 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, all 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 2021 was 46,621,026 (2020: 62,262,140), with an average fair value of £0.44 (2020: £0.34), 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. From June 2020, the fixed share awards are released over three years with one third being released each year following the year of award. The number of shares purchased in 2021 was 8,320,948 (2020: 13,975,993).

The fixed share award is not subject to any performance conditions, performance adjustment or clawback. On an employee leaving the Lloyds Banking Group, there is no change to the timeline for which shares will become unrestricted.

Note 31: 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:

	2021 £m	2020 £m
Compensation		
Salaries and other short-term benefits	**4**	5
Share-based payments	**6**	5
Total compensation	**10**	10

The aggregate of the emoluments of the directors was £4.2 million (2020: £4.7 million).

Aggregate company contributions in respect of key management personnel to defined contribution pension schemes were £nil (2020: £nil).

The total for the highest paid director (Sir António Horta-Osório) was £1,247,000 (2020: Juan Colombás: £1,668,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in any year.

Note 31: Related party transactions (continued)

	2021 million	2020 million
Share plans settled in Lloyds Banking Group plc shares		
At 1 January	**117**	101
Granted, including certain adjustments (includes entitlements of appointed key management personnel)	**19**	46
Exercised/lapsed (includes entitlements of former key management personnel)	**(62)**	(30)
At 31 December	**74**	117

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:

	2021 £m	2020 £m
Loans		
At 1 January	**2**	2
Advanced (includes loans of appointed key management personnel)	**1**	—
At 31 December	**3**	2

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 0.39 per cent and 22.93 per cent in 2021 (2020: 0.39 per cent and 24.20 per cent; 2019: 6.45 per cent and 24.20 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2020 and 2019: £nil).

	2021 £m	2020 £m
Deposits		
At 1 January	**11**	23
Placed (includes deposits of appointed key management personnel)	**26**	26
Withdrawn (includes deposits of former key management personnel)	**(26)**	(38)
At 31 December	**11**	11

Deposits placed by key management personnel attracted interest rates of up to 1.0 per cent (2020: 2.0 per cent).

At 31 December 2021, the Group did not provide any guarantees in respect of key management personnel (2020: none).

At 31 December 2021, transactions, arrangements and agreements entered into by the Lloyds Banking Group and its banking subsidiaries with Directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £0.6 million with five Directors and two connected persons (2020: £0.6 million with five Directors and two connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings
Balances and transactions between members of the Bank of Scotland Group
In accordance with IFRS 10 *Consolidated Financial Statements*, transactions and balances between the Bank and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

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

	2021 £m	2020 £m
Assets, included within:		
Derivative financial instruments	**2**	7
Financial assets at amortised cost: due from fellow Lloyds Banking Group undertakings	**6,857**	9,826
Liabilities, included within:		
Due to fellow Lloyds Banking Group undertakings	**5,356**	7,948
Derivative financial instruments	**7**	2
Debt securities in issue	**441**	1,704
Subordinated liabilities	**—**	151

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2021 the Bank earned interest income on the above asset balances of £277 million (2020: £97 million) and incurred interest expense on the above liability balances of £265 million (2020: £105 million).

Note 31: Related party transactions (continued)

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

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Assets, included within:				
Derivative financial instruments	**2,411**	4,819	**2,411**	4,820
Financial assets at amortised cost: due from fellow Lloyds Banking Group undertakings	**17,062**	28,988	**17,062**	28,900
Liabilities, included within:				
Due to fellow Lloyds Banking Group undertakings	**77,839**	91,953	**77,837**	91,664
Derivative financial instruments	**3,632**	7,374	**3,632**	7,374
Debt securities in issue	**3,387**	1,215	**3,387**	1,186
Subordinated liabilities	**1,564**	6,512	**1,564**	6,512

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2021 the Group earned £119 million and the Bank earned £119 million interest income on the above asset balances (2020: Group £340 million, Bank £340 million); the Group incurred £1,639 million and the Bank incurred £1,639 million interest expense on the above liability balances (2020: Group £1,882 million, Bank £1,881 million).

Other related party transactions
Pension funds
At 31 December 2021, customer deposits of £144 million (2020: £43 million) related to the HBOS Group's pension funds.

Joint ventures and associates
At 31 December 2021 there were loans and advances to customers of £14 million (2020: £11 million) outstanding and balances within customer deposits of £4 million (2020: £4 million) relating to joint ventures and associates.

Note 32: Contingent liabilities, commitments and guarantees

Interchange fees
With respect to multi-lateral interchange fees (MIFs), the Lloyds Banking Group is not involved in the ongoing litigation which involves the card schemes Visa and Mastercard (as described below). However, the Group is a member/licensee of Visa and Mastercard and other card schemes. The litigation in question is as follows:

- Litigation brought by retailers against both Visa and Mastercard continues in the English Courts, in which retailers are seeking damages on grounds that Visa and Mastercard's MIFs breached competition law (this includes a judgment of the Supreme Court in June 2020 upholding the Court of Appeal's finding in 2018 that historic interchange arrangements of Mastercard and Visa infringed competition law)
- Litigation brought on behalf of UK consumers in the English Courts against Mastercard

Any impact on the Group of the litigation against Visa and Mastercard remains uncertain at this time, such that it is not practicable for the Group to provide an estimate of any potential financial effect. Insofar as Visa is required to pay damages to retailers for interchange fees set prior to June 2016, contractual arrangements to allocate liability have been agreed between various UK banks (including the Lloyds Banking Group) and Visa Inc, as part of Visa Inc's acquisition of Visa Europe in 2016. These arrangements cap the maximum amount of liability to which the Lloyds Banking Group may be subject and this cap is set at the cash consideration received by the Lloyds Banking Group for the sale of its stake in Visa Europe to Visa Inc in 2016. In 2016, the Lloyds Banking Group received Visa preference shares as part of the consideration for the sale of its shares in Visa Europe. In 2020, some of these Visa preference shares were converted into Visa Inc Class A common stock (in accordance with the provisions of the Visa Europe sale documentation) and they were subsequently sold by the Lloyds Banking Group. The sale has no impact on this contingent liability.

LIBOR and other trading rates
Certain Lloyds Banking Group companies, together with other panel banks, have been named as defendants in ongoing 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 London Interbank Offered Rate and the Australian BBSW reference rate.

Certain Lloyds Banking Group companies are also named as defendants in (i) UK-based claims; and (ii) two Dutch class actions, raising LIBOR manipulation allegations. A number of the claims against the Lloyds Banking Group in the UK relating to the alleged mis-sale of interest rate hedging products also include allegations of LIBOR manipulation.

It is currently not possible to predict the scope and ultimate outcome on the Lloyds Banking Group of 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. As such, it is not practicable to provide an estimate of any potential financial effect.

Note 32: Contingent liabilities, commitments and guarantees (continued)

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 its interpretation of the UK rules means that the group relief is not available. In 2020, HMRC concluded their enquiry into the matter and issued a closure notice. The Lloyds Banking Group's interpretation of the UK rules has not changed and hence it has appealed to the First Tier Tax Tribunal, with a hearing expected in 2022. If the final determination of the matter by the judicial process is that HMRC's position is correct, management estimate that this would result in an increase in current tax liabilities of the Group of approximately £180 million (including interest). The Lloyds Banking Group, 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 Lloyds Banking Group is in discussions with HMRC (including the tax treatment of certain costs arising from the divestment of TSB Banking Group plc), none of which is expected to have a material impact on the financial position of the Group.

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, which could relate to a number of issues, including financial, environmental or other regulatory matters, both in the UK and overseas. Where material, such 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 based on 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 to assess properly 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. Where there is a contingent liability related to an existing provision the relevant disclosures are included within note 23.

Contingent liabilities, commitments and guarantees

	The Group and the Bank	
	2021	2020
	£m	£m
Contingent liabilities	**263**	207

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

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Commitments and guarantees				
Documentary credits and other short-term trade-related transactions	**—**	1	**—**	1
Forward asset purchases and forward deposits placed	**6**	28	**6**	28
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	**16,147**	17,828	**16,035**	17,705
Other commitments and guarantees	**24,794**	26,203	**24,759**	26,162
	40,941	44,031	**40,794**	43,867
1 year or over original maturity	**3,061**	3,512	**3,061**	3,512
Total commitments and guarantees	**44,008**	47,572	**43,861**	47,408

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £18,740 million (2020: £20,919 million) for the Group and £18,628 million (2020: £20,796 million) for the Bank were irrevocable.

Capital commitments
There was no capital expenditure contracted but not provided for at 31 December 2021 (2020: £nil).

Note 33: 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.

The Group	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m	Total £m
At 31 December 2021							
Financial assets							
Cash and balances at central banks	—	—	—	—	—	3,201	3,201
Items in the course of collection from banks	—	—	—	—	—	47	47
Financial assets at fair value through profit or loss	—	—	362	—	—	—	362
Derivative financial instruments	198	4,066	—	—	—	—	4,264
Loans and advances to banks	—	—	—	—	—	51	51
Loans and advances to customers	—	—	—	—	—	279,409	279,409
Due from fellow Lloyds Banking Group undertakings	—	—	—	—	—	17,062	17,062
Financial assets at amortised cost	—	—	—	—	—	296,522	296,522
Financial assets at fair value through other comprehensive income	—	—	—	—	2,047	—	2,047
Total financial assets	**198**	**4,066**	**362**	**—**	**2,047**	**299,770**	**306,443**
Financial liabilities							
Deposits from banks and repurchase agreements	—	—	—	—	—	30,625	30,625
Customer deposits	—	—	—	—	—	170,777	170,777
Due to fellow Lloyds Banking Group undertakings	—	—	—	—	—	77,839	77,839
Items in course of transmission to banks	—	—	—	—	—	98	98
Financial liabilities at fair value through profit or loss	—	—	—	33	—	—	33
Derivative financial instruments	48	4,272	—	—	—	—	4,320
Notes in circulation	—	—	—	—	—	1,321	1,321
Debt securities in issue	—	—	—	—	—	7,353	7,353
Other	—	—	—	—	—	627	627
Subordinated liabilities	—	—	—	—	—	1,644	1,644
Total financial liabilities	**48**	**4,272**	**—**	**33**	**—**	**290,284**	**294,637**

Note 33: Financial instruments (continued)

