Bank of Scotland plc

Report and Accounts

2009

Member of Lloyds Banking Group

Contents

Directors' report.. 2

Directors 6

Principal risks and uncertainties 7

Independent auditors' report 10

Consolidated income statement 12

Consolidated statement of comprehensive income 13

Consolidated balance sheet.............................. 14

Consolidated statement of changes in equity 16

Consolidated cash flow statement 17

Bank statement of comprehensive income 18

Bank balance sheet 19

Bank statement of changes in equity................. 21

Bank cash flow statement 22

Notes to the consolidated financial statements 23

Registered office:
The Mound, Edinburgh EH1 1YZ
Registered in Scotland No. 327000

Directors' report

Results

The consolidated income statement on page 12 shows a loss attributable to equity shareholders for the year ended 31 December 2009 of £12,240 million.

Principal activities

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

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

Acquisition of the Group by Lloyds Banking Group plc

On 16 January 2009, Lloyds Banking Group plc acquired 100 per cent of the ordinary share capital of HBOS plc, the Bank's parent company.

Business review

The loss before tax increased by £4,649 million or 44 per cent to £15,284 million. The trading surplus increased by 75 per cent or £2,386 million to £5,584 million but is more than offset by the increase in the impairment charge, reflecting the weak credit environment and current economic conditions.

Net interest income decreased by £2,345 million or 27 per cent to £6,195 million as both interest income and interest expense fell as assets have contracted, in response to the historically low interest rate environment that has prevailed throughout the year.

Other income, including subvention income, increased by £4,338 million from £632 million to £4,970 million; the increase arising primarily from the receipt by Bank of Scotland plc of a subvention payment of £3,000 million from Lloyds TSB Bank plc. This payment was made by Lloyds TSB Bank plc to support the financial and reputational position of Bank of Scotland plc and to facilitate the ongoing integration of the group's banking operations. Net trading income improved by £2,382 million from a loss of £2,938 million to a loss of £556 million, reflecting the inclusion of substantial write-downs associated with the dislocation in financial markets in 2008. The Group's insurance activities have ceased following the sale of St. Andrews in the last quarter of 2008. Net fee and commission income decreased by £483 million or 31 per cent to £1,096 million reflecting lower volumes of new business.

Operating expenses decreased 6 per cent or £356 million to £5,581 million, principally as a result of lower depreciation.

This was offset by increased goodwill impairment which increased by £243 million to £385 million. The 2009 charge was principally in respect of Lex Vehicle Leasing Services.

Impairment losses increased by £8,005 million or 66 per cent. This largely represents falls in the values of commercial real estate and the impact of the economic deterioration during the year, including the effects of rising unemployment and reduced corporate cash flows. Significant provisions were required against the Group's Irish and Australian commercial real estate portfolios.

The Group suffered an additional loss of £100 million in 2009 in respect of the disposal of the Australian businesses, BankWest and St. Andrews, in addition to the £845 million loss recorded in 2008.

Loans and advances to customers fell by £48,675 million, or 10 per cent, to £439,538 million reflecting activity undertaken in accordance with the strategy to reduce assets associated with non-relationship lending. Customer deposits decreased by £11,428 million, or 4 per cent, to £265,971 million resulting in a decrease in the customer loans to deposits ratio from 176 per cent at 31 December 2008 to 165 per cent at 31 December 2009.

Loans and advances to banks increased from £12,445 million to £91,259 million and deposits from banks increased from £97,066 million to £174,338 million reflecting transactions with other parts of the Lloyds Banking Group following the acquisition of HBOS plc by Lloyds Banking Group plc on 16 January 2009.

Debt securities in issue decreased by £69,291 million or 37 per cent as some of the maturing debt securities were replaced by deposits by banks as the Group repositioned its funding through transactions with other Lloyds Banking Group subsidiaries.

Shareholders' equity has increased by £10,486 million to £22,147 million as capital injections and gains on available-for-sale assets during the year were significantly greater than the Group's loss for the year.

Capital

The following table shows a summary of the Group's capital position at the end of 2009 and 2008.

	2009 £m	2008 £m
Tier 1 capital	**25,565**	17,328
Tier 2 capital	**14,112**	15,238
	39,677	32,566
Supervisory deductions	**(1,062)**	(919)
Total capital	**38,615**	31,647
Risk weighted assets	**322,866**	326,703
Core tier 1 ratio	**7.5%**	4.7%
Tier 1 capital ratio	**7.9%**	5.3%
Total capital ratio	**12.0%**	9.7%

Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Bank and its subsidiary undertakings, in relation to the use of financial instruments, is given in note 46 of the financial statements.

Group structure

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

Directors

The names of the directors of the Company are shown on page 6.

Mr R J Cousins, Mr P J Cummings, Mr M H Ellis, Sir Ron Garrick, Mr A J Hobson, Mr A H Hornby, Ms K E D Jones, Mr J E Mack, Mr C Matthew, Ms C L McConville, Ms K A Nealon and Lord Stevenson left the board on 16 January 2009.

Dr W C G Berndt, Sir Victor Blank, Mr Ewan Brown, Mr J E Daniels, Mr J P du Plessis, Mr P N Green, Sir Julian Horn-Smith, Mr A G Kane, Lord Leitch, Sir David Manning, Ms C J McCall, Mr M A Scicluna, Mr G T Tate, Mr T J W Tookey and Mrs H A Weir joined the board on 16 January 2009.

Mr J P du Plessis, Mr Ewan Brown, Sir Victor Blank, Mr P N Green, Sir David Manning and Ms C J McCall left the board on 17 April 2009, 5 June 2009, 15 September 2009, 23 October 2009, 2 November 2009 and 31 December 2009, respectively. Ms J Dawson, Mr P A Gore-Randall and Mr D J Watkins left the board on 8 April 2009.

Mr T T Ryan, Mr Anthony Watson and Sir Winfried Bischoff joined the board on 1 March 2009, 2 April 2009 and 15 September 2009, respectively and Mr G R Moreno and Mr D L Roberts have been appointed directors from 1 March 2010.

Directors' interests

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

Directors' indemnities

The directors, including seven former directors who left during the year, have entered into individual contracts of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. These contracts were in force during the whole of the financial year or from the date of appointment in respect of the directors who joined the board in 2009. The contracts for existing directors remain in force and are available for inspection at the registered office of Lloyds Banking Group plc.

Directors' report

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

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the consolidated and parent company financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the parent company and the Group and of the profit or loss of the Group for that period. The directors consider that, in preparing the financial statements on pages 12 to 97, the Bank and the Group have used appropriate accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, and that all accounting standards which they consider applicable have been followed.

The directors have responsibility for ensuring that the Bank and the Group keep adequate accounting records which disclose with reasonable accuracy at any time the financial position of the Bank and the Group and which enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation. They have a general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Bank and the Group and to prevent and detect fraud and other irregularities.

A copy of the financial statements is placed on our website www.lloydsbankinggroup.com. The directors are responsible for the maintenance and integrity of statutory and audited information in relation to the Bank on that website. Information published on the internet is accessible in many countries with different legal requirements. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current directors, whose names are shown on page 6 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position of the Bank and Group and the profit or loss of the Group; and
- the management report contained in the business review includes a fair review of the development and performance of the business and the position of the Bank and Group, together with a description of the principal risks and uncertainties they face.

Going concern
The going concern of the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future the directors have considered a number of key dependencies as discussed in note 1 and additionally have considered projections for the Group's capital and funding position. Having considered these, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Employees
The Group is committed to providing employment practices and policies which recognise the diversity of our workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief.

In the UK, the Group belongs to the major employer groups campaigning for equality for the above groups of staff, including Employers' Forum on Disability, Employers' Forum on Age, Stonewall and the Race for Opportunity. Our involvement with these organisations enables us to identify and implement best practice for our staff.

Employees are kept closely involved in major changes affecting them through measures such as team meetings, briefings, internal communications and opinion surveys. There are well established procedures, including regular meetings with recognised unions, to ensure that the views of employees are taken into account in reaching decisions.

Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in Lloyds Banking Group plc.

Policy and practice on payment of creditors
The Bank has signed up to the 'Prompt Payment Code' published by the Department for Business Innovation and Skills ('BIS'), regarding the making of payments to suppliers. A copy of the code and information about it may be obtained from the BIS Publications Orderline 0845 015 0010, quoting ref URN 04/606. Alternatively, visit www.payontime.co.uk for details.

The Bank policy is to agree terms of payment with suppliers and these normally provide for settlement within 30 days after the date of the invoice, except where other arrangements have been negotiated. It is the policy of the Bank to abide by the agreed terms of payment, provided the supplier performs according to the terms of the contract.

The number of days required to be shown in this report, to comply with the provisions of the Companies Act 2006, is 20. This bears the same proportion to the number of days in the year as the aggregate of the amounts owed to trade creditors at 31 December 2009 bears to the aggregate of the amounts invoiced by suppliers during the year.

Auditors and audit information
Each person who is a director at the date of approval of this report confirms that, so far as the director is aware, there is no relevant audit information of which the Bank's auditors are unaware and each director has taken all the steps that he or she ought to have taken as a director to make himself or herself aware of any relevant audit information and to establish that the Bank's auditors are aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

On behalf of the board

Harry F Baines
Company Secretary
25 February 2010
Company Number 327000

Directors

Sir Winfried Bischoff *Chairman*

J E Daniels *Chief Executive*

T J W Tookey *Finance Director*

Dr W C G Berndt

Sir Julian Horn-Smith

A G Kane

Lord Leitch

G R Moreno
(from 1 March 2010)

D L Roberts
(from 1 March 2010)

T T Ryan, Jr

M A Scicluna

G T Tate

A Watson CBE

H A Weir CBE

Principal risks and uncertainties

At present the most significant risks faced by the Group are:

Credit
Definition: The risk of reductions in earnings and/or value, through financial loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

Features: Arising from the Group's lending activities in its retail, wholesale and wealth and international operations. Over the last two years the deteriorating economic outlook, both in the UK and overseas, brought about by the banking crisis has impacted the financial services industry resulting in further high profile losses and writedowns. The Group is impacted by the economic downturn and a further worsening of the business environment could adversely impact earnings.

This poses a major risk to the Group and its lending to:

- Retail customers, where reducing affordability and/or asset values arising from a combination of house price falls, continuing high, or increasing levels of unemployment, consumer over-indebtedness, and rising interest rates impact both secured and unsecured retail exposures.
- Wholesale customers, where companies are facing increasingly difficult business conditions, resulting in corporate default levels rising and leading to increases in corporate impairment. The Group has high levels of exposure in both the UK and internationally, including Ireland, USA, Australia and Spain. There are particular concentrations to: financial institutions, commercial real estate, and joint ventures, with high leverage and exposures through capital structure.

The Group follows a through the economic cycle, relationship based, business model with risk management processes, appetites and experienced staff in place.

Legal and regulatory
Definition: The risk of regulatory action leading to fine and/or public censure and/or successful legal action being taken against the Group as a result of failure to meet one or more legal and/or regulatory requirements either in the UK or overseas.

Features: The industry is currently subject to a wide range of international and UK consultations on proposals to change the regulatory requirements. For example the Basel Committee on Banking Supervision has issued proposals with respect to capital and liquidity requirements for banks ('Strengthening the resilience of the banking sector' and 'International framework for liquidity risk measurement, standards and monitoring') and draft proposals have also been issued for new capital requirements for insurers (Solvency II). In the UK we have seen the Turner review and more recently, proposals have been issued for governance, recovery and resolution ('Living Wills') arrangements and also, potentially conduct of business requirements, which could have significant implications for past business as well as future product offerings for customers. There is a high level of uncertainty both as to the financial outcome in terms of specific requirements and the speed of implementation in the UK and internationally.

The Group is currently assessing the impacts of these regulatory proposals, and will participate in the consultation and calibration processes to be undertaken by the various regulatory bodies during 2010. The Group currently meets and exceeds its regulatory capital requirements and expects to continue to do so. However, the FSA could impose more stringent capital and liquidity requirements, and/or introduce new ratios and/or change the manner in which it applies existing requirements to recapitalised banks, including those within the Group. Any one or combination of these events could result in the Group being forced to raise further capital or to divest assets.

The Group has made good preparations for the FSA's new liquidity regime (ILAS) and is ready to meet the reporting implications later in the year.

The Group's policy is to maintain high levels of compliance with regulatory requirements and it will organise its business to maintain this level of compliance as the requirements become clearer, being mindful of maintaining an appropriate balance between risk and reward.

Principal risks and uncertainties

Liquidity and funding

Definition: 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. 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.

Features: Arising in the banking business of the Group and reflecting the risk that the Group is unable to attract and retain either retail, wholesale or corporate deposits or issue debt securities. Like all major banks, the Group is dependent on confidence in the short and longer term wholesale funding markets; should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding and provide liquidity when necessary, it could impact its ability to fund its financial obligations.

The key dependencies for successfully funding the Group's balance sheet include the continued functioning of the money and capital markets at their current levels; successful right sizing of the Group's balance sheet; the continuation of HM Treasury facilities in accordance with the terms agreed; limited further deterioration in the UK's and the Group's credit rating and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or UK Government support schemes. A return to the extreme market conditions of 2008 would place a strain on the Group's ability to meet its financial commitments.

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

Customer treatment

Definition: The risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment.

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

The Office of Fair Trading's (OFT) investigation and legal test case in respect of unarranged overdraft charges on personal current accounts concluded in 2009. The OFT is however continuing to discuss its concerns in relation to the personal current account market with the banks, consumer groups and other organisations under the auspices of its Market Study into personal current accounts. In October 2009, the OFT published voluntary initiatives agreed with the industry and consumer groups to improve transparency of the costs and benefits of personal current accounts and improvements to the switching process. The OFT aims to report on progress in respect of further changes it believes are required to make the market work in the best interest of bank customers by the end of March 2010.

The Group regularly reviews its product range to ensure that it meets regulatory requirements and is competitive in the market place. Treating Customers Fairly remains the key principle underpinning the FSA's consumer protection objective. An additional challenge for the Group is ensuring the fair treatment of customers during integration of the two heritage businesses. As a result the customer relationship management risks posed by integration are carefully considered through the integration governance process in place. If the Group is unable to demonstrate the fair treatment of its customers there is the risk of increased complaints from customers, the potential for regulatory action (which could include reviews of past business and/or the payment of fines and compensation) and adverse media coverage (leading to reputational damage in the marketplace). The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers.

People

Definition: The risk of reduction in earnings and/or value, through financial or reputational loss, from failure to retain, train, reward, recruit and incentivise appropriately skilled staff, inappropriate staff behaviour or industrial action.

Features: The delivery of the Group's objectives is underpinned by the ability to attract, retain and develop the best talent in the industry. The challenges to the people agenda have never been greater with increased regulatory and public interest in remuneration practices, the effects of the Government shareholding and the impacts of integration. The Group welcomes the regulation of remuneration provided there is an international consensus and will comply with the FSA Code. The Group has

managed the initial stages of integration, working to establish control by defining and implementing the new organisational structures and continues to manage the relationship with colleagues during this period of change. The Group has policies, procedures and governance arrangements in place to ensure the effective management of people risk as the Group integrates and grows its business. Proposals to harmonise employee terms and conditions have been published and the Group is consulting with the various representative unions. The Group actively manages its relationships with unions, but is aware of the danger of industrial action, business disruption and reputational impact arising from union behaviour and communications. People risk is closely monitored as a key risk indicator, as well as being subject to oversight by the board.

Integration

Definition: The risk that the Group fails to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or incurs unanticipated costs and losses associated with, the acquisition of HBOS plc by Lloyds TSB Group plc.

Features: The integration of the two legacy organisations presents one of the largest integration challenges that has been seen in the UK financial services industry. There is a risk that the Group may fail to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from the acquisition of HBOS plc by Lloyds Banking Group plc, or may incur unanticipated costs and losses associated as a result. As a consequence, the Group's results may suffer as a result of operational, financial management and other integration risks. The risk of failure to deliver synergy benefits or to meet publicly stated targets could potentially result in a loss of shareholder or market confidence with negative perceptions of the Group's integration strategy. As the Group goes through the integration process there is a danger of losing key staff potentially impacting upon integration plans.

An integration executive board has been created to oversee the integration process. The Group is now one year into the integration programme and has a fully developed and functioning governance framework to manage these risks, with clear understanding of the dependencies and phased deliverables through to 2012. The programme is ahead of plan.

Independent auditors' report to the members of Bank of Scotland plc

We have audited the Consolidated and Bank financial statements (the 'financial statements') of Bank of Scotland plc for the year ended 31 December 2009 which comprise the Consolidated Income Statement, the Consolidated and Bank Statements of Comprehensive Income, the Consolidated and Bank Balance Sheets, the Consolidated and Bank Statements of Changes in Equity, the Consolidated and Bank Cash Flow Statements, and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 4, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Bank's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Bank's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Bank's affairs as at 31 December 2009 and of the Group's loss and Group's and Bank's cash flows for the year then ended;
- the Consolidated financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the Bank financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Consolidated financial statements, Article 4 of the IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Independent auditors' report to the members of Bank of Scotland plc

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- 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 financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Ian Rankin (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh
25 February 2010

Consolidated income statement

for the year ended 31 December 2009

	Note	**2009** **£ million**	2008 (restated)[1] £ million
Interest and similar income		**19,060**	36,093
Interest and similar expense		**(12,865)**	(27,553)
Net interest income	*5*	**6,195**	8,540
Fee and commission income		**1,304**	1,961
Fee and commission expense		**(208)**	(382)
Net fee and commission income	*6*	**1,096**	1,579
Net trading income	*7*	**(556)**	(2,938)
Insurance premium income		**–**	215
Subvention income	*8*	**3,000**	–
Other operating income	*8*	**1,430**	1,776
Other income		**4,970**	632
Total income		**11,165**	9,172
Insurance claims		**–**	(37)
Total income, net of insurance claims		**11,165**	9,135
Operating expenses	*9*	**(5,581)**	(5,937)
Trading surplus		**5,584**	3,198
Impairment	*10*	**(20,055)**	(12,050)
Share of results of joint ventures and associates	*11*	**(713)**	(938)
Loss on sale of businesses	*12*	**(100)**	(845)
Loss before tax		**(15,284)**	(10,635)
Taxation	*13*	**3,057**	2,448
Loss for the year		**(12,227)**	(8,187)
Profit attributable to minority interests		**13**	51
Loss attributable to equity shareholders		**(12,240)**	(8,238)
Loss for the year		**(12,227)**	(8,187)

[1]See note 48.

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

Consolidated statement of comprehensive income

for the year ended 31 December 2009

	2009 £ million	2008[1] £ million
Loss for the year	**(12,227)**	(8,187)
Other comprehensive income:		
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax:		
Change in fair value	**1,877**	(5,897)
Transferred to income statement in respect of disposals	**2**	(17)
Transferred to income statement in respect of impairment	**446**	915
	2,325	(4,999)
Movement in cash flow hedging reserve, net of tax:		
Effective portion of changes in fair value taken to other comprehensive income	**(442)**	(2,801)
Net gains transferred to the income statement	**645**	1,844
	203	(957)
Currency translation differences, net of tax	**9**	95
Other comprehensive income for the year, net of tax	**2,537**	(5,861)
Total comprehensive income for the year	**(9,690)**	(14,048)
Total comprehensive income attributable to minority interests	**13**	51
Total comprehensive income attributable to equity shareholders	**(9,703)**	(14,099)
Total comprehensive income for the year	**(9,690)**	(14,048)

[1]See note 48.

Consolidated balance sheet

as at 31 December 2009

	Note	**2009** **£ million**	2008 (restated)[1] £ million	1 January 2008 (restated)[1] £ million
Assets				
Cash and balances at central banks		**2,905**	2,502	2,944
Items in the course of collection from banks		**534**	445	945
Trading and other financial assets at fair value through profit or loss	*14*	**27,867**	23,430	55,789
Derivative financial instruments	*15*	**30,222**	50,517	13,794
Loans and receivables:				
Loans and advances to banks	*16*	**91,259**	12,445	4,095
Loans and advances to customers	*17*	**439,538**	488,213	485,201
Debt securities	*20*	**31,211**	38,878	527
		562,008	539,536	489,823
Available-for-sale financial assets	*22*	**21,565**	28,035	49,980
Investment properties	*23*	**30**	43	34
Investments in joint ventures and associates	*11*	**423**	1,193	1,739
Goodwill	*25*	**376**	667	1,041
Other intangible assets	*26*	**91**	108	110
Tangible fixed assets	*27*	**4,903**	5,527	6,300
Current tax recoverable		**745**	865	–
Deferred tax assets	*34*	**5,153**	3,182	–
Other assets	*28*	**4,522**	3,126	6,067
Total assets		**661,344**	659,176	628,566

[1] See note 48.

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

The directors approved the consolidated financial statements on 25 February 2010.

Sir Winfried Bischoff
Chairman

J Eric Daniels
Chief Executive

Tim J W Tookey
Finance Director

Consolidated balance sheet

as at 31 December 2009

	Note	**2009** **£ million**	2008 (restated)[1] £ million	1 January 2008 (restated)[1] £ million
Equity and liabilities				
Liabilities				
Deposits from banks	*29*	**174,338**	97,066	41,513
Customer deposits	*30*	**265,971**	277,399	297,621
Items in course of transmission to banks		**495**	521	542
Trading and other financial liabilities at fair value through profit or loss	*31*	**27,372**	18,851	22,552
Derivative financial instruments	*15*	**27,452**	40,827	12,160
Notes in circulation		**981**	957	1,034
Debt securities in issue	*32*	**119,157**	188,448	206,520
Liabilities arising from insurance contracts and participating investment contracts		**–**	–	24
Liabilities arising from non-participating investment contracts		**–**	–	98
Other liabilities	*33*	**6,291**	4,235	4,912
Current tax liabilities		**3**	23	728
Deferred tax liabilities	*34*	**–**	–	965
Other provisions	*35*	**247**	145	172
Subordinated liabilities	*36*	**16,684**	18,779	17,881
Total liabilities		**638,991**	647,251	606,722
Equity				
Share capital	*37*	**5,847**	1,324	499
Share premium account	*38*	**26,684**	11,018	6,343
Other reserves	*39*	**(2,094)**	(4,694)	1,167
Retained profits	*40*	**(8,290)**	4,013	13,479
Shareholders' equity		**22,147**	11,661	21,488
Minority interests		**206**	264	356
Total equity		**22,353**	11,925	21,844
Total equity and liabilities		**661,344**	659,176	628,566

[1] See note 48.

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

Consolidated statement of changes in equity

for the year ended 31 December 2009

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Minority interests £ million	Total £ million
Balance at 1 January 2008	6,842	1,167	13,479	21,488	356	21,844
Total comprehensive income	–	(5,861)	(8,238)	(14,099)	51	(14,048)
Dividends	–	–	(1,228)	(1,228)	(43)	(1,271)
Issue of ordinary and preference shares	5,500	–	–	5,500	–	5,500
Repayment of capital to minority shareholders	–	–	–	–	(100)	(100)
Balance at 31 December 2008	12,342	(4,694)	4,013	11,661	264	11,925
Total comprehensive income	**–**	**2,537**	**(12,240)**	**(9,703)**	**13**	**(9,690)**
Dividends	**–**	**–**	**–**	**–**	**(12)**	**(12)**
Issue of ordinary and preference shares	**20,189**	**–**	**–**	**20,189**	**–**	**20,189**
Capital redemption reserve	**–**	**63**	**(63)**	**–**	**–**	**–**
Extinguishment of minority interests	**–**	**–**	**–**	**–**	**(59)**	**(59)**
Balance at 31 December 2009	**32,531**	**(2,094)**	**(8,290)**	**22,147**	**206**	**22,353**

Consolidated cash flow statement

for the year ended 31 December 2009

	Note	2009 £ million	2008 (restated)[1] £ million
Loss before tax		**(15,284)**	(10,635)
Adjustments for:			
Change in operating assets	*43a*	**45,204**	(73,045)
Change in operating liabilities	*43b*	**911**	33,318
Non-cash and other items	*43c*	**24,760**	16,143
Tax received (paid)		**374**	(1,061)
Net cash (used in) provided by operating activities		**55,965**	(35,280)
Cash flows from investing activities			
Purchase of available-for-sale financial assets		**10,935**	55,637
Proceeds from sale and maturity of available-for-sale financial assets		**(15,760)**	(18,238)
Purchase of fixed assets		**(188)**	(565)
Proceeds from sale of fixed assets		**54**	587
Acquisition of businesses, net of cash acquired	*43f*	**(279)**	(454)
Disposal of businesses, net of cash disposed	*43g*	**137**	1,224
Net cash (used in) provided by investing activities		**(5,101)**	38,191
Cash flows from financing activities			
Dividends paid to equity shareholders		**–**	(1,228)
Dividends paid to minority interests	*43e*	**(12)**	(43)
Interest paid on subordinated liabilities		**(816)**	(1,323)
Proceeds from issue of subordinated liabilities	*43e*	**–**	3,000
Proceeds from issue of ordinary shares	*43e*	**20,189**	5,500
Repayment of subordinated liabilities	*43e*	**(1,781)**	(3,405)
Minority interest acquired	*43e*	**–**	242
Repayment of capital to minority shareholders	*43e*	**(59)**	(353)
Net cash provided by financing activities		**17,521**	2,390
Effects of exchange rate changes on cash and cash equivalents		**39**	(245)
Change in cash and cash equivalents[2]		**68,424**	5,056
Cash and cash equivalents at beginning of year		**7,967**	2,911
Cash and cash equivalents at end of year	*43d*	**76,391**	7,967

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

[1] Following the reclassification of the Group balance sheet to align the presentation with the presentation practices adopted by Lloyds Banking Group plc (as detailed in note 48) the cash flow statement has been represented on a basis consistent with the reclassified balance sheet.

