# Bank of Scotland plc

## Report and Accounts

## 2014

Member of Lloyds Banking Group

# Contents

# Strategic report

**Principal activities**

Bank of Scotland plc (the Bank) and its subsidiary undertakings (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.

**Business review**

During the year ended 31 December 2014, the Group recorded a profit before tax of £3,180 million compared with a profit before tax in 2013 of £1,450 million. The result in 2014 included provisions in respect of redress to customers relating to past sales of Payment Protection Insurance and other issues of £918 million compared to a charge of £800 million in the year ended 31 December 2013. Excluding these items from both years, profit before tax was £1,848 million, or 82 per cent, higher at £4,098 million in the year ended 31 December 2014 compared to £2,250 million in the previous year.

Total income decreased by £49 million, or 1 per cent, to £7,605 million in 2014 compared with £7,654 million in 2013, comprising a £510 million increase in other income offset by a decrease of £559 million in net interest income.

Net interest income was £6,225 million in 2014; a decrease of £559 million, or 8 per cent compared to £6,784 million in 2013 reflecting the effect of disposals and the reduced portfolio of assets which are outside of the Group's risk appetite. Net interest margin benefited from improved deposit pricing and lower funding costs, partly offset by continued pressure on asset prices.

Other income was £510 million, or 59 per cent, higher at £1,380 million in 2014 compared to £870 million in 2013. Fee and commission income was £170 million, or 17 per cent, lower at £817 million compared to £987 million in 2013. Fee and commission expense reduced by £38 million, or 12 per cent, to £280 million compared with £318 million in 2013. Net trading income increased by £965 million to £771 million in 2014 compared to a deficit of £194 million in 2013. Other operating income was £323 million lower at £72 million in 2014 compared to £395 million in 2013.

Operating expenses increased by £144 million, or 4 per cent to £3,933 million in 2014 compared with £3,789 million in 2013; the main reason for the increase being the £118 million increase in charges for regulatory provisions from £800 million in 2013 to £918 million in 2014. Excluding these charges from both years, operating expenses were £26 million, or 1 per cent, higher at £3,015 million in 2014 compared to £2,989 million in 2013. Staff costs were £4 million lower at £1,672 million in 2014 compared with £1,676 million in 2013; annual pay rises being offset by the impact of headcount reductions resulting from business disposals and the Group's rationalisation programmes. Premises and equipment costs were £19 million, or 6 per cent, lower at £319 million in 2014 compared with £338 million in 2013. Other expenses were £145 million, or 21 per cent, higher at £845 million in 2014 compared with £700 million in 2013. Depreciation and amortisation costs were £45 million lower at £179 million in 2014 compared to £224 million in 2013.

Impairment losses decreased by £1,923 million, or 80 per cent, to £492 million in 2014 compared with £2,415 million in 2013. Impairment losses in respect of loans and advances to customers were £1,955 million, or 81 per cent, lower at £469 million in 2014 compared with £2,424 million in 2013. The overall performance of the portfolio reflects a significant reduction in lending which is outside of the Group's risk appetite and lower levels of new impairment as a result of effective risk management, improving economic conditions and the continued low interest rate environment. The impairment charge in respect of debt securities classified as loans and receivables was a charge of £2 million in 2014 compared to a credit of £24 million in 2013 and the impairment charge in respect of available-for-sale financial assets was £11 million lower at £4 million in 2014 compared to £15 million in 2013.

In 2014, the Group recorded a tax charge of £514 million compared to a tax charge of £1,095 million in 2013. The tax charge in 2014 was £170 million lower than the charge that would arise at the standard UK corporation tax rate of 21.5 per cent; principally as a result of non-taxable income including tax exempt gains on sales of businesses. The tax charge of £1,095 million in 2013 arose on a profit before tax of £1,450 million; this tax charge reflected a £430 million charge arising from the reduction in the corporation tax rate and a £348 million write-off of deferred tax assets following the sale of the Group's Australian operations.