The Group	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m	Total £m
At 31 December 2020							
Financial assets							
Cash and balances at central banks	—	—	—	—	—	2,841	2,841
Items in the course of collection from banks	—	—	—	—	—	42	42
Financial assets at fair value through profit or loss	—	—	477	—	—	—	477
Derivative financial instruments	1,285	6,138	—	—	—	—	7,423
Loans and advances to banks	—	—	—	—	—	207	207
Loans and advances to customers	—	—	—	—	—	263,766	263,766
Due from fellow Lloyds Banking Group undertakings	—	—	—	—	—	28,988	28,988
Financial assets at amortised cost	—	—	—	—	—	292,961	292,961
Financial assets at fair value through other comprehensive income	—	—	—	—	2,395	—	2,395
Total financial assets	1,285	6,138	477	—	2,395	295,844	306,139
Financial liabilities							
Deposits from banks and repurchase agreements	—	—	—	—	—	14,695	14,695
Customer deposits	—	—	—	—	—	163,001	163,001
Due to fellow Lloyds Banking Group undertakings	—	—	—	—	—	91,953	91,953
Items in course of transmission to banks	—	—	—	—	—	98	98
Financial liabilities at fair value through profit or loss	—	—	—	45	—	—	45
Derivative financial instruments	998	7,674	—	—	—	—	8,672
Notes in circulation	—	—	—	—	—	1,305	1,305
Debt securities in issue	—	—	—	—	—	8,297	8,297
Other	—	—	—	—	—	699	699
Subordinated liabilities	—	—	—	—	—	6,964	6,964
Total financial liabilities	998	7,674	—	45	—	287,012	295,729

Note 33: Financial instruments (continued)

The Bank	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	At fair value through other comprehensive income £m	Held at amortised cost £m	Total £m
At 31 December 2021						
Financial assets						
Cash and balances at central banks	—	—	—	—	3,201	3,201
Items in the course of collection from banks	—	—	—	—	47	47
Financial assets at fair value through profit or loss	—	—	152	—	—	152
Derivative financial instruments	198	4,066	—	—	—	4,264
Loans and advances to banks	—	—	—	—	50	50
Loans and advances to customers	—	—	—	—	276,005	276,005
Due from fellow Lloyds Banking Group undertakings	—	—	—	—	23,919	23,919
Financial assets at amortised cost	—	—	—	—	299,974	299,974
Financial assets at fair value through other comprehensive income	—	—	—	2,047	—	2,047
Total financial assets	198	4,066	152	2,047	303,222	309,685
Financial liabilities						
Deposits from banks and repurchase agreements	—	—	—	—	30,625	30,625
Customer deposits	—	—	—	—	170,776	170,776
Due to fellow Lloyds Banking Group undertakings	—	—	—	—	83,193	83,193
Items in course of transmission to banks	—	—	—	—	98	98
Derivative financial instruments	48	4,096	—	—	—	4,144
Notes in circulation	—	—	—	—	1,321	1,321
Debt securities in issue	—	—	—	—	6,140	6,140
Other	—	—	—	—	627	627
Subordinated liabilities	—	—	—	—	1,644	1,644
Total financial liabilities	48	4,096	—	—	294,424	298,568
At 31 December 2020						
Financial assets						
Cash and balances at central banks	—	—	—	—	2,841	2,841
Items in the course of collection from banks	—	—	—	—	42	42
Financial assets at fair value through profit or loss	—	—	158	—	—	158
Derivative financial instruments	1,248	6,175	—	—	—	7,423
Loans and advances to banks	—	—	—	—	205	205
Loans and advances to customers	—	—	—	—	259,697	259,697
Due from fellow Lloyds Banking Group undertakings	—	—	—	—	38,726	38,726
Financial assets at amortised cost	—	—	—	—	298,628	298,628
Financial assets at fair value through other comprehensive income	—	—	—	2,395	—	2,395
Total financial assets	1,248	6,175	158	2,395	301,511	311,487
Financial liabilities						
Deposits from banks and repurchase agreements	—	—	—	—	14,694	14,694
Customer deposits	—	—	—	—	163,000	163,000
Due to fellow Lloyds Banking Group undertakings	—	—	—	—	99,612	99,612
Items in course of transmission to banks	—	—	—	—	98	98
Derivative financial instruments	977	7,383	—	—	—	8,360
Notes in circulation	—	—	—	—	1,305	1,305
Debt securities in issue	—	—	—	—	7,012	7,012
Other	—	—	—	—	699	699
Subordinated liabilities	—	—	—	—	6,964	6,964
Total financial liabilities	977	7,383	—	—	293,384	301,744

Note 33: 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 measures valuation adjustments for its derivative exposures on the same basis as the derivatives are managed.

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.

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, premises and equipment, and shareholders' equity. These items are material and accordingly the Group believes that any fair value information presented would 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 lifecycle. 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 structured credit, over-the-counter options and the credit valuation adjustment (CVA), funding valuation adjustment (FVA) and other valuation adjustments.

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 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. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are classified as level 3.

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.

Note 33: Financial instruments (continued)

(3) Financial assets and liabilities carried at fair value

(A) Financial assets, excluding derivatives

Valuation hierarchy

At 31 December 2021, the Group's financial assets carried at fair value, excluding derivatives, totalled £2,409 million (2020: £2,872 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 75). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2021				
Financial assets at fair value through profit or loss				
Loans and advances to customers	**—**	**—**	**362**	**362**
Financial assets at fair value through other comprehensive income				
Corporate and other debt securities	**—**	**2,047**	**—**	**2,047**
Total financial assets carried at fair value, excluding derivatives	**—**	**2,047**	**362**	**2,409**
At 31 December 2020				
Financial assets at fair value through profit or loss				
Loans and advances to customers	—	—	477	477
Financial assets at fair value through other comprehensive income				
Corporate and other debt securities	—	2,395	—	2,395
Total financial assets carried at fair value, excluding derivatives	—	2,395	477	2,872

The Bank	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2021				
Financial assets at fair value through profit or loss				
Loans and advances to customers	**—**	**—**	**152**	**152**
Financial assets at fair value through other comprehensive income				
Corporate and other debt securities	**—**	**2,047**	**—**	**2,047**
Total financial assets carried at fair value, excluding derivatives	**—**	**2,047**	**152**	**2,199**
At 31 December 2020				
Financial assets at fair value through profit or loss				
Loans and advances to customers	—	—	158	158
Financial assets at fair value through other comprehensive income				
Corporate and other debt securities	—	2,395	—	2,395
Total financial assets carried at fair value, excluding derivatives	—	2,395	158	2,553

Movements in level 3 portfolio

The table below analyses movements in level 3 financial assets, excluding derivatives, carried at fair value (recurring measurement).

	The Group		The Bank	
	2021 £m	2020 £m	**2021 £m**	2020 £m
At 1 January	**477**	463	**158**	117
(Losses) gains recognised in the income statement within other income	**(78)**	16	**(6)**	21
Purchases/increases to customer loans	**4**	25	**4**	25
Sales/repayments of customer loans	**(41)**	(27)	**(4)**	(5)
At 31 December	**362**	477	**152**	158
(Losses) gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December	**(68)**	15	**(7)**	15

Note 33: Financial instruments (continued)

Valuation methodology for financial assets, excluding derivatives

Loans and advances to customers

The fair value of these assets is determined using discounted cash flow techniques. The discount rates are derived from market observable interest rates, a risk margin that reflects loan credit ratings and an incremental illiquidity premium based on historical spreads at origination on similar loans.

Debt securities

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.

(B) Financial liabilities, excluding derivatives

Valuation hierarchy

At 31 December 2021, the Group's financial liabilities carried at fair value, excluding derivatives, comprised its financial liabilities at fair value through profit or loss and totalled £33 million (2020: £45 million). The table below analyses these financial liabilities by balance sheet classification and valuation methodology (level 1, 2 or 3, as described on page 75). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

	2021				2020			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
The Group	£m	£m	£m	£m	£m	£m	£m	£m
Debt securities in issue designated at fair value through profit or loss	**—**	**—**	**33**	**33**	—	—	45	45

Movements in level 3 portfolio

The table below analyses movements in the level 3 financial liabilities portfolio, excluding derivatives.

	2021	2020
The Group	£m	£m
At 1 January	**45**	47
(Gains) losses recognised in the income statement within other income	**(5)**	1
Redemptions	**(7)**	(3)
At 31 December	**33**	45
(Gains) losses recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December	**(4)**	1

(C) Derivatives

Valuation hierarchy

All of the Group's derivative assets and liabilities are carried at fair value. At 31 December 2021, such assets totalled £4,264 million for the Group and £4,264 million for the Bank (2020: £7,423 million for the Group and £7,423 million for the Bank) and liabilities totalled £4,320 million for the Group and £4,144 million for the Bank (2020: £8,672 million for the Group and £8,360 million for the Bank). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 75). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

	2021				2020			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
The Group	£m	£m	£m	£m	£m	£m	£m	£m
Derivative assets	**—**	**4,264**	**—**	**4,264**	—	7,411	12	7,423
Derivative liabilities	**—**	**(4,144)**	**(176)**	**(4,320)**	—	(8,401)	(271)	(8,672)

	2021				2020			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
The Bank	£m	£m	£m	£m	£m	£m	£m	£m
Derivative assets	**—**	**4,264**	**—**	**4,264**	—	7,411	12	7,423
Derivative liabilities	**—**	**(4,144)**	**—**	**(4,144)**	—	(8,360)	—	(8,360)

Note 33: Financial instruments (continued)

Movements in level 3 portfolio
The table below analyses movements in level 3 derivative assets and liabilities carried at fair value.

	2021		2020	
	Derivative assets	**Derivative liabilities**	Derivative assets	Derivative liabilities
The Group	**£m**	**£m**	£m	£m
At 1 January	**12**	**(271)**	—	(297)
(Losses) gains recognised in the income statement within other income	**(12)**	**76**	1	7
Redemptions	**—**	**19**	—	20
Transfers into the level 3 portfolio	**—**	**—**	11	(1)
At 31 December	**—**	**(176)**	12	(271)
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	**—**	**69**	1	7

Valuation methodology for derivatives
Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

– Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates
– Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources
– Credit derivatives 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 inputs to the valuation are significant, 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.

Certain unobservable inputs used to calculate CVA, FVA, and own credit adjustments, are not significant in determining the classification of the derivative and debt instruments. Consequently, these inputs do not form part of the level 3 sensitivities presented.

Derivative valuation adjustments
Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

(i) Uncollateralised derivative valuation adjustments
The following table summarises the movement on this valuation adjustment account during 2020 and 2021:

	2021	2020
	£m	£m
At 1 January	**120**	102
Income statement (credit) charge	**(32)**	18
At 31 December	**88**	120

Represented by:

	2021	2020
	£m	£m
Credit Valuation Adjustment	**73**	97
Debit Valuation Adjustment	**(3)**	(3)
Funding Valuation Adjustment	**18**	26
	88	120

Note 33: Financial instruments (continued)

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 strong interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers.

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
– Expectations of counterparty creditworthiness

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 £18 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 (although no such adjustment was required at 31 December 2021).

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
– The Group's own CDS spread

A one per cent rise in the CDS spread would lead to an increase in the DVA of £6 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £23 million fall in the overall valuation adjustment to £47 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 uncollateralised derivative positions. 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 £3 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 time frame 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 2021, the Group's derivative trading business held mid to bid-offer valuation adjustments of £2 million (2020: £4 million).