[2] Mandatory reserve deposits of £373 million at 1 January 2008 have been reclassified from loans and advances to banks to cash and balances at central banks. In addition, total cash and cash equivalents at 1 January 2008 have been restated to include certain cash deposits held with the Central Bank of Ireland of £853 million and cash held at central bank as collateral against notes in circulation of £881 million which are available to finance the Group's day to day operations. The cash flow statement has been adjusted accordingly.

Bank statement of comprehensive income

for the year ended 31 December 2009

	2009 £ million	2008 (restated)[1] £ million
Loss for the year	**(14,168)**	(7,062)
Other comprehensive income:		
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax:		
Change in fair value	**1,331**	(2,992)
Transferred to income statement in respect of disposals	**42**	31
Transferred to income statement in respect of impairment	**–**	466
	1,373	(2,495)
Movement in cash flow hedging reserve, net of tax:		
Effective portion of changes in fair value taken to other comprehensive income	**(454)**	(2,789)
Net losses transferred to the income statement	**652**	1,863
	198	(926)
Currency translation differences, net of tax	**33**	–
Other comprehensive income for the year, net of tax	**1,604**	(3,421)
Total comprehensive income for the year	**(12,564)**	(10,483)

[1]See note 48.

Bank balance sheet

for the year ended 31 December 2009

Assets	Note	2009 £ million	2008 (restated)[1] £ million	1 January 2008 (restated)[1] £ million
Cash and balances at central banks		**2,168**	1,820	1,667
Items in the course of collection from banks		**538**	449	890
Trading and other financial assets at fair value through profit or loss	*14*	**27,628**	22,920	52,574
Derivative financial instruments	*15*	**26,680**	43,260	12,067
Loans and receivables:				
Loans and advances to banks	*16*	**108,133**	34,144	25,458
Loans and advances to customers	*17*	**439,967**	578,528	478,840
Debt securities	*20*	**23,684**	19,259	7
		571,784	631,931	504,305
Available-for-sale financial assets	*22*	**19,316**	24,339	26,608
Investment in subsidiary undertakings	*24*	**2,451**	4,383	3,298
Investments in joint ventures and associates	*11*	**104**	103	103
Goodwill	*25*	**376**	376	426
Other intangible assets	*26*	**85**	98	88
Tangible fixed assets	*27*	**1,344**	1,359	1,406
Current tax recoverable		**975**	1,180	–
Deferred tax assets	*34*	**4,410**	2,563	165
Other assets	*28*	**5,792**	2,876	5,331
Total assets		**663,651**	737,657	608,928

[1] See note 48.

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

Approved by the Board on 25 February 2010 and signed on its behalf by:

Sir Winfried Bischoff
Chairman

J Eric Daniels
Chief Executive

Tim J W Tookey
Finance Director

Bank balance sheet

for the year ended 31 December 2009

Equity and liabilities	Note	2009 £ million	2008 (restated)[1] £ million	1 January 2008 (restated)[1] £ million
Liabilities				
Deposits from banks	29	**168,246**	97,091	47,321
Customer deposits	30	**300,124**	373,173	332,322
Items in course of transmission to banks		**495**	522	543
Trading and other financial liabilities at fair value through profit or loss	31	**27,372**	18,851	22,145
Derivative financial instruments	15	**27,171**	39,613	10,073
Notes in circulation		**981**	957	881
Debt securities in issue	32	**98,075**	172,464	158,257
Other liabilities	33	**4,925**	4,422	2,968
Current tax liabilities		**–**	–	544
Other provisions	35	**235**	132	481
Subordinated liabilities	36	**16,052**	18,082	14,855
Total liabilities		**643,676**	725,307	590,390
Equity				
Share capital	37	**5,847**	1,324	499
Share premium account	38	**26,684**	11,018	6,343
Other reserves	39	**(449)**	(2,116)	1,318
Retained profits	40	**(12,107)**	2,124	10,378
Shareholders' equity		**19,975**	12,350	18,538
Total equity and liabilities		**663,651**	737,657	608,928

[1] See note 48.

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

Bank statement of changes in equity

for the year ended 31 December 2009

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
Balance at 31 December 2007 as previously stated	6,842	1,296	10,041	18,179
Prior year adjustment (note 48)	–	9	350	359
Balance at 1 January 2008 as restated	6,842	1,305	10,391	18,538
Total comprehensive income	–	(3,421)	(7,062)	(10,483)
Dividends	–	–	(1,205)	(1,205)
Issue of ordinary and preference shares	5,500	–	–	5,500
Balance at 31 December 2008	12,342	(2,116)	2,124	12,350
Total comprehensive income	**–**	**1,604**	**(14,168)**	**(12,564)**
Issue of ordinary shares	**20,189**	**–**	**–**	**20,189**
Capital redemption	**–**	**63**	**(63)**	**–**
Balance at 31 December 2009	**32,531**	**(449)**	**(12,107)**	**19,975**

Bank cash flow statement

for the year ended 31 December 2009

	Note	**2009** **£ million**	2008 (restated)[1] £ million
Loss before tax		**(17,080)**	(9,051)
Adjustments for:			
Fair value and exchange adjustments		**1,671**	923
Change in operating assets	*43a*	**118,144**	(180,300)
Change in operating liabilities	*43b*	**(69,621)**	190,960
Non-cash and other items	*43c*	**21,899**	11,795
Tax received (paid)		**642**	(759)
Net cash provided by operating activities		**55,655**	13,568
Cash flows from investing activities			
Acquisition of business, net of cash acquired	*43f*	**(2,517)**	(1,217)
Purchase of fixed assets		**(142)**	(230)
Proceeds from sale of fixed assets		**39**	130
Net cash used in investing activities		**(2,620)**	(1,317)
Cash flows from financing activities			
Dividends paid to equity shareholders		**–**	(1,205)
Proceeds from issue of subordinated liabilities	*43e*	**–**	3,000
Repayment of debt securities/subordinated liabilities in issue	*43e*	**(1,781)**	(870)
Proceeds from issue of other ordinary shares	*43e*	**20,189**	5,500
Interest paid on subordinated liabilities		**(757)**	(1,045)
Net cash provided by financing activities		**17,651**	5,380
Change in cash and cash equivalents		**70,686**	17,631
Cash and cash equivalents at beginning of year		**19,353**	1,722
Cash and cash equivalents at end of year	*43d*	**90,039**	19,353

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

[1] Following the reclassification of the Bank balance sheet to align the presentation with the presentation practices adopted by Lloyds Banking Group plc (as detailed in note 48) the cash flow statement has been represented on a basis consistent with the reclassified balance sheet.

Notes to the consolidated financial statements

1 Basis of preparation

The global upheaval in the financial markets that occurred during 2008 has abated during the latter part of 2009. The steps taken in 2008 by HM Treasury through the introduction of the UK Government's Credit Guarantee Scheme for senior funding and the Bank of England through various facilities have together continued to provide assurance of liquidity support to the banking markets. Notwithstanding the improvement in market liquidity during 2009, Lloyds Banking Group plc continues to be reliant upon these facilities in order to maintain its wholesale funding position. The Bank is dependent upon its ultimate parent, Lloyds Banking Group plc and its fellow subsidiary undertaking, Lloyds TSB Bank plc, to provide capital and funding.

During the year, Lloyds Banking Group plc has taken steps to strengthen the Bank's capital position in order to provide a buffer against further shocks arising from the economic environment.

Based upon projections prepared by management, which take into account the funding needs of the Lloyds Banking Group as a whole and which assume that the Government sponsored facilities will continue to be available, the directors are satisfied that the Bank has adequate resources to continue in business for the foreseeable future. Accordingly, the financial statements of the Bank have been prepared on a going concern basis.

2 Accounting policies

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) and, as regards to the Bank financial statements, as applied in accordance with the provisions of the Companies Act 2006. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

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

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

(i) *IAS 1 (revised), 'Presentation of financial statements'.* The revised standard prohibits the presentation of items of income and expense (that is 'non-owner changes in equity') in the statement of changes in equity, requiring 'non-owner changes in equity' to be presented separately from owner changes in equity. All non-owner changes in equity are required to be shown in a performance statement. Entities can choose whether to present one performance statement (the statement of comprehensive income) or two statements (the income statement and statement of comprehensive income). The Group has elected to present two statements: an income statement and a statement of comprehensive income. The financial statements have been prepared under the revised disclosure requirements; the application of this revised standard, which affects presentation only, has not had any impact for amounts recognised in these financial statements. A balance sheet as at 1 January 2008 is presented to deal with the reclassifications as detailed in note 48.

(ii) *Amendments to IFRS 7 'Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments'*. The amendment requires enhanced disclosures about fair value measurement and liquidity risk. In particular, the amendment requires disclosure of a three level fair value measurement hierarchy for financial instruments carried on the Group's balance sheet at fair value. As the amendments only result in additional disclosures, the amendments have not had any impact for amounts recognised in these financial statements.

(iii) *IFRS 8 'Operating Segments'.* The new standard replaces IAS 14 'Segment Reporting' and requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision maker has been identified as the Group Executive Committee (GEC). The Group is managed on the entity basis and not by segment, and the GEC does not assess performance and allocate resources across any segments; accordingly no segmental information is provided. A brief overview of its 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 Group.

The application of the following IFRS pronouncements which all became effective in 2009 has had no material impact on these financial statements:

- Amendments to IFRIC 9 *Reassessment of Embedded Derivatives* and IAS 39 *Financial Instruments: Recognition and Measurement*. This amendment clarifies that a reassessment of embedded derivatives is required whenever a financial asset has been reclassified out of the fair value through profit or loss category.

- IFRIC 13 *Customer Loyalty Programmes*. This interpretation addresses accounting by entities who grant customer loyalty award credits to customers as part of sales transactions and which can be redeemed in the future for free or discounted goods or services. The majority of customer loyalty award schemes are operated by third parties.

- IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*. This interpretation provides guidance on accounting for hedges of net investments in foreign operations in an entity's consolidated financial statements.

- IAS 23 *Borrowing Costs*. This revised standard requires interest and other costs incurred in connection with the borrowing of funds to be recognised as an expense excepting that those which are directly attributable to the acquisition, construction or production of assets that take a substantial period of time to get ready for their intended use or sale must be capitalised as part of the cost of those assets.

- Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation*. The amendments require some puttable financial instruments (being those which give the holder the right to put the instrument back to the issuer for cash or another financial asset) and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation to be classified as equity.

- *Improvements to IFRSs* (issued May 2008). Sets out minor amendments to IFRS standards as part of annual improvements process. Most amendments clarified existing practice.

2 Accounting policies (continued)

- Amendment to IAS 27 *Consolidated and Separate Financial Statements – Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*. This amendment removes the definition of the cost method and requires the presentation of dividends as income in the separate financial statements of the investor.

The application of these new interpretations has not had any impact for amounts recognised in these financial statements.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2009 and which have not been applied in preparing these financial statements are given in note 50.

The accounting policies are set out below.

a Consolidation
The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, joint ventures and associates.

(1) *Subsidiaries*
Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 24.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

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

(2) *Joint ventures and associates*
Joint ventures are entities over which the Group has joint control under a contractual arrangement with other parties. Associates are entities over which the Group has significant influence, but not control or joint control, over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity and is normally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting and are initially recorded at cost and adjusted each year to reflect the Group's share of the post-acquisition results of the joint venture or associate based on audited accounts which are coterminous with the Group or made up to a date which is not more than three months before the Group's reporting date. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

b Goodwill
Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates, 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. Goodwill arising on acquisitions of joint ventures and associates is included in the Group's investment in joint ventures and associates. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

c Other intangible assets
Other intangible assets comprise software enhancement and brands. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 5 years
Brands (which have been assessed as having finite lives)	10-15 years

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

d Revenue recognition
Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

2 Accounting policies (continued)

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group including expected early redemption fees and related penalties and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account in the calculation. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see h).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

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

e Financial assets and liabilities
On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. Purchases and sales of securities and other financial assets and liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

(1) *Financial instruments at fair value through profit or loss*
Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see accounting policy f).

Trading securities are debt securities and equity shares acquired principally for the purpose of selling in the short term or which are part of a portfolio which is managed for short-term gains. Such securities are classified as trading securities and recognised in the balance sheet at their fair value. Gains and losses arising from changes in their fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

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

– it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases.

– the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis. As noted in accounting policy 2(a)(2), certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.

– where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Valuation of financial instruments) and note 46 (Financial risk management: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

The Group is permitted to reclassify, at fair value at the date of transfer, non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the trading category if they are no longer held for the purpose of being sold or repurchased in the near term, as follows:

– if the financial assets would have met the definition of loans and receivables (but for the fact that they had to be classified as held for trading at initial recognition), they may be reclassified into loans and receivables where the Group has the intention and ability to hold the assets for the foreseeable future or until maturity;

– if the financial assets would not have met the definition of loans and receivables, they may be reclassified out of the held for trading category into available-for-sale financial assets in 'rare circumstances'.

(2) *Available-for-sale financial assets*
Debt securities and equity shares that are not classified as trading securities, at fair value through profit or loss or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Available-for-sale financial assets are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

2 Accounting policies (continued)

The Group is permitted to transfer, at fair value at the date of transfer, a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. For assets transferred, gains or losses recognised in equity in respect of these assets as at the date of transfer are amortised to profit or loss over the remaining life of the asset using the effective interest method.

(3) *Loans and receivables*
Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see d) less provision for impairment (see h).

The Group has entered into securitisations and similar transactions to finance certain loans and advances to customers. These loans and advances to customers continue to be recognised by the Group, together with a corresponding liability for the funding.

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

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 original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss together with any related costs or fees incurred.

(5) *Sale and repurchase agreements*
Securities sold subject to repurchase agreements ('repos') continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer accounts, or trading liabilities. Conversely, securities purchased under agreements to resell ('reverse repos'), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities lent to counterparties are retained in the financial statements. Securities borrowed are not recognised in the financial statements, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability.

(6) *Derecognition of financial assets and liabilities*
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 the risks and rewards, but has not retained control.

Financial liabilities are derecognised when they are extinguished (i.e. when the obligation is discharged), cancelled or expires.

f Derivative financial instruments and hedge accounting
All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Valuation of financial instruments) and note 46 (Financial risk management: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

Changes in the fair value of any derivative instrument that is not part of a hedging relationship are recognised immediately in the income statement.

Derivatives embedded in financial instruments 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.

The method of recognising the movements in the fair value of the derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. 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 the same. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

The Group designates certain derivatives as either: (1) hedges of the fair value of the particular risks inherent in recognised assets or liabilities (fair value hedges); (2) hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges); or (3) hedges of net investments in foreign operations (net investment hedges). These are accounted for as follows:

2 Accounting policies (continued)

(1) *Fair value hedges*
Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as an available-for-sale financial asset. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

(2) *Cash flow hedges*
The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedge reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

(3) *Net investment hedges*
Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income; the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instrument in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

g Offset
Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

h Impairment of financial assets
(1) *Assets accounted for at amortised cost*
At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

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

– Delinquency in contractual payments of principal and/or interest;

– Indications that the borrower or group of borrowers is experiencing significant financial difficulty;

– Restructuring of debt to reduce the burden on the borrower;

– Breach of loan covenants or conditions; and

– Initiation of bankruptcy or individual voluntary arrangement proceedings.

For impaired debt instruments which are classified as loans and receivables, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows. A reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment.

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

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original effective interest rate. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current effective interest rate.

For the Group's portfolios of smaller balance homogenous loans, such as the residential mortgage, personal lending and credit card portfolios, allowances are calculated for groups of assets taking into account historical cash flow experience. For the Group's other lending portfolios, allowances are established on a case-by-case basis. The calculation of the present value of the estimated future cash flows of a collateralised asset or group of assets reflects the cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

If there is no objective evidence of individual impairment the asset is included in a group of financial assets with similar credit risk characteristics and collectively assessed for impairment. Segmentation takes into account such factors as the type of asset, industry, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the Group and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

2 Accounting policies (continued)

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement.

Equity securities acquired in exchange for loans in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of equity securities. Where control is obtained over an entity as a result of the transaction, the entity is consolidated; where the Group has significant influence over an entity as a result of the transaction, the investment is accounted by the equity method of accounting (see accounting policy a). Any subsequent impairment of the assets or business acquired is treated as an impairment of the relevant asset or business and not as an impairment of the original instrument.

(2) *Available-for-sale financial assets*
The Group assesses at each balance sheet date whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

i Investment property
Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital appreciation or both. The Group's investment property primarily relates to property held for long-term rental yields and capital appreciation within the long-term assurance funds. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices on less active markets. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income for investment property within the long-term assurance funds and as other operating income for other investment property.

j Tangible fixed assets
Tangible fixed assets are included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

– Freehold/long and short leasehold premises: shorter of 50 years or the remaining period of the lease

– Leasehold improvements: shorter of 10 years or, if lease renewal is not likely, the remaining period of the lease

Equipment:

– Fixtures and furnishings: 10 to 20 years

– Other equipment and motor vehicles: 2 to 8 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

k Leases
(1) *As lessee*
The leases entered into by the Group are primarily operating leases. Operating lease rentals payable are charged to the income statement on a straight-line basis over the period of the lease.

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

(2) *As lessor*
Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

2 Accounting policies (continued)

Operating lease assets are included within tangible fixed assets at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight line basis over the life of the lease.

The Group evaluates non-lease arrangements such as outsourcing and similar contracts to determine if they contain a lease which is then accounted for separately.

l Taxation
Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

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

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Deferred tax is provided on temporary differences arising from investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, the deferred tax is also recognised in other comprehensive income. Such deferred tax is subsequently transferred to the income statement together with the deferred gain or loss.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

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'). The consolidated financial statements are presented in sterling, which is the Bank's functional and presentation currency.

Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit or loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in other comprehensive income unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.

The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translations of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments (see f(3)). On disposal of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal.

n Provisions
Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

The Group recognises provisions in respect of vacant leasehold property where the unavoidable costs of the present obligations exceed anticipated rental income.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

o Dividends
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 a maturity of less than three months.

2 Accounting policies (continued)

q Balance sheet presentation
To provide a more relevant presentation of the Group's financial instruments, an additional line has been added to the consolidated balance sheet to separately show debt securities classified as loans and receivables. In addition, certain amounts have been reclassified to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group (see note 48).

Comparatives have been reclassified to conform to the revised presentation.

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

3 Critical accounting judgements and estimates

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements and which together are deemed critical to the Group's results and financial position are discussed below.

Allowance for impairment losses on loans and receivables
The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in accounting policy 2(h). The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are established to recognise incurred impairment losses in the Group's loan portfolios carried at amortised cost. In determining whether an impairment has occurred at the balance sheet date the Group considers whether there is any observable data indicating that there has been a measurable decrease in the estimated future cash flows or their timings. Where this is the case, the impairment loss is the difference between the carrying value of the loan and the present value of the estimated future cash flows discounted at the loan's original effective interest rate.

At 31 December 2009 gross loans and receivables totalled £585,195 million (2008: £551,152 million) against which impairment allowances of £23,187 million (2008: £11,616 million) had been made (see note 21). Impairment allowances are made up of two components, those determined individually and those determined collectively. At 31 December 2009 the individual component was £20,355 million (2008: £6,736 million) and the collective component was £2,832 million (2008: £4,880 million)

Individual component
All impaired loans which exceed a certain threshold are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security. The determination of these allowances often requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in the current economic environment in assessing borrower's cash flows and debt servicing capability together with the realisable value of commercial real estate collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective component
Impairment allowances for portfolios of smaller balance homogenous loans, such as residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis. Collective impairment allowances are calculated on a portfolio basis using models which take into account factors such as historical experience of accounts progression through the various stages of delinquency, historical loss rates, the credit quality of the portfolio, and the value of any collateral held, which is estimated, where appropriate, using indices such as house price indices.

The calculation of the collective impairment allowance is therefore subject to estimation uncertainty. The variables used in the collective impairment models are kept under regular review to ensure that as far as possible they reflect current economic circumstances. However, significant management judgement is applied in assessing whether current economic conditions and borrowers' behaviour are fully reflected in the historical loss data and other inputs to the impairment models.

The collective impairment allowance is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the Group's mortgage portfolio, a key variable is UK house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices within the Group's mortgage portfolio were 10 per cent lower than those estimated at 31 December 2009, the house price index related impact on the impairment charge would be an increase of approximately £280 million.

Impairment of available-for-sale financial assets
In determining whether an impairment loss has been incurred in respect of an available-for-sale financial asset, the Group performs an objective review of the current financial circumstances and future prospects of the issuer and, in the case of equity shares, considers whether there has been a significant or prolonged decline in the fair value of that asset below its cost. This consideration requires management judgement. Among factors considered by the Group is whether the decline in fair value

3 Critical accounting judgements and estimates (continued)

is a result of a change in the quality of the asset or a downward movement in the market as a whole. An assessment is performed of the future cash flows expected to be realised from the asset, taking into account, where appropriate, the quality of underlying security and credit protection available. The increase in the fair value of available-for-sale financial assets during the year was £2,550 million (2008: decrease of £8,173 million). Impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement totalled £620 million (2008: £1,270 million).

Valuation of financial instruments
Financial instruments classified by management as trading and other financial assets and liabilities at fair value through profit or loss, derivative financial instruments and available-for-sale financial assets are carried at fair value which is determined as being the amount for which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Management judgement is required in determining the appropriate classification of financial instruments.

In 2009, the Group adopted '*Amendments to IFRS 7 'Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments*' which among other matters, established a three level valuation hierarchy for disclosure of fair value measurements of financial instruments carried on the Group's balance sheet at fair value.

Management judgement is required in determining the categorisation of the Group's financial instruments that are carried at fair value. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is less judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and level 3 is determined using valuation techniques which include discounted cash flow analysis and pricing models and, where appropriate, comparison to similar instruments. These require management judgment and therefore contain significant estimation uncertainty.

In particular, significant judgement is required by management in determining appropriate assumptions to be used for level 3 financial instruments. In valuing level 3 asset-backed securities and derivatives, such assumptions include prepayment rates, probability of default, loss given default and yield curves. In respect of the group's unlisted equity investments, fair value is determined through the use of third party valuations which may be adjusted to take into account other relevant information that management judge to be relevant.

The valuation techniques used are set out in note 45. This provides details of the inputs into valuation models that have the potential to significantly impact the value determined, sets out the assumptions, used for those inputs and provides the effects of applying reasonably possible alternative assumptions.

Taxation
At 31 December 2009 the Group carried net deferred tax assets on its balance sheet of £5,153 million (2008: £3,182 million) (note 34).

This statutory presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 34 also presents the Group's deferred tax assets and liabilities by tax category. The largest category of deferred tax asset which contains significant estimation uncertainty and which requires management judgement in assessing its recoverability relates to tax losses carried forward. At 31 December 2009, the Group recognised a deferred tax asset of £3,624 million (2008: £1,514 million) in respect of tax losses carried forward. The significant increase reflects the tax losses generated by certain Group companies, primarily Bank of Scotland plc, in the last two years.

Applicable accounting standards permit the recognition of deferred tax assets only to the extent that it is probable that future taxable profits will be available to utilise the tax losses carried forward. The assessment of future taxable profits involves significant estimation uncertainty, principally relating to an assessment of management's projections of future taxable income based on business plans and ongoing tax planning strategies. These projections include assumptions about the future strategy of the Group, the economic and regulatory environment in which the Group operates, future tax legislation, customer behaviour, and the ability of the Group to deliver expected integration benefits, amongst other variables. At 31 December 2009, management has concluded that future taxable profits generated by the Group companies with tax losses carried forward are expected to be sufficient to utilise the tax losses carried forward in full.

At 31 December 2009 the Group carried an asset for current tax recoverable of £745 million (2008: £865 million) and current tax liabilities of £3 million (2008: £23 million). In determining the carrying value of these balances, management have taken account of tax issues that are subject to ongoing discussion with HM Revenue & Customs and other tax authorities. Inherent in this is management's assessment of legal and professional advice, case law and other relevant guidance. The determination of the outcome of such matters requires significant management judgement in assessing the various risks and applying appropriate probability weightings in determining the carrying value of current and deferred tax balances.

Goodwill
At 31 December 2009 the Group carried goodwill on its balance sheet totalling £376 million (2008: £667 million), substantially all of which relates to acquisitions made a number of years ago.

The Group reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place. The impairment review is performed by projecting future cash flows, excluding finance and tax, based upon budgets and plans and making appropriate assumptions about rates of growth and discounting these using a rate that takes into account prevailing market interest rates and the risks inherent in the business. If the present value of the projected cash flows is less than the carrying value of the underlying net assets and related goodwill an impairment charge is required in the income statement. This calculation requires the exercise of significant judgement by management; if the estimates made prove to be incorrect or performance does not meet expectations which affect the amount and timing of future cash flows, goodwill may become impaired in future periods. Further details are given in note 25.

Effective interest rate
The Group accounts for its revenue on loans and receivables on an effective interest rate basis. This approach takes into account interest received or paid and fees and commission paid or received that are integral to the yield as well as incremental transaction costs and all other premiums and discounts. Following the acquisition of HBOS plc by Lloyds Banking Group plc on 16 January 2009, the Group reviewed the effective interest rate methodology applied to the Group's mortgage portfolio. As a result of this methodology review, the Group has revised the period over which the fees, commissions and costs are spread into the yield. This change in accounting estimate has resulted in an additional charge to the income statement of £945 million in the year to 31 December 2009.