On the balance sheet, total assets were £187,187 million, or 33 per cent, lower at £381,225 million at 31 December 2014 compared to £568,412 million at 31 December 2013; this decrease is principally as a result of a £151,004 million reduction in amounts due from fellow Lloyds Banking Group undertakings, following a rationalisation of balances within the Lloyds Banking Group and matched on the liability side of the balance sheet by a £145,736 million reduction in amounts due to fellow Lloyds Banking Group undertakings. Loans and advances to customers were £11,964 million, or 4 per cent, lower at £271,674 million at 31 December 2014 compared to £283,638 million at 31 December 2013, as a result of the continuing reduction in the portfolio of assets which are outside of the Group's credit risk appetite, including the disposal of tranches of lending in Ireland. Debt securities in issue were £9,054 million, or 31 per cent, lower at £20,408 million at 31 December 2014 compared to £29,462 million at 31 December 2013; and customer deposits was £3,070 million, or 1 per cent, higher at £203,498 million at 31 December 2014 compared to £206,568 million at 31 December 2013. Total equity was £2,479 million, or 13 per cent, higher at £20,853 million at 31 December 2014 compared to £18,374 million at 31 December 2013; this reflected the retained profit for the year.

During 2014 the Bank reduced its share premium account by Special Resolution which was confirmed by an Order of the Court of Session, Scotland on 16 December 2014. The balance on the share premium account of £27,479 million has been transferred to retained profits.

As at 31 December 2014, the Group's capital ratios had decreased with a common equity/core tier 1 ratio of 13.3 per cent on a transitional CRD IV basis (compared to 15.2 per cent at 31 December 2013, calculated on a Basel II basis); the reduction in ratios reflects the impact of the application of transitional CRD IV rules from 1 January 2014 and adjustment to retained earnings for foreseeable dividends recommended by the Board of £5 billion for year ended 31 December 2014.

**Future developments**

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

**Capital position at 31 December 2014**

The Group's capital position applying CRD IV transitional rules as at 31 December 2014 is set out in the following section.

**Table 1.1 : Capital resources (audited)**

| Capital resources | At 31 Dec 2014 £m | At 31 Dec 2013[1] £m |
|---|---|---|
| **Common equity/core tier 1** | | |
| Shareholders' equity | **20,845** | 18,354 |
| Adjustment to retained earnings for foreseeable dividends | **(5,000)** | – |
| Regulatory filters: | | |
| Unrealised reserve on available-for-sale securities | **(134)** | (26) |
| Cash flow hedging reserve | **(484)** | (907) |
| Other adjustments | **(123)** | – |
| | **15,104** | 17,421 |
| **Less: deductions from common equity/core tier 1** | | |
| Goodwill and other intangible assets | **(423)** | (429) |
| Excess of expected losses over impairment provisions and value adjustments | **(314)** | (152) |
| Securitisation deductions | **(181)** | (48) |
| Deferred tax assets | **(2,144)** | – |
| **Common equity/core tier 1 capital** | **12,042** | 16,792 |
| **Additional tier 1** | | |
| Additional tier 1 instruments | **569** | 699 |
| **Less: deductions from tier 1** | | |
| Significant investments | **–** | (41) |
| **Total tier 1 capital** | **12,611** | 17,450 |
| **Tier 2** | | |
| Tier 2 instruments | **6,860** | 12,294 |
| Unrealised gains on available-for-sale equity investments | **–** | 84 |
| Eligible provisions | **354** | 355 |
| **Less: deductions from tier 2** | | |
| Expected losses over impairment provisions and value adjustments | **–** | (152) |
| Securitisation deductions | **–** | (48) |
| Significant investments | **–** | (41) |
| **Total tier 2 capital** | **7,214** | 12,492 |
| **Supervisory deductions** | | |
| Connected lending of a capital nature | **–** | (2,029) |
| **Total supervisory deductions** | **–** | (2,029) |
| **Total capital resources** | **19,825** | 27,913 |

**Table 1.2 : Risk Weighted Assets and Capital Ratios (unaudited)**

| | At 31 Dec 2014 £m | At 31 Dec 2013 £m |
|---|---|---|
| Risk-weighted assets | **90,550** | 110,146 |
| Common equity/core tier 1 capital ratio | **13.3%** | 15.2% |
| Tier 1 capital ratio | **13.9%** | 15.8% |
| Total capital ratio | **21.9%** | 25.3% |

[1]Calculated in line with the rules prevailing at 31 December 2013 and not restated for the implementation of CRD IV on 1 January 2014.