Note 33: Financial instruments (continued)

(D) Sensitivity of level 3 valuations

			2021			2020		
				Effect of reasonably possible alternative assumptions[2]			Effect of reasonably possible alternative assumptions[2]	
	Valuation techniques	Significant unobservable inputs[1]	Carrying value £m	Favourable changes £m	Unfavourable changes £m	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Financial assets at fair value through profit or loss								
Loans and advances to customers	Discounted cash flows	Interest rate spreads (bps) (+/- 50bps)[3]	**362**	**31**	**(29)**	477	36	(34)
Derivative financial assets								
Interest rate derivatives	Option pricing model	Interest rate volatility (n/a)[4]	**—**	**—**	**—**	12	—	—
Level 3 financial assets carried at fair value			**362**			489		
Financial liabilities at fair value through profit or loss								
Securitisation notes	Discounted cash flows	Interest rate spreads (+/- 50bps)[5]	**33**	**1**	**(1)**	45	1	(1)
Derivative financial liabilities								
Shared appreciation right	Market values – property valuation	HPI (+/- 1%)[6]	**176**	**19**	**(18)**	271	24	(22)
Level 3 financial liabilities carried at fair value			**209**			316		

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 2020: -50bps/106bps
4 2020: 30%/60%
5 2020: +/- 50bps
6 2020: +/- 1%

Unobservable inputs
Significant unobservable inputs affecting the valuation of debt securities 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
– Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes

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.

(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 75). Financial assets carried at amortised cost 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		
The Group	**Carrying value £m**	**Fair value £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
At 31 December 2021					
Loans and advances to banks	**51**	**51**	**—**	**—**	**51**
Loans and advances to customers	**279,409**	**282,369**	**—**	**—**	**282,369**
Due from fellow Lloyds Banking Group undertakings	**17,062**	**17,062**	**—**	**—**	**17,062**
At 31 December 2020					
Loans and advances to banks	207	207	—	—	207
Loans and advances to customers	263,766	265,635	—	—	265,635
Due from fellow Lloyds Banking Group undertakings	28,988	28,988	—	—	28,988

Note 33: Financial instruments (continued)

The Bank	Carrying value £m	Fair value £m	Valuation hierarchy Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2021					
Loans and advances to banks	**50**	**50**	**—**	**—**	**50**
Loans and advances to customers	**276,005**	**278,916**	**—**	**—**	**278,916**
Due from fellow Lloyds Banking Group undertakings	**23,919**	**23,919**	**—**	**—**	**23,919**
At 31 December 2020					
Loans and advances to banks	205	205	—	—	205
Loans and advances to customers	259,697	261,512	—	—	261,512
Due from fellow Lloyds Banking Group undertakings	38,726	38,726	—	—	38,726

Valuation methodology

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.

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.

(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 75).

The Group	Carrying value £m	Fair value £m	Valuation hierarchy Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2021					
Deposits from banks and repurchase agreements	**30,625**	**30,625**	**—**	**30,625**	**—**
Customer deposits	**170,777**	**170,842**	**—**	**170,842**	**—**
Due to fellow Lloyds Banking Group undertakings	**77,839**	**77,839**	**—**	**77,839**	**—**
Debt securities in issue	**7,353**	**7,425**	**—**	**7,425**	**—**
Subordinated liabilities	**1,644**	**1,671**	**—**	**1,671**	**—**
Repurchase agreements included in above amounts:					
Deposits from banks and repurchase agreements	**30,028**	**30,028**	**—**	**30,028**	**—**
At 31 December 2020					
Deposits from banks and repurchase agreements	14,695	14,695	—	14,695	—
Customer deposits	163,001	163,148	—	163,148	—
Due to fellow Lloyds Banking Group undertakings	91,953	91,953	—	91,953	—
Debt securities in issue	8,297	8,622	—	8,622	—
Subordinated liabilities	6,964	6,990	—	6,990	—
Repurchase agreements included in above amounts:					
Deposits from banks and repurchase agreements	13,680	13,680	—	13,680	—

Note 33: Financial instruments (continued)

The Bank	Carrying value £m	Fair value £m	Valuation hierarchy Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2021					
Deposits from banks and repurchase agreements	**30,625**	**30,625**	**—**	**30,625**	**—**
Customer deposits	**170,776**	**170,842**	**—**	**170,842**	**—**
Due to fellow Lloyds Banking Group undertakings	**83,193**	**83,193**	**—**	**83,193**	**—**
Debt securities in issue	**6,140**	**6,210**	**—**	**6,210**	**—**
Subordinated liabilities	**1,644**	**1,671**	**—**	**1,671**	**—**
Repurchase agreements included in above amounts:					
Deposits from banks and repurchase agreements	**30,028**	**30,028**	**—**	**30,028**	**—**
At 31 December 2020					
Deposits from banks and repurchase agreements	14,694	14,694	—	14,694	—
Customer deposits	163,000	163,147	—	163,147	—
Due to fellow Lloyds Banking Group undertakings	99,612	99,612	—	99,612	—
Debt securities in issue	7,012	7,226	—	7,226	—
Subordinated liabilities	6,964	6,990	—	6,990	—
Repurchase agreements included in above amounts:					
Deposits from banks and repurchase agreements	13,680	13,680	—	13,680	—

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) Reclassifications of financial assets
There have been no reclassifications of financial assets in 2020 or 2021.

Note 34: Transfers of financial assets

There were no significant transferred financial assets which were derecognised in their entirety, but with ongoing exposure. Details of transferred financial assets that continue to be recognised in full are as follows.

The Group and the Bank enter into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets 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 20, included within financial assets measured at amortised cost are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all or 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 while 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 20). The liabilities shown in the table below have recourse to the transferred assets.

	2021		2020	
The Group	**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				
Financial assets at fair value through other comprehensive income	**24**	**—**	37	—
Securitisation programmes				
Financial assets at amortised cost:				
Loans and advances to customers[1]	**22,101**	**1,687**	27,504	3,034

1 The carrying value of associated liabilities for the Group excludes securitisation notes held by the Group of £19,037 million (31 December 2020: £23,199 million).

	2021		2020	
The Bank	**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				
Financial assets at fair value through other comprehensive income	**24**	**—**	37	—
Securitisation programmes				
Financial assets at amortised cost:				
Loans and advances to customers[1]	**22,101**	**—**	27,504	—

1 The carrying value of transferred assets for the Bank includes amounts relating to assets transferred to structured entities which are fully consolidated into the Group. The liabilities associated with such assets are issued by the structured entities.

Note 35: 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 or collateral arrangements in place with counterparties.

				Related amounts where set off in the balance sheet not permitted[2]		
	Gross amounts of assets and liabilities[1] £m	Amount offset in the balance sheet £m	Net amounts presented in the balance sheet £m	Cash collateral received/ pledged £m	Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
At 31 December 2021						
Financial assets						
Financial assets at fair value through profit or loss	**362**	**—**	**362**	**—**	**—**	**362**
Derivative financial instruments	**4,264**	**—**	**4,264**	**(712)**	**(350)**	**3,202**
Loans and advances to banks	**51**	**—**	**51**	**(42)**	**—**	**9**
Loans and advances to customers	**279,409**	**—**	**279,409**	**(12)**	**(305)**	**279,092**
Financial assets at fair value through other comprehensive income	**2,047**	**—**	**2,047**	**—**	**—**	**2,047**
Financial liabilities						
Deposits from banks	**597**	**—**	**597**	**(596)**	**—**	**1**
Repurchase agreements	**30,028**	**—**	**30,028**	**—**	**(30,028)**	**—**
Customer deposits	**170,777**	**—**	**170,777**	**(116)**	**(305)**	**170,356**
Financial liabilities at fair value through profit or loss	**33**	**—**	**33**	**—**	**—**	**33**
Derivative financial instruments	**4,320**	**—**	**4,320**	**(54)**	**(1,237)**	**3,029**
At 31 December 2020						
Financial assets						
Financial assets at fair value through profit or loss	477	—	477	—	—	477
Derivative financial instruments	7,423	—	7,423	(1,394)	(621)	5,408
Loans and advances to banks	207	—	207	(17)	—	190
Loans and advances to customers	263,766	—	263,766	(229)	(606)	262,931
Financial assets at fair value through other comprehensive income	2,395	—	2,395	—	—	2,395
Financial liabilities						
Deposits from banks	1,015	—	1,015	(774)	—	241
Repurchase agreements	13,680	—	13,680	—	(13,680)	—
Customer deposits	163,001	—	163,001	(620)	(606)	161,775
Financial liabilities at fair value through profit or loss	45	—	45	—	—	45
Derivative financial instruments	8,672	—	8,672	(246)	(1,572)	6,854

1 After impairment allowance.

2 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 respective 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 36: Financial risk management

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: market risk, which includes interest rate risk and foreign exchange risk; credit risk; liquidity risk and capital risk. The following disclosures provide quantitative and qualitative information about the Group's exposure to these risks.

Market risk

(A) Interest rate risk

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 UK Bank Rate, set by the Bank of England. The rates on the remaining deposits are 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.

The Group's risk management policy is to optimise reward while managing its market risk exposures within the risk appetite defined by the Lloyds Banking Group Board. The largest residual risk exposure arises from balances that are deemed to be insensitive to changes in market rates (including current accounts, a portion of variable rate deposits and investable equity), and is managed through the Lloyds Banking Group's structural hedge. The Lloyds Banking Group's structural hedge consists of longer-term fixed rate assets or interest rate swaps and the amount and duration of the hedging activity is reviewed regularly by the Lloyds Banking Group Asset and Liability Committee.

The Lloyds Banking Group establishes hedge accounting relationships for interest rate risk using cash flow hedges and fair value hedges. The Lloyds Banking Group is exposed to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The derivatives used to manage the Lloyds Banking Group structural hedge may be designated into cash flow hedges to manage income statement volatility. The economic items related to the Lloyds Banking Group structural hedge, for example current accounts, are not eligible hedged items under IAS 39 for inclusion into accounting hedge relationships. The Lloyds Banking Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The Lloyds Banking Group applies netting between similar risks before applying hedge accounting.

Hedge ineffectiveness arises during the management of interest rate risk due to residual unhedged risk. Sources of ineffectiveness, which the Group may decide to not fully mitigate, can include basis differences, timing differences and notional amount differences. The effectiveness of accounting hedge relationships is assessed between the hedging derivatives and the documented hedged item, which can differ to the underlying economically hedged item.

At 31 December 2021 the aggregate notional principal of interest rate swaps designated as fair value hedges was £2,306 million (2020: £4,235 million) for the Group and £2,306 million (2020: £4,108 million) for the Bank with a net fair value asset of £150 million (2020: asset of £427 million) for the Group and a net fair value asset of £150 million (2020: asset of £411 million) for the Bank (note 12). There were losses recognised on the hedging instruments of £151 million (2020: losses of £23 million) for the Group and losses of £151 million (2020: losses of £23 million) for the Bank. There were gains on the hedged items attributable to the hedged risk of £151 million (2020: gains of £23 million) for the Group and gains of £151 million (2020: gains of £23 million) for the Bank. The gains and losses relating to the fair value hedges are recorded in net trading income.