4 Segmental analysis

Geographical areas
The Group's external customers are predominantly based in the UK and revenues are determined by the location of the customer. Information on assets and liabilities is included based on the location of the branch or entity holding those assets and liabilities.

	2009			2008		
	UK £m	**Non-UK £m**	**Total £m**	UK £m	Non-UK £m	Total £m
Total income	**10,111**	**1,054**	**11,165**	9,954	(782)	9,172
Total assets	**588,559**	**72,785**	**661,344**	569,163	90,013	659,176

There are no individual non-UK countries contributing more than 5 per cent of total income or total assets.

5 Net interest income

	Weighted average effective interest rate			
	2009 %	2008 %	**2009 £m**	2008 £m
Interest and similar income:				
Loans and advances to banks	**0.78**	5.16	**399**	450
Loans and advances to customers	**3.59**	6.79	**17,142**	32,490
Debt securities designated as loans and receivables	**1.84**	3.14	**663**	619
Lease and hire purchase receivables	**4.86**	6.76	**254**	299
Interest receivable on loans and receivables	**3.24**	6.62	**18,458**	33,858
Available-for-sale financial assets	**2.06**	4.63	**572**	2,108
Other	**–**	–	**30**	127
Total interest and similar income	**3.19**	6.48	**19,060**	36,093
Interest and similar expense:				
Deposits from banks	**0.77**	4.16	**(1,121)**	(2,880)
Customer deposits	**2.60**	4.25	**(6,133)**	(11,967)
Debt securities in issue	**2.31**	4.91	**(3,329)**	(10,141)
Subordinated liabilities	**3.82**	5.43	**(724)**	(392)
Liabilities under sale and repurchase agreements	**2.22**	4.89	**(1,261)**	(1,496)
Interest payable on liabilities held at amortised cost	**2.09**	4.52	**(12,568)**	(26,876)
Other	**–**	–	**(297)**	(677)
Total interest and similar expense	**2.14**	4.63	**(12,865)**	(27,553)
Net interest income			**6,195**	8,540

Included within interest and similar income is £969 million (2008: £351 million) in respect of impaired financial assets. Net interest income also includes a charge of £890 million (2008: £2,559 million) transferred from the cash flow hedging reserve.

6 Net fee and commission income

	2009 £m	2008 £m
Fee and commission income:		
Current accounts	**329**	361
Insurance broking	**239**	254
Credit and debit card fees	**212**	253
Other	**524**	1,093
	1,304	1,961
Fee and commission expense	**(208)**	(382)
Net fee and commission income	**1,096**	1,579

As discussed in note accounting policy 2(d), fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

7 Net trading income

	2009 £m	2008 £m
Foreign exchange translation gains (losses)	**65**	(9)
Gains on foreign exchange trading transactions	**111**	101
Total foreign exchange	**176**	92
Investment property losses (note 23)	**(13)**	(10)
Securities and other losses	**(719)**	(3,020)
Net trading income	**(556)**	(2,938)

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

	2009 £m	2008 £m
Net income (expense) arising on assets designated at fair value through profit or loss:		
Debt securities, loans and advances to banks and customers	**–**	–
Equity shares	**7**	51
Total net income arising on assets designated at fair value through profit or loss	**7**	51
Net expense arising on liabilities designated at fair value through profit or loss	**–**	–
Total net gains arising on assets and liabilities designated at fair value through profit or loss	**7**	51
Net losses on financial instruments held for trading	**(726)**	(3,071)
Securities and other losses	**(719)**	(3,020)

8 Other operating income

	2009 £m	2008 £m
Operating lease rental income	**1,100**	1,287
Other rents receivable	**20**	26
(Losses) gains on disposal of available-for-sale financial assets (note 39)	**(3)**	24
Gains on capital transactions	**125**	–
Rental income from investment properties	**–**	2
Other income	**188**	437
	1,430	1,776

During the year, the Bank received a payment of £3,000 million from its fellow subsidiary, Lloyds TSB Bank plc, to support its financial and reputational position and to facilitate the on-going integration of the group's banking operations.

9 Operating expenses

	2009 £m	2008 £m
Staff costs:		
Salaries	**1,829**	2,016
Social security costs	**168**	183
Pensions and other post-retirement benefit schemes	**260**	264
Restructuring costs	**222**	71
Other staff costs	**168**	176
	2,647	2,710
Premises and equipment:		
Rent and rates	**213**	271
Hire of equipment	**9**	11
Repairs and maintenance	**48**	38
Other	**142**	158
	412	478
Other expenses:		
Communications and data processing	**103**	127
Advertising and promotion	**128**	199
Professional fees	**171**	141
Other	**642**	598
	1,044	1,065
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 27)	**233**	330
Amortisation of other intangible assets (note 26)	**25**	34
Operating lease assets (note 27)	**835**	1,178
	1,093	1,542
Goodwill impairment (note 25)	**385**	142
Total operating expenses	**5,581**	5,937

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

	2009	2008
UK	**57,463**	56,599
Overseas	**3,037**	6,220
	60,500	62,819

Fees payable to the Bank's auditors

During the year the auditors earned the following fees:

	2009 £m	2008 £m
Fees payable for the audit of the Bank's current year annual report	**2.6**	1.7
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	**5.2**	3.3
Other services supplied pursuant to legislation	**0.4**	0.5
Services relating to taxation	**0.5**	0.5
Services relating to corporate finance transactions	**–**	0.1
All other services	**0.2**	0.6
Total fees payable to the Bank's auditors by the Group	**8.9**	6.7

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

	2009 £m	2008 £m
Reviews of the financial position of corporate and other borrowers	**12.0**	3.8

The amounts detailed above are in respect of the Bank's current auditors for 2009 and its predecessor auditors for 2008.

10 Impairment

	2009 £m	2008 £m
Impairment losses on loans and receivables (note 21):		
Loans and advances to customers	**18,231**	9,857
Debt securities classified as loans and receivables	**1,199**	923
	19,430	10,780
Impairment of available-for-sale financial assets (note 39)	**620**	1,270
Other credit risk provisions (note 35)	**5**	–
Total impairment charged to the income statement	**20,055**	12,050

11 Investments in joint ventures and associates

The Group's share of results of and investments in joint ventures and associates comprise:

	Joint ventures		Associates		Total	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Income	**145**	(320)	**5**	(233)	**150**	(553)
Expenses	**(445)**	(89)	**(97)**	(18)	**(542)**	(107)
Impairment	**(272)**	(267)	**(77)**	(53)	**(349)**	(320)
Loss before tax	**(572)**	(676)	**(169)**	(304)	**(741)**	(980)
Tax	**26**	25	**2**	17	**28**	42
Share of post-tax results	**(546)**	(651)	**(167)**	(287)	**(713)**	(938)
Current assets	**2,658**	2,149	**605**	1,131	**3,263**	3,280
Non-current assets	**4,553**	4,885	**1,611**	1,557	**6,164**	6,442
Current liabilities	**(2,030)**	(1,429)	**(493)**	(615)	**(2,523)**	(2,044)
Non-current liabilities	**(4,868)**	(4,635)	**(1,613)**	(1,850)	**(6,481)**	(6,485)
Share of net assets	**313**	970	**110**	223	**423**	1,193
At 1 January	**970**	1,367	**223**	372	**1,193**	1,739
Additional investments	**123**	253	**12**	120	**135**	373
Acquisitions	**3**	59	**60**	40	**63**	99
Disposals	**(198)**	(43)	**(39)**	(14)	**(237)**	(57)
Share of post-tax results	**(546)**	(651)	**(167)**	(287)	**(713)**	(938)
Dividends paid	**(21)**	(10)	**–**	(8)	**(21)**	(18)
Exchange and other adjustments	**(18)**	(5)	**21**	–	**3**	(5)
At 31 December	**313**	970	**110**	223	**423**	1,193

The Group's unrecognised share of losses of associates for the year is £64 million (2008: £126 million) and of joint ventures is £424 million (2008: £164 million). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £155 million (2008: £131 million) and of joint ventures is £623 million (2008: £211 million).

The Group's most significant joint venture is Sainsbury's Bank plc, a banking business with operations principally in the UK. Bank of Scotland plc has a 50 per cent stake in the ordinary share capital of Sainsbury Bank plc, which makes up its statutory accounts to 31 December each year. All other interests in joint ventures are held by subsidiaries. Where entities have statutory accounts drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

12 Loss on sale of businesses

	2009 £m	2008 £m
Loss on the sale of Bank of Western Australia Limited and St. Andrews Australia Pty Limited	**(100)**	(845)

On 8 October 2008, the Group agreed the sale of part of its Australian operations, principally Bank of Western Australia Limited and St. Andrews Australia Pty Limited, to Commonwealth Bank of Australia Limited. The sale completed on 19 December 2008 and resulted in an estimated pre-tax loss on disposal of £845 million (including goodwill written-off of £240 million). The agreement provided for adjustments to the consideration received in certain circumstances and as a result a further loss of £100 million has been recognised in the current year.

Notes to the consolidated financial statements

13 Taxation

(a) Analysis of tax credit for the year

	2009 £m	2008 £m
UK corporation tax:		
Current tax on loss for the year	354	525
Adjustments in respect of prior years	(121)	181
	233	706
Double taxation relief	–	21
	233	727
Foreign tax:		
Current tax on loss for the year	(49)	(195)
Adjustments in respect of prior years	33	(14)
	(16)	(209)
Current tax credit	217	518
Deferred tax (note 34):		
Origination and reversal of temporary differences	2,707	1,931
Adjustments in respect of prior years	133	(1)
	2,840	1,930
Tax credit	3,057	2,448

The tax credit for the year is based on a UK corporation tax rate of 28.0 per cent (2008: 28.5 per cent).

(b) Factors affecting the tax credit for the year

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

	2009 £m	2008 £m
Loss before tax	(15,284)	(10,635)
Tax credit thereon at UK corporation tax rate of 28.0 per cent (2008: 28.5 per cent)	4,279	3,031
Factors affecting credit:		
Goodwill impairment	(110)	(26)
Disallowed and non-taxable items	(41)	(64)
Overseas tax rate differences	(428)	(83)
Gains exempted or covered by capital losses	(16)	102
Adjustments in respect of previous years	45	166
Impairment of financial instruments	43	(52)
Reduction in deferred tax from changes in tax rates	–	(10)
Effect of profit or loss in joint ventures and associates	(196)	(268)
Tax losses where no deferred tax provided	(484)	(310)
Other items	(35)	(38)
Tax credit on loss on ordinary activities	3,057	2,448

13 Taxation (continued)

(c) The tax effects relating to each component of comprehensive income are as follows:

Year ended 31 December 2009	**Before tax amount £m**	**Tax (expense) benefit £m**	**After tax amount £m**
Movements in available-for-sale financial assets:			
Change in fair value	**2,550**	**(673)**	**1,877**
Transferred to income statement in respect of disposals	**3**	**(1)**	**2**
Transferred to income statement in respect of impairment	**620**	**(174)**	**446**
	3,173	**(848)**	**2,325**
Movements in cash flow hedges:			
Effective portion of changes in fair value taken to other comprehensive income	**(613)**	**171**	**(442)**
Net gains transferred to the income statement	**895**	**(250)**	**645**
	282	**(79)**	**203**
Currency translation differences and other movements	**14**	**(5)**	**9**
Other comprehensive income for the year	**3,469**	**(932)**	**2,537**

Year ended 31 December 2008	Before tax amount £m	Tax (expense) benefit £m	After tax amount £m
Movements in available-for-sale financial assets:			
Change in fair value	(8,173)	2,276	(5,897)
Transferred to income statement in respect of disposals	(24)	7	(17)
Transferred to income statement in respect of impairment	1,270	(355)	915
	(6,927)	1,928	(4,999)
Movements in cash flow hedges:			
Effective portion of changes in fair value taken to other comprehensive income	(3,889)	1,088	(2,801)
Net gains transferred to the income statement	2,561	(717)	1,844
	(1,328)	371	(957)
Currency translation differences and other movements	92	3	95
Other comprehensive income for the year	(8,163)	2,302	(5,861)

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

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Trading assets	**27,611**	22,571	**27,611**	22,571
Other financial assets at fair value through profit or loss	**256**	859	**17**	349
	27,867	23,430	**27,628**	22,920

These assets are comprised as follows:	**2009**		2008		**2009**		2008	
	Trading assets £m	**Other financial assets at fair value through profit or loss £m**	Trading assets £m	Other financial assets at fair value through profit or loss £m	**Trading assets £m**	**Other financial assets at fair value through profit or loss £m**	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to banks	**5,577**	**–**	3,344	–	**5,577**	**–**	3,344	–
Loans and advances to customers	**13,307**	**–**	5,689	–	**13,307**	**–**	5,689	–
Debt securities:								
Government securities	**2,864**	**–**	5,792	–	**2,864**	**–**	5,792	–
Bank and building society certificates of deposit	**2,034**	**–**	3,068	–	**2,034**	**–**	3,068	–
Mortgage-backed securities	**–**	**–**	15	–	**–**	**–**	15	–
Other asset-backed securities	**891**	**–**	2,509	346	**891**	**–**	2,509	346
Corporate and other debt securities	**2,938**	**4**	2,154	217	**2,938**	**4**	2,154	–
	8,727	**4**	13,538	563	**8,727**	**4**	13,538	346
Equity shares:								
Listed	**–**	**13**	–	3	**–**	**13**	–	3
Unlisted	**–**	**239**	–	293	**–**	**–**	–	–
	–	**252**	–	296	**–**	**13**	–	3
	27,611	**256**	22,571	859	**27,611**	**17**	22,571	349

14 Trading and other financial assets at fair value through profit or loss (continued)

At 31 December 2009 £3,939 million (2008: £4,247 million) of trading and other financial assets at fair value through profit or loss of the Group and £3,791 million (2008: £4,247 million) of the Bank had a contractual residual maturity of greater than one year.

The carrying value of financial assets held for trading of the Group that are subject to repurchase agreements was £3,799 million at 31 December 2009 (2008: £4,369 million).

Included in trading assets of the Group were amounts advanced to counterparties under reverse repurchase agreements which are treated as collateralised loans and amounted to £18,867 million at 31 December 2009 (2008: £9,027 million). The related securities held as collateral are not recognised on balance sheet as the risks and rewards of ownership remain with the counterparty.

15 Derivative financial instruments

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value, cash flow and net investment hedge approaches as described in note 46; and

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 45.

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.

15 Derivative financial instruments (continued)

The Group	2009 Contract/ notional amount £m	2009 Fair value assets £m	2009 Fair value liabilities £m	2008 Contract/ notional amount £m	2008 Fair value assets £m	2008 Fair value liabilities £m
Trading						
Exchange rate contracts:						
Spot, forwards and futures	**22,074**	**281**	**279**	77,769	2,101	3,562
Currency swaps	**92,342**	**4,301**	**565**	55,535	3,144	1,208
	114,416	**4,582**	**844**	133,304	5,245	4,770
Interest rate contracts:						
Interest rate swaps	**698,522**	**14,557**	**14,907**	823,710	18,781	20,725
Forward rate agreements	**796,099**	**401**	**381**	656,700	1,474	1,461
Options purchased	**20,018**	**689**	**–**	22,993	884	–
Options written	**25,134**	**–**	**791**	26,092	–	758
Futures	**11,963**	**–**	**–**	42,140	47	120
	1,551,736	**15,647**	**16,079**	1,571,635	21,186	23,064
Credit derivatives	**4,980**	**153**	**11**	7,150	748	33
Equity and other contracts	**11,052**	**895**	**860**	2,068	1,256	958
Total derivative assets/liabilities held for trading	**1,682,184**	**21,277**	**17,794**	1,714,157	28,435	28,825
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**53,979**	**3,053**	**557**	67,649	4,738	805
Cross currency swaps	**26,162**	**632**	**1,675**	60,282	8,863	2,713
	80,141	**3,685**	**2,232**	127,931	13,601	3,518
Derivatives designated as cash flow hedges:						
Interest rate swaps	**229,390**	**5,247**	**7,276**	323,971	7,218	8,337
Forward rate agreements	**–**	**–**	**–**	3,474	1,037	21
Cross currency swaps	**8,938**	**8**	**144**	10,484	180	123
Options	**2,754**	**4**	**5**	36,876	46	–
Futures	**5,137**	**1**	**1**	16	–	3
	246,219	**5,260**	**7,426**	374,821	8,481	8,484
Total derivative assets/liabilities held for hedging	**326,360**	**8,945**	**9,658**	502,752	22,082	12,002
Total recognised derivative assets/liabilities	**2,008,544**	**30,222**	**27,452**	2,216,909	50,517	40,827

At 31 December 2009 £25,822 million of total recognised derivative assets of the Group and £23,792 million of total recognised derivative liabilities of the Group (2008: £41,185 million of assets and £31,508 million of liabilities) had a contractual residual maturity of greater than one year.

15 Derivative financial instruments (continued)

The Bank	**2009**			2008		
	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						
Exchange rate contracts:						
Spot, forwards and futures	**25,388**	**285**	**359**	79,211	2,205	3,677
Currency swaps	**78,328**	**1,108**	**554**	55,535	3,131	1,207
	103,716	**1,393**	**913**	134,746	5,336	4,884
Interest rate contracts:						
Interest rate swaps	**697,740**	**14,503**	**14,859**	831,891	18,737	19,755
Forward rate agreements	**792,962**	**401**	**381**	656,717	1,481	1,465
Options purchased	**19,999**	**688**	**–**	23,768	882	–
Options written	**25,117**	**–**	**789**	26,021	–	1,006
Futures	**–**	**–**	**–**	44,800	47	120
	1,535,818	**15,592**	**16,029**	1,583,197	21,147	22,346
Credit derivatives	**4,980**	**153**	**11**	7,150	705	33
Equity and other contracts	**11,052**	**585**	**585**	4,920	618	614
Total derivative assets/liabilities held for trading	**1,655,566**	**17,723**	**17,538**	1,730,013	27,806	27,877
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps (including swap options)	**49,554**	**3,063**	**544**	68,474	4,941	556
Cross currency swaps	**26,162**	**627**	**1,675**	60,282	2,588	2,713
	75,716	**3,690**	**2,219**	128,756	7,529	3,269
Derivatives designated as cash flow hedges:						
Interest rate swaps	**229,812**	**5,250**	**7,276**	323,971	6,681	8,337
Forward rate agreements	**–**	**–**	**–**	3,474	1,037	3
Cross currency swaps	**8,938**	**8**	**130**	10,484	180	123
Options	**2,754**	**8**	**5**	36,876	27	–
Futures	**5,137**	**1**	**3**	16	–	4
	246,641	**5,267**	**7,414**	374,821	7,925	8,467
Total derivative assets/liabilities held for hedging	**322,357**	**8,957**	**9,633**	503,577	15,454	11,736
Total recognised derivative assets/liabilities	**1,977,923**	**26,680**	**27,171**	2,233,590	43,260	39,613

At 31 December 2009 £22,630 million of total recognised derivative assets of the Bank and £23,467 million of total recognised derivative liabilities of the Bank (2008: £37,584 million of assets and £30,664 million of liabilities) had a contractual residual maturity of greater than one year.

16 Loans and advances to banks

At 31 December 2009, the Group had loans and advances to banks of £91,259 million (2008: £12,445 million) and the Bank had £108,133 million (2008: £34,144 million). No allowance for impaired loans was carried against these exposures at 31 December 2009 or 31 December 2008.

At 31 December 2009, £2,285 million (2008: £1,276 million) of loans and advances to banks of the Group and £2,247 million (2008: £1,133 million) of the Bank had a contractual residual maturity of greater than one year.

Included in loans and advances to banks of the Group were amounts advanced to counterparties under reverse repurchase agreements which are treated as collateralised loans and amounted to £34,423 million at 31 December 2009 (2008: £632 million). The related securities held as collateral are not recognised on balance sheet as the risks and rewards of ownership remain with the counterparty.

Included in loans and advances to banks of the Group were collateral balances in the form of cash provided in respect of repurchase and reverse repurchase agreements amounting to £19 million (2008: £14 million).

17 Loans and advances to customers

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Agriculture, forestry and fishing	**772**	854	**521**	803
Energy and water supply	**1,129**	890	**779**	786
Manufacturing	**6,836**	7,436	**5,236**	6,403
Construction	**11,169**	11,456	**7,730**	10,012
Transport, distribution and hotels	**21,496**	22,664	**15,841**	23,769
Postal and telecommunications	**1,449**	958	**1,328**	735
Property companies	**65,144**	63,807	**49,503**	54,018
Financial, business and other services	**72,076**	92,988	**128,857**	235,940
Personal:				
Mortgages	**252,745**	263,644	**230,325**	232,891
Other	**19,518**	23,854	**16,121**	22,714
Lease financing	**4,990**	5,655	**–**	–
Hire purchase	**3,486**	4,700	**2,467**	932
	460,810	498,906	**458,708**	589,003
Allowance for impairment losses (note 21)	**(21,272)**	(10,693)	**(18,741)**	(10,475)
	439,538	488,213	**439,967**	578,528

At 31 December 2009 £325,855 million (2008: £328,999 million) of loans and advances to customers of the Group and £281,579 million (2008: £271,550 million) of the Bank had a contractual residual maturity of greater than one year.

The carrying value of loans and advances to customers of the Group that are subject to repurchase agreements was £8,749 million at 31 December 2009 (2008: £56,858 million) all of which the secured party is permitted by contract or custom to sell or repledge.

Included in loans and advances to customers of the Group were amounts advanced to counterparties under reverse repurchase agreements which are treated as collateralised loans and amounted to £nil at 31 December 2009 (2008: £1,350 million). The related securities held as collateral are not recognised on balance sheet as the risks and rewards of ownership remain with the counterparty.

Included in loans and advances to customers of the Group are collateral balances in the form of cash provided in respect of repurchase and reverse repurchase agreements amounting to £203 million (2008: £429 million).

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

	The Group	
	2009 £m	2008 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**726**	576
Later than 1 year and not later than 5 years	**2,106**	2,568
Later than 5 years	**2,988**	3,518
	5,820	6,662
Unearned future finance income on finance leases	**(830)**	(1,007)
Net investment in finance leases	**4,990**	5,655

	The Group	
	2009 £m	2008 £m
The net investment in finance leases represents amounts recoverable as follows:		
Not later than 1 year	**644**	487
Later than 1 year and not later than 5 years	**1,511**	2,180
Later than 5 years	**2,835**	2,988
	4,990	5,655

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2009 and 2008 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £193 million for the Group (2008: £103 million).

18 Securitisations and covered bonds

The Group's principal securitisation and covered bonds programmes, together with the balances of the advances subject to notes in issue at 31 December, are listed below. The notes in issue are reported in note 32.

		2009		2008[1]	
Securitisation	*Type of asset*	**Gross assets securitised £m**	**Notes in issue £m**	Gross assets securitised £m	Notes in issue £m
Permanent	UK residential mortgages	**38,915**	**31,878**	38,602	38,490
Balliol	UK residential mortgages	**12,771**	**12,819**	12,701	12,549
Pendeford	UK residential mortgages	**12,240**	**9,174**	12,894	9,870
Trinity	UK residential mortgage	**11,033**	**11,466**	12,975	12,638
Mound	UK residential mortgages	**8,779**	**7,153**	10,147	8,238
Picard	US residential mortgage-backed securities	**7,897**	**7,897**	–	–
Brae	UK residential mortgages	**7,838**	**9,588**	9,213	9,955
Deva	UK residential mortgages	**6,691**	**6,906**	6,747	6,703
Wolfhound	Irish residential mortgages	**6,522**	**6,585**	4,083	4,107
Penarth	Credit card receivables	**5,155**	**2,699**	4,189	2,633
Candide	Dutch residential mortgages	**4,812**	**4,834**	5,569	5,704
Dakota	UK residential mortgages	**3,832**	**3,826**	3,988	3,885
Handbridge	Personal Loans	**3,730**	**2,613**	–	–
Tioba	UK residential mortgages	**2,094**	**2,249**	2,647	2,568
Prominent	Commercial loans	**928**	**976**	1,053	1,149
Bella	Motor vehicle loans	**443**	**470**	–	–
Other	UK residential mortgages	**64**	**169**	68	179
		133,744	**121,302**	124,876	118,668
Less held by the Group			**(87,359)**		(75,960)
Total securitisation (note 32)			**33,943**		42,708
Covered Bonds	*Type of asset*				
Covered Bonds	UK residential mortgages	**61,537**	**49,644**	51,756	49,408
Covered Bonds	UK social housing loans	**3,407**	**2,976**	3,475	2,919
		64,944	**52,620**	55,231	52,327
Less held by the Group			**(23,060)**		(18,305)
Total covered bonds (note 32)			**29,560**		34,022
Total securitisations and covered bonds			**63,503**		76,730

[1] Following the acquisition of the Group by Lloyds Banking Group plc, the presentation of gross securitised assets and notes in issue has been aligned to a basis consistent with the presentation practices adopted by Lloyds Banking Group plc and comparatives have been represented accordingly.

Securitisation

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

Covered bonds

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

Cash deposits of £24,271 million (2008: £12,423 million) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs, covered bonds issued by Bank of Scotland plc and other legal obligations.

In total the Group has securitised £124,088 million (2008: £97,363 million) of mortgage and other assets under certain securitisation and covered bond programmes and purchased all of the loan notes in issue relating to those issuances for £110,419 million (2008: £94,265 million). These transactions do not lead to any derecognition of the assets as the Group has retained all of the risks and rewards associated with the loan notes.