As at 31 December 2014, the Group's capital ratios decreased with a total capital ratio of 21.9 per cent compared with 25.3 per cent at 31 December 2013; a tier 1 capital ratio of 13.9 per cent compared with 15.8 per cent and a common equity/core tier 1 ratio of 13.3 per cent compared with 15.2 per cent. Reduction in ratios reflects the impact of the application of transitional CRD IV rules from 1 January 2014 and adjustment to retained earnings for foreseeable dividends of £5 billion for year ended 31 December 2014 as recommended by the Board of Directors. During 2014 risk-weighted assets decreased by £19.5 billion to £90.6 billion at 31 December 2014 compared with £110.1 billion at 31 December 2013; this decrease primarily reflected risk-weighted asset reductions in the Run-off portfolio, active portfolio management in the commercial business and improvements in economic conditions.

# Strategic report

**Principal risks and uncertainties**

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

**Credit risk**

*Principal risks*

Any adverse changes in the economic and market environment we operate in, or the credit quality and/or behaviour of our borrowers and counterparties would reduce the value of our assets and potentially increase our write-downs and allowances for impairment losses, adversely impacting profitability.

*Mitigating actions*

- Credit policy incorporating prudent lending criteria aligned with the Lloyds Banking Group Board approved risk appetite to effectively manage credit risk.
- Clearly defined levels of authority ensure we lend appropriately and responsibly with separation of origination and sanctioning activities.
- Robust credit processes and controls including well-established governance to ensure distressed and impaired loans are identified early, considered and controlled with independent credit risk assurance.

**Conduct risk**

*Principal risks*

We face significant potential conduct risk, including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers expectations; and exhibiting behaviours which do not meet market or regulatory standards.

*Mitigating actions*

- Customer focused conduct strategy implemented to ensure customers are at the heart of everything we do.
- Product approval, review processes and outcome testing supported by conduct management information.
- Clear customer accountabilities for colleagues, with rewards driven off customer-centric metrics.
- Learning from past mistakes, including root-cause analysis.

**Market risk**

*Principal risks*

Key market risks include interest rate risk across the business. Movements in the interest rate could impact on our balance sheet.

*Mitigating actions*

- A structural hedge programme has been implemented to manage liability margins and margin compression.
- Stress and scenario testing of risk exposures.

**Operational risk**

*Principal risks*

We face significant operational risks which may result in financial loss, disruption or damage to our reputation. These include the availability, resilience and security of our core IT systems and the potential for failings in our customer processes.

*Mitigating actions*

- Continually review IT system architecture to ensure that our systems are resilient, and the confidentiality, integrity and availability of our critical systems and information assets are protected against cyber attacks.
- Continue to implement the actions from the 2013 independent Lloyds Banking Group IT Resilience Review to enhance the resilience of systems supporting the processes most critical to our customers.

**Funding and liquidity**

*Principal risks*

Our funding and liquidity position is supported by a significant and stable customer deposit base. A deterioration in either our or the UK's credit rating, or a sudden and significant withdrawal of customer deposits could adversely impact our funding and liquidity position.

*Mitigating actions*

- Hold a large pool of unencumbered primary liquid assets and maintain a further large pool of secondary assets that can be used to access Central Bank liquidity facilities.
- Daily monitoring against a number of market and Lloyds Banking Group specific early warning indicators and regular stress tests.
- Contingency funding plan to identify emerging liquidity concerns earlier.

**Capital risk**

*Principal risks*

Our future capital position is potentially at risk from a worsening macroeconomic environment. This could lead to adverse financial performance which could deplete capital resources and/or increase capital requirements due to a deterioration in customers' creditworthiness.

*Mitigating actions*

- Close monitoring of capital and leverage ratios to ensure we meet our current and future regulatory requirements.
- Comprehensive stress testing analysis to evidence sufficient levels of capital adequacy under various adverse scenarios.
- In addition to accumulating retained profits, we can raise additional capital in a variety of ways.