The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2021 was £nil (2020: £9,993 million) for the Group and £nil (2020: £9,993 million) for the Bank with a net fair value asset of £nil (2020: liability of £140 million) for the Group and a net fair value asset of £nil (2020: liability of £140 million) for the Bank (note 12). In 2021, ineffectiveness recognised in the income statement that arises from cash flow hedges was a loss of £3 million (2020: £nil).

Interest Rate Benchmark Reform

During 2021, the Group has continued to manage the transition to alternative benchmark rates under its Group-wide IBOR transition programme including delivery of the core changes required to its technology and business processes. Through this programme, the Group has ensured that the most appropriate benchmark rate is used for new products, has transitioned the vast majority of its legacy products to new benchmark rates for IBORs ceasing immediately after 31 December 2021 and has managed the impacts and risks relating to systems, processes, accounting and reporting. The Group does not expect material changes to its risk management approach and strategy as a result of interest rate benchmark reform.

The material risks identified include the following:

Conduct and litigation risk. The Group may be exposed to conduct and litigation charges as a direct result of inappropriate or negligent actions taken during IBOR transition resulting in detriment to the customer. The Group is working closely with its counterparties to avoid this outcome.

Market risk. IBOR transition is expected to lead to changes in the Group's market risk profile which will continue to be monitored and managed within the appropriate risk appetites. The key change is expected to be on the management of basis risk profile during the period when alternative benchmark rates are referenced in contracts up to the cessation of the in-scope IBOR index.

Credit risk. Clients may wish to renegotiate the terms of existing transactions as a consequence of IBOR reform. This could lead to a change in the credit risk exposure of the client depending on the outcome of the negotiations. The Group will continue to monitor and manage changes within the appropriate risk appetites.

Accounting risk. If IBOR transition is finalised in a manner that does not permit the application of the reliefs introduced in the IFRS Phase 2 amendments, the financial instrument may be required to be derecognised and a new instrument recognised. In addition, where instruments used in hedge accounting relationships are transitioned either at different times or to different benchmarks, this may result in additional volatility to the income statement either through hedge accounting ineffectiveness or failure of the hedge accounting relationships.

Operational risk. Additional operational risks may arise due to the IBOR transition programme impacting all businesses and functions within the Group and leading to the implementation of changes to technology, operations, client communication and the valuation of in-scope financial instruments.

Note 36: Financial risk management (continued)

At 31 December 2021, the Group had successfully transitioned all derivative products settled though the London Clearing House (LCH) that were dependent on Sterling, Euro, Japanese Yen and Swiss Franc LIBOR to alternative benchmark rates and has transitioned the majority of its commercial lending contracts from Sterling LIBOR to alternative benchmark rates. US Dollar LIBOR is not expected to cease before 30 June 2023 and the Group continues to work on its planned transition to alternative benchmark rates for those financial contracts currently referencing US dollar LIBOR.

At 31 December 2021, the Group and the Bank had the following significant exposures impacted by interest rate benchmark reform which have yet to transition to the replacement benchmark rate:

	The Group				The Bank			
	Sterling LIBOR	US Dollar LIBOR	Other LIBOR	Total	Sterling LIBOR	US Dollar LIBOR	Other LIBOR	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Non-derivative financial assets								
Financial assets at fair value through profit or loss	98	—	—	98	98	—	—	98
Loans and advances to customers	404	23	—	427	404	23	—	427
Due from fellow Lloyds Banking Group undertakings	7	127	—	134	7	127	—	134
Financial assets at amortised cost	411	150	—	561	411	150	—	561
	509	150	—	659	509	150	—	659
Non-derivative financial liabilities								
Debt securities in issue	—	—	23	23	—	—	23	23
Derivative notional/contract amount								
Interest rate	2,860	1,092	10	3,962	2,860	1,092	10	3,962
Cross currency	—	1,716	—	1,716	—	1,716	—	1,716

As at 31 December 2021, the Sterling LIBOR balances in the above table relate to contracts that have not converted to a risk-free rate. The balance includes both contracts that mature in 2022 with further LIBOR interest rate fixings in the period and contracts where the counterparty has not yet agreed to fallback provisions that would have effect when LIBOR ceases. In both cases, these contracts will have both cash flows and valuations determined on a 'synthetic' LIBOR basis for reporting periods during 2022, unless they are transitioned to alternative benchmark rates.

In respect of the Group's hedge accounting relationships, for the purposes of determining whether:

– A forecast transaction is highly probable
– Hedged future cash flows are expected to occur
– A hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk
– An accounting hedging relationship should be discontinued because of a failure of the retrospective effectiveness test

the Group assumes that the interest rate benchmark on which the hedged risk or the cash flows of the hedged item or hedging instrument are based is not altered by uncertainties resulting from interest rate benchmark reform. In addition, for a fair value hedge of a non-contractually specified benchmark portion of interest rate risk, the Group assesses only at inception of the hedge relationship and not on an ongoing basis that the risk is separately identifiable and hedge effectiveness can be measured. The Group's most significant hedge accounting relationships are exposed to the following interest rate benchmarks: Sterling LIBOR, US Dollar LIBOR and EURIBOR.

At 31 December 2021, the Group expects that EURIBOR will continue to exist as a benchmark rate for the foreseeable future. Accordingly, the Group does not consider its fair value or cash flow hedges of the EURIBOR benchmark interest rate to be directly affected by interest rate benchmark reform and as a result does not anticipate changing the hedged risk to a different benchmark.

The notional amount of the hedged items that the Group has designated into cash flow hedge relationships that is directly affected by the interest rate benchmark reform is £nil for the Group and £nil for the Bank (2020: £3,498 million for the Group and £3,498 million for the Bank, of which £3,471 million for the Group and £3,471 million for the Bank related to Sterling LIBOR; principally loans and advances to commercial and corporate customers).

The interest rate benchmark reforms also affect assets designated in fair value hedges with a notional amount of £nil for the Group and £nil for the Bank (2020: £610 million for the Group and £610 million for the Bank, of which £603 million for the Group and £603 million for the Bank is in respect of Sterling LIBOR), and liabilities designated in fair value hedges with a notional amount of £nil for the Group and £nil for the Bank (2020: £1,044 million for the Group and £1,044 million for the Bank, of which £702 million for the Group and £702 million for the Bank is in respect of Sterling LIBOR; these fair value hedges principally related to debt securities in issue).

At 31 December 2021, the notional amount of the hedging instruments in hedging relationships to which these amendments apply was £nil for the Group and £nil for the Bank (2020: £11,470 million for the Group and £11,470 million for the Bank, of which £1,124 million for the Group and £1,124 million for the Bank relates to Sterling LIBOR fair value hedges and £9,895 million for the Group and £9,895 million for the Bank relates to Sterling LIBOR cash flow hedges)

Note 36: Financial risk management (continued)

(B) Foreign exchange risk

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 managed centrally within allocated exposure limits. Trading book exposures in the authorised trading centres are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market and liquidity risk function in London.

The Group manages foreign currency accounting exposure via cash flow hedge accounting, utilising currency swaps and forward foreign exchange trades.

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 ceased all hedge accounting of the currency translation risk of the net investment in foreign operations in 2018.

The Group has overseas operations in Europe. Structural foreign currency exposures in respect of operations with a Euro functional currency are £119 million (2020: £71 million) for the Group and £118 million (2020: £73 million) for the Bank.

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 assess credit risk 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 is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	2021			2020		
	Maximum exposure	**Offset[1]**	**Net exposure**	Maximum exposure	Offset[1]	Net exposure
The Group	**£m**	**£m**	**£m**	£m	£m	£m
Financial assets at fair value through profit or loss:						
Loans and advances	**362**	**—**	**362**	477	—	477
Derivative financial instruments	**4,264**	**(350)**	**3,914**	7,423	(621)	6,802
Financial assets at amortised cost, net[2]:						
Loans and advances to banks, net[2]	**51**	**—**	**51**	207	—	207
Loans and advances to customers, net[2]	**279,409**	**(305)**	**279,104**	263,766	(606)	263,160
	279,460	**(305)**	**279,155**	263,973	(606)	263,367
Financial assets at fair value through other comprehensive income	**2,047**	**—**	**2,047**	2,395	—	2,395
Off-balance sheet items:						
Other items serving as direct credit substitutes	**58**	**—**	**58**	18	—	18
Performance bonds, including letters of credit, and other transaction-related contingencies	**205**	**—**	**205**	189	—	189
Irrevocable commitments and guarantees	**18,740**	**—**	**18,740**	20,919	—	20,919
	19,003	**—**	**19,003**	21,126	—	21,126
	305,136	**(655)**	**304,481**	295,394	(1,227)	294,167

1 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.

2 Amounts shown net of related impairment allowances.

Note 36: Financial risk management (continued)

The Bank	2021 Maximum exposure £m	2021 Offset[1] £m	2021 Net exposure £m	2020 Maximum exposure £m	2020 Offset[1] £m	2020 Net exposure £m
Financial assets at fair value through profit or loss:						
Loans and advances	**152**	**—**	**152**	158	—	158
Derivative financial instruments	**4,264**	**(350)**	**3,914**	7,423	(621)	6,802
Financial assets at amortised cost, net[2]						
Loans and advances to banks, net[2]	**50**	**—**	**50**	205	—	205
Loans and advances to customers, net[2]	**276,005**	**(305)**	**275,700**	259,697	(606)	259,091
	276,055	**(305)**	**275,750**	259,902	(606)	259,296
Financial assets at fair value through other comprehensive income	**2,047**	**—**	**2,047**	2,395	—	2,395
Off-balance sheet items:						
Other items serving as direct credit substitutes	**58**	**—**	**58**	18	—	18
Performance bonds, including letters of credit, and other transaction-related contingencies	**205**	**—**	**205**	189	—	189
Irrevocable commitments and guarantees	**18,628**	**—**	**18,628**	20,796	—	20,796
	18,891	**—**	**18,891**	21,003	—	21,003
	301,409	**(655)**	**300,754**	290,881	(1,227)	289,654

1 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.

2 Amounts shown net of related impairment allowances.

(B) Concentrations of exposure

The Group's management of concentration risk includes portfolio controls on certain industries, sectors and products to reflect risk appetite as well as individual, customer and bank limit risk tolerances. Credit policies and appetite statements are aligned to the Lloyds Banking Group's risk appetite and restrict exposure to higher risk countries and potentially vulnerable sectors and asset classes. Exposures are monitored to prevent both an excessive concentration of risk and single name concentrations. The Group's largest credit limits are regularly monitored by the Lloyds Banking Group Board Risk Committee and reported in accordance with regulatory requirements. As part of its credit risk policy, the Group considers sustainability risk (which incorporates Environmental (including climate), Social and Governance) in the assessment of commercial facilities.

At 31 December 2021 the most significant concentrations of exposure were in mortgages (comprising 94 per cent of total loans and advances to customers) and in other personal lending (comprising 3 per cent of the total).