19 Special purpose entities

In addition to the SPEs disclosed in note 18, which are used for securitisation and covered bond programmes, the Group sponsors two asset-backed conduits, Grampian and Landale which invest in asset-backed securities and other assets. The total consolidated exposures in these conduits are set out in the table below:

At 31 December 2009	**Grampian £m**	**Landale £m**	**Total £m**
Debt securities classified as loans and receivables (note 20)	**9,924**	**698**	**10,622**
Total assets	**9,924**	**698**	**10,622**

At 31 December 2008	Grampian £m	Landale £m	Total £m
Debt securities classified as:			
Loans and receivables (note 20)	17,703	–	17,703
Available-for-sale financial assets (note 22)	–	681	681
Total assets	17,703	681	18,384

20 Debt securities classified as loans and receivables

Debt securities accounted for as loans and receivables comprise:

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Asset-backed securities:				
Mortgage-backed securities	**15,555**	18,273	**11,968**	9,375
Other asset-backed securities	**16,706**	20,783	**12,853**	10,068
Corporate and other debt securities	**865**	745	**390**	231
	33,126	39,801	**25,211**	19,674
Allowance for impairment losses (note 21)	**(1,915)**	(923)	**(1,527)**	(415)
	31,211	38,878	**23,684**	19,259

At 31 December 2009, £31,063 million (2008: £26,826 million) of debt securities designated as loans and receivables of the Group and £22,195 million (2008: £16,557 million) of the Bank had a contractual residual maturity of greater than one year.

The carrying value of debt securities classified as loans and receivables of the Group that are subject to repurchase agreements was £12,238 million at 31 December 2009 (2008: £18,509 million) all of which the secured party is permitted by contract or custom to sell or repledge.

21 Allowance for impairment losses on loans and receivables

The Group

	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January 2008	3,373	–	3,373
Exchange and other adjustments	135	–	135
Advances written off	(2,515)	–	(2,515)
Recoveries of advances written off in previous years	107	–	107
Disposals of subsidiary undertakings	(115)	–	(115)
Unwinding of discount	(149)	–	(149)
Charge to the income statement (note 10)	9,857	923	10,780
At 31 December 2008	10,693	923	11,616
Exchange and other adjustments	**162**	**(172)**	**(10)**
Advances written off	**(7,459)**	**(35)**	**(7,494)**
Recoveries of advances written off in previous years	**36**	**–**	**36**
Unwinding of discount	**(391)**	**–**	**(391)**
Charge to the income statement (note 10)	**18,231**	**1,199**	**19,430**
At 31 December 2009	**21,272**	**1,915**	**23,187**

21 Allowance for impairment losses on loans and receivables (continued)

The Bank

	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January 2008	2,997	–	2,997
Exchange and other adjustments	18	–	18
Advances written off	(2,120)	–	(2,120)
Recoveries of advances written off in previous years	99	–	99
Unwinding of discount	(140)	–	(140)
Charge to the income statement	9,621	415	10,036
At 31 December 2008	10,475	415	10,890
Exchange and other adjustments	**(27)**	**(3)**	**(30)**
Advances written off	**(6,812)**	**(18)**	**(6,830)**
Recoveries of advances written off in previous years	**35**	**–**	**35**
Unwinding of discount	**(394)**	**–**	**(394)**
Charge to the income statement	**15,464**	**1,133**	**16,597**
At 31 December 2009	**18,741**	**1,527**	**20,268**

22 Available-for-sale financial assets

The Group

	2009 £m	2008 £m
Debt securities:		
Government securities	**326**	380
Bank and building society certificates of deposit	**285**	2,958
Asset-backed securities:		
Mortgage-backed securities	**17**	17
Other asset-backed securities	**79**	843
Corporate and other debt securities	**18,924**	21,580
	19,631	25,778
Equity shares:		
Listed	**85**	110
Unlisted	**1,849**	2,147
	1,934	2,257
	21,565	28,035

Included within other asset backed securities are £nil (2008: £681 million) held within the Group's conduit entities.

Included within corporate and other debt securities are £18,781million (2008: £21,495 million) managed within the Group's wholesale activities, which includes £13,851 million (2008: £15,985 million) of floating rate notes issued by financial institutions, £1,045 million (2008: £1,405 million) of fixed rate bonds, £3,871 million (2008: £4,062 million) of covered bonds and £14 million (2008: £43 million) of other debt securities.

The Bank

	2009 £m	2008 £m
Debt securities:		
Government securities	**325**	379
Bank and building society certificates of deposit	**285**	2,958
Asset-backed securities:		
Other asset-backed securities	**60**	148
Corporate and other debt securities	**17,569**	19,791
	18,239	23,276
Equity shares:		
Listed	**26**	5
Unlisted	**1,051**	1,058
	1,077	1,063
	19,316	24,339

Included within corporate and other debt securities of the Bank are £17,425 million (2008: £19,712 million) managed within the wholesale activities, which includes £12,509 million (2008: £14,245 million) of floating rate notes issued by financial institutions, £1,045 million (2008: £1,405 million) of fixed rate bonds and £3,871 million (2008: £4,062 million) of covered bonds.

At 31 December 2009 £18,810 million (2008: £17,847 million) of available-for-sale financial assets of the Group and £17,021 million (2008: £20,925 million) of the Bank had a contractual residual maturity of greater than one year.

The carrying value of available-for-sale financial assets of the Group that are subject to repurchase agreements was £10,628 million at 31 December 2009 (2008: £18,753 million) all of which the secured party is permitted by contract or custom to sell or repledge.

22 Available-for-sale financial assets (continued)

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in accounting policy 2(h). Included in available-for-sale financial assets at 31 December 2009 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £329 million and in respect of which no collateral was held.

Comparatives have not been disclosed in relation to these amounts due to the fact that data was not collected on this basis in the prior year and it is impracticable to recreate this information.

23 Investment properties

	2009 £m	2008 £m
At 1 January	**43**	34
Exchange and other adjustments	**–**	1
Additions:		
Acquisitions of new properties	**–**	8
Additional expenditure on existing properties	**–**	10
Total additions	**–**	18
Changes in fair value (note 7)	**(13)**	(10)
At 31 December	**30**	43

The investment properties are valued at least annually at open-market value, by independent, professionally qualified valuers, who have recent experience in the location and categories of the investment properties being valued.

No capital expenditure has been contracted for, but not recognised in the financial statements, at the balance sheet date (2008: £nil).

24 Investment in subsidiary undertakings

	2009 £m	2008 £m
At 1 January	**4,383**	3,273
Additions	**–**	1,217
Additional capital injections and transfers	**2,517**	–
Impairment	**(4,449)**	(107)
At 31 December	**2,451**	4,383

A reassessment of the carrying value of the Bank's investments in Bank of Scotland (Ireland) and HBOS Australia resulted in the recognition of an impairment charge of £4,449 million which represents the write down of the Bank's investments to their recoverable amount.

Recoverable amount is based on the fair value less cost to sell and was determined by using a discounted cash flow valuation technique. This calculation uses projections of future cash flows based on management's plans covering a five year period. These cash flows are based on past experience and have been adjusted to take into account expected future market conditions. Cash flows beyond the five year period have been extrapolated using a steady 2.5 per cent rate of increase. The expected cash flows have been discounted at a rate of 17.75 per cent which has been determined to be in line with available market information.

The impairment charge of £4,449 million (2008: £107 million) in the Bank's investment in Bank of Scotland (Ireland) and HBOS Australia was triggered by the continued deterioration of the financial performance of these companies, principally due to increased impairment losses in their lending portfolios.

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

	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Bank of Scotland (Ireland) Limited	Ireland	100%	Banking
Uberior Investments plc	UK	100%	Investment holding

The principal area of operation for each of the above group undertakings is its country of registration/incorporation.

In November 2009, as part of the restructuring plan that was a requirement for European Community (EC) approval of state aid received by the Group, Lloyds Banking Group agreed to suspend the payment of coupons and dividends on certain of the Group preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. The Group has agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra-group. Consequently, in accordance with the terms of some of these instruments, subsidiaries may be prevented from making dividend payments on ordinary shares during this period. In addition, certain subsidiary companies currently have insufficient distributable reserves to make dividend payments.

Subject to the foregoing, there were no further significant restrictions on any of the Bank's subsidiaries in paying dividends or repaying loans and advances. All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

Notes to the consolidated financial statements

25 Goodwill

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
At 1 January	**667**	1,041	**376**	426
Exchange and other adjustments	**(5)**	24	**–**	–
Acquired through business combinations	**99**	–	**–**	–
Disposals	**–**	(256)	**–**	–
Impairment charged to the income statement	**(385)**	(142)	**–**	(50)
At 31 December	**376**	667	**376**	376
Cost*	**944**	850	**426**	426
Accumulated impairment losses	**(568)**	(183)	**(50)**	(50)
At 31 December	**376**	667	**376**	376

*For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is included net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's and the Bank's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit, which is principally the retail banking activities. This compares the recoverable amount, being the higher of a cash-generating units' 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.

The recoverable amount of goodwill carried at 31 December 2009 has been based upon value in use. This calculation uses cash flow projections based upon the Group's business plans where the main assumptions relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows for the period subsequent to the term of the business plan are extrapolated using a growth rate of 2.5 per cent reflecting management's view of the expected future long term trend in growth rate of the respective economies concerned, predominantly being in the UK, and the long term performances of the businesses concerned. The discount rate used in discounting the projected cash flows is 12.5 per cent (pre-tax) reflecting, inter alia, 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.

The goodwill impairment charge of £385 million (2008: £142 million) includes the write-down, triggered primarily by deteriorating economic conditions, of the goodwill arising on the acquisition of Lex Vehicle Leasing Services (£265 million).

26 Other intangible assets

	The Group			The Bank
	Brands £m	Capitalised software enhance-ments £m	Total £m	Capitalised software enhance-ments £m
Cost:				
At 1 January 2008	19	241	260	229
Exchange and other adjustments	(2)	–	(2)	–
Additions	2	38	40	38
Disposals	(9)	–	(9)	–
At 31 December 2008	10	279	289	267
Additions	**–**	**11**	**11**	**10**
Disposals	**–**	**(2)**	**(2)**	**–**
At 31 December 2009	**10**	**288**	**298**	**277**
Accumulated amortisation:				
At 1 January 2008	5	145	150	141
Charge for the year	3	31	34	28
Disposals	(3)	–	(3)	–
At 31 December 2008	5	176	181	169
Exchange and other adjustments	**1**	**–**	**1**	**–**
Charge for the year (note 9)	**1**	**24**	**25**	**23**
At 31 December 2009	**7**	**200**	**207**	**192**
Balance sheet amount at 31 December 2009	**3**	**88**	**91**	**85**
Balance sheet amount at 31 December 2008	5	103	108	98

Capitalised software enhancements principally comprise identifiable and directly associated internal staff and other costs.

27 Tangible fixed assets

	The Group				The Bank			
	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:								
At 1 January 2008	1,541	2,459	6,483	10,483	1,395	2,045	30	3,470
Exchange and other adjustments	17	70	96	183	2	3	2	7
Adjustments on disposal of businesses	(53)	(108)	–	(161)	–	–	–	–
Additions	63	444	1,488	1,995	48	314	–	362
Disposals	(116)	(319)	(1,733)	(2,168)	(83)	(148)	(30)	(261)
At 31 December 2008	1,452	2,546	6,334	10,332	1,362	2,214	2	3,578
Exchange and other adjustments	**–**	**(3)**	**(78)**	**(81)**	**–**	**1**	**(2)**	**(1)**
Additions	**59**	**118**	**1,478**	**1,655**	**43**	**87**	**102**	**232**
Disposals	**(55)**	**(55)**	**(2,511)**	**(2,621)**	**(50)**	**(42)**	**–**	**(92)**
At 31 December 2009	**1,456**	**2,606**	**5,223**	**9,285**	**1,355**	**2,260**	**102**	**3,717**
Accumulated depreciation and impairment:								
At 1 January 2008	625	1,718	1,840	4,183	600	1,463	1	2,064
Exchange and other adjustments	7	30	34	71	(1)	(2)	–	(3)
Adjustments on disposal of businesses	(16)	(85)	–	(101)	–	–	–	–
Charge for the year	61	269	1,178	1,508	55	206	(6)	255
Disposals	(18)	(153)	(685)	(856)	(13)	(89)	5	(97)
At 31 December 2008	659	1,779	2,367	4,805	641	1,578	–	2,219
Exchange and other adjustments	**4**	**(1)**	**5**	**8**	**3**	**(2)**	**–**	**1**
Charge for the year (note 9)	**54**	**179**	**835**	**1,068**	**50**	**146**	**–**	**196**
Disposals	**(17)**	**(28)**	**(1,454)**	**(1,499)**	**(21)**	**(22)**	**–**	**(43)**
At 31 December 2009	**700**	**1,929**	**1,753**	**4,382**	**673**	**1,700**	**–**	**2,373**
Balance sheet amount at 31 December 2009	**756**	**677**	**3,470**	**4,903**	**682**	**560**	**102**	**1,344**
Balance sheet amount at 31 December 2008	793	767	3,967	5,527	721	636	2	1,359

At 31 December the future minimum rentals receivable by the Group under non-cancellable operating leases were as follows:	**2009 £m**	2008 £m
Receivable within 1 year	**428**	849
1 to 5 years	**1,376**	2,245
Over 5 years	**51**	52
	1,855	3,146

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2009 and 2008 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £3 million for the Group and £nil for the Bank at 31 December 2009 (2008: £13 million for the Group and £nil for the Bank) is expected to be received under non-cancellable sub-leases of the Group's premises.

Notes to the consolidated financial statements

28 Other assets

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Settlement balances	**1,354**	942	**1,354**	893
Other assets and prepayments	**3,168**	2,184	**4,438**	1,983
	4,522	3,126	**5,792**	2,876

29 Deposits from banks

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Deposits from banks	**174,338**	97,066	**168,246**	97,091

At 31 December 2009 £6,374 million (2008: £2,205 million) of deposits from banks of the Group and £3,592 million (2008: £1,658 million) of the Bank had a contractual residual maturity of greater than one year.

Included in deposits from banks of the Group were amounts received from counterparties under repurchase agreements which are treated as secured borrowings and amounted to £66,441 million at 31 December 2009 (2008: £83,783 million).

Included in deposits from banks of the Group are collateral balances in the form of cash received in respect of repurchase and reverse repurchase agreements amounting to £19 million (2008: £42 million).

30 Customer deposits

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Non-interest bearing current accounts	**2,471**	1,878	**2,471**	1,878
Interest bearing current accounts	**80,097**	85,217	**118,644**	125,394
Savings and investment accounts	**137,902**	142,218	**109,439**	165,084
Other customer deposits	**45,501**	48,086	**69,570**	80,817
Customer deposits	**265,971**	277,399	**300,124**	373,173

At 31 December 2009 £19,011 million (2008: £11,743 million) of customer deposits of the Group and £81,598 million (2008: £91,740 million) of the Bank had a contractual residual maturity of greater than one year.

Included in customer deposits of the Group were amounts received from counterparties under repurchase agreements which are treated as secured borrowings and amounted to £35,330 million at 31 December 2009 (2008: £18,229 million).

Included in customer deposits of the Group were collateral balances in the form of cash received in respect of repurchase and reverse repurchase agreements amounting to £22 million (2008: £nil).

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

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Liabilities held at fair value through profit or loss	**–**	–	**–**	–
Trading liabilities	**27,372**	18,851	**27,372**	18,851
Trading and other financial liabilities at fair value through profit or loss	**27,372**	18,851	**27,372**	18,851

At 31 December 2009, for both the Group and the Bank, £131 million (2008: £nil) of trading liabilities had a contractual residual maturity of greater than one year.

Included in trading liabilities of the Group were amounts received from counterparties under repurchase agreements which are treated as secured borrowings and amounted to £26,852 million at 31 December 2009 (2008: £18,842 million).

32 Debt securities in issue

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Medium-term notes	**36,455**	48,630	**36,455**	47,897
Covered bonds (note 18)	**29,560**	34,022	**29,560**	34,022
Certificates of deposit	**6,413**	50,956	**6,724**	50,956
Securitisation notes (note 18)	**33,943**	42,708	**22,037**	30,503
Commercial paper	**12,786**	12,132	**3,299**	9,086
Total debt securities in issue	**119,157**	188,448	**98,075**	172,464

Included within commercial paper above is £9,330 million (2008: £2,979 million) issued by the Grampian conduit and £138 million (2008: £nil) issued by the Landale conduit.

At 31 December 2009 £76,484 million (2008: £97,341 million) of debt securities in issue of the Group and £46,660 million (2008: £65,142 million) of the Bank had a contractual residual maturity of greater than one year.

33 Other liabilities

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Settlement balances	**1,610**	337	**1,610**	952
Other creditors and accruals	**4,681**	3,898	**3,315**	3,470
	6,291	4,235	**4,925**	4,422

34 Deferred tax

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Statutory position				
Deferred tax asset	**5,153**	3,182	**4,410**	2,563
Deferred tax liability	**–**	–	**–**	–
Net deferred tax asset	**5,153**	3,182	**4,410**	2,563
Tax disclosure				
Deferred tax asset	**5,325**	3,969	**4,533**	2,722
Deferred tax liability	**(172)**	(787)	**(123)**	(159)
Net deferred tax asset	**5,153**	3,182	**4,410**	2,563

34 Deferred tax (continued)

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

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Asset (liability) at 1 January as previously stated		(965)		152
Prior year adjustment		–		13
Asset (liability) at 1 January as restated	**3,182**	(965)	**2,563**	165
Exchange and other adjustments	**60**	(33)	**1**	13
Adjustment on acquisition	**3**	–	**–**	–
Disposals	**–**	(41)	**–**	–
Income statement credit (note 13)	**2,840**	1,930	**2,462**	1,038
Amount (charged) credited to equity:				
Available-for-sale financial assets (note 39)	**(848)**	1,917	**(534)**	982
Cash flow hedges (note 39)	**(79)**	371	**(82)**	367
Employee benefits	**(5)**	3	**–**	(2)
	(932)	2,291	**(616)**	1,347
Asset at 31 December	**5,153**	3,182	**4,410**	2,563

The deferred tax credit in the income statement comprises the following temporary differences:

	The Group	
	2009 £m	2008 £m
Accelerated capital allowances	**547**	516
Pensions and other post-retirement benefits	**21**	(5)
Effective interest rate	**–**	12
Tax losses carried forward	**2,207**	1,513
Provisions	**(121)**	348
Unrealised gains	**1**	(977)
Other temporary differences	**185**	523
	2,840	1,930

Deferred tax assets and liabilities are comprised as follows:

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Deferred tax assets:				
Employee benefits	**40**	19	**27**	6
Capital allowances	**–**	–	**174**	53
Other provisions	**386**	478	**122**	142
Derivatives	**326**	405	**324**	406
Available-for-sale asset revaluation	**612**	924	**–**	–
Tax losses carried forward	**3,624**	1,514	**3,612**	1,935
Other temporary differences	**337**	629	**274**	180
	5,325	3,969	**4,533**	2,722
Deferred tax liabilities:				
Accelerated capital allowances	**(45)**	(620)	**–**	–
Available-for-sale asset revaluation	**–**	–	**(10)**	(11)
Effective interest rate	**(86)**	(86)	**(76)**	(89)
Other temporary differences	**(41)**	(81)	**(37)**	(59)
	(172)	(787)	**(123)**	(159)

34 Deferred tax (continued)

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised a deferred tax asset of £3,624 million and £3,612 million for the Bank (2008: £1,514 million for the Group and £1,935 million for the Bank) in relation to tax losses carried forward. After reviews of medium term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset.

Deferred tax assets of £349 million for the Group and £nil for the Bank (2008: £nil for the Group and the Bank) have not been recognised in respect of trading losses carried forward mainly in overseas companies as there are limited predicted future trading profits to offset them. Trading losses can be carried forward indefinitely.

Deferred tax assets of £349 million for the Group and £nil for the Bank (2008: £92 million for the Group and the Bank) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2009 of £40 million for the Group and the Bank (2008: £42 million for the Group and £40 million for the Bank), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

35 Other provisions

The Group	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2009	–	96	49	145
Provisions applied	**–**	**(5)**	**(3)**	**(8)**
Charge for the year (note 10)	**5**	**105**	**–**	**110**
At 31 December 2009	**5**	**196**	**46**	**247**

The Bank	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2009	–	96	36	132
Provisions applied	**–**	**(5)**	**–**	**(5)**
Charge for the year	**5**	**103**	**–**	**108**
At 31 December 2009	**5**	**194**	**36**	**235**

Provisions for contingent liabilities and commitments

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

Customer remediation provisions

The Group establishes provisions for the estimated cost of making redress payments to customers in respect of past product sales where the original sales processes have been found to be deficient or where fees and premiums have been overcharged.

Vacant leasehold property and other

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

Notes to the consolidated financial statements

36 Subordinated liabilities

	Group 2009 £m	Group 2008 £m	Bank 2009 £m	Bank 2008 £m
Preference shares	**800**	1,227	**800**	1,227
Preferred securities	**403**	403	**–**	–
Undated subordinated liabilities	**5,565**	5,948	**5,967**	6,350
Dated subordinated liabilities	**9,916**	11,201	**9,285**	10,505
	16,684	18,779	**16,052**	18,082

Preference shares	Group 2009 £m	Group 2008 £m	Bank 2009 £m	Bank 2008 £m
$6^1/_8$% Non-cumulative Redeemable preference shares (£800 million)	**800**	815	**800**	815
$9^1/_4$% Non-cumulative Irredeemable £1 preference shares (£300 million)	**–**	309	**–**	309
$9^3/_4$% Non-cumulative Irredeemable £1 preference shares (£100 million)	**–**	103	**–**	103
	800	1,227	**800**	1,227

Preferred securities	Group 2009 £m	Group 2008 £m	Bank 2009 £m	Bank 2008 £m
8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1.000 each (Class B) (£250 million)	**252**	252	**–**	–
7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1.000 each (Class B) (£150 million)	**151**	151	**–**	–
	403	403	**–**	–

Undated subordinated liabilities	Group 2009 £m	Group 2008 £m	Bank 2009 £m	Bank 2008 £m
£200 million Perpetual Notes	**62**	203	**62**	203
£300 million Perpetual Regulatory Tier 1 Securities	**300**	300	**300**	300
€500 million Instruments	**445**	481	**445**	481
US$250 million Floating Rate Primary Capital Notes	**146**	171	**146**	171
£150 million Instruments	**77**	205	**77**	205
JPY 17 billion Instruments	**136**	150	**136**	150
£100 million Instruments	**60**	104	**60**	104
£300 million Instruments	**300**	300	**300**	300
£250 million Perpetual Preferred Notes	**–**	–	**252**	251
£150 million Perpetual Preferred Notes	**–**	–	**150**	151
£150 million Floating Rate Subordinated Notes	**150**	150	**150**	150
£500 million Floating Rate Subordinated Notes	**500**	500	**500**	500
£100 million 12% Perpetual Subordinated Bonds*	**104**	104	**104**	104
£100 million 8.75% Perpetual Subordinated Bonds*	**103**	103	**103**	103
£75 million 13.625% Perpetual Subordinated Bonds*	**78**	76	**78**	76
£50 million 9.375% Perpetual Subordinated Bonds*	**54**	51	**54**	51
£500 million Floating Rate Subordinated Notes*	**500**	500	**500**	500
£300 million Floating Rate Subordinated Notes*	**300**	300	**300**	300
£250 million Floating Rate Subordinated Notes*	**250**	250	**250**	250
£2,000 Floating Rate Subordinated Notes	**2,000**	2,000	**2,000**	2,000
	5,565	5,948	**5,967**	6,350

*Transferred in under the HBOS Group Reorganisation Act 2006

On 30 September 2008, £2 billion floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 133 basis points.

No exercise of any redemption option or purchase by the relevant entity of any of the undated subordinated liabilities may be made without the consent of the Financial Services Authority. On a winding up of the Bank or subsidiary, the claims of the holders of undated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank or subsidiary other than creditors whose claims are expressed to rank *pari passu* with or junior to the claims of the holders of the undated loan capital. The undated loan capital is junior in point of subordination to the dated loan capital referred to above.

36 Subordinated liabilities (continued)

Dated subordinated liabilities	Group 2009 £m	Group 2008 £m	Bank 2009 £m	Bank 2008 £m
€500 million 5.50% Instruments 2009	**–**	489	**–**	489
€650 million 4.75% Subordinated Bonds 2009*	**–**	644	**–**	644
US$500 million Notes 2010	**326**	368	**326**	368
US$150 million Notes 2011	**101**	116	**101**	116
€12.8 million 6.25% Instruments 2012	**10**	12	**–**	–
€325 million 6.125% Notes 2013	**306**	326	**306**	326
£250 million 6.375% Instruments 2019	**287**	304	**287**	304
€750 million 5.5% Notes 2012	**725**	764	**725**	764
US$1,000 million 4.25% Subordinated Guaranteed Notes 2013	**621**	684	**–**	–
£330 million Floating Rate Subordinated Notes 2014	**330**	330	**330**	330
£300 million Floating Rate Subordinated Notes 2014	**300**	300	**300**	300
£700 million Floating Rate Subordinated Notes 2014	**700**	700	**700**	700
£300 million Floating Rate Subordinated Notes 2014	**300**	300	**300**	300
£250 million 11% Subordinated Bonds 2014*	**276**	276	**276**	276
£150 million 10.5% Subordinated Bonds 2018*	**164**	164	**164**	164
£500 million 9.375% Subordinated Bonds 2021*	**580**	534	**580**	534
£520 million Floating Rate Subordinated Notes 2014	**520**	520	**520**	520
£300 million Floating Rate Subordinated Notes 2014*	**300**	300	**300**	300
£300 million Floating Rate Subordinated Notes 2014*	**300**	300	**300**	300
£270 million Floating Rate Subordinated Notes 2014*	**270**	270	**270**	270
£500 million Floating Rate Subordinated Notes 2014	**500**	500	**500**	500
£2,000 Floating Rate Subordinated Notes 2014	**2,000**	2,000	**2,000**	2,000
£1,000 million Floating Rate Subordinated Notes 2014	**1,000**	1,000	**1,000**	1,000
	9,916	11,201	**9,285**	10,505

*Transferred in under the HBOS Group Reorganisation Act 2006

On 30 June 2008, £1 billion floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR plus 67 basis points.