**Regulatory risk**

*Principal risks*

We are subject to industry wide investigations and reviews into a perceived lack of competition in UK banking and financial services. The outcomes of the UK General Election in May 2015 and the investigations by the CMA and FCA are presently unclear and their impact therefore remains uncertain. Other initiatives under review include the ring-fencing proposals in the Banking Reform Act 2013, the new FCA Consumer Credit regime and CRD IV.

*Mitigating actions*

- The Lloyds Banking Group Legal, Regulatory and Mandatory Change Committee ensures we develop plans for regulatory changes and tracks their progress.
- Continued investment in our people, processes and IT systems is enabling us to meet our regulatory commitments.
- Continued engagement with government and regulatory authorities on forthcoming regulatory changes and market investigations and reviews.

# Strategic report

**People risk**
*Principal risks*
Key people risks include the risk that we fail to lead responsibly in an increasingly competitive marketplace, particularly with the introduction of the Senior Managers' Regime and Certification Regime which will come into force in 2015. This may dissuade capable individuals from taking up senior positions within Lloyds Banking Group.

*Mitigating actions*
– Work collaboratively with Regulators to implement the new Individual Accountability Regime in 2015, ensuring burden of proof and attestation requirements are effectively implemented.
– Maintain competitive working practices to attract, retain and engage high quality people.
– Create a work environment which listens and acts on colleague feedback.

**Financial risk management objectives and policies**
Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in note 42 on page 68. Additional information can be found in the annual report of Lloyds Banking Group plc, the Bank's ultimate parent, which does not form part of this report.

The 2014 Strategic Report has been approved by the Board of Directors.

On behalf of the Board

**Lord Blackwell**
Bank of Scotland plc
11 March 2015

# Directors' report

**Results**
The consolidated income statement on page 12 shows a statutory profit before tax for the year ended 31 December 2014 of £3,180 million.

**Dividends**
The Directors recommend to shareholders a dividend for the year ended 31 December 2014 of £5,000 million (2013: nil) to be paid on 12 March 2015.

**Post balance sheet events**
There have been no material post balance sheet events.

**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 including the continued functioning of the money and capital markets, the reduction in wholesale funding requirements resulting from Lloyds Banking Group's strategy to right-size the balance sheet and the absence of significant and sudden withdrawals of customer deposits. The Directors have also considered projections for Lloyds Banking Group's capital and funding position. Having consulted these, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

**Directors**
The names of the current Directors are shown on page 8. Changes to the composition of the Board since 1 January 2014 up to the date of this report are shown in the table below:

| | Joined the Board | Retired from the Board |
|---|---|---|
| Dyfrig John | 1 January 2014 | |
| Sir Winfried Bischoff | | 3 April 2014 |
| David Roberts | | 14 May 2014 |
| Nick Prettejohn | 23 June 2014 | |
| Simon Henry | 26 June 2014 | |
| Alan Dickinson | 8 September 2014 | |

Lord Blackwell, who has served on the Board since 1 June 2012, was appointed Chairman in place of Sir Winfried Bischoff on 3 April 2014.

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

**Directors' indemnities**
The Directors of the Bank, including the former Directors who retired during the year, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006. The deeds indemnify the Directors to the maximum extent permitted by law and remain in force for the duration of a Director's period of office. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Directors appointed in 2014. Deeds for existing Directors are available for inspection at the Bank's registered office. In addition, Lloyds Banking Group had appropriate Directors and Officers Liability Insurance cover in place throughout 2014.

Lloyds Banking Group plc has also granted a deed of indemnity through deed poll which constituted 'qualifying third party indemnity provisions' to the Directors of the Bank's subsidiary companies, including to former Directors who retired during the year and since the year end. Qualifying pension scheme indemnities were also granted to the Trustees of the Lloyds Banking Group's Pension Schemes.

**Directors' interests**
The Directors are also Directors of Lloyds Banking Group plc and their interests in shares in Lloyds Banking Group plc are shown in the report and accounts of that company.