Loans and advances to customers

	The Group 2021 £m	The Group 2020 £m	The Bank 2021 £m	The Bank 2020 £m
Agriculture, forestry and fishing	**578**	608	**578**	608
Energy and water supply	**65**	70	**65**	70
Manufacturing	**240**	273	**240**	273
Construction	**693**	973	**693**	973
Transport, distribution and hotels	**2,473**	3,019	**2,473**	3,019
Postal and telecommunications	**97**	159	**97**	159
Property companies	**3,216**	3,462	**3,241**	3,487
Financial, business and other services	**1,197**	1,627	**1,197**	1,627
Personal:				
Mortgages	**264,099**	247,380	**260,772**	243,373
Other	**8,870**	8,973	**8,865**	8,964
Lease financing	**213**	235	**—**	—
Hire purchase	**247**	179	**247**	179
Total loans and advances to customers before allowance for impairment losses	**281,988**	266,958	**278,468**	262,732
Allowance for impairment losses (note 13)	**(2,579)**	(3,192)	**(2,463)**	(3,035)
Total loans and advances to customers	**279,409**	263,766	**276,005**	259,697

The Group's operations are predominantly UK-based and as a result an analysis of credit risk exposures by geographical region is not provided.

Note 36: Financial risk management (continued)

(C) Credit quality of assets

Loans and advances

The Group uses two credit ratings systems, according to the characteristics of exposures and the way that they are managed internally; these credit ratings are set out below. All probabilities of default (PDs) include forward-looking information and are based on 12-month values, with the exception of credit-impaired.

RMS		CMS	
Quality classification	IFRS 9 PD range	Quality classification	IFRS 9 PD range
RMS 1-6	0.00-4.50%	CMS 1-10	0.00-0.50%
RMS 7-9	4.51-14.00%	CMS 11-14	0.51-3.00%
RMS 10	14.01-20.00%	CMS 15-18	3.01-20.00%
RMS 11-13	20.01-99.99%	CMS 19	20.01-99.99%
RMS 14	100.00%	CMS 20-23	100.00%

Stage 3 assets of the Group include balances of £113 million (2020: £65 million) (with outstanding amounts due of £323 million (2020: £288 million)) which have been subject to a partial write-off and where the Group continues to enforce recovery action.

Stage 2 and Stage 3 assets of the Group with a carrying amount of £612 million (2020: £14,900 million) were modified during the year. No material gain or loss was recognised by the Group.

As at 31 December 2021 assets that had been previously modified while classified as Stage 2 or Stage 3 and were classified as Stage 1 amounted to £4,568 million (not material at 31 December 2020).

The Group - Gross drawn exposures and expected credit loss allowance	Drawn exposures Stage 1 £m	Drawn exposures Stage 2 £m	Drawn exposures Stage 3 £m	Drawn exposures Total £m	Expected credit loss allowance Stage 1 £m	Expected credit loss allowance Stage 2 £m	Expected credit loss allowance Stage 3 £m	Expected credit loss allowance Total £m
At 31 December 2021								
Loans and advances to banks								
CMS 1-10	51	—	—	51	—	—	—	—
CMS 11-14	—	—	—	—	—	—	—	—
CMS 15-18	—	—	—	—	—	—	—	—
CMS 19	—	—	—	—	—	—	—	—
CMS 20-23	—	—	—	—	—	—	—	—
	51	—	—	51	—	—	—	—
Loans and advances to customers								
RMS 1-6	243,740	19,528	—	263,268	113	373	—	486
RMS 7-9	784	3,578	—	4,362	27	164	—	191
RMS 10	8	588	—	596	1	43	—	44
RMS 11-13	11	1,876	—	1,887	—	182	—	182
RMS 14	—	—	4,041	4,041	—	—	665	665
	244,543	25,570	4,041	274,154	141	762	665	1,568
CMS 1-10	2,503	1	—	2,504	1	—	—	1
CMS 11-14	2,797	361	—	3,158	8	7	—	15
CMS 15-18	162	453	—	615	2	37	—	39
CMS 19	2	35	—	37	—	4	—	4
CMS 20-23	—	—	1,520	1,520	—	—	712	712
	5,464	850	1,520	7,834	11	48	712	771
Central adjustment	—	—	—	—	240	—	—	240
Total loans and advances to customers	250,007	26,420	5,561	281,988	392	810	1,377	2,579

Note 36: Financial risk management (continued)

The Group - Gross undrawn exposures and expected credit loss allowance	Undrawn exposures				Expected credit loss allowance			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2021								
Loans and advances to customers								
RMS 1-6	**38,202**	**1,542**	**—**	**39,744**	**23**	**19**	**—**	**42**
RMS 7-9	**107**	**85**	**—**	**192**	**2**	**3**	**—**	**5**
RMS 10	**—**	**15**	**—**	**15**	**—**	**1**	**—**	**1**
RMS 11-13	**—**	**28**	**—**	**28**	**—**	**2**	**—**	**2**
RMS 14	**—**	**—**	**44**	**44**	**—**	**—**	**—**	**—**
	38,309	**1,670**	**44**	**40,023**	**25**	**25**	**—**	**50**
CMS 1-10	**3,196**	**—**	**—**	**3,196**	**—**	**—**	**—**	**—**
CMS 11-14	**569**	**149**	**—**	**718**	**1**	**3**	**—**	**4**
CMS 15-18	**10**	**59**	**—**	**69**	**—**	**1**	**—**	**1**
CMS 19	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**
CMS 20-23	**—**	**—**	**2**	**2**	**—**	**—**	**1**	**1**
	3,775	**208**	**2**	**3,985**	**1**	**4**	**1**	**6**
Total loans and advances to customers	**42,084**	**1,878**	**46**	**44,008**	**26**	**29**	**1**	**56**

The Group - Gross drawn exposures and expected credit loss allowance	Drawn exposures				Expected credit loss allowance			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2020								
Loans and advances to banks								
CMS 1-10	207	—	—	207	—	—	—	—
CMS 11-14	—	—	—	—	—	—	—	—
CMS 15-18	—	—	—	—	—	—	—	—
CMS 19	—	—	—	—	—	—	—	—
CMS 20-23	—	—	—	—	—	—	—	—
	207	—	—	207	—	—	—	—
Loans and advances to customers								
RMS 1-6	218,352	22,023	—	240,375	169	358	—	527
RMS 7-9	1,629	5,043	—	6,672	68	202	—	270
RMS 10	62	1,532	—	1,594	7	84	—	91
RMS 11-13	186	4,512	—	4,698	5	402	—	407
RMS 14	—	—	4,207	4,207	—	—	788	788
	220,229	33,110	4,207	257,546	249	1,046	788	2,083
CMS 1-10	2,667	1	—	2,668	1	—	—	1
CMS 11-14	3,171	458	—	3,629	19	12	—	31
CMS 15-18	677	776	—	1,453	17	63	—	80
CMS 19	2	92	—	94	—	25	—	25
CMS 20-23	—	—	1,568	1,568	—	—	772	772
	6,517	1,327	1,568	9,412	37	100	772	909
Central adjustment	—	—	—	—	200	—	—	200
Total loans and advances to customers	226,746	34,437	5,775	266,958	486	1,146	1,560	3,192

Note 36: Financial risk management (continued)

The Group - Gross undrawn exposures and expected credit loss allowance	Undrawn exposures Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Expected credit loss allowance Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2020								
Loans and advances to customers								
RMS 1-6	40,170	1,853	—	42,023	39	29	—	68
RMS 7-9	323	230	—	553	8	11	—	19
RMS 10	7	32	—	39	—	3	—	3
RMS 11-13	1	59	—	60	—	12	—	12
RMS 14	—	—	41	41	—	—	—	—
	40,501	2,174	41	42,716	47	55	—	102
CMS 1-10	3,389	—	—	3,389	1	—	—	1
CMS 11-14	796	359	—	1,155	4	4	—	8
CMS 15-18	97	179	—	276	2	6	—	8
CMS 19	—	30	—	30	—	4	—	4
CMS 20-23	—	—	6	6	—	—	6	6
	4,282	568	6	4,856	7	14	6	27
Total loans and advances to customers	44,783	2,742	47	47,572	54	69	6	129

The Bank - Gross drawn exposures and expected credit loss allowance	**Drawn exposures Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	**Expected credit loss allowance Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**
At 31 December 2021								
Loans and advances to banks								
CMS 1-10	**50**	**—**	**—**	**50**	**—**	**—**	**—**	**—**
CMS 11-14	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**
CMS 15-18	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**
CMS 19	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**
CMS 20-23	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**
	50	**—**	**—**	**50**	**—**	**—**	**—**	**—**
Loans and advances to customers								
RMS 1-6	**241,805**	**18,762**	**—**	**260,567**	**111**	**335**	**—**	**446**
RMS 7-9	**780**	**3,407**	**—**	**4,187**	**27**	**153**	**—**	**180**
RMS 10	**8**	**555**	**—**	**563**	**1**	**39**	**—**	**40**
RMS 11-13	**11**	**1,789**	**—**	**1,800**	**—**	**173**	**—**	**173**
RMS 14	**—**	**—**	**3,706**	**3,706**	**—**	**—**	**583**	**583**
	242,604	**24,513**	**3,706**	**270,823**	**139**	**700**	**583**	**1,422**
CMS 1-10	**2,396**	**1**	**—**	**2,397**	**1**	**—**	**—**	**1**
CMS 11-14	**2,690**	**361**	**—**	**3,051**	**7**	**7**	**—**	**14**
CMS 15-18	**162**	**453**	**—**	**615**	**2**	**37**	**—**	**39**
CMS 19	**2**	**35**	**—**	**37**	**—**	**4**	**—**	**4**
CMS 20-23	**—**	**—**	**1,545**	**1,545**	**—**	**—**	**743**	**743**
	5,250	**850**	**1,545**	**7,645**	**10**	**48**	**743**	**801**
Central adjustment	**—**	**—**	**—**	**—**	**240**	**—**	**—**	**240**
Total loans and advances to customers	**247,854**	**25,363**	**5,251**	**278,468**	**389**	**748**	**1,326**	**2,463**

Note 36: Financial risk management (continued)

The Bank - Gross undrawn exposures and expected credit loss allowance	Undrawn exposures Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Expected credit loss allowance Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2021								
Loans and advances to customers								
RMS 1-6	**38,113**	**1,486**	**—**	**39,599**	**23**	**19**	**—**	**42**
RMS 7-9	**107**	**85**	**—**	**192**	**2**	**3**	**—**	**5**
RMS 10	**—**	**15**	**—**	**15**	**—**	**1**	**—**	**1**
RMS 11-13	**—**	**28**	**—**	**28**	**—**	**2**	**—**	**2**
RMS 14	**—**	**—**	**42**	**42**	**—**	**—**	**—**	**—**
	38,220	**1,614**	**42**	**39,876**	**25**	**25**	**—**	**50**
CMS 1-10	**3,196**	**—**	**—**	**3,196**	**—**	**—**	**—**	**—**
CMS 11-14	**569**	**149**	**—**	**718**	**1**	**3**	**—**	**4**
CMS 15-18	**10**	**59**	**—**	**69**	**—**	**1**	**—**	**1**
CMS 19	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**
CMS 20-23	**—**	**—**	**2**	**2**	**—**	**—**	**1**	**1**
	3,775	**208**	**2**	**3,985**	**1**	**4**	**1**	**6**
Total loans and advances to customers	**41,995**	**1,822**	**44**	**43,861**	**26**	**29**	**1**	**56**