At 31 December 2009 £9,590 million (2008: £10,068 million) of subordinated liabilities of the Group and £8,959 million (2008: £9,372 million) of the Bank has a contractual residual maturity of greater than one year.

No repayment, for whatever reason, of dated subordinated liabilities prior to their stated maturity and no purchase by the relevant entity of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the Bank or subsidiary, the claims of the holders of dated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank or subsidiary other than creditors whose claims are expressed to rank *pari passu* with, or junior to, the claims of the holders of the dated loan capital.

37 Share capital

(1) Authorised share capital

On 16 January 2009 the Bank approved an increase in the authorised ordinary share capital of £4,000 million, by creating 16,000 million new authorised ordinary shares of £0.25 each. The balance of authorised ordinary share capital at 31 December 2009 was £6,021 million, comprising 24,085 million authorised ordinary shares of £0.25 each.

On 4 August 2009 the redemption of all the Bank's equity preference shares was approved. These shares had been classified as subordinated debt rather than as issued share capital due to their terms.

(2) Issued share capital

	2009 Number of shares	2008 Number of shares	2009 £m	2008 £m
Ordinary shares of 25p each				
At 1 January	**5,296,712,311**	1,996,712,311	**1,324**	499
Ordinary share issue June 2008	**–**	300,000,000	**–**	75
Ordinary share issue September 2008	**–**	500,000,000	**–**	125
Ordinary share issue December 2008	**–**	2,500,000,000	**–**	625
Ordinary share issue February 2009	**13,918,333,333**	–	**3,480**	–
Ordinary share issue March 2009	**1,500,000,000**	–	**375**	–
Ordinary share issue June 2009	**2,500,000,000**	–	**625**	–
Ordinary share issue October 2009	**169,000,000**	–	**42**	–
Ordinary share issue December 2009	**3,500,000**	–	**1**	–
At 31 December	**23,387,545,644**	5,296,712,311	**5,847**	1,324

Details of movements in preference shares that are treated for accounting purposes as debt are given in note 36.

37 Share capital (continued)

Share issuances during 2009

Ordinary shares
On 26 February 2009 £8,351 million was raised through a capital injection by HBOS plc, comprising £3,480 million of ordinary shares and £4,871 million of share premium.

On 31 March 2009 £3,000 million was raised through a capital injection by HBOS plc, comprising £375 million of ordinary shares and £2,625 million of share premium.

On 26 June 2009 £5,000 million was raised through a capital injection by HBOS plc, comprising £625 million of ordinary shares and £4,375 million of share premium.

On 14 October 2009 £338 million was raised through the issue of ordinary shares, comprising £42 million of ordinary shares and £296 million of share premium. This transaction arose following the redemption of preference shares noted in note 36.

On 18 December 2009 £3,500 million was raised through a capital injection by HBOS plc, comprising £1 million of ordinary shares and £3,499 million of share premium.

38 Share premium account

	Group and Bank	
	2009 £m	2008 £m
At 1 January	**11,018**	6,343
Issue of ordinary shares	**15,666**	4,675
At 31 December	**26,684**	11,018

39 Other reserves

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Other reserves comprise:				
Merger and other reserves	**1,600**	1,600	**1,600**	1,600
Capital redemption reserve	**63**	–	**63**	–
Revaluation reserve in respect of available-for-sale financial assets	**(2,972)**	(5,335)	**(1,356)**	(2,729)
Cash flow hedging reserve	**(839)**	(1,042)	**(832)**	(1,030)
Foreign currency translation reserve	**54**	83	**76**	43
	(2,094)	(4,694)	**(449)**	(2,116)

Movements in other reserves were as follows:

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Merger and other reserves				
At 1 January	**1,600**	1,600	**1,600**	1,600
At 31 December	**1,600**	1,600	**1,600**	1,600

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Capital redemption reserve				
At 1 January	**–**	–	**–**	–
Redemption of preference shares	**63**	–	**63**	–
At 31 December	**63**	–	**63**	–

39 Other reserves (continued)

	2009 £m	2008 £m	2009 £m	2008 £m
Revaluation reserve in respect of available-for-sale financial assets				
At 1 January	**(5,335)**	(313)	**(2,729)**	(234)
Exchange and other adjustments	**38**	(23)	**–**	–
Change in fair value of available-for-sale financial assets	**2,550**	(8,173)	**1,848**	(4,181)
Deferred tax	**(673)**	2,265	**(517)**	1,179
Current tax	**–**	11	**–**	10
	1,877	(5,897)	**1,331**	(2,992)
Income statement transfers:				
Disposals (note 8)	**3**	(24)	**59**	43
Deferred tax	**(1)**	7	**(17)**	(12)
	2	(17)	**42**	31
Impairment (note 10)	**620**	1,270	**–**	651
Deferred tax	**(174)**	(355)	**–**	(185)
	446	915	**-**	466
At 31 December	**(2,972)**	(5,335)	**(1,356)**	(2,729)

	2009 £m	2008 £m	2009 £m	2008 £m
Cash flow hedging reserve				
At 31 December 2007 as previously stated		(85)		(113)
Prior year adjustment		–		9
At 1 January as restated	**(1,042)**	(85)	**(1,030)**	(104)
Change in fair value of hedging derivatives	**(613)**	(3,889)	**(627)**	(3,881)
Deferred tax	**171**	1,088	**173**	1,092
	(442)	(2,801)	**(454)**	(2,789)
Income statement transfer	**895**	2,561	**907**	2,588
Deferred tax	**(250)**	(717)	**(255)**	(725)
	645	1,844	**652**	1,863
At 31 December	**(839)**	(1,042)	**(832)**	(1,030)

	2009 £m	2008 £m	2009 £m	2008 £m
Foreign currency translation reserve				
At 1 January	**83**	(35)	**43**	43
Currency translation differences arising in the year	**(29)**	118	**33**	–
At 31 December	**54**	83	**76**	43

40 Retained profits

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
At 31 December 2007 as previously stated		13,479		10,041
Prior year adjustment		–		350
At 1 January as restated	**4,013**	13,479	**2,124**	10,391
Loss for the year*	**(12,240)**	(8,238)	**(14,168)**	(7,062)
Capital redemption	**(63)**	–	**(63)**	–
Dividends	**–**	(1,228)	**–**	(1,205)
At 31 December	**(8,290)**	4,013	**(12,107)**	2,124

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

41 Dividends

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Ordinary share dividends				
Final dividend for previous year paid during the current year	**–**	1,205	–	1,205
Interim dividend	**–**	–	–	–
Total ordinary share dividends	**–**	1,205	–	1,205
Preference share dividends				
Equity dividends paid	**–**	23	–	–
	–	1,228	–	1,205

The directors do not propose to pay a final dividend (2008: £nil).

42 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. At 31 December 2008, key management personnel comprised the members of the board of the Bank, the Company Secretary and the HBOS Executive Committee. At 31 December 2009, the Group's key management personnel are the members of the board of Bank of Scotland plc and the members of the Lloyds Banking Group executive committee.

The table below details, on an aggregated basis, key management personnel compensation which has been allocated to the Bank on an estimated basis. In 2008, no director received emoluments for qualifying services to the Bank:

	2009 £m
Compensation	
Salaries and other short-term benefits	**6**

The aggregate of the emoluments of the directors for qualifying services to the Bank, on an estimated basis, in 2009 was £3,960,000. The total for the highest paid director G T Tate was £722,000.

As a result of the acquisition of HBOS plc by Lloyds Banking Group plc on 16 January 2009, the Board of the Bank changed in its entirety. Accordingly, the disclosures for 2009 begin with the balances of key management personnel on 16 January 2009. The disclosures for 2008, which are based on the previous members of key management personnel, are presented separately.

The information below is in relation to key management personnel for 2009:

	2009 million
Share options	
At 16 January 2009 and 31 December 2009	**2**

	2009 million
Share incentive plans	
At 16 January 2009	**7**
Granted (including entitlements of appointed directors)	**17**
Exercised/lapsed (including entitlements of former directors)	**(5)**
At 31 December 2009	**19**

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:

	2009 £m
Loans	
At 16 January 2009	**3**
Advanced (including loans of appointed directors)	**–**
Repayments (including loans of former directors)	**(1)**
At 31 December 2009	**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 1.28 per cent and 24.9 per cent in 2009.

42 Related party transactions (continued)

No provisions have been recognised in respect of loans given to key management personnel.

	2009 £m
Deposits	
At 16 January 2009	**6**
Placed (including deposits of appointed directors)	**12**
Withdrawn (including deposits of former directors)	**(14)**
At 31 December 2009	**4**

Deposits placed by key management personnel attracted interest rates of up to 6.5 per cent.

At 31 December 2009, the Group did not provide any guarantees in respect of key management personnel.

At 31 December 2009, transactions, arrangements and agreements entered into by the Group's banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £2 million with seven directors and four connected persons.

The information below is in relation to key management personnel for 2008:

	2008 £m
Loans	
At 1 January 2008	2
Advanced	–
Repayments	–
At 31 December 2008	2

	2008 £m
Deposits	
At 1 January 2008	12
Net movements	(5)
At 31 December 2008	7

Share schemes

Potential pre-tax gains on share options exercised

During 2008, two key management personnel exercised 2,045 options under share option schemes.

Shares vested under long-term incentive schemes

During 2008, one key management personnel had a share grant of 43,350 shares released under long term incentive schemes, in accordance with his contractual entitlement under the rules of the schemes. This relates to the 2003-2006 long term incentive plan granted in January 2003. HBOS's Total Shareholder Return over the five year performance period exceeded the weighted average of the comparator group by 1.57 per cent, consequently 183 per cent of the original share grant was released under the terms of the long term incentive scheme on 27 February 2008.

Shares vested under short-term incentive schemes

During 2008, seven key management personnel had share grants of 428,938 shares in total released under short term incentive schemes, in accordance with contractual entitlements under the rules of the schemes. The release of these 428,938 shares relates to the shares placed in trust using short term incentive plan awards in 2004 together with the additional shares awarded following the three year holding period. In respect of one key management personnel, a share grant of 49,191 was released under short term incentive plans, and a special award originally granted in 2002 of 212,739 shares was also released. Both of these releases occurred before April 2008. None of these releases related to performance in 2008.

The value of additional shares is shown net of income tax and National Insurance liability although the value of the additional shares was grossed up to take account of the associated income tax and National Insurance payable by the participant.

Value of shares vested under free shares plan

During 2008, 2,674 free shares relating to six key management personnel vested. In 2008, seven key management personnel were awarded shares under the free shares plan.

Change of control

All of the HBOS share plans contained a provision relating to change of control. The acquisition of HBOS by Lloyds Banking Group resulted in awards and options vesting and becoming exercisable, in accordance with contractual entitlements under plan rules. Certain awards were exchanged for awards over Lloyds Banking Group ordinary shares, but otherwise subject to the same terms as the original award. Certain options will also be exchanged to the extent they have not been exercised within the six month exercise period following the change of control.

42 Related party transactions (continued)

Where the vesting of awards and options were subject to the satisfaction of performance conditions, in accordance with the plan rules and the terms of such conditions, the Remuneration Committee of the Bank determined the extent to which such awards and options vested by taking into account the level of performance. In relation to the directors, the Remuneration Committee exercised this discretion by reducing vesting to exclude any payments in relation to the 2008 financial year.

The total payments made to directors of the Bank on change of control were £914,000 and 16,310 share options.

Subsidiaries
Details of the principal subsidiaries are given in note 24. In accordance with IAS 27, transactions and balances with subsidiaries have been eliminated on consolidation.

Transactions with Lloyds Banking Group
On 16 January 2009 Lloyds Banking Group plc acquired HBOS plc and its subsidiaries, including Bank of Scotland plc and as a result Lloyds Banking Group and its subsidiaries became related parties.

The Group transacts with other Lloyds Banking Group companies during the ordinary course of business. Details of transactions and outstanding balances as at and for the year ended 31 December 2009 are set out below:

	2009 £m
Transactions	
Interest income	**277**
Interest expense	**(823)**
Other income	**2,530**

	As at 31 December 2009 £m
Balances	
Loans and advances to banks	**85,456**
Loans and advances to customers	**261**
Debt securities classified as loans and receivables	**554**
Trading and other financial assets designated at fair value through profit or loss	**876**
Derivative assets	**664**
Available-for-sale financial assets	**132**
Other assets	**197**
Deposits from banks	**(144,876)**
Trading and other financial liabilities designated at fair value through profit or loss	**(5,463)**
Debt securities in issue	**(1,578)**
Derivative liabilities	**(853)**
Subordinated liabilities	**(14)**

HM Treasury
On 15 January 2009, HM Treasury subscribed for £8.5 billion of new ordinary shares and £3.0 billion of new preference shares in HBOS plc which, at that time was the Bank's ultimate parent company. Consequently, from 15 January 2009, HM Treasury became a related party of the Bank. On 16 January 2009, the HBOS Group was acquired by Lloyds Banking Group plc, which became the Bank's ultimate parent company. As at 16 January 2009, HM Treasury had a 43.4 per cent interest in Lloyds Banking Group plc, and therefore HM Treasury remained a related party of the Bank.

There were no material transactions between the Group and HM Treasury during the period between 15 January 2009 and 31 December 2009 that were not made in the ordinary course of business or that are unusual in their nature or conditions.

Other related party disclosures
In the year ended 31 December 2009, the Group provided both administration and processing services to Sainsbury's Bank plc. The amount payable to the Group during the year was £34 million (2008: £26 million), of which £10 million was outstanding at the year end (2008: £10 million). At 31 December 2009, Sainsbury's Bank plc also had balances with the Group and the Bank that were included in loans and advances to banks of £1,218 million (2008: £906 million). Balances with the Group and Bank that were included in deposits by banks were £1,405 million (2008: £1,274 million) and £1,405 million (2008: £1,274 million) respectively.

The Group has a number of associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2009, these companies had total assets of approximately £11,816 million (2008: £12,113 million), total liabilities of approximately £12,106 million (2008: £11,068 million) and for the year ended 31 December 2009 had turnover of approximately £8,766 million (2008: £7,411 million) and made a net loss of approximately £557 million (2008: net loss of £36 million). In addition, the Group has provided £5,245 million (2008: £5,986 million) of financing to these companies on which it received £140 million (2008: £207 million) of interest income in the year.

Banking transactions are entered into by the Bank with its subsidiaries in the normal course of business and are at normal commercial terms. These include loans, deposits and foreign currency transactions.

42 Related party transactions (continued)

At 31 December 2009 the Group had loans and advances to customers of £12,216 million (2008: £14,180 million), the Bank had loans and advances to customers of £12,197 million (2008: £14,153 million), and the Group and Bank had outstanding balances within customer accounts of £174 million (2008: £213 million) relating to jointly controlled entities and associated undertakings.

At 31 December 2009, the Group's pension funds had call deposits with Bank of Scotland plc amounting to £46 million (2008: £34 million).

Included within the balances of the Group and Bank are the following amounts relating to fellow subsidiary undertakings: Group: loans and advances to customers £35,460 million (2008: £36,341 million), customer accounts £33,395 million (2008: £37,354 million); Bank: loans and advances to customers £34,829 million (2008: £37,106 million), customer accounts £33,385 million (2008: £38,513 million).

Included within balances of the Bank are the following amounts relating to its own subsidiaries: loans and advances to banks £17,193 million (2008: £22,826 million), loans and advances to customers £57,730 million (2008: £141,859 million), deposits by banks £3,402 million (2008: £7,676 million), customer accounts £45,346 million (2008: £76,407 million).

The ultimate parent of the Group during 2008 was HBOS plc. The Group entered into banking transactions with it and its subsidiaries in the normal course of business. Interest income and interest expense for the year ended 31 December 2009 was £1,948 million and £627 million respectively (2008: £2,101 million and £2,873 million respectively). HBOS plc is the principal employer of the Group and staff and other costs of £2,187 million (2008: £2,251 million) were recharged to the Group in the year ended 31 December 2009.

43 Cash flow statement

a Change in operating assets

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Change in loans and advances to banks	**(10,772)**	(8,350)	**(3,624)**	(8,686)
Change in loans and advances to customers	**16,824**	(12,748)	**111,554**	(116,665)
Change in debt securities held as loans and receivables	**7,667**	(10,331)	**(4,425)**	(77,272)
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**15,858**	13,511	**11,872**	19,800
Change in other operating assets	**15,627**	(55,127)	**2,767**	2,523
Change in operating assets	**45,204**	(73,045)	**118,144**	(180,300)

b Change in operating liabilities

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Change in deposits from banks	**77,272**	55,553	**71,155**	49,770
Change in customer deposits	**(11,428)**	(10,486)	**(73,049)**	142,118
Change in debt securities in issue	**(69,291)**	(18,072)	**(74,389)**	(5,732)
Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss	**(4,854)**	3,743	**(3,921)**	5,477
Change in investment contract liabilities	**–**	(98)	**–**	–
Change in other operating liabilities	**9,212**	2,678	**10,583**	(673)
Change in operating liabilities	**911**	33,318	**(69,621)**	190,960

c Non-cash and other items

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Depreciation and amortisation	**1,093**	1,542	**219**	313
Revaluation of investment properties	**13**	9	**–**	–
Allowance for loan losses	**19,430**	10,780	**16,597**	10,036
Write-off of allowance for loan losses	**(7,458)**	(2,408)	**(6,795)**	(2,021)
Impairment of available-for-sale securities	**620**	1,270	**99**	659
Impairment of goodwill	**385**	142	**–**	50
Impairment losses on investments in subsidiaries	**–**	–	**4,449**	107
Change in insurance contract liabilities	**–**	(24)	**–**	–
Other provision movements	**102**	173	**103**	197
Other non-cash items	**9,733**	2,491	**6,546**	1,409
Total non-cash items	**23,918**	13,975	**21,218**	10,750
Interest expense on subordinated liabilities	**742**	1,323	**681**	1,045
Loss on disposal of businesses	**100**	845	**–**	–
Total other items	**842**	2,168	**681**	1,045
Non-cash and other items	**24,760**	16,143	**21,899**	11,795

43 Cash flow statement (continued)

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

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Cash and balances with central banks	**2,905**	2,502	**2,168**	1,820
Less: mandatory reserve deposits[1]	**(336)**	(315)	**(323)**	(296)
	2,569	2,187	**1,845**	1,524
Loans and advances to banks	**91,259**	12,445	**108,133**	34,144
Less: amounts with a maturity of three months or more	**(17,437)**	(6,665)	**(19,939)**	(16,315)
	73,822	5,780	**88,194**	17,829
Total cash and cash equivalents	**76,391**	7,967	**90,039**	19,353

[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.

e Analysis of changes in financing during the year

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Share capital (including share premium account and merger reserve):				
At 1 January	**13,942**	8,442	**13,942**	8,442
Issue of share capital:				
Private placement	**20,189**	5,500	**20,189**	5,500
At 31 December	**34,131**	13,942	**34,131**	13,942

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Minority interests:				
At 1 January	**264**	356	**–**	–
Exchange and other adjustments	**–**	11	**–**	–
Minority interest acquired	**–**	242	**–**	–
Repayment of capital to minority shareholders	**(59)**	(353)	**–**	–
Minority share of profit after tax	**13**	51	**–**	–
Dividends to minority shareholders	**(12)**	(43)	**–**	–
At 31 December	**206**	264	**–**	–

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Subordinated liabilities:				
At 1 January	**18,779**	18,082	**18,082**	14,855
Exchange and other adjustments	**(314)**	1,102	**(249)**	1,097
Issue of subordinated liabilities	**–**	3,000	**–**	3,000
Repayments of subordinated liabilities	**(1,781)**	(3,405)	**(1,781)**	(870)
At 31 December	**16,684**	18,779	**16,052**	18,082

f Acquisition of group undertakings, joint ventures and associates

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Capital subscriptions in joint ventures and associates	**(279)**	(454)	**–**	–
Additional capital injections and investment in subsidiaries	**–**	–	**(2,517)**	(1,217)
At 31 December	**(279)**	(454)	**(2,517)**	(1,217)

43 Cash flow statement (continued)

g Disposal and closure of group undertakings, joint ventures and associates

	Group		Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Cash and balances at central banks	**–**	577	**–**	–
Trading and other financial assets at fair value through profit or loss	**–**	490	**–**	–
Liabilities arising from insurance contracts and participating investment contracts	**–**	(27)	**–**	–
Liabilities arising from non-participating investment contracts	**–**	(77)	**–**	–
Other net assets and liabilities	**–**	1,626	**–**	–
	–	2,589	**–**	–
Loss on sale of businesses	**(100)**	(845)	**–**	–
Cash and cash equivalents disposed of	**–**	(577)	**–**	–
Net cash inflow from disposals	**(100)**	1,167	**–**	–
Capital redemptions in joint ventures and associates	**237**	57	**–**	–
At 31 December	**137**	1,224	**–**	–

44 Contingent liabilities and commitments

Legal proceedings

Payment protection insurance

In January 2009, the UK Competition Commission (the 'Competition Commission') completed its formal investigation into the supply of Payment Protection Insurance (PPI) services (except store card PPI) to non-business customers in the UK and published its final report setting out its remedies. The Competition Commission decided to adopt various remedies including a prohibition on the active sale of PPI by a distributor to a customer within seven days of the distributor's sale of credit to that customer.

On 30 March 2009, Barclays Bank plc lodged an appeal in the UK Competition Appeal Tribunal (the 'Competition Appeal Tribunal') against the Competition Commission's findings. Lloyds Banking Group, was granted permission by the Competition Appeal Tribunal to intervene in the appeal. The Competition Appeal Tribunal handed down its judgment on 16 October 2009 finding in favour of Barclays in respect of its challenge to the Competition Commission's prohibition of distributors selling PPI at the credit point of sale but it did not uphold Barclays' challenge to the Competition Commission's findings on market definition. The matter has now been referred back to the Competition Commission. This may or may not result in the Competition Commission ultimately reaching a different conclusion.

On 1 July 2008 the Financial Ombudsman Service referred concerns regarding the handling of PPI complaints to the FSA as an issue of wider implication. The Lloyds Banking Group has been working with other industry members and trade associations in preparing an industry response to address regulatory concerns regarding the handling of PPI complaints. On 29 September 2009, the FSA issued a consultation paper on PPI complaints handling. The FSA has escalated its regulatory activity in relation to past PPI sales generally and has proposed new guidance on the fair assessment of a complaint and the calculation of redress and a new rule requiring firms to reassess historically rejected complaints.

The statement on 29 September 2009 also announced that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. The Lloyds Banking Group has subsequently agreed in principle that it will undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. The precise details of the review are still being discussed with the FSA. The ultimate impact on the Group of any review and/or reassessment can only be known at the conclusion of these discussions and on publication of the FSA's final rules.

Interchange fees

The European Commission has adopted a formal decision finding that an infringement of European Commission competition laws has arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the fee be reduced to zero for relevant cross-border transactions within the European Economic Area. This decision has been appealed to the General Court of the European Union (the 'General Court'). Bank of Scotland plc (along with certain other MasterCard issuers) have successfully applied to intervene in the appeal in support of MasterCard's position that the arrangements for the charging of a uniform fallback interchange fee are compatible with European Commission competition laws. Meanwhile, the European Commission and the UK's OFT are pursuing investigations with a view to deciding whether arrangements adopted by other payment card schemes for the levying of uniform fallback interchange fees in respect of domestic and/or cross-border payment transactions also infringe European Commission and/or UK competition laws. As part of this initiative the OFT will also intervene in the General Court appeal supporting the European Commission's position. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

Unarranged overdraft charges

The Supreme Court published its judgement in respect of the fairness of unarranged overdraft charges on personal current accounts on 25 November 2009, finding in favour of the litigant banks. On 22 December 2009, the OFT announced that it will not continue its investigation into the fairness of these charges. The Group is working with the regulators to ensure that outstanding customer complaints are concluded as quickly as possible and anticipate that most cases in the county courts will be discontinued. The Group expects that some customers will argue that despite the test case ruling they are entitled to a refund of unarranged overdraft charges on the basis of other legal arguments or challenges. The Group would robustly defend any such complaints or claims and does not expect the outcome of any such complaints or claims to have a material adverse effect on its financial position.

44 Contingent liabilities and commitments (continued)

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

Contingent liabilities and commitments arising from the banking business
Acceptances and endorsements arise where the Group agrees to guarantee payment on a negotiable instrument drawn up by a customer.