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

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

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

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

**Branches, future developments and financial risk management objectives and policies**
Information regarding the existence of branches, future developments and financial risk management objectives and policies of the Group, in relation to the use of financial instruments, that would otherwise be required to be disclosed in the directors' report, and which is incorporated into this report by reference can be found in the strategic report.

**Share capital**
Information about share capital is shown in notes 34 and 38 on pages 52 and 54 and is incorporated into this report by reference.

The Bank did not repurchase any of its shares during the year (2013: none). There are no restrictions on the transfer of shares in the Bank other than set out in the articles of association and certain restrictions which may from time to time be imposed by law and regulations.

The powers of the Directors, including in relation to the issue or buy back of the Bank's shares, are set out in the Companies Act 2006 and the Bank's articles of association.

# Directors' report

**Change of control**
The Bank is not party to any significant contracts that are subject to change of control provisions in the event of a takeover bid. There are no agreements between the Bank and its Directors or employees providing compensation for loss of office or employment that occurs because of a takeover bid.

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

**Employees**
The Bank, as part of Lloyds Banking Group, is committed to providing employment practices and policies which recognise the diversity of its workforce. The Group will not unfairly discriminate in the recruitment or employment practices on the basis of any factor which is not relevant to individuals' performance including sex, race, disability, age, sexual orientation or religious belief. The Group works hard to ensure Lloyds Banking Group is inclusive for all colleagues.

To support this aim, Lloyds Banking Group belongs to a number of major UK employment equality campaign groups, including the Business Disability Forum, The Age and Employment Network, Stonewall and Race for Opportunity. Involvement with these organisations enables the Group to identify and implement best practice for staff. The Bank, as part of Lloyds Banking Group, has a range of programmes to support colleagues who become disabled or acquire a long-term health condition. These include a workplace adjustment programme to provide physical equipment or changes to the way a job is done. The Group also runs residential Personal and Career Development Programmes to help colleagues deal positively with the impact of a disability and the colleague disability network, Access, provides peer support. In 2014 the Group launched a work experience programme with Remploy to support people with disabilities wanting to enter the workplace.

Employees are kept closely involved in major changes affecting them through such measures 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.

Lloyds Banking Group is committed to providing employees with comprehensive coverage of the economic and financial issues affecting the Group. The Group has established a full suite of communication channels, including an extensive face-to-face briefing programme, which allows it to update employees on performance and any financial issues throughout the year.

**Significant contracts**
Details of related party transactions are set out in note 40 on pages 61 to 65.

**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 Group and Bank financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law, the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and the Bank and of the profit or loss of the Bank and Group for that period. In preparing these financial statements, the Directors are required to: select suitable accounting policies and then apply them consistently; make judgements and accounting estimates that are reasonable and prudent; and state whether applicable IFRSs as adopted by the European Union have been followed.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Bank and the Group and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Bank and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the financial statements is placed on the website www.lloydsbankinggroup.com. The Directors are responsible for the maintenance and integrity in relation to the Bank on that website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors, who are in office and whose names are shown on page 8 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position of the Bank and Group and the profit or loss of the Group; and
- the management report contained in the strategic report and the directors' report includes a fair review of the development and performance of the business and the position of the Bank and Group, together with a description of the principal risks and uncertainties faced by the Bank and the Group.

The Directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for Shareholders to assess the Bank's performance, business model and strategy. The Directors have also separately reviewed and approved the strategic report.

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

A resolution will be proposed at the 2015 annual general meeting to re-appoint PricewaterhouseCoopers LLP as auditor. The Bank's Audit Committee is satisfied that the external auditor remains independent and effective.