The Bank - Gross drawn exposures and expected credit loss allowance	Drawn exposures Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Expected credit loss allowance Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2020								
Loans and advances to banks								
CMS 1-10	205	—	—	205	—	—	—	—
CMS 11-14	—	—	—	—	—	—	—	—
CMS 15-18	—	—	—	—	—	—	—	—
CMS 19	—	—	—	—	—	—	—	—
CMS 20-23	—	—	—	—	—	—	—	—
	205	—	—	205	—	—	—	—
Loans and advances to customers								
RMS 1-6	216,210	21,398	—	237,608	166	335	—	501
RMS 7-9	1,614	4,704	—	6,318	67	186	—	253
RMS 10	62	1,426	—	1,488	7	77	—	84
RMS 11-13	65	4,223	—	4,288	5	368	—	373
RMS 14	—	—	3,827	3,827	—	—	685	685
	217,951	31,751	3,827	253,529	245	966	685	1,896
CMS 1-10	2,667	1	—	2,668	1	—	—	1
CMS 11-14	3,067	458	—	3,525	19	12	—	31
CMS 15-18	650	672	—	1,322	17	63	—	80
CMS 19	2	92	—	94	—	25	—	25
CMS 20-23	—	—	1,594	1,594	—	—	802	802
	6,386	1,223	1,594	9,203	37	100	802	939
Central adjustment	—	—	—	—	200	—	—	200
Total loans and advances to customers	224,337	32,974	5,421	262,732	482	1,066	1,487	3,035

Note 36: Financial risk management (continued)

The Bank - Gross undrawn exposures and expected credit loss allowance	Undrawn exposures Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Expected credit loss allowance Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2020								
Loans and advances to customers								
RMS 1-6	40,072	1,795	—	41,867	39	29	—	68
RMS 7-9	322	225	—	547	8	11	—	19
RMS 10	7	32	—	39	—	3	—	3
RMS 11-13	1	58	—	59	—	12	—	12
RMS 14	—	—	40	40	—	—	—	—
	40,402	2,110	40	42,552	47	55	—	102
CMS 1-10	3,389	—	—	3,389	1	—	—	1
CMS 11-14	796	359	—	1,155	4	4	—	8
CMS 15-18	97	179	—	276	2	6	—	8
CMS 19	—	30	—	30	—	4	—	4
CMS 20-23	—	—	6	6	—	—	6	6
	4,282	568	6	4,856	7	14	6	27
Total loans and advances to customers	44,684	2,678	46	47,408	54	69	6	129

Cash and balances at central banks
Significantly all of the Group's cash and balances at central banks of £3,201 million (2020: £2,841 million) are due from the Bank of England.

Financial assets at fair value through other comprehensive income
The credit quality of financial assets at fair value through other comprehensive income is set out below:

	2021			2020		
The Group and the Bank	**Investment grade[1] £m**	**Other[2] £m**	**Total £m**	Investment grade[1] £m	Other[2] £m	Total £m
Corporate and other debt securities	**2,003**	**44**	**2,047**	2,342	53	2,395

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2021: £nil; 2020: £nil) and not rated (2021: £44 million; 2020: £53 million).

Derivative assets
An analysis of derivative assets is given in note 12. 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 credit risk relating to derivative assets of £3,914 million for the Group and £3,914 million for the Bank (2020: £6,802 million for the Group and £6,802 million for the Bank), cash collateral of £712 million for the Group and the Bank (2020: £1,394 million for the Group and the Bank) was held and a further £29 million for the Group and the Bank (2020: £35 million for the Group and the Bank) was due from OECD banks.

	2021			2020		
The Group	**Investment grade[1] £m**	**Other[2] £m**	**Total £m**	Investment grade[1] £m	Other[2] £m	Total £m
Trading and other	**1,158**	**693**	**1,851**	1,665	861	2,526
Hedging	**2**	**—**	**2**	78	—	78
	1,160	**693**	**1,853**	1,743	861	2,604
Due from fellow Lloyds Banking Group undertakings			**2,411**			4,819
Total derivative financial instruments			**4,264**			7,423

	2021			2020		
The Bank	**Investment grade[1] £m**	**Other[2] £m**	**Total £m**	Investment grade[1] £m	Other[2] £m	Total £m
Trading and other	**1,156**	**693**	**1,849**	1,665	853	2,518
Hedging	**2**	**—**	**2**	78	—	78
	1,158	**693**	**1,851**	1,743	853	2,596
Due from fellow Lloyds Banking Group undertakings			**2,413**			4,827
Total derivative financial instruments			**4,264**			7,423

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2021: £580 million for the Group and £580 million for the Bank; 2020: £834 million for the Group and £834 million for the Bank) and not rated (2021: £113 million for the Group and £113 million for the Bank; 2020: £27 million for the Group and £19 million for the Bank).

Note 36: Financial risk management (continued)

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

The principal types of collateral accepted by the Group include: residential and commercial properties; charges over business assets such as premises, inventory and accounts receivable; financial instruments, cash and guarantees from third-parties. The terms and conditions associated with the use of the collateral are varied and are dependent on the type of agreement and the counterparty. The Group holds collateral against loans and advances and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for financial assets at fair value through profit or loss and for derivative assets is also shown below.

The Group holds collateral in respect of loans and advances to banks and customers as set out below.

Loans and advances to banks
These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Loans and advances to customers
Retail lending
Mortgages
An analysis by loan-to-value ratio of the Group's and the Bank'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 allowances for indexation error and dilapidations. The market takes into account many factors, including environmental considerations such as flood risk and energy efficient additions, in arriving at the value of a home.

In some circumstances, where the discounted value of the estimated net proceeds from the liquidation of collateral (i.e. net of costs, expected haircuts and anticipated changes in the value of the collateral to the point of sale) is greater than the estimated exposure at default, no credit losses are expected and no ECL allowance is recognised.

	The Group				The Bank			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total gross £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total gross £m
At 31 December 2021								
Less than 70 per cent	**182,922**	**21,843**	**2,970**	**207,735**	**181,117**	**20,916**	**2,750**	**204,783**
70 per cent to 80 per cent	**40,313**	**1,722**	**325**	**42,360**	**40,244**	**1,668**	**287**	**42,199**
80 per cent to 90 per cent	**11,509**	**299**	**138**	**11,946**	**11,485**	**275**	**117**	**11,877**
90 per cent to 100 per cent	**718**	**109**	**79**	**906**	**703**	**93**	**66**	**862**
Greater than 100 per cent	**145**	**212**	**190**	**547**	**119**	**178**	**147**	**444**
Total	**235,607**	**24,185**	**3,702**	**263,494**	**233,668**	**23,130**	**3,367**	**260,165**
At 31 December 2020								
Less than 70 per cent	150,490	26,028	2,872	179,390	148,650	24,996	2,653	176,299
70 per cent to 80 per cent	40,234	3,555	439	44,228	40,002	3,382	393	43,777
80 per cent to 90 per cent	20,273	1,051	218	21,542	20,229	996	185	21,410
90 per cent to 100 per cent	468	178	103	749	450	156	84	690
Greater than 100 per cent	156	393	256	805	132	321	198	651
Total	211,621	31,205	3,888	246,714	209,463	29,851	3,513	242,827

Commercial lending
Stage 3 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 2021, Stage 3 secured commercial lending amounted to £429 million, net of an impairment allowance of £72 million (2020: £495 million, net of an impairment allowance of £86 million). The fair value of the collateral held in respect of impaired secured commercial lending was £73 million (2020: £162 million) for the Group. 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, 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.

Stage 3 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.

Note 36: Financial risk management (continued)

Stage 1 and Stage 2 secured lending
For Stage 1 and Stage 2 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.

Stage 1 and Stage 2 secured commercial lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for Stage 3 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.

Financial assets at fair value through profit or loss
Securities held as collateral in the form of stock borrowed amounted to £3,025 million for the Group and the Bank (2020: £12,283 million for the Group and the Bank). Of this amount, £424 million for the Group and the Bank (2020: £12,283 million for the Group and the Bank) 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 £3,914 million for the Group and £3,914 million for the Bank (2020: £6,802 million for the Group and £6,802 million for the Bank), cash collateral of £712 million for the Group and the Bank (2020: £1,394 million for the Group and the Bank) was held.

Irrevocable loan commitments and other credit-related contingencies
At 31 December 2021, there were irrevocable loan commitments and other credit-related contingencies of £19,003 million for the Group and £18,891 million for the Bank (2020: £21,126 million for the Group and £21,003 million for the Bank). Collateral is held as security, in the event that lending is drawn down, on £16,147 million for the Group and £16,035 million for the Bank (2020: £17,828 million for the Group and £17,705 million for the Bank) of these balances.

Collateral repossessed
During the year, £80 million for the Group and £67 million for the Bank of collateral was repossessed (2020: £120 million for the Group and £100 million for the Bank), 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.

(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
As at 31 December 2021 there were balances arising from repurchase transactions with banks of £30,028 million for the Group and the Bank (2020: £13,680 million for the Group and the Bank), which include amounts due under the Bank of England's Term Funding Scheme with additional incentives for SMEs (TFSME); the fair value of the collateral provided under these agreements at 31 December 2021 was £39,875 million for the Group and the Bank (2020: £13,677 million for the Group and the Bank).

Securities lending transactions
The following on-balance sheet financial assets have been lent to counterparties under securities lending transactions:

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Financial assets at fair value through other comprehensive income	**24**	37	**24**	37

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 note 20.

Note 36: Financial risk management (continued)

Liquidity risk

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. 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 tables below analyse financial instrument liabilities of the Group and the Bank on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

The Group's and the Bank's liabilities may 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 and the Bank's liquidity positions. 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.