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

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

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

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Contingent liabilities				
Acceptances and endorsements	**5**	–	**3**	–
Other:				
Other items serving as direct credit substitutes	**99**	73	**99**	73
Performance bonds and other transaction-related contingencies	**1,251**	1,279	**2,332**	979
	1,350	1,352	**2,431**	1,052
	1,355	1,352	**2,434**	1,052

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

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Commitments				
Documentary credits and other short-term trade-related transactions	**69**	137	**34**	76
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	**6,188**	11,847	**6,085**	10,980
Other commitments	**30,130**	38,364	**50,955**	36,136
	36,318	50,211	**57,040**	47,116
1 year or over original maturity	**17,665**	26,341	**16,510**	24,203
	54,052	76,689	**73,584**	71,395

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £30,124 million (2008: £49,551 million) for the Group and £63,207 million (2008: £46,081 million) for the Bank were irrevocable.

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

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Not later than 1 year	**174**	161	**138**	124
Later than 1 year and not later than 5 years	**608**	593	**492**	453
Later than 5 years	**1,095**	1,120	**701**	751
	1,877	1,874	**1,331**	1,328

44 Contingent liabilities and commitments (continued)

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

Capital commitments
Excluding commitments of the Group in respect of investment property (note 23), capital expenditure contracted but not provided for at 31 December 2009 amounted to £127 million for the Group and nil for the Bank (2008: £144 million for the Group and nil for the Bank). Of the capital commitments of the Group, £107 million (2008: £126 million) relates to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

45 Financial instruments

(1) Measurement basis of financial assets and liabilities
The accounting policies in accounting policy 2(f) 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		**At fair value through profit or loss**					
	Derivatives designated as hedging instruments £m	**Held for trading £m**	**Designated upon initial recognition £m**	**Available-for-sale £m**	**Loans and receivables £m**	**Held at amortised cost £m**	**Total £m**
As at 31 December 2009							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,905	2,905
Items in the course of collection from banks	–	–	–	–	–	534	534
Trading and other financial assets at fair value through profit or loss	–	27,611	256	–	–	–	27,867
Derivative financial instruments	8,945	21,277	–	–	–	–	30,222
Loans and receivables:							
Loans and advances to banks	–	–	–	–	91,259	–	91,259
Loans and advances to customers	–	–	–	–	439,538	–	439,538
Debt securities	–	–	–	–	31,211	–	31,211
	–	–	–	–	562,008	–	562,008
Available-for-sale financial assets	–	–	–	21,565	–	–	21,565
Total financial assets	8,945	48,888	256	21,565	562,008	3,439	645,101
Financial liabilities							
Deposits from banks	–	–	–	–	–	174,338	174,338
Customer deposits	–	–	–	–	–	265,971	265,971
Items in course of transmission to banks	–	–	–	–	–	495	495
Trading and other financial liabilities at fair value through profit or loss	–	27,372	–	–	–	–	27,372
Derivative financial instruments	9,658	17,794	–	–	–	–	27,452
Notes in circulation	–	–	–	–	–	981	981
Debt securities in issue	–	–	–	–	–	119,157	119,157
Subordinated liabilities	–	–	–	–	–	16,684	16,684
Total financial liabilities	9,658	45,166	–	–	–	577,626	632,450

45 Financial instruments (continued)

The Group

	Derivatives designated as hedging instruments £m	At fair value through profit or loss: Held for trading £m	At fair value through profit or loss: Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
As at 31 December 2008							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,502	2,502
Items in the course of collection from banks	–	–	–	–	–	445	445
Trading and other financial assets at fair value through profit or loss	–	22,571	859	–	–	–	23,430
Derivative financial instruments	22,082	28,435	–	–	–	–	50,517
Loans and receivables:							
Loans and advances to banks	–	–	–	–	12,445	–	12,445
Loans and advances to customers	–	–	–	–	488,213	–	488,213
Debt securities	–	–	–	–	38,878	–	38,878
	–	–	–	–	539,536	–	539,536
Available-for-sale financial assets	–	–	–	28,035	–	–	28,035
Total financial assets	22,082	51,006	859	28,035	539,536	2,947	644,465
Financial liabilities							
Deposits from banks	–	–	–	–	–	97,066	97,066
Customer deposits	–	–	–	–	–	277,399	277,399
Items in course of transmission to banks	–	–	–	–	–	521	521
Trading and other financial liabilities at fair value through profit or loss	–	18,851	–	–	–	–	18,851
Derivative financial instruments	12,002	28,825	–	–	–	–	40,827
Notes in circulation	–	–	–	–	–	957	957
Debt securities in issue	–	–	–	–	–	188,448	188,448
Subordinated liabilities	–	–	–	–	–	18,779	18,779
Total financial liabilities	12,002	47,676	–	–	–	583,170	642,848

45 Financial instruments (continued)

The Bank

	Derivatives designated as hedging instruments £m	At fair value through profit or loss: Held for trading £m	At fair value through profit or loss: Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
As at 31 December 2009							
Financial assets							
Cash and balances at central banks	**–**	**–**	**–**	**–**	**–**	**2,168**	**2,168**
Items in the course of collection from banks	**–**	**–**	**–**	**–**	**–**	**538**	**538**
Trading and other financial assets at fair value through profit or loss	**–**	**27,611**	**17**	**–**	**–**	**–**	**27,628**
Derivative financial instruments	**8,957**	**17,723**	**–**	**–**	**–**	**–**	**26,680**
Loans and advances to banks	**–**	**–**	**–**	**–**	**108,133**	**–**	**108,133**
Loans and advances to customers	**–**	**–**	**–**	**–**	**439,967**	**–**	**439,967**
Debt securities	**–**	**–**	**–**	**–**	**23,684**	**–**	**23,684**
	–	**–**	**–**	**–**	**571,784**	**–**	**571,784**
Available-for-sale financial assets	**–**	**–**	**–**	**19,316**	**–**	**–**	**19,316**
Total financial assets	**8,957**	**45,334**	**17**	**19,316**	**571,784**	**2,706**	**648,114**
Financial liabilities							
Deposits from banks	**–**	**–**	**–**	**–**	**–**	**168,246**	**168,246**
Customer deposits	**–**	**–**	**–**	**–**	**–**	**300,124**	**300,124**
Items in course of transmission to banks	**–**	**–**	**–**	**–**	**–**	**495**	**495**
Trading and other financial liabilities at fair value through profit or loss	**–**	**27,372**	**–**	**–**	**–**	**–**	**27,372**
Derivative financial instruments	**9,633**	**17,538**	**–**	**–**	**–**	**–**	**27,171**
Notes in circulation	**–**	**–**	**–**	**–**	**–**	**981**	**981**
Debt securities in issue	**–**	**–**	**–**	**–**	**–**	**98,075**	**98,075**
Subordinated liabilities	**–**	**–**	**–**	**–**	**–**	**16,052**	**16,052**
Total financial liabilities	**9,633**	**44,910**	**–**	**–**	**–**	**583,973**	**638,516**

The Bank

	Derivatives designated as hedging instruments £m	At fair value through profit or loss: Held for trading £m	At fair value through profit or loss: Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
As at 31 December 2008							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	1,820	1,820
Items in the course of collection from banks	–	–	–	–	–	449	449
Trading and other financial assets at fair value through profit or loss	–	22,571	349	–	–	–	22,920
Derivative financial instruments	15,454	27,806	–	–	–	–	43,260
Loans and advances to banks	–	–	–	–	34,144	–	34,144
Loans and advances to customers	–	–	–	–	578,528	–	578,528
Debt securities	–	–	–	–	19,259	–	19,259
	–	–	–	–	631,931	–	631,931
Available-for-sale financial assets	–	–	–	24,339	–	–	24,339
Total financial assets	15,454	50,377	349	24,339	631,931	2,269	724,719
Financial liabilities							
Deposits from banks	–	–	–	–	–	97,091	97,091
Customer deposits	–	–	–	–	–	373,173	373,173
Items in course of transmission to banks	–	–	–	–	–	522	522
Trading and other financial liabilities at fair value through profit or loss	–	18,851	–	–	–	–	18,851
Derivative financial instruments	11,736	27,877	–	–	–	–	39,613
Notes in circulation	–	–	–	–	–	957	957
Debt securities in issue	–	–	–	–	–	172,464	172,464
Subordinated liabilities	–	–	–	–	–	18,082	18,082
Total financial liabilities	11,736	46,728	–	–	–	662,289	720,753

45 Financial instruments (continued)

(2) Reclassification of financial assets
In accordance with the amendment to IAS 39 that became applicable during 2008, the Group reviewed the categorisation of its financial assets classified as held for trading and available-for-sale. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, the Group reclassified the following financial assets:

In January 2009, the Group reclassified £1,825 million of debt securities classified as held for trading to debt securities classified as loans and receivables.

In addition, the Group reclassified £649 million of securities classified as available-for-sale to debt securities classified as loans and receivables.

With effect from 1 July 2008, the Group transferred £12,210 million of assets previously classified as held for trading into available-for-sale.

With effect from 1 November 2008, the Group transferred £35,446 million of assets previously classified as available-for-sale into loans and receivables.

At the time of these transfers, the Group had the intention and ability to hold them for the foreseeable future or until maturity. As at the date of reclassification, the weighted average effective interest rate of the assets transferred was 0.7 per cent to 9.5 per cent with the estimated recoverable cash flows of £56,743 million.

Carrying amount and fair values of reclassified assets
The table below sets out the carrying value and fair value of reclassified financial assets.

	31 December 2009		31 December 2008	
	Carrying Value £m	**Fair Value £m**	Carrying Value £m	Fair Value £m
From held for trading to loans and receivables	**1,428**	**1,120**	–	–
From held for trading to available-for-sale	**10,478**	**10,176**	13,542	13,542
From available-for-sale to loans and receivables	**29,153**	**27,820**	37,173	36,191
	41,059	**39,116**	50,715	49,733

Additional fair value gains (losses) that would have been recognised had the reclassifications not occurred
The table below shows the additional gains (losses) that would have been recognised since the date of reclassification in the Group's income statement or through the Group's available-for-sale revaluation reserve if the reclassifications had not occurred.

	2009			2008	
	Reclassified in 2009 £m	**Reclassified in 2008 £m**	**Total £m**	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables	**13**	**–**	**13**	–	–
From held for trading to available-for-sale	**–**	**904**	**904**	981	981
From available-for-sale to loans and receivables[1]	**70**	**1,147**	**1,217**	708	708
	83	**2,051**	**2,134**	1,689	1,689

[1]amounts recognised through available-for-sale revaluation reserve (post tax).

Actual amounts recognised in respect of reclassified assets
After reclassification the reclassified financial assets contributed the following amounts to the Group income statement:

	2009			2008	
	Reclassified in 2009 £m	**Reclassified in 2008 £m**	**Total £m**	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables:					
Net interest income	**45**	**–**	**45**	–	–
Impairment losses	**(110)**	**–**	**(110)**	–	–
Gains on disposal	**17**	**–**	**17**	–	–
Total	**(48)**	**–**	**(48)**	–	–
From held for trading to available-for-sale:					
Net interest income	**–**	**281**	**281**	442	442
Impairment losses	**–**	**(305)**	**(305)**	(215)	(215)
Gains on disposal	**–**	**70**	**70**	–	–
Total	**–**	**46**	**46**	227	227
From available-for-sale to loans and receivables:					
Net interest income	**25**	**377**	**402**	82	82
Impairment losses	**–**	**(371)**	**(371)**	(558)	(558)
Gains (losses) on disposal	**–**	**(152)**	**(152)**	16	16
Total	**25**	**(146)**	**(121)**	(460)	(460)

45 Financial instruments (continued)

(3) Fair values of financial assets and liabilities

The following table summarises the carrying values of financial assets and liabilities presented on the Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

	The Group				The Bank			
	Carrying value 2009 £m	Carrying value 2008 £m	**Fair value 2009 £m**	Fair value 2008 £m	**Carrying value 2009 £m**	Carrying value 2008 £m	**Fair value 2009 £m**	Fair value 2008 £m
Financial assets								
Trading and other financial assets at fair value through profit or loss	**27,867**	23,430	**27,867**	23,430	**27,628**	22,920	**27,628**	22,920
Derivative financial instruments	**30,222**	50,517	**30,222**	50,517	**26,680**	43,260	**26,680**	43,260
Loans and receivables:								
Loans and advances to banks	**91,259**	12,445	**91,322**	12,478	**108,133**	34,144	**108,193**	34,179
Loans and advances to customers	**439,538**	488,213	**418,005**	477,260	**439,967**	578,528	**419,440**	568,089
Debt securities	**31,211**	38,878	**37,736**	38,056	**23,684**	19,259	**29,045**	18,852
Available-for-sale financial assets	**21,565**	28,035	**21,565**	28,035	**19,316**	24,339	**19,316**	24,339
Financial liabilities								
Deposits from banks	**174,338**	97,066	**174,413**	97,100	**168,246**	97,091	**168,319**	97,126
Customer deposits	**265,971**	277,399	**266,005**	278,150	**300,124**	373,173	**299,659**	373,763
Trading and other financial liabilities at fair value through profit or loss	**27,372**	18,851	**27,372**	18,851	**27,372**	18,851	**27,372**	18,851
Derivative financial instruments	**27,452**	40,827	**27,452**	40,827	**27,171**	39,613	**27,171**	39,613
Debt securities in issue	**119,157**	188,448	**116,133**	182,470	**98,075**	172,464	**95,318**	167,573
Subordinated liabilities	**16,684**	18,779	**15,548**	20,839	**16,052**	18,082	**14,915**	17,514

(4) Valuation methodology

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

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

Because a variety of estimation techniques are employed and significant estimates made, comparisons of fair values between financial institutions may not be meaningful. Readers of these financial statements are thus advised to use caution when using this data to evaluate the Group's financial position.

Fair value information is not provided for items that do not meet the definition of a financial instrument. These items include intangible assets, premises, equipment and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

The table below provides an analysis of the financial assets and liabilities of the Group that are carried at fair value in the Group's consolidated balance sheet, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

Valuation hierarchy

At 31 December 2009		**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
Trading and other financial assets at fair value through profit or loss	(i)	**2,881**	**23,861**	**1,125**	**27,867**
Available-for-sale financial assets	(ii)	**1,819**	**17,881**	**1,865**	**21,565**
Derivative financial instruments	(iii)	**20**	**30,128**	**74**	**30,222**
Financial assets		**4,720**	**71,870**	**3,064**	**79,654**
Trading and other financial liabilities at fair value through profit or loss	(iv)	**511**	**26,861**	**–**	**27,372**
Derivative financial instruments	(iii)	**22**	**27,234**	**196**	**27,452**
Financial liabilities		**533**	**54,095**	**196**	**54,824**

45 Financial instruments (continued)

At 31 December 2008	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Trading and other financial assets at fair value through profit or loss	5,799	14,476	3,155	23,430
Available-for-sale financial assets	786	24,959	2,290	28,035
Derivative financial instruments	121	49,827	569	50,517
Financial assets	6,706	89,262	6,014	101,982
Trading and other financial liabilities at fair value through profit or loss	–	18,851	–	18,851
Derivative financial instruments	55	39,670	1,102	40,827
Financial liabilities	55	58,521	1,102	59,678

There were no significant transfers between Level 1 and Level 2 portfolios during the year.

Level 1 portfolios
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 portfolios
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, the instrument is considered to be level 2. 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 portfolios
Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include the Group's venture capital and unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities, principally where there is no trading activity in such securities, are also classified as level 3.

Level 3 portfolio At 31 December 2009	Valuation basis/technique	Main assumptions	Carrying value £m	Effect of reasonably possible alternative assumptions £m
Trading and other financial assets at fair value through profit or loss:				
Asset-backed securities	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**891**	74
Equity investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	**234**	
			1,125	
Available-for-sale financial assets				
Equity investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	**1,865**	
Derivative financial assets	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**74**	31
Financial assets			**3,064**	
Derivative financial liabilities	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**196**	8
Financial liabilities			**196**	

Reasonably possible alternative valuations have been calculated for asset-backed securities by using alternative pricing sources and calculating an absolute difference and for derivative financial instruments by flexing the spread between the underlying asset and the credit derivative, or adjusting market yields, by a reasonable amount.

45 Financial instruments (continued)

The valuation techniques used for unlisted equities vary depending on the nature of the investment. Further details of these are given below. As these factors differ for each investment depending on the nature of the valuation technique used and the inputs there is no single common factor that could be adjusted to provide a reasonable alternative valuation for these investments portfolios.

The main products where level 3 valuations have been used are described below:

Asset-backed securities
Where there is no trading activity in asset-backed securities, valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes are used to determine an appropriate valuation. Asset-backed securities are then classified as either level 2 or level 3 depending on whether there is more than one consistent independent source of data. If there is a single, uncorroborated market source for a significant valuation input or where there are materially inconsistent levels then the valuation is reported as level 3. Asset classes classified as level 3 mainly comprise certain residential mortgage backed securities, collateralised loan obligations and collateralised debt obligations.

Equity investments
Unlisted equities and funds accounted for as available-for-sale assets are valued using different techniques as a result of the variety of investments across the portfolio. A valuation technique is selected for each investment in accordance with the Group's valuation policy. Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

– The earnings multiple methodology involves applying the relevant earnings multiple to the maintainable earnings of the business being valued. A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.

– Valuations using net asset values are often used for property-based businesses and use the latest valuations included in management or statutory accounts adjusted for subsequent movements in property valuations and other factors including recoverability.

– Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return.

For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

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, except for the items classified as level 3 which are valued using publicly available yield and credit default swap curves; the Group uses standard models with observable inputs.

– 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.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the securities are referred to as 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 security.

Credit valuation adjustment
A credit valuation adjustment (CVA) is applied to the Group's over-the-counter derivative instruments to adjust the counterparty credit risk free derivative valuations provided by standard interbank lending interest rate curves. The Group uses a simulation model to develop expected future exposures and calculate a bilateral CVA. Credit and debit valuation adjustments are calculated by counterparty and the net adjustment booked. At 31 December 2009 the total reserve booked was £585 million (31 December 2008: £607 million). This adjustment has been made to the valuation of over-the-counter derivative instruments classified as level 2.

45 Financial instruments (continued)

Movement in level 3 portfolio
The table below analyses asset movements in the Level 3 portfolio:

	Trading and other financial assets at fair value through profit or loss £m	Available for sale £m	Derivative assets £m	Total financial assets £m
At 31 December 2008	3,155	2,290	569	6,014
Losses recognised in the income statement	**(244)**	**(600)**	**(555)**	**(1,399)**
Gains recognised in other comprehensive income	**–**	**141**	**–**	**141**
Purchases	**8**	**403**	**60**	**471**
Sales	**(51)**	**(259)**	**–**	**(310)**
Transfers into the level 3 portfolio	**–**	**11**	**–**	**11**
Transfers out of the level 3 portfolio	**(1,743)**	**(121)**	**–**	**(1,864)**
At 31 December 2009	**1,125**	**1,865**	**74**	**3,064**

The table below analyses liability movements in the level 3 portfolio.

	Derivative liabilities £m	Total financial liabilities £m
At 31 December 2008	1,102	1,102
Gains recognised in the income statement	**(123)**	**(123)**
Transfers out of the level 3 portfolio	**(783)**	**(783)**
At 31 December 2009	**196**	**196**

Included with the gains (losses) recognised in the income statement are losses of £977 million related to financial instruments that are held at the relevant year end.

Fair value of financial instruments carried at amortised cost

Loans and receivables
The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair values of asset-backed securities and secondary loans, which were previously within assets held for trading and were reclassified to loans and receivables (see page 66), are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market-standard consensus pricing services, broker quotes and other research data.

Deposits from banks and customers
The fair value of deposits repayable on demand is considered 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 and subordinated liabilities
The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices.

46 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 Group has adopted the heritage Lloyds TSB approach to risk management.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and currency risk; and liquidity risk. Qualitative and quantitative information about the Group's management of these risks is given below.

(i) Qualitative information

(1) Credit risk

Definition
The risk of reductions in earnings and/or value, through financial or reputational loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

Risk appetite
Credit risk appetite is set by the Lloyds Banking Group board and is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio performance measures which in turn use the various credit risk rating systems as inputs. These metrics are supported by a comprehensive suite of policies, sector caps, product and country limits to manage concentration risk and exposures within the Group's approved risk appetite.

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

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

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 15 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2009. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in the credit risk table on page 75.

Measurement
In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components: (i) the 'probability of default' by the client or counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios, and a growing number of wholesale lending portfolios, exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and subject matter expert judgement. Each rating model is subject to a rigorous validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. All material rating models are authorised by executive management.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between classifications if the assessment of the obligor probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale.

The rating systems described above assess probability of default, exposure at default and loss given default, in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes.

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

Internal control

- Credit principles and policy: Lloyds Banking Group Risk sets out the Group's credit principles and policy according to which credit risk is managed, which in turn is the basis for business unit credit policy. Principles and policy are reviewed regularly and any changes are subject to a review and approval process. Business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions.
- Counterparty limits: Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.

46 Financial risk management (continued)

- Individual credit assessment and sanction: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting are the same as that for assets intended to be held over the period to maturity.
- Credit scoring: In its principal retail portfolios, the Group uses statistically-based decisioning techniques (primarily credit scoring). Business unit risk departments review scorecard effectiveness and approve changes, with material changes being subject to Lloyds Banking Group risk approval.
- Controls over rating systems: The Group has established an independent process built on a set of common minimum standards designed to challenge the discriminatory power of the systems, accuracy of calibration and ability to rate consistently over time and across obligors. The internal rating systems are developed and implemented by independent risk functions in the business units with the business unit managing directors having ownership of the systems. They also take responsibility for ensuring the validation of the respective internal rating systems, supported and challenged by specialist functions in their respective business unit.
- Cross-border and cross-currency exposures: Country limits are authorised by the Lloyds Banking Group Country Limits Panel taking into account economic and political factors.
- Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to the Group's risk appetite and restricts exposure to certain high risk and more vulnerable sectors and segments. Note 17 provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.
- Stress testing and scenario analysis: The credit portfolio is also subjected to stress-testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group wide level, at business unit level and by rating model and portfolio, for example, for a specific industry sector.
- Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector-specific expertise; and legal services applicable to the particular market place and product range offered by the business.
- Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.
- Risk assurance and oversight: Oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Risk assurance teams are engaged where appropriate to conduct further credit reviews if a need for closer scrutiny is identified.

Collateral

The principal collateral types for loans and advances are:

- mortgages over residential and commercial real estate;
- charges over business assets such as premises, inventory and accounts receivable;
- charges over financial instruments such as debt securities and equities; and
- guarantees received from third parties.

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

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

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

The Group considers risk concentrations by collateral providers and collateral type, as appropriate, with a view to ensuring that any potential undue concentrations of risk are identified and suitably managed by changes to strategy, policy and/or business plans.

Master netting agreements

Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), the Group enters into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period since it is affected by each transaction subject to the agreement.

46 Financial risk management (continued)

Other credit risk transfers
The Group also undertakes asset sales, securitisations and credit derivative based transactions as a means of mitigating or reducing credit risk, taking into account the nature of assets and the prevailing market conditions.

Monitoring

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

(2) Market risk

Definition
The risk of reductions in earnings, value and/or reserves, through financial or reputational loss, arising from unexpected changes in financial prices, including interest rates, inflation rates, exchange rates, credit spreads and prices for bonds, commodities, equities, property and other instruments. It arises in all areas of the Group's activities and is managed by a variety of different techniques.

Risk appetite
Market risk appetite is defined with regard to the quantum and composition of market risk that exists currently in the Group and the direction in which the Lloyds Banking Group wishes to manage this. This statement of the Lloyds Banking Group's overall appetite for market risk is reviewed and approved annually by the Lloyds Banking Group board.

Exposures
The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset.

Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products. However, some interest rate, exchange rate and credit spread positions are taken using derivatives and other on-balance sheet instruments with the objective of earning a profit from favourable movements in market rates.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets and liabilities. Interest rate risk arises predominantly from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets.

Foreign currency risk also arises from the Group's investment in its overseas operations.

Measurement
The primary market risk measure used within the Group is the Value at Risk (VaR) methodology, which incorporates the volatility of relevant market prices and the correlation of their movements. This is used for determining the Group's overall market risk appetite and for the high level allocation of risk appetite across the Group.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures.

Banking - trading assets and other treasury positions
Since the acquisition of HBOS plc, it has been the policy of Lloyds Banking Group to monitor and report its trading and other treasury positions on a consolidated basis to facilitate management and control and capture diversification benefits it is therefore not appropriate to report this data separately for the Group.

Banking - non-trading
Market risk in non-trading books consists almost entirely of exposure to changes in interest rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets; or when, if rates rise, assets cannot be re-priced as quickly or by as much as liabilities.

Risk exposure is monitored monthly at the Lloyds Banking Group level, primarily, market value sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks. Where re-pricing maturity is based on assumptions about customer behaviour these assumptions are also reviewed monthly.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Lloyds Banking Group's risk appetite.

Since the acquisition of HBOS plc, it has been the policy of Lloyds Banking Group to monitor and report its banking-non-trading exposure on a consolidated basis to facilitate management and control. It is therefore not appropriate to report this data separately for the Group.

46 Financial risk management (continued)

Mitigation
Various mitigation activities are undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits.

Banking - non-trading activities
Interest rate risk arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets, is managed centrally. Matching assets and liabilities are offset against each other and internal interest rate swaps are also used.

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

Monitoring
The Lloyds Banking Group Asset and Liability Committee regularly reviews high level market risk exposure including, but not limited to, the data described above. It also makes recommendations to executive management concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored locally by independent risk functions and at a high level by Lloyds Banking Group risk. Where appropriate, escalation procedures are in place.

Banking activities
Trading is restricted to a number of specialist centres, the most important centre being the treasury and trading business in London. These centres also manage market risk in the non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed within limits defined in the detailed Lloyds Banking Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

(3) Liquidity risk

Definition
Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost.