On behalf of the Board

**Malcolm Wood**
Company Secretary
11 March 2015

Bank of Scotland plc
Registered in Scotland
Company Number SC327000

# Directors

Lord Blackwell *Chairman*

António Horta-Osório *Executive Director and Group Chief Executive*

George Culmer *Executive Director and Chief Financial Officer*

Juan Colombás *Executive Director and Chief Risk Officer*

Alan Dickinson

Carolyn Fairbairn

Anita Frew

Dyfrig John CBE

Simon Henry

Nick Luff

Nick Prettejohn

Anthony Watson CBE

Sara Weller

# Forward looking statements

This annual report contains certain forward looking statements with respect to the business, strategy and plans of Bank of Scotland Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about Bank of Scotland Group or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, expenditures or any other financial items or ratios; statements of plans, objectives or goals of the Group or its management including in respect of certain synergy targets; statements about the future business and economic environments in the United Kingdom (UK) and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; inflation, deflation, interest rates and policies of the Bank of England, the European Central Bank and other G8 central banks; fluctuations in exchange rates, stock markets and currencies; the ability to access sufficient funding to meet the Group's liquidity needs; changes to the Group's or Lloyds Banking Group plc's, Lloyds Bank plc's or HBOS plc's credit ratings; the ability to derive cost savings and other benefits including, without limitation, as a result of the Lloyds Banking Group's Simplification Programme; changing demographic developments including mortality and changing customer behaviour including consumer spending, saving and borrowing habits; changes in customer preferences; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to cyber security; natural and other disasters, adverse weather and similar contingencies outside the Lloyds Banking Group's control; inadequate or failed internal or external processes, people and systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, taxation, accounting standards or practices including as a result of further Scottish devolution; changes to regulatory capital or liquidity requirements and similar contingencies outside the Lloyds Banking Group's control; the policies and actions of governmental or regulatory authorities in the UK, the European Union (EU), the US or elsewhere including the implementation of key legislation and regulation; the implementation of the draft EU crisis management framework directive and banking reform, following the recommendations made by the Independent Commission on Banking; the ability to attract and retain senior management and other employees; requirements or limitations imposed on Lloyds Banking Group plc, Lloyds Bank plc, HBOS plc and the Group as a result of HM Treasury's investment in Lloyds Banking Group plc; actions or omissions by the Group's directors, management or employees including industrial action; changes to the Group's post-retirement defined benefit scheme obligations; the ability to complete satisfactorily the disposal of certain assets as part of Lloyds Banking Group plc's EU State Aid obligations; the provision of banking operations services to TSB Banking Group plc; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; market related trends and developments; exposure to regulatory or competition scrutiny, legal proceedings, regulatory or competition investigations or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services and lending companies; and the success of the Group in managing the risks of the foregoing. Please refer to the latest Annual Report of Lloyds Banking Group plc on Form 20-F filed with the US Securities and Exchange Commission for a discussion of certain factors, together with examples of forward looking statements.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this annual report are made as of the date hereof, and Bank of Scotland Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this annual report to reflect any change in Bank of Scotland Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

# Independent auditors' report

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

**Report on the financial statements**
*Our opinion*
In our opinion:

– the financial statements, defined below, give a true and fair view of the state of the Group's and of the Bank's affairs as at 31 December 2014 and of the Group's profit and the Group's and the Bank's cash flows for the year then ended;
– the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union;
– the Bank's financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
– the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

*What we have audited*
The Group's financial statements and Bank's financial statements (the "financial statements"), which are prepared by Bank of Scotland plc, comprise:

– the Balance sheets as at 31 December 2014;
– the Consolidated income statement and Statements of comprehensive income for the year then ended;
– the Cash flow statements for the year then ended;
– the Statements of changes in equity for the year then ended; and
– the notes to the accounts, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in the preparation of the financial statements is applicable law and IFRSs as adopted by the European Union and, as regards the Bank's financial statements, as applied in accordance with the provisions of the Companies Act 2006.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

**Opinions on other matters prescribed by the Companies Act 2006**
In our opinion:

– the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

**Other matters on which we are required to report by exception**
*Adequacy of accounting records and information and explanations received*
Under the Companies Act 2006 we are required to report to you if, in our opinion:

– we have not received all the information and explanations we require for our audit; or
– adequate accounting records have not been kept by the Group or Bank, or returns adequate for our audit have not been received from branches not visited by us; or
– the Group or Bank financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

*Directors' remuneration*
Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

**Responsibilities for the financial statements and the audit**
*Our responsibilities and those of the directors*
As explained more fully in the Statement of directors' responsibilities set out on page 7, 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 and express an opinion on the financial statements in accordance with applicable law and Internatonal Standards on Auditing (UK & Ireland) ("ISAs (UK & Ireland)"). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Group's and 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.