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2021						
Deposits from banks and repurchase agreements	**9**	**10**	**170**	**31,593**	**—**	**31,782**
Customer deposits	**163,248**	**550**	**2,996**	**4,266**	**5**	**171,065**
Financial liabilities at fair value through profit or loss	**—**	**—**	**—**	**—**	**33**	**33**
Debt securities in issue	**1**	**20**	**3,155**	**3,842**	**475**	**7,493**
Lease liabilities	**1**	**29**	**75**	**272**	**396**	**773**
Subordinated liabilities	**22**	**5**	**3**	**1,678**	**87**	**1,795**
Total non-derivative financial liabilities	**163,281**	**614**	**6,399**	**41,651**	**996**	**212,941**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**32**	**29**	**404**	**865**	**647**	**1,977**
Gross settled derivatives – inflows	**(10)**	**(18)**	**(400)**	**(838)**	**(639)**	**(1,905)**
Gross settled derivatives – net flows	**22**	**11**	**4**	**27**	**8**	**72**
Net settled derivative liabilities	**475**	**—**	**—**	**—**	**40**	**515**
Total derivative financial liabilities	**497**	**11**	**4**	**27**	**48**	**587**
At 31 December 2020						
Deposits from banks and repurchase agreements	16	2	57	18,329	137	18,541
Customer deposits	151,762	2,680	4,030	4,705	12	163,189
Financial liabilities at fair value through profit or loss	—	—	—	—	45	45
Debt securities in issue	175	82	2,761	4,803	1,026	8,847
Lease liabilities	9	17	76	295	303	700
Subordinated liabilities	—	15	383	179	2,489	3,066
Total non-derivative financial liabilities	151,962	2,796	7,307	28,311	4,012	194,388
Derivative financial liabilities:						
Gross settled derivatives – outflows	478	81	955	614	2,059	4,187
Gross settled derivatives – inflows	(391)	(21)	(936)	(619)	(2,256)	(4,223)
Gross settled derivatives – net flows	87	60	19	(5)	(197)	(36)
Net settled derivative liabilities	702	4	10	70	120	906
Total derivative financial liabilities	789	64	29	65	(77)	870

Note 36: Financial risk management (continued)

The Bank	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 2021						
Deposits from banks and repurchase agreements	**9**	**10**	**170**	**31,593**	**—**	**31,782**
Customer deposits	**163,248**	**550**	**2,996**	**4,266**	**5**	**171,065**
Debt securities in issue	**—**	**19**	**2,321**	**3,263**	**226**	**5,829**
Lease liabilities	**1**	**29**	**75**	**272**	**396**	**773**
Subordinated liabilities	**22**	**5**	**3**	**1,678**	**87**	**1,795**
Total non-derivative financial liabilities	**163,280**	**613**	**5,565**	**41,072**	**714**	**211,244**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**32**	**29**	**404**	**865**	**647**	**1,977**
Gross settled derivatives – inflows	**(10)**	**(18)**	**(400)**	**(838)**	**(639)**	**(1,905)**
Gross settled derivatives – net flows	**22**	**11**	**4**	**27**	**8**	**72**
Net settled derivative liabilities	**468**	**—**	**—**	**—**	**—**	**468**
Total derivative financial liabilities	**490**	**11**	**4**	**27**	**8**	**540**
At 31 December 2020						
Deposits from banks and repurchase agreements	16	2	57	18,329	136	18,540
Customer deposits	151,762	2,680	4,030	4,705	12	163,189
Debt securities in issue	—	77	1,975	3,412	585	6,049
Lease liabilities	9	17	76	295	303	700
Subordinated liabilities	—	30	433	558	9,256	10,277
Total non-derivative financial liabilities	151,787	2,806	6,571	27,299	10,292	198,755
Derivative financial liabilities:						
Gross settled derivatives – outflows	477	81	750	614	2,059	3,981
Gross settled derivatives – inflows	(390)	(21)	(751)	(619)	(2,256)	(4,037)
Gross settled derivatives – net flows	87	60	(1)	(5)	(197)	(56)
Net settled derivative liabilities	700	4	10	51	73	838
Total derivative financial liabilities	787	64	9	46	(124)	782

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of £6 million (2020: £6 million) per annum for the Group and £6 million (2020: £6 million) for the Bank which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

The following tables set out the amounts and residual maturities of the Group's and the Bank's off-balance sheet contingent liabilities, commitments and guarantees.

The Group	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2021					
Total contingent liabilities	**135**	**26**	**30**	**72**	**263**
Lending commitments and guarantees	**40,941**	**1,461**	**592**	**1,008**	**44,002**
Other commitments	**—**	**—**	**—**	**6**	**6**
Total commitments and guarantees	**40,941**	**1,461**	**592**	**1,014**	**44,008**
Total contingents, commitments and guarantees	**41,076**	**1,487**	**622**	**1,086**	**44,271**
At 31 December 2020					
Total contingent liabilities	94	9	—	104	207
Lending commitments and guarantees	44,030	2,146	453	914	47,543
Other commitments	1	16	—	12	29
Total commitments and guarantees	44,031	2,162	453	926	47,572
Total contingents, commitments and guarantees	44,125	2,171	453	1,030	47,779

Note 36: Financial risk management (continued)

The Bank	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2021					
Total contingent liabilities	**135**	**26**	**30**	**72**	**263**
Lending commitments and guarantees	**40,794**	**1,461**	**592**	**1,008**	**43,855**
Other commitments	**—**	**—**	**—**	**6**	**6**
Total commitments and guarantees	**40,794**	**1,461**	**592**	**1,014**	**43,861**
Total contingents, commitments and guarantees	**40,929**	**1,487**	**622**	**1,086**	**44,124**
At 31 December 2020					
Total contingent liabilities	94	9	—	104	207
Lending commitments and guarantees	43,866	2,146	453	914	47,379
Other commitments	1	16	—	12	29
Total commitments and guarantees	43,867	2,162	453	926	47,408
Total contingents, commitments and guarantees	43,961	2,171	453	1,030	47,615

Capital risk

Capital is actively managed on an ongoing basis for both the Bank and its regulated subsidiaries. Regulatory capital ratios are considered a key part of the budgeting and planning processes and forecast ratios are reviewed by the Lloyds Banking Group and Ring-Fenced Banks Asset and Liability Committees. Target capital levels take account of current and future regulatory requirements, capacity for growth and to cover uncertainties. Capital policies and procedures are subject to regular review.

Under UK law, EU capital rules that existed on 31 December 2020 continue to apply to the Bank following the end of the transition period for the UK's withdrawal from the European Union, subject to the temporary transitional powers (TTP) granted to the PRA which extend until 31 March 2022. The Bank continues to therefore measure both its capital requirements and the amount of capital resources it holds to meet those requirements through applying the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV), as amended by revisions to the Capital Requirements Directive implemented in December 2020 (CRD V) and by those provisions of the revised Capital Requirements Regulation (CRR II) that came into force in June 2019 and December 2020. The requirements are implemented in the UK by the PRA and supplemented through additional regulation under the PRA Rulebook and associated statements of policy, supervisory statements and other guidance.

The remaining provisions of CRR II will apply in the UK from 1 January 2022 and have been largely enacted via the PRA Rulebook.

The minimum amount of total capital required, under Pillar 1 of the regulatory capital framework, is set at 8 per cent of total risk-weighted assets. At least 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital and at least 6 per cent of risk-weighted assets are required to be covered by tier 1 capital. These minimum Pillar 1 capital requirements are supplemented by additional minimum capital requirements under Pillar 2A of the regulatory capital framework, the aggregate of which is referred to as the Bank's Total Capital Requirement (TCR).

Under Pillar 2A, additional minimum capital requirements are set through the issuance of a bank specific Individual Capital Requirement (ICR), which adjusts the Pillar 1 minimum capital requirement for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICR 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 Bank's nominal Pillar 2A capital requirement was the equivalent of around 2.5 per cent of risk-weighted assets as at 31 December 2021, of which the minimum amount to be met by CET1 capital was the equivalent of around 1.4 per cent of risk-weighted assets. During 2022, the PRA will revert to setting a variable amount for the Bank's Pillar 2A capital requirement (being a set percentage of risk-weighted assets), with fixed add-ons for certain risk types.

A range of additional bank specific regulatory capital buffers apply under CRD IV, which are required to be met with CET1 capital. These include a capital conservation buffer (2.5 per cent of risk-weighted assets) and a time-varying countercyclical capital buffer (CCyB) which is currently around 0 per cent of risk-weighted assets. In December 2021 the Bank of England's Financial Policy Committee announced that the UK CCyB rate will increase to 1 per cent in December 2022, with an expectation that it will increase to 2 per cent in Q2 2023 if the economy continues to recover broadly in line with the Bank of England's central projections and upon the assumption there is no significant change to the financial stability outlook. This would represent an equivalent increase in the Bank's CCyB to 1.0 per cent in December 2022 and 2.0 per cent in Q2 2023, based upon the position of the Bank at 31 December 2021.

The Bank applies the full extent of the IFRS 9 transitional arrangements for capital as set out under CRR Article 473a (as amended via the CRR 'Quick Fix' revisions published in June 2020). Specifically, the Bank has opted to apply both paragraphs 2 and 4 of CRR Article 473a (static and dynamic relief) and in addition to apply a 100 per cent risk weight to the consequential Standardised credit risk exposure add-back as permitted under paragraph 7a of the revisions. As at 31 December 2021, static relief (including 'locked' dynamic relief recognised prior to 1 January 2020) under the transitional arrangements amounted to £146 million (31 December 2020: £204 million) and dynamic relief (from 1 January 2020) under the transitional arrangements amounted to £253 million (31 December 2020: £606 million), through CET1 capital.

Regulatory capital development
The regulatory framework within which the Bank operates continues to be developed at a global level through the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS) and within the UK by the PRA and through directions from the Financial Policy Committee (FPC). The Bank continues to monitor these developments very closely, analysing potential capital impacts to ensure that, through organic capital generation and management actions, the Bank and its regulated subsidiaries continue to maintain a strong capital position that exceeds both minimum regulatory requirements and the Bank's risk appetite and is consistent with market expectations.

On 1 January 2022 the Bank implemented new CRD IV mortgage and other models (which are subject to finalisation and approval by the PRA) in order to meet revised regulatory standards for modelled outputs. This was in addition to the implementation of the remainder of CRR II which includes a new standardised approach for measuring counterparty credit risk (SA-CCR).

Note 36: Financial risk management (continued)

Capital resources

Regulatory capital is divided into tiers depending on the degree of permanency and loss absorbency exhibited.

- Common equity tier 1 (CET1) capital represents the strongest form of capital consisting of shareholders' equity after a number of regulatory adjustments and deductions are applied. These include adjustments for IFRS 9 transitional arrangements, the accrual for foreseeable dividends (where applicable), the elimination of the cash flow hedging reserve and deductions for goodwill, other intangible assets, prudent valuation, defined benefit pension surplus and deferred tax assets.
- Fully qualifying additional tier 1 (AT1) capital comprises non-cumulative perpetual securities containing specific provisions to write down the security should the CET1 ratio fall to a defined trigger limit. Under transitional rules for capital, legacy capital instruments that did not qualify in their own right to be recognised as AT1 capital but were issued and recognised as eligible tier 1 capital prior to the implementation of CRD IV could be partially included within AT1 capital ('grandfathering') until they were phased out altogether on 1 January 2022.
- Tier 2 (T2) capital largely comprises certain other subordinated debt securities that do not qualify as AT1. They must have an original term of at least 5 years, cannot normally be redeemed within their first 5 years and are phased out as T2 regulatory capital in the final 5 years before maturity through the application of regulatory amortisation. Under transitional rules for capital, legacy capital instruments that did not qualify in their own right to be recognised as T2 capital but were issued and recognised as eligible T2 capital prior to the implementation of CRD IV could be partially included within T2 capital ('grandfathering') until they were phased out altogether on 1 January 2022. Eligible provisions, reflecting the excess of IFRS 9 expected credit losses over corresponding regulatory expected losses, are added back to T2 capital, net of the application of IFRS 9 transitional adjustments.