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

Exposure
Liquidity exposure represents the amount of potential outflows in any future period less committed inflows. Liquidity is considered from both an internal and regulatory perspective.

Measurement
A series of measures are used across the Group to monitor both short and long term liquidity including: ratios, cash outflow triggers, liquidity gaps, early warning indicators and stress test survival period triggers. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Mitigation
The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant retail deposit base, accompanied by appropriate funding from the wholesale markets. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise inter-bank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's short-term money market funding is based on a qualitative analysis of the market's capacity for the Group's credit. The Group has developed strong relationships with certain wholesale market segments, and also has access to central banks and corporate customers, to supplement its retail deposit base.

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

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

46 Financial risk management (continued)

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

(ii) Quantitative information

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; and liquidity risk. Information about the Group's exposure to each of the above risks, the Group's objectives, policies and processes for measuring and managing risk and the Group's management of capital can be found below. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

(1) Credit risk

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

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.

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Loans and receivables:				
Loans and advances to banks	**91,259**	12,445	**108,133**	34,144
Loans and advances to customers	**460,810**	498,906	**458,708**	589,003
Debt securities	**33,126**	39,801	**25,211**	19,674
Deposit amounts available for offset[1]	**(9,257)**	(15,198)	**(9,257)**	(15,198)
Impairment losses	**(23,187)**	(11,616)	**(20,268)**	(10,890)
	552,751	524,338	**562,527**	616,733
Available-for-sale financial assets (excluding equity shares)	**19,631**	25,778	**18,239**	23,276
Trading and other financial assets at fair value through profit or loss (excluding equity shares)	**27,615**	23,134	**27,615**	22,917
Derivative assets, before netting	**30,222**	50,517	**26,680**	43,260
Amounts available for offset under master netting arrangements[1]	**(19,910)**	(37,022)	**(19,910)**	(37,022)
	10,312	13,495	**6,770**	6,238
Financial guarantees	**8,025**	10,314	**26,974**	17,068
Irrevocable loan commitments and other credit-related contingencies[2]	**31,479**	50,903	**65,641**	47,133
Maximum credit risk exposure	**649,813**	647,962	**707,766**	733,365
Maximum credit risk exposure before offset items	**678,980**	700,182	**736,933**	785,585

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

[2]See note 44 – Contingent liabilities and commitments for further information.

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

Available-for-sale debt securities, treasury and other bills, and trading and other financial assets at fair value through profit or loss – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 14 and a similar analysis for available-for-sale financial assets is included in note 22.

Derivative assets – the Group reduces exposure to credit risk by using master netting agreements and by obtaining cash collateral. An analysis of derivative assets is given in note 15. Of the net derivative assets of the Group shown above of £10,312 million (2008: £13,495 million), cash collateral of £568 million (2008: £298 million) was held and a further £3,879 million was due from OECD banks (2008: £3,807 million).

46 Financial risk management (continued)

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

Reverse repurchase and repurchase transactions – for reverse repurchase transactions which are accounted for as collateralised loans, it is the Group's policy to seek collateral which is at least equal to the amount loaned. At 31 December 2009, the fair value of collateral accepted under reverse repurchase transactions that the Group is permitted by contract or custom to sell or repledge was £53,072 million (2008: £15,880 million). Of this, £50,138 million (2008: £9,366 million) was sold or repledged as at 31 December 2009. The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £138,728 million (2008: £155,838 million).

Stock lending - in addition to the financial assets on the Group's balance sheet which are subject to repurchase agreements, there are financial assets on the Group's balance sheet pledged as collateral as part of securities lending transactions which amounted to £87,191 million at 31 December 2009 (2008: £89,109 million).

Stock borrowing – Securities held as collateral for stock borrowed or under reverse repurchase agreements amounted to £137,635 million at 31 December 2009 (2008: £76,017 million); of which £128,236 million at 31 December 2009 (2008: £64,377 million) had been resold or repledged.

Loans and advances – The Group

		Loans and advances to customers				
	Loans and advances to banks £m	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2009						
Neither past due nor impaired	**91,259**	**236,050**	**17,672**	**144,763**	**398,485**	**18,884**
Past due but not impaired	**–**	**9,793**	**805**	**4,708**	**15,306**	**–**
Impaired – no provision required	**–**	**1,515**	**26**	**5,015**	**6,556**	**–**
– provision held	**–**	**4,405**	**1,438**	**34,620**	**40,463**	**–**
Gross	**91,259**	**251,763**	**19,941**	**189,106**	**460,810**	**18,884**
Allowance for impairment losses (note 21)	**–**	**(1,412)**	**(749)**	**(19,111)**	**(21,272)**	**–**
Net	**91,259**	**250,351**	**19,192**	**169,995**	**439,538**	**18,884**
31 December 2008						
Neither past due nor impaired	12,445	243,011	21,448	191,398	455,857	9,033
Past due but not impaired	–	11,974	660	6,745	19,379	–
Impaired – no provision required	–	1,057	1	3,327	4,385	–
– provision held	–	2,928	2,556	13,801	19,285	–
Gross	12,445	258,970	24,665	215,271	498,906	9,033
Allowance for impairment losses (note 21)	–	(1,280)	(1,907)	(7,506)	(10,693)	–
Net	12,445	257,690	22,758	207,765	488,213	9,033

The analysis of lending between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in accounting policy 2(h). All impaired loans which exceed certain thresholds are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £39,788 million (2008: £17,302 million) which have associated collateral with a fair value of £9,558 million (2008: £4,322 million).

46 Financial risk management (continued)

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

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2009						
Good quality	**91,259**	**227,558**	**11,237**	**56,148**		**18,884**
Satisfactory quality	**–**	**6,296**	**4,212**	**32,262**		**–**
Lower quality	**–**	**746**	**632**	**38,712**		**–**
Below standard, but not impaired	**–**	**1,450**	**1,591**	**17,641**		**–**
Total	**91,259**	**236,050**	**17,672**	**144,763**	**398,485**	**18,884**
31 December 2008						
Good quality	12,445	238,891	14,660	69,822		9,033
Satisfactory quality	–	3,193	4,796	66,956		–
Lower quality	–	371	552	41,295		–
Below standard, but not impaired	–	556	1,440	13,325		–
Total	12,445	243,011	21,448	191,398	455,857	9,033

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models. Good quality lending includes the lower assessed default probabilities and all loans with low expected losses in the event of default, with other categories reflecting progressively higher risks and lower expected recoveries.

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

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2009						
0-30 days	**–**	**4,693**	**503**	**2,123**	**7,319**	**–**
30-60 days	**–**	**2,087**	**150**	**787**	**3,024**	**–**
60-90 days	**–**	**1,337**	**47**	**740**	**2,124**	**–**
90-180 days	**–**	**1,676**	**47**	**538**	**2,261**	**–**
Over 180 days	**–**	**–**	**58**	**520**	**578**	**–**
Total	**–**	**9,793**	**805**	**4,708**	**15,306**	**–**
Fair value of collateral held	**–**	**8,578**	**n/a**	**n/a**	**n/a**	
31 December 2008						
0-30 days	–	343	460	3,917	4,720	–
30-60 days	–	5,632	148	1,257	7,037	–
60-90 days	–	2,571	28	447	3,046	–
90-180 days	–	3,428	10	918	4,356	–
Over 180 days	–	–	14	206	220	–
Total	–	11,974	660	6,745	19,379	–
Fair value of collateral held	–	10,096	n/a	n/a	n/a	

46 Financial risk management (continued)

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

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

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

Loans and advances – The Bank

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
31 December 2009						
Neither past due nor impaired	**108,133**	**216,001**	**13,044**	**181,929**	**410,974**	**18,884**
Past due but not impaired	**–**	**8,322**	**489**	**3,131**	**11,942**	**–**
Impaired – no provision required	**–**	**787**	**2**	**2,340**	**3,129**	**–**
– provision held	**–**	**3,672**	**1,259**	**25,217**	**30,148**	**–**
Gross	**108,133**	**228,782**	**14,794**	**212,617**	**456,193**	**18,884**
Allowance for impairment losses	**–**	**(1,145)**	**(590)**	**(14,491)**	**(16,226)**	**–**
Net	**108,133**	**227,637**	**14,204**	**198,126**	**439,967**	**18,884**

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
31 December 2008						
Neither past due nor impaired	34,144	220,720	13,849	318,955	553,524	9,033
Past due but not impaired	–	10,177	516	4,547	15,240	–
Impaired – no provision required	–	672	1	1,961	2,634	–
– provision held	–	2,526	2,542	12,755	17,823	–
Gross	34,144	234,095	16,908	338,218	589,221	9,033
Allowance for impairment losses	–	(1,280)	(1,907)	(7,506)	(10,693)	–
Net	34,144	232,815	15,001	330,712	578,528	9,033

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

46 Financial risk management (continued)

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

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
31 December 2009						
Good quality	**108,133**	**211,471**	**8,557**	**111,494**		**18,884**
Satisfactory quality	**–**	**3,302**	**2,545**	**22,879**		**–**
Lower quality	**–**	**444**	**569**	**34,516**		**–**
Below standard, but not impaired	**–**	**784**	**1,373**	**13,040**		**–**
Total	**108,133**	**216,001**	**13,044**	**181,929**	**410,974**	**18,884**
31 December 2008						
Good quality	34,144	218,908	8,896	223,049		9,033
Satisfactory quality	–	1,625	3,288	50,326		–
Lower quality	–	89	534	35,971		–
Below standard, but not impaired	–	98	1,131	9,609		–
Total	34,144	220,720	13,849	318,955	553,524	9,033

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

	Loans and advances to banks £m	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
31 December 2009						
0-30 days	**–**	**4,139**	**286**	**1,592**	**6,017**	**–**
30-60 days	**–**	**1,652**	**87**	**372**	**2,111**	**–**
60-90 days	**–**	**1,065**	**17**	**405**	**1,487**	**–**
90-180 days	**–**	**1,466**	**42**	**311**	**1,819**	**–**
Over 180 days	**–**	**–**	**57**	**451**	**508**	**–**
Total	**–**	**8,322**	**489**	**3,131**	**11,942**	**–**
Fair value of collateral held	**–**	**7,234**	**n/a**	**n/a**	**n/a**	**–**
31 December 2008						
0-30 days	–	172	359	3,349	3,880	–
30-60 days	–	4,908	122	739	5,769	–
60-90 days	–	2,120	11	42	2,173	–
90-180 days	–	2,977	10	417	3,404	–
Over 180 days	–	–	14	–	14	–
Total	–	10,177	516	4,547	15,240	–
Fair value of collateral held	–	8,338	n/a	n/a	n/a	–

46 Financial risk management (continued)

Renegotiated loans and advances

Loans and advances that were renegotiated during the year and that would otherwise have been past due or impaired at 31 December 2009 totalled £3,702 million (2008: £478 million) for the Group and £2,072 million (2008: £424 million) for the Bank.

	The Group		The Bank	
Repossessed collateral	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Residential property	**1,143**	617	**981**	537
Other	**17**	–	**–**	–
Total	**1,160**	617	**981**	537

The Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

	The Group		The Bank	
Loan-to-value ratio of mortgage lending	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Analysis by loan-to-value ratio of residential mortgage lending which is neither past due nor impaired:				
Less than 70 per cent	**88,795**	92,098	**82,981**	88,276
70 per cent to 80 per cent	**37,214**	33,052	**34,422**	28,694
80 per cent to 90 per cent	**37,177**	38,877	**34,443**	35,315
Greater than 90 per cent	**72,864**	78,984	**64,155**	68,435
Total	**236,050**	243,011	**216,001**	220,720

Debt securities – analysis by credit rating:

The Group	**AAA £m**	**AA £m**	**A £m**	**BBB £m**	**Rated BB or lower £m**	**Not rated £m**	**Total £m**
As at 31 December 2009							
Debt securities held at fair value through profit or loss							
Trading assets							
Government securities	**2,059**	**805**	**–**	**–**	**–**	**–**	**2,864**
Corporate and other debt securities	**1,331**	**1,613**	**2,608**	**283**	**28**	**–**	**5,863**
Total held as trading assets	**3,390**	**2,418**	**2,608**	**283**	**28**	**–**	**8,727**
Other assets held at fair value through profit or loss							
Corporate and other debt securities	**–**	**–**	**–**	**–**	**–**	**4**	**4**
Total held at fair value through profit or loss*	**3,390**	**2,418**	**2,608**	**283**	**28**	**4**	**8,731**
Available-for-sale financial assets							
Debt securities:							
Government securities	**12**	**314**	**–**	**–**	**–**	**–**	**326**
Bank and building society certificates of deposit	**22**	**142**	**99**	**22**	**–**	**–**	**285**
Asset-backed securities:							
Mortgage-backed securities	**17**	**–**	**–**	**–**	**–**	**–**	**17**
Other asset-backed securities	**69**	**10**	**–**	**–**	**–**	**–**	**79**
	86	**10**	**–**	**–**	**–**	**–**	**96**
Corporate and other debt securities	**2,011**	**6,653**	**8,667**	**1,350**	**228**	**15**	**18,924**
Total debt securities held as available-for-sale financial assets	**2,131**	**7,119**	**8,766**	**1,372**	**228**	**15**	**19,631**
Debt securities classified as loans and receivables							
Asset-backed securities:							
Mortgage-backed securities	**9,192**	**2,917**	**1,524**	**890**	**1,032**	**–**	**15,555**
Other asset-backed securities	**11,768**	**2,308**	**1,383**	**412**	**835**	**–**	**16,706**
	20,960	**5,225**	**2,907**	**1,302**	**1,867**	**–**	**32,261**
Corporate and other debt securities	**–**	**–**	**–**	**–**	**–**	**865**	**865**
Total debt securities classified as loans and receivables	**20,960**	**5,225**	**2,907**	**1,302**	**1,867**	**865**	**33,126**

*This total excludes equity shares of £252 million and loans and advances of £18,884 million.

46 Financial risk management (continued)

Debt securities – analysis by credit rating:

The Group

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2008							
Debt securities held at fair value through profit or loss							
Trading assets							
Government securities	5,556	236	–	–	–	–	5,792
Corporate and other debt securities	2,543	2,626	2,307	106	164	–	7,746
Total held as trading assets	8,099	2,862	2,307	106	164	–	13,538
Other assets held at fair value through profit or loss							
Asset-backed securities	346	–	–	–	–	–	346
Corporate and other debt securities	–	62	–	–	–	155	217
Total held at fair value through profit or loss*	8,445	2,924	2,307	106	164	155	14,101
Available-for-sale financial assets							
Debt securities:							
Government securities	23	343	–	14	–	–	380
Bank and building society certificates of deposit	1,032	977	904	45	–	–	2,958
Asset-backed securities:							
Mortgage-backed securities	5	12	–	–	–	–	17
Other asset-backed securities	240	591	–	–	–	12	843
	245	603	–	–	–	12	860
Corporate and other debt securities	3,739	9,302	7,926	298	204	111	21,580
Total debt securities held as available-for-sale financial assets	5,039	11,225	8,830	357	204	123	25,778
Debt securities classified as loans and receivables							
Asset-backed securities:							
Mortgage-backed securities	13,090	1,930	824	1,054	1,375	–	18,273
Other asset-backed securities	15,649	1,735	1,422	785	1,192	–	20,783
	28,739	3,665	2,246	1,839	2,567	–	39,056
Corporate and other debt securities	–	–	–	–	–	745	745
Total debt securities classified as loans and receivables	28,739	3,665	2,246	1,839	2,567	745	39,801

*This total excludes equity shares of £296 million and loans and advances of £9,033 million

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

46 Financial risk management (continued)

Debt securities – analysis by credit rating:

The Bank

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2009							
Debt securities held at fair value through profit or loss							
Trading assets							
Government securities	**2,059**	**805**	**–**	**–**	**–**	**–**	**2,864**
Corporate and other debt securities	**1,331**	**1,613**	**2,608**	**283**	**28**	**–**	**5,863**
Total held as trading assets	**3,390**	**2,418**	**2,608**	**283**	**28**	**–**	**8,727**
Other assets held at fair value through profit or loss							
Corporate and other debt securities	**–**	**–**	**–**	**–**	**–**	**4**	**4**
Total held at fair value through profit or loss	**3,390**	**2,418**	**2,608**	**283**	**28**	**4**	**8,731**
Available-for-sale financial assets							
Debt securities:							
Government securities							
Other public sector securities	**12**	**313**	**–**	**–**	**–**	**–**	**325**
Bank and building society certificates of deposit	**22**	**142**	**99**	**22**	**–**	**–**	**285**
Asset-backed securities	**50**	**10**	**–**	**–**	**–**	**–**	**60**
Corporate and other debt securities	**2,011**	**6,382**	**7,633**	**1,313**	**228**	**2**	**17,569**
Total debt securities held as available-for-sale assets	**2,095**	**6,847**	**7,732**	**1,335**	**228**	**2**	**18,239**
As at 31 December 2008							
Debt securities held at fair value through profit or loss							
Trading assets							
Government securities	5,556	236	–	–	–	–	5,792
Corporate and other debt securities	2,543	2,626	2,307	106	164	–	7,746
Total held as trading assets	8,099	2,862	2,307	106	164	–	13,538
Other assets held at fair value through profit or loss							
Asset-backed securities	346	–	–	–	–	–	346
Total held at fair value through profit or loss	8,445	2,862	2,307	106	164	–	13,884
Available-for-sale financial assets							
Debt securities:							
Government securities	23	342	–	14	–	–	379
Bank and building society certificates of deposit	1,032	977	904	45	–	–	2,958
Asset-backed securities	101	47	–	–	–	–	148
Corporate and other debt securities	3,739	8,305	7,216	272	204	55	19,791
Total debt securities	4,895	9,671	8,120	331	204	55	23,276
Treasury bills and other bills	–	–	–	–	–	–	–
Total held as available-for-sale assets	4,895	9,671	8,120	331	204	55	23,276

(2) Market Risk

Interest rate risk

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

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

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate mortgage portfolio.

At 31 December 2009 the aggregate notional principal of interest rate swaps designated as fair value hedges was £53,979 million (2008: £67,649 million) with a net fair value asset of £2,496 million (2008: £3,933 million) (see derivative note 15). The losses on the hedging instruments were £1,125 million (2008: gains of £2,413 million). The gains on the hedged items attributable to the hedged risk were £1,103 million (2008: losses of £2,246 million).

46 Financial risk management (continued)

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next six years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2009 was £229,390 million (2008: £323,971 million) with a net fair value liability of £2,029 million (2008: £1,119 million) (see note 15). In 2009, ineffectiveness recognised in the income statement that arises from cash flow hedges was £5 million (2008: £2 million). There were no transactions for which cash flow hedge accounting had to be ceased in 2009 or 2008 as a result of the highly probable cash flows no longer being expected to occur.

Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market risk function.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using cross currency borrowings.

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

	The Group		The Bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Functional currency of Group operations:				
Euro:				
Gross exposure	**1,906**	2,201	**–**	–
Net exposure	**(1,906)**	(2,201)	**–**	–
	–	–	**–**	–
US dollar:				
Gross exposure	**(62)**	191	**(14)**	39
Net exposure	**62**	(181)	**14**	(29)
	–	10	**–**	10
Australian Dollar:				
– Gross exposure	**1,869**	2,015	**–**	–
– Net investment hedge	**(1,832)**	(2,015)	**–**	–
	37	–	**–**	–
Other non-sterling	**(2)**	(23)	**–**	–
	35	(13)	**–**	10

46 Financial risk management (continued)

(3) Liquidity risk

The table below analyses financial instrument liabilities of the Group, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
As at 31 December 2009						
Deposits from banks	**82,967**	**71,519**	**16,167**	**2,281**	**2,493**	**175,427**
Customer deposits	**159,232**	**29,194**	**23,271**	**20,267**	**35,997**	**267,961**
Trading and other financial liabilities at fair value through profit or loss	**15,471**	**5,120**	**6,684**	**134**	**–**	**27,409**
Debt securities in issue	**14,169**	**11,938**	**18,722**	**69,671**	**20,270**	**134,770**
Subordinated liabilities	**28**	**60**	**658**	**3,396**	**15,306**	**19,448**
Total non-derivative financial liabilities	**271,867**	**117,831**	**65,502**	**95,749**	**74,066**	**625,015**
Derivative financial liabilities:						
Gross settled derivatives – outflow	**14,582**	**6,021**	**8,282**	**37,602**	**37,720**	**104,207**
Gross settled derivatives – inflow	**(14,399)**	**(6,134)**	**(8,364)**	**(37,097)**	**(36,202)**	**(102,196)**
Gross settled derivatives – netflow	**183**	**(113)**	**(82)**	**505**	**1,518**	**2,011**
Gross settled derivatives liabilities	**16,135**	**1,017**	**3,349**	**3,254**	**93**	**23,848**
Total derivative financial liabilities	**16,318**	**904**	**3,267**	**3,759**	**1,611**	**25,859**
As at 31 December 2008						
Deposits from banks	49,711	41,710	3,880	1,428	492	97,221
Customer deposits	176,183	16,669	42,758	25,795	30,133	291,538
Trading and other financial liabilities at fair value through profit or loss	10,994	4,640	3,518	–	–	19,152
Debt securities in issue	21,684	25,443	40,453	83,513	26,732	197,825
Subordinated liabilities	28	861	1,150	5,936	20,636	28,611
Total non-derivative financial liabilities	258,600	89,323	91,759	116,672	77,993	634,347
Derivative financial liabilities:						
Gross settled derivatives – outflow	35,701	31,615	19,016	42,827	35,077	164,236
Gross settled derivatives – inflow	(36,761)	(32,588)	(19,028)	(42,323)	(33,121)	(163,821)
Gross settled derivatives – netflow	(1,060)	(973)	(12)	504	1,956	415
Net settled derivative liabilities	1,041	1,085	8,557	15,198	7,576	33,457
Total derivative financial liabilities	(19)	112	8,545	15,702	9,532	33,872

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

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

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £11 million (2008: £15 million) of the Group and the Bank per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

46 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
As at 31 December 2009						
Deposits from banks	**81,295**	**72,141**	**11,601**	**2,081**	**5,254**	**172,372**
Customer deposits	**140,095**	**24,417**	**20,438**	**53,462**	**74,138**	**312,550**
Trading and other financial liabilities at fair value through profit or loss	**15,471**	**5,120**	**6,684**	**134**	**–**	**27,409**
Debt securities in issue	**5,659**	**10,611**	**20,750**	**42,282**	**23,830**	**103,132**
Subordinated liabilities	**28**	**60**	**915**	**2,699**	**15,194**	**18,896**
Total non-derivative financial liabilities	**242,548**	**112,349**	**60,388**	**100,658**	**118,416**	**634,359**
Derivative financial liabilities:						
Gross settled derivatives – outflow	**14,567**	**7,440**	**8,354**	**37,592**	**37,393**	**105,346**
Gross settled derivatives – inflow	**(14,399)**	**(7,472)**	**(8,434)**	**(37,095)**	**(36,172)**	**(103,572)**
Gross settled derivatives – netflow	**168**	**(32)**	**(80)**	**497**	**1,221**	**1,774**
Net settled derivative liabilities	**16,083**	**1,003**	**3,291**	**3,029**	**308**	**23,714**
Total derivative financial liabilities	**16,251**	**971**	**3,211**	**3,526**	**1,529**	**25,488**
As at 31 December 2008						
Deposits from banks	51,118	40,900	5,620	8,779	579	106,996
Customer deposits	182,915	14,092	40,341	110,496	40,647	388,491
Trading and other financial liabilities at fair value through profit or loss	10,994	4,640	3,518	–	–	19,152
Debt securities in issue	18,543	30,011	46,030	58,627	30,634	183,845
Subordinated liabilities	28	861	1,121	5,138	20,636	27,784
Total non-derivative financial liabilities	263,598	90,504	96,630	183,040	92,496	726,268
Derivative financial liabilities:						
Gross settled derivatives – outflow	37,667	33,718	18,561	39,760	34,320	164,026
Gross settled derivatives – inflow	(38,784)	(34,704)	(18,578)	(39,254)	(32,721)	(164,041)
Gross settled derivatives – netflow	(1,117)	(986)	(17)	506	1,599	(15)
Net settled derivative liabilities	877	1,087	8,571	15,183	7,161	32,879
Total derivative financial liabilities	(240)	101	8,554	15,689	8,760	32,864

46 Financial risk management (continued)

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

The Group	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2009					
Acceptances and endorsements	**5**	**–**	**–**	**–**	**5**
Other contingent liabilities	**489**	**54**	**753**	**54**	**1,350**
Total contingent liabilities	**494**	**54**	**753**	**54**	**1,355**
Lending commitments	**36,318**	**3,283**	**10,787**	**3,595**	**53,983**
Other commitments	**55**	**–**	**14**	**–**	**69**
Total commitments	**36,373**	**3,283**	**10,801**	**3,595**	**54,052**
Total contingents and commitments	**36,867**	**3,337**	**11,554**	**3,649**	**55,407**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2008					
Acceptances and endorsements	–	–	–	–	–
Other contingent liabilities	495	74	644	139	1,352
Total contingent liabilities	495	74	644	139	1,352
Lending commitments	50,211	1,492	15,272	9,577	76,552
Other commitments	83	–	54	–	137
Total commitments	50,294	1,492	15,326	9,577	76,689
Total contingents and commitments	50,789	1,566	15,970	9,716	78,041

The Bank	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2009					
Acceptances and endorsements	**3**	**–**	**–**	**–**	**3**
Other contingent liabilities	**392**	**11**	**748**	**1,280**	**2,431**
Total contingent liabilities	**395**	**11**	**748**	**1,280**	**2,434**
Lending commitments	**57,040**	**2,647**	**10,609**	**3,254**	**73,550**
Other commitments	**20**	**–**	**14**	**–**	**34**
Total commitments	**57,060**	**2,647**	**10,623**	**3,254**	**73,584**
Total contingents and commitments	**57,455**	**2,658**	**11,371**	**4,534**	**76,018**
31 December 2008					
Acceptances and endorsements	–	–	–	–	–
Other contingent liabilities	295	–	638	119	1,052
Total contingent liabilities	295	–	638	119	1,052
Lending commitments	47,116	3,142	14,380	6,681	71,319
Other commitments	43	19	14	–	76
Total commitments	47,159	3,161	14,394	6,681	71,395
Total contingents and commitments	47,454	3,161	15,032	6,800	72,447

47 Capital

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

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

The Group's capital resources are summarised as follows:

	2009 £m	2008 £m
Tier 1 capital	**25,565**	17,328
Tier 2 capital	**14,112**	15,238
	39,677	32,566
Supervisory deductions	**(1,062)**	(919)
Total capital	**38,615**	31,647

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities.