The Bank's transitional capital resources are summarised as follows:

	2021 £m	2020 £m
Common equity tier 1 capital	**9,540**	9,510
Additional tier 1 capital	**2,222**	2,221
Tier 2 capital	**1,497**	1,846
Total capital	**13,259**	13,577

Note 37: Cash flow statements

(A) Change in operating assets

	The Group		The Bank	
	2021 £m	2020 £m	2021 £m	2020 £m
Change in amounts due from fellow Lloyds Banking Group undertakings	**11,927**	68,546	**14,791**	70,209
Change in other financial assets held at amortised cost	**(15,236)**	(6,658)	**(15,934)**	(8,020)
Change in financial assets at fair value through profit or loss	**115**	(14)	**5**	(39)
Change in derivative financial instruments	**3,139**	2,904	**3,139**	2,863
Change in other operating assets	**102**	90	**93**	113
Change in operating assets	**47**	64,868	**2,094**	65,126

(B) Change in operating liabilities

	The Group		The Bank	
	2021 £m	2020 £m	2021 £m	2020 £m
Change in deposits from banks and repurchase agreements	**15,930**	(1,777)	**15,931**	(1,778)
Change in customer deposits	**7,776**	11,154	**7,776**	11,182
Change in amounts due to fellow Lloyds Banking Group undertakings	**(14,114)**	(69,665)	**(16,419)**	(70,201)
Change in financial liabilities at fair value through profit or loss	**(13)**	(2)	**—**	—
Change in derivative financial instruments	**(4,352)**	(2,680)	**(4,216)**	(2,688)
Change in debt securities in issue	**(944)**	(2,907)	**(872)**	(2,688)
Change in other operating liabilities[1]	**68**	(273)	**75**	(290)
Change in operating liabilities	**4,351**	(66,150)	**2,275**	(66,463)

1 Includes £72 million (2020: £1 million) for the Group and £72 million (2020: £1 million) for the Bank in respect of lease liabilities.

Note 37: Cash flow statements (continued)

(C) Non-cash and other items

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Depreciation and amortisation	**284**	232	**284**	233
Dividends received from subsidiary undertakings	**—**	—	**(49)**	(45)
Revaluation of investment properties	**—**	20	**—**	—
Allowance for loan losses	**(303)**	1,548	**(252)**	1,530
Write-off of allowance for loan losses, net of recoveries	**(320)**	(454)	**(309)**	(445)
Impairment (credit) charge relating to undrawn balances	**(72)**	74	**(72)**	74
Regulatory and legal provisions	**982**	107	**983**	106
Other provision movements	**3**	68	**4**	67
Foreign exchange impact on balance sheet[1]	**20**	6	**15**	59
Interest expense on subordinated liabilities	**104**	146	**103**	146
Other non-cash items	**56**	1	**35**	(2)
Total non-cash items	**754**	1,748	**742**	1,723
Payments in respect of regulatory and legal provisions	**(377)**	(705)	**(377)**	(696)
Other	**(114)**	9	**(114)**	9
Total other items	**(491)**	(696)	**(491)**	(687)
Non-cash and other items	**263**	1,052	**251**	1,036

1 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.

(D) Analysis of cash and cash equivalents as shown in the balance sheet

	The Group		The Bank	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Cash and balances at central banks	**3,201**	2,841	**3,201**	2,841
Less mandatory reserve deposits[1]	**(2,355)**	(2,143)	**(2,355)**	(2,143)
	846	698	**846**	698
Loans and advances to banks	**51**	207	**50**	205
Less amounts with a maturity of three months or more	**(42)**	(56)	**(42)**	(56)
	9	151	**8**	149
Total cash and cash equivalents	**855**	849	**854**	847

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.

Note 38: Other information

Bank of Scotland plc is incorporated as a public limited company and registered in Scotland with the registered number SC327000. Bank of Scotland plc's registered office is The Mound, Edinburgh, EH1 1YZ, and its principal executive offices are located at 25 Gresham Street, London, EC2V 7HN.

Bank of Scotland plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services.

Bank of Scotland plc's immediate parent undertaking is HBOS plc and its ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

Subsidiaries and related undertakings

In compliance with Section 409 of the Companies Act 2006, the following comprises a list of all related undertakings of the Group, as at 31 December 2021. The list includes each undertaking's registered office and the percentage of the class(es) of shares held by the Group. All shares held are ordinary shares unless indicated otherwise in the notes.

Subsidiary undertakings

The Group directly or indirectly holds 100 per cent of the share class or a majority of voting rights (including where the undertaking does not have share capital as indicated) in the following undertakings. All material subsidiary undertakings are consolidated by Lloyds Banking Group.

Name of Undertaking	Notes
Anglo Scottish Utilities Partnership	+ *
Automobile Association Personal Finance Ltd	4 i
Bank of Scotland (B G S) Nominees Ltd	5 *
Bank of Scotland Edinburgh Nominees Ltd	5 *
Bank of Scotland Equipment Finance Ltd (in liquidation)	6 i
Bank of Scotland Structured Asset Finance Ltd	1 i
Bank of Scotland Transport Finance 1 Ltd (in liquidation)	6 i
Bank of Wales Ltd	7 i
Barents Leasing Ltd	1 i
Birmingham Midshires Financial Services Ltd	4 i
Birmingham Midshires Land Development Ltd (in liquidation)	6 i
Birmingham Midshires Mortgage Services Ltd (in liquidation)	6 i
BOS (Ireland) Property Services 2 Ltd	3 i
BOS (Shared Appreciation Mortgages (Scotland) No. 2) Ltd	4 i
BOS (Shared Appreciation Mortgages (Scotland) No. 3) Ltd	4 i
BOS (Shared Appreciation Mortgages (Scotland)) Ltd	4 i
BOS (Shared Appreciation Mortgages) No. 1 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 2 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 3 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 4 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 5 plc	4 i
BOS (Shared Appreciation Mortgages) No. 6 plc	4 i
BOSSAF Rail Ltd	1 i
BOS Personal Lending Ltd	4 ii iii
British Linen Leasing (London) Ltd	5 i
British Linen Leasing Ltd	5 i
British Linen Shipping Ltd	5 i
Capital 1945 Ltd	7 i
Capital Bank Leasing 3 Ltd (in liquidation)	6 i
Capital Bank Leasing 5 Ltd	7 i
Capital Bank Leasing 12 Ltd	5 i
Capital Bank Property Investments (3) Ltd	7 i
Capital Personal Finance Ltd	4 i
CF Asset Finance Ltd (in liquidation)	6 i
First Retail Finance (Chester) Ltd	4 i
Forthright Finance Ltd	7 i
Halifax Leasing (March No.2) Ltd	1 i
Halifax Leasing (September) Ltd	1 i
Halifax Loans Ltd	4 i
Halifax Mortgage Services Ltd (in liquidation)	6 i
Halifax Vehicle Leasing (1998) Ltd	4 i
HBOS Covered Bonds LLP	4 *
HBOS Social Housing Covered Bonds LLP	7 *
Home Shopping Personal Finance Ltd	4 i
IBOS Finance Ltd	7 i
Intelligent Finance Software Ltd	4 i
Lex Vehicle Leasing (Holdings) Ltd (in liquidation)	6 ii iii iv
Lex Vehicle Leasing Ltd (in liquidation)	6 i
Lloyds Capital GP Ltd	10 i
Lloyds Secretaries Ltd	1 i
Membership Services Finance Ltd	4 i
NFU Mutual Finance Ltd	7 ii vi #
Nordic Leasing Ltd (in liquidation)	6 i
NWS Trust Ltd	5 i
Pacific Leasing Ltd	1 i
Seabreeze Leasing Ltd	1 i
Seaspirit Leasing Ltd	1 i
Standard Property Investment (1987) Ltd	5 ii iii
Sussex County Homes Ltd	4 i
The British Linen Company Ltd	5 i
The Mortgage Business plc	4 i
Thistle Leasing	+ *
Tower Hill Property Investments (7) Ltd	7 i #
Tower Hill Property Investments (10) Ltd	7 i #
Tranquility Leasing Ltd	1 i
Waymark Asset Investments Ltd	1 ii iii

The Group has determined that it has the power to exercise control over the following entities without having the majority of the voting rights of the undertakings. Unless otherwise stated, the undertakings do not have share capital or the Group does not hold any shares.

Name of Undertaking	Notes
Addison Social Housing Holdings Ltd	2
Deva Financing Holdings Ltd	9
Deva Financing plc	9
Edgbaston RMBS 2010-1 plc	9
Edgbaston RMBS Holdings Ltd	9
Elland RMBS 2018 plc	9
Elland RMBS Holdings Ltd	9
Molineux RMBS 2016-1 plc	9
Molineux RMBS Holdings Ltd	9
Penarth Asset Securitisation Holdings Ltd	9
Penarth Funding 1 Ltd	9
Penarth Funding 2 Ltd	9
Penarth Master Issuer plc	9
Penarth Receivables Trustee Ltd	9
Permanent Funding (No. 1) Ltd	9
Permanent Funding (No. 2) Ltd	9
Permanent Holdings Ltd	9
Permanent Master Issuer plc	9
Permanent Mortgages Trustee Ltd	9
Permanent PECOH Holdings Ltd	9
Permanent PECOH Ltd	9
Syon Securities 2019 DAC	8
Syon Securities 2020 DAC	8
Syon Securities 2020-2 DAC	8

Associated undertakings
The Group has a participating interest in the following undertakings.

Name of undertaking	% of share class held by immediate parent company (or by the Group where this varies)	Registered office address	Notes
Addison Social Housing Ltd	20%	1 Bartholomew Lane, London, EC2N 2AX	i
Connery Ltd	20%	44 Esplanade, St. Helier, Jersey, JE4 9WG	&

Registered office addresses
(1) 25 Gresham Street, London, EC2V 7HN
(2) 44 Esplanade, St. Helier, Jersey, JE4 9WG
(3) Suite 6, Rineanna House, Shannon Free Zone, Co. Clare, Ireland
(4) Trinity Road, Halifax, West Yorkshire HX1 2RG
(5) The Mound, Edinburgh, EH1 1YZ
(6) 1 More London Place, London, SE1 2AF
(7) Cawley House, Chester Business Park, Chester, CH4 9FB
(8) 5th Floor, The Exchange, George's Dock, IFSC, Dublin 1, Ireland
(9) 1 Bartholomew Lane, London EC2N 2AX
(10) 6th Floor, 125 London Wall, London EC2Y 5AS

* The undertaking does not have share capital
+ The undertaking does not have a registered office
# In relation to Subsidiary Undertakings, an undertaking external to the Group holds shares
& The Group holds voting rights of between 20% and 49.9%
(i) Ordinary Shares
(ii) A Ordinary Shares
(iii) B Ordinary Shares
(iv) Redeemable Preference Shares
(v) Preference Shares
(vi) C Ordinary Shares