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

During the year, the individual entities within the Group and the Group complied with all of the externally imposed capital requirements to which they are subject.

48 Prior year reclassifications

The following table sets out the balance sheet as at 31 December 2008 of the Group as presented in the 2008 financial statements for the Group with reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group plc.

Consolidated balance sheet as at 31 December 2008

		As previously presented £m	Balance sheet reclassifications £m	As restated £m
Assets				
Cash and balances at central banks		2,502	–	2,502
Items in course of collection from banks		445	–	445
Trading and other financial assets designated at fair value	(i)	22,571	859	23,430
Derivative financial instruments		50,517	–	50,517
Loans and receivables:				
Loans and advances to customers	(v)	473,015	15,198	488,213
Loans and advances to banks		12,445	–	12,445
Debt securities	(i)	–	38,878	38,878
		485,460	54,076	539,536
Investment securities	(i)	67,772	(67,772)	–
Available-for-sale financial assets	(i)	–	28,035	28,035
Interests in joint ventures and associates		1,193	–	1,193
Goodwill	(iv)	–	667	667
Goodwill and other intangible assets	(iv)	1,148	(1,148)	–
Other intangible assets	(iv)	–	108	108
Property and equipment/tangible fixed assets	(ii), (iv)	1,187	4,340	5,527
Investment property		43	–	43
Operating lease assets	(ii)	3,967	(3,967)	–
Deferred costs	(iii)	2	(2)	–
Current tax assets		865	–	865
Deferred tax assets		3,182	–	3,182
Other assets	(iii)	2,430	696	3,126
Prepayments and accrued income	(iii)	694	(694)	–
Total assets		643,978	15,198	659,176
Liabilities				
Deposits from banks		97,066	–	97,066
Customer deposits	(v)	262,201	15,198	277,399
Items in course of transmission to banks	(vi)	–	521	521
Trading and other financial liabilities at fair value		18,851	–	18,851
Derivative financial instruments		40,827	–	40,827
Debt securities in issue		188,448	–	188,448
Notes in circulation		957	–	957
Other liabilities	(vi)	2,250	1,985	4,235
Current tax liabilities		23	–	23
Accruals and deferred income	(vi)	2,306	(2,306)	–
Other provisions	(vi)	345	(200)	145
Subordinated liabilities/other borrowed funds		18,779	–	18,779
Total liabilities		632,053	15,198	647,251
Net assets		11,925	–	11,925

Notes to the consolidated financial statements

48 Prior year reclassifications (continued)

The significant balance sheet reclassifications (none of which require the remeasurement of an asset or liability) are in relation to:

(i) the reclassification of investment securities (£67,772 million) to trading and other financial assets at fair value through the profit and loss (£859 million); available-for-sale financial assets (£28,035 million) and debt securities classified as loans and receivables (£38,878 million);

(ii) the reclassification of operating lease assets (£3,967 million) to tangible fixed assets;

(iii) the reclassification of deferred costs (£2 million) and prepayments and accrued income (£694 million) to other assets;

(iv) the reclassification of goodwill and intangible assets into their separate components, goodwill (£667 million) and other intangibles (£108 million), and the reclassification of software items deemed integral to the equipment balance from within intangibles to tangible fixed assets (£373 million);

(v) the representation of certain customer deposit amounts (£15,198 million) available for offset onto a gross basis; and

(vi) the reclassification of accruals and deferred income (£2,306 million) to other liabilities, the reclassification of other liabilities (£521 million) to items in the course of transmission to banks. The reclassification of other provisions (£200 million) to other liabilities.

The following table sets out the balance sheet as at 31 December 2008 as presented in the 2008 financial statements of the Bank with a prior year adjustment and reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group plc:

Bank balance sheet as at 31 December 2008

			Adjustments		
		As previously presented £m	Prior year adjustment £m	Balance sheet reclassifications £m	As restated £m
Assets					
Cash and balances at central banks		1,820	–	–	1,820
Items in course of collection from banks		449	–	–	449
Trading and other assets designated at fair value through profit or loss	(i)	22,571	–	349	22,920
Derivative financial instruments		46,374	(3,114)	–	43,260
Loans and receivables:					
Loans and advances to banks		34,144	–	–	34,144
Loans and advances to customers	(v)	570,255	(6,925)	15,198	578,528
Debt securities	(i)	–	(63,905)	83,164	19,259
		604,399	(70,830)	98,362	631,931
Investment securities	(i)	107,852	–	(107,852)	–
Available-for-sale financial assets	(i)	–	–	24,339	24,339
Investment in subsidiary undertakings		4,383	–	–	4,383
Interests in joint ventures and associates		103	–	–	103
Goodwill and other intangible assets	(iv)	770	–	(770)	–
Goodwill	(iv)	–	–	376	376
Other intangible assets	(iv)	–	–	98	98
Property and equipment/tangible fixed assets	(ii)	1,061	–	298	1,359
Operating lease assets	(ii)	2	–	(2)	–
Current tax assets		1,180	–	–	1,180
Deferred tax assets		2,123	440	–	2,563
Retirement benefit asset		–	–	–	–
Other assets	(iii)	2,661	(350)	565	2,876
Prepayments and accrued income	(iii)	565	–	(565)	–
Total assets		796,313	(73,854)	15,198	737,657

48 Prior year reclassifications (continued)

Bank balance sheet as at 31 December 2008

			Adjustments		
		As previously presented £m	Prior year adjustment £m	Balance sheet reclassifications £m	As restated £m
Liabilities					
Deposits from banks		97,091	–	–	97,091
Customer deposits	(v)	458,967	(100,992)	15,198	373,173
Items in course of transmission to banks	(vi)	–	–	522	522
Notes in circulation		957	–	–	957
Trading and other financial liabilities at fair value through profit or loss		18,851	–	–	18,851
Derivative financial instruments		39,648	(35)	–	39,613
Debt securities in issue		143,456	29,008	–	172,464
Other liabilities	(vi)	2,359	548	1,515	4,422
Accruals and deferred income	(vi)	1,837	–	(1,837)	–
Other provisions	(vi)	332	–	(200)	132
Subordinated liabilities/other borrowed funds		18,082	–	–	18,082
Total liabilities		781,580	(71,471)	15,198	725,307
Net assets		14,733	(2,383)	–	12,350

Prior year adjustment

For further details of the prior year adjustment, refer to the end of this note.

Balance sheet reclassifications

The significant balance sheet reclassifications (none of which require the remeasurement of an asset or liability) are in relation to:

(i) the reclassification of investment securities (£107,852 million) to trading and other financial assets designated at fair value (£349 million); available-for-sale financial assets (£24,339 million), and debt securities classified as loans and receivables (£83,164 million);

(ii) the reclassification of operating lease assets (£2 million) to tangible fixed assets;

(iii) the reclassification of prepayments and accrued income (£565 million) to other assets;

(iv) the reclassification of goodwill and intangible assets into their separate components, goodwill (£376 million) and other intangibles (£98 million), and the reclassification of software items deemed integral to the equipment balance from within intangibles to tangible fixed assets (£296 million);

(v) the representation of certain customer deposit amounts (£15,198 million) available for offset onto a gross basis;

(vi) the reclassification of accruals and deferred income (£1,837 million) to other liabilities, the reclassification of other liabilities (£522 million) to items in the course of transmission to banks. The reclassification of other provisions (£200 million) to other liabilities.

48 Prior year reclassifications (continued)

The following table sets out the balance sheet as at 1 January 2008 as presented in the 2008 financial statements of the Group with reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group plc:

Consolidated balance sheet as at 1 January 2008

		As previously presented £m	Balance sheet reclassifications £m	As restated £m
Assets				
Cash and balances at central banks		2,944	–	2,944
Items in course of collection from banks		945	–	945
Trading and other assets designated at fair value through profit or loss	(i)	54,681	1,108	55,789
Derivative financial instruments		13,794	–	13,794
Loans and receivables:				
Loans and advances to banks		4,095	–	4,095
Loans and advances to customers	(v)	460,267	24,934	485,201
Debt securities	(i)	–	527	527
		464,362	25,461	489,823
Investment securities	(i)	51,615	(51,615)	–
Available-for-sale financial assets	(i)	–	49,980	49,980
Investment property		34	–	34
Interests in joint ventures and associates		1,739	–	1,739
Goodwill and other intangible assets	(iv)	1,517	(1,517)	–
Goodwill	(iv)	–	1,041	1,041
Other intangible assets	(iv)	–	110	110
Property and equipment/tangible fixed assets	(ii), (iv)	1,291	5,009	6,300
Operating lease assets	(ii)	4,643	(4,643)	–
Deferred costs	(iii)	4	(4)	–
Other asset	(iii)	4,633	1,434	6,067
Prepayments and accrued income	(iii)	1,430	(1,430)	–
Total assets		603,632	24,934	628,566

48 Prior year reclassifications (continued)

Consolidated balance sheet as at 1 January 2008

		As previously presented £m	Balance sheet reclassifications £m	As restated £m
Liabilities				
Deposits from banks		41,513	–	41,513
Customer deposits	(v)	272,687	24,934	297,621
Items in course of transmission to banks	(vi)	–	542	542
Notes in circulation		881	153	1,034
Trading and other financial liabilities at fair value through profit or loss		22,705	(153)	22,552
Derivative financial instruments		12,160	–	12,160
Debt securities in issue		206,520	–	206,520
Insurance contract liabilities	(vii)	24	(24)	–
Investment contract liabilities	(vii)	98	(98)	–
Liabilities arising from insurance contracts and participating investment contracts	(vii)	–	24	24
Liabilities arising from non-participating investment contracts	(vii)	–	98	98
Other liabilities	(vi)	2,560	2,352	4,912
Retirement benefit obligations		–	–	–
Current tax liabilities		728	–	728
Deferred tax liabilities		965	–	965
Accruals and deferred income	(vi)	2,894	(2,894)	–
Other provisions		172	–	172
Subordinated liabilities/other borrowed funds		17,881	–	17,881
Total liabilities		581,788	24,934	606,722
Net assets		21,844	–	21,844

The significant balance sheet reclassifications (none of which require the remeasurement of an asset or liability) are in relation to:

(i) the reclassification of investment securities (£51,615 million) to trading and other financial assets at fair value through the profit or loss (£1,108 million); available-for-sale financial assets (£49,980 million), and debt securities classified as loans and receivables (£527 million);

(ii) the reclassification of operating lease assets (£4,643 million) to tangible fixed assets;

(iii) the reclassification of prepayments and accrued income (£1,430 million) and deferred costs (£4 million) to other assets;

(iv) the reclassification of goodwill and intangible assets into their separate components goodwill (£1,041 million), other intangibles (£110 million), and the reclassification of software items deemed integral to the equipment balance within intangibles to tangible fixed assets (£366 million);

(v) the representation of certain customer deposit amounts (£24,934 million) available for offset onto a gross basis; and

(vi) the reclassification of accruals and deferred income (£2,894 million) to other liabilities, the reclassification of other liabilities (£542 million) to items in the course of transmission to banks.

(vii) the reclassification of insurance contract liabilities (£24 million) to liabilities arising from insurance contracts and participating investment contracts, and the reclassification of investment contract liabilities (£98 million) to liabilities arising from non-participating investment contracts.

48 Prior year reclassifications (continued)

The following table sets out the balance sheet as at 1 January 2008 as presented in the 2008 financial statements of the Bank with a prior year adjustment and reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group plc.

Bank balance sheet as at 1 January 2008

			Adjustments		
		As previously presented £m	Prior year adjustment £m	Balance sheet reclassifications £m	As restated £m
Assets					
Cash and balances at central banks		1,667	–	–	1,667
Items in course of collection from banks		890	–	–	890
Trading and other assets designated at fair value through profit or loss	(i)	52,169	–	405	52,574
Derivative financial instruments		12,134	(67)	–	12,067
Loans and receivables:					
Loans and advances to banks		25,458	–	–	25,458
Loans and advances to customers	(v)	453,590	316	24,934	478,840
Debt securities	(i)	–	–	7	7
		479,048	316	24,941	504,305
Investment securities	(i)	27,020	–	(27,020)	–
Available-for-sale financial assets	(i)	–	–	26,608	26,608
Investment in subsidiary undertakings		3,273	25	–	3,298
Interests in joint ventures and associates		103	–	–	103
Goodwill and other intangible assets	(iv)	783	–	(783)	–
Goodwill	(iv)	–	–	426	426
Other intangible assets	(iv)	–	–	88	88
Property and equipment/tangible fixed assets	(ii), (iv)	1,108	–	298	1,406
Operating lease assets	(ii)	29	–	(29)	–
Deferred tax assets		152	13	–	165
Other assets	(iii)	4,364	(325)	1,292	5,331
Prepayments and accrued income	(iii)	1,292	–	(1,292)	–
Total assets		584,032	(38)	24,934	608,928

48 Prior year reclassifications (continued)

Bank balance sheet as at 1 January 2008

			Adjustments		
		As previously presented £m	Prior year adjustment £m	Balance sheet reclassifications £m	As restated £m
Liabilities					
Deposits from banks		47,321	–	–	47,321
Customer deposits	(v)	316,849	(9,461)	24,934	332,322
Items in course of transmission to banks	(vi)	–	–	543	543
Notes in circulation		881	–	–	881
Trading and other financial liabilities at fair value through profit or loss		22,145	–	–	22,145
Derivative financial instruments		10,546	(473)	–	10,073
Debt securities in issue		149,188	9,069	–	158,257
Other liabilities	(vi)	1,735	–	1,233	2,968
Current tax liabilities		544	–	–	544
Accruals and deferred income	(vi)	1,654	–	(1,654)	–
Other provisions	(vi)	135	468	(122)	481
Subordinated liabilities/other borrowed funds		14,855	–	–	14,855
Total liabilities		565,853	(397)	24,934	590,390
Net assets		18,179	359	–	18,538

Prior year adjustment
For further details of the prior year adjustment at 1 January 2008, refer to the end of this note.

Balance sheet reclassifications
The significant balance sheet reclassifications (none of which require the remeasurement of an asset or liability) are in relation to:

(i) the reclassification of investment securities (£27,020 million) to trading and other assets at fair value through the profit or loss (£405 million); available-for-sale financial assets (£26,608 million) and debt securities classified as loans and receivables (£7 million);

(ii) the reclassification of operating lease assets (£29 million) to tangible fixed assets;

(iii) the reclassification of prepayments and accrued income (£1,292 million) to other assets;

(iv) the reclassification of goodwill and intangible assets into their separate components goodwill (£426 million) and other intangibles (£88 million), and the reclassification of software items deemed integral to the equipment balance within intangibles to tangible fixed assets (£269 million);

(v) the representation of certain customer deposit accounts (£24,934 million) available for offset onto a gross basis; and

(vi) the reclassification of accruals and deferred income (£1,654 million) to other liabilities the reclassification of other liabilities (£543 million) to items in the course of transmission to banks and the reclassification of other provisions (£122 million) to other liabilities.

48 Prior year reclassifications (continued)

The following table sets out the income statement for the year ended 31 December 2008 of the Group as presented in the 2008 financial statements for the Group with reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group plc.

Income statement for the year to 31 December 2008

The Group		As previously presented £m	Reclassifications £m	As restated £m
Interest and similar income	(i)	39,332	(3,239)	36,093
Interest and similar expense	(i)	(31,039)	3,486	(27,553)
Fee and commission income	(i)	2,208	(247)	1,961
Fee and commission expense		(382)	–	(382)
Net earned premiums on insurance contracts		215	(215)	–
Net trading income		(2,963)	25	(2,938)
Net investment income related to insurance and investment business		34	(34)	–
Insurance premium income		–	215	215
Other operating income		1,665	111	1,776
Change in investment contract liabilities		17	(17)	–
Net claims incurred on insurance contracts		(76)	76	–
Net change in insurance contract liabilities		22	(22)	–
Insurance claims		–	(37)	(37)
Operating expenses	(ii)	–	(5,937)	(5,937)
Administrative expenses	(ii)	(4,253)	4,253	–
Depreciation and amortisation:				
Intangible assets other than goodwill	(ii)	(153)	153	–
Property and equipment	(ii)	(211)	211	–
Operating lease assets	(ii)	(1,178)	1,178	–
		(1,542)	1,542	–
Goodwill impairment	(ii)	(142)	142	–
Impairment losses on loans and advances	(iii)	(9,857)	9,857	–
Impairment on investment securities	(iii)	(2,193)	2,193	–
Impairment	(iii)	–	(12,050)	(12,050)
Share of profits of jointly controlled entities	(iv)	(651)	651	–
Share of losses of associated undertakings	(iv)	(287)	287	–
Share of results of joint ventures and associates	(iv)	–	(938)	(938)
Non-operating income/loss on sale of businesses		(743)	(102)	(845)
Loss before taxation		(10,635)	–	(10,635)
Tax		2,448	–	2,448
Loss for the year		(8,187)	–	(8,187)

Certain income statement captions and presentations have been aligned to a basis consistent with the practices adopted by the Lloyds Banking Group. The significant income statement reclassifications are in relation to:

(i) the representation of certain derivative income amounts (£3,486 million) that are available for offset onto a net basis from within interest and similar income to interest and similar expense and the reclassification of certain loan fees from fee and commission income to interest and similar income (£247 million) as they form part of the effective yield;

(ii) the reclassification of administrative expenses (£4,253 million), depreciation and amortisation (£1,542 million) and goodwill impairment (£142 million) to operating expenses;

(iii) the reclassification of impairment losses on loans and advances (£9,857 million) and investment securities (£2,193 million) to impairment losses; and

(vi) the reclassification of share of profits of jointly controlled entities (£651 million) and share of losses of associated undertakings (£287 million) to shares of results of joint ventures and associates.

Prior year adjustment

On 16 January 2009, the Bank as the principal banking subsidiary of the HBOS Group was acquired by Lloyds Banking Group. Following the acquisition the Bank adopted the accounting practices of the Lloyds Banking Group.

The essential features of the change in practices, relating to the accounting for Securitisation and Covered Bond activities which are only applicable to the Bank and have no impact at a consolidated level set below:

(a) Where the Bank transfers mortgage assets to a Special Purpose Vehicles (SPV) and the parties enter into a basis swap where the SPV pays the Bank the interest received on the mortgages and receives LIBOR based payments in return. In prior periods the Bank separately recognised these swaps in the accounts of the Bank and the SPVs. The Bank now incorporates these swaps into the deemed loan rather than separately recognising them and accordingly; in order to align with Lloyds Banking Group practices, the swaps that were previously separately recognised are derecognised for all periods presented. Deferred tax balances on the fair values of these swaps are also reversed. The impact of this is to reduce derivative financial assets and retained earnings by £2,383 million at 31 December 2008 and decrease derivative financial liabilities and increase retained earnings by £359 million at 1 January 2008.

Notes to the consolidated financial statements

48 Prior year reclassifications (continued)

(b) The Bank previously recorded an asset and an associated liability for certain notes issued from SPVs where those notes were bought back by the Bank rather than sold to third parties. These notes are held for the purposes of accessing central bank liquidity schemes, or used in other collateral pledging transactions. Following a review of the Bank's accounting treatment for such notes, the Bank will not record an asset for the notes it retains. As a consequence, the Bank will show on its balance sheet a financing liability for the amount of the securitisation notes held by third parties, but will not show a liability in relation to notes which it holds itself on the basis that the transaction is purely internal and there is no observable external market data for similar retained transactions.

49 Ultimate parent undertaking

From 16 January 2009, Bank of Scotland plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc (formerly Lloyds TSB Group plc) which is incorporated in Scotland. Lloyds Banking Group plc will produce consolidated accounts for the year ended 31 December 2009. Copies of the annual report and accounts of Lloyds TSB Group plc for the year ended 31 December 2008 may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com

Prior to 16 January 2009, HBOS plc was the ultimate parent undertaking of Bank of Scotland plc. Copies of the annual report and accounts of HBOS plc for the year ended 31 December 2008 may be obtained from HBOS plc's registered office at The Mound, Edinburgh, EH1 1YZ or downloaded via www.lloydsbankinggroup.com.

50 Future accounting developments

The following pronouncements will be relevant to the Group but were not effective at 31 December 2009 and have not been applied in preparing these financial statements. The full impact of these accounting changes is being assessed by the Group. With the exception of IFRS 9 'Financial Instruments: Classification and Measurement', the initial view is that none of these pronouncements are expected to cause any material adjustments to reported numbers in the financial statements.

IFRS 9 is the initial stage of a project to replace IAS 39 'Financial Instruments: Recognition and Measurement' and will fundamentally change the way in which the Group accounts for financial instruments. Future stages are expected to result in amendments to IFRS 9 to deal with classification and measurement of financial liabilities, amortised cost and impairment and hedge accounting. Until all stages of the replacement project are complete, it is not possible to determine the overall impact on the financial statements from the replacement of IAS 39.

Pronouncement	Nature of change	Effective date
IFRS 3 *Business Combinations*	The revised standard continues to apply the acquisition method to business combinations, however, all payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the minority interest, and all transaction costs are expensed.	Annual periods beginning on or after 1 July 2009.
IAS 27 *Consolidated and Separate Financial Statements*	Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is re-measured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.	Annual periods beginning on or after 1 July 2009.
IFRIC 17 *Distributions of Non-cash Assets to Owners*	Provides accounting guidance for non-reciprocal distributions of non-cash assets to owners (and those in which owners may elect to receive a cash alternative).	Annual periods beginning on or after 1 July 2009.
Amendment to IAS 39 *Financial Instruments: Recognition and Measurement – Eligible Hedged Items*	Clarifies how the principles underlying hedge accounting should be applied in particular situations.	Annual periods beginning on or after 1 July 2009.
Improvements to IFRSs[1] (issued April 2009)	Sets out minor amendments to IFRS standards as part of annual improvements process.	Dealt with on a standard by standard basis but not earlier than annual periods beginning on or after 1 January 2010.
Amendments to IFRS 2 *Group Cash-settled Share-based Payment Transactions*[1]	Clarifies that an entity that receives goods or services in a share-based payment arrangement must account for those goods or services no matter which entity in the group settles the transaction, whether or not settled in shares or cash.	Annual periods beginning on or after 1 January 2010.
Amendment to IAS 32 *Financial Instruments: Presentation – Classification of Rights Issues*	Requires rights issues denominated in a currency other than the functional currency of the issuer to be classified as equity regardless of the currency in which the exercise price is denominated.	Annual periods beginning on or after 1 February 2010.

50 Future accounting developments (continued)

IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*[1]	Clarifies that when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor, a gain or loss is recognised in profit or loss representing the difference between the carrying value of the financial liability and the fair value of the equity instruments issued; the fair value of the financial liability is used to measure the gain or loss where the fair value of the equity instruments cannot be reliably measured.	Annual periods beginning on or after 1 July 2010.
IAS 24 *Related Party Disclosures*[1]	Simplifies the definition of a related party and provides a partial exemption from the disclosure requirements for government related entities	Annual periods beginning on or after 1 January 2011.
Amendment to IFRIC 14 *Prepayments of a Minimum Funding Requirement*[1]	Applies when an entity is subject to minimum funding requirements and makes an early payment of contributions to cover those requirements and permits such an entity to treat the benefit of such an early payment as an asset	Annual periods beginning on or after 1 January 2011.
IFRS 9 *Financial Instruments: Classification and Measurement*[1]	Replaces those parts of IAS 39 Financial Instruments: Recognition and Measurement relating to the classification and measurement of financial assets. Requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of entity's business model for managing it financial assets and the contractual cash flow characteristics of the instrument. The available-for-sale financial asset and held-to-maturity categories in existing IAS 39 will be eliminated.	Annual periods beginning on or after 1 January 2013.

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

51 Post balance sheet events

Corporate structure

On 23 December 2009 Lloyds Banking Group plc announced its intention to adjust the Group's corporate structure and transfer its current holding in the Group to Lloyds TSB Bank plc. Following this move Lloyds TSB Bank plc became the immediate parent of the Group. Lloyds Banking Group plc will continue to directly own Lloyds TSB Bank plc.

This transfer follows a review by management of the structure of the Lloyds Banking Group and a programme to develop and implement a legal entity structure that is efficient from a financial, regulatory and capital perspective. The transfer has been approved by the Financial Services Authority, and became effective on 1 January 2010.

52 Approval of financial statements

These financial statements were approved by the directors of Bank of Scotland plc on 25 February 2010.

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