*What an audit of financial statements involves*
We conducted our audit in accordance with ISAs (UK & Ireland). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

– whether the accounting policies are appropriate to the Group's and the 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.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

# Independent auditors' report

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Report & Accounts to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Philip Rivett (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London

11 March 2015

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

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

# Consolidated income statement

for the year ended 31 December 2014

| | Note | **2014 £ million** | 2013 £ million |
|---|---|---|---|
| Interest and similar income | | **11,532** | 13,845 |
| Interest and similar expense | | **(5,307)** | (7,061) |
| **Net interest income** | 5 | **6,225** | 6,784 |
| Fee and commission income | | **817** | 987 |
| Fee and commission expense | | **(280)** | (318) |
| Net fee and commission income | 6 | **537** | 669 |
| Net trading income | 7 | **771** | (194) |
| Other operating income | 8 | **72** | 395 |
| **Other income** | | **1,380** | 870 |
| **Total income** | | **7,605** | 7,654 |
| Regulatory provisions | | **(918)** | (800) |
| Other operating expenses | | **(3,015)** | (2,989) |
| Operating expenses | 9 | **(3,933)** | (3,789) |
| **Trading surplus** | | **3,672** | 3,865 |
| Impairment | 10 | **(492)** | (2,415) |
| **Profit before tax** | | **3,180** | 1,450 |
| Taxation | 11 | **(514)** | (1,095) |
| **Profit for the year** | | **2,666** | 355 |
| | | | |
| Profit attributable to non-controlling interests | | **–** | – |
| Profit attributable to equity shareholders | | **2,666** | 355 |
| **Profit for the year** | | **2,666** | 355 |

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

# Statements of comprehensive income

for the year ended 31 December 2014

| **The Group** | **2014 £ million** | 2013 £ million |
|---|---|---|
| **Profit for the year** | **2,666** | 355 |
| **Other comprehensive income – items that may subsequently be reclassified to profit or loss** | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets: | | |
| Change in fair value | **234** | 232 |
| Income statement transfers in respect of disposals | **(137)** | 3 |
| Income statement transfers in respect of impairment | **8** | 45 |
| Taxation | **1** | (108) |
| | **106** | 172 |
| Movements in cash flow hedging reserve: | | |
| Effective portion of changes in fair value taken to other comprehensive income | **(56)** | (80) |
| Net income statement transfers | **(474)** | (394) |
| Taxation | **106** | 143 |
| | **(424)** | (331) |
| Currency translation differences (tax: nil) | **7** | (99) |
| **Other comprehensive income for the year, net of tax** | **(311)** | (258) |
| **Total comprehensive income for the year** | **2,355** | 97 |
| Total comprehensive income attributable to non-controlling interests | **–** | – |
| Total comprehensive income attributable to equity shareholders | **2,355** | 97 |
| **Total comprehensive income for the year** | **2.355** | 97 |

| **The Bank** | **2014 £ million** | 2013 £ million |
|---|---|---|
| **Profit for the year** | **2,918** | 418 |
| **Other comprehensive income – items that may subsequently be reclassified to profit or loss** | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets: | | |
| Change in fair value | **205** | 117 |
| Income statement transfers in respect of disposals | **(42)** | 74 |
| Income statement transfers in respect of impairment | **4** | 2 |
| Taxation | **(16)** | (89) |
| | **151** | 104 |
| Movements in cash flow hedging reserve: | | |
| Effective portion of changes in fair value taken to other comprehensive income | **(56)** | (80) |
| Net income statement transfers | **(474)** | (394) |
| Taxation | **106** | 143 |
| | **(424)** | (331) |
| Currency translation differences (tax: nil) | **8** | (2) |
| **Other comprehensive income for the year, net of tax** | **(265)** | (229) |
| **Total comprehensive income for the year** | **2,653** | 189 |

The accompanying notes are an integral part of the financial statements

# Balance sheets

at 31 December 2014

| | | The Group | | The Bank | |
|---|---|---|---|---|---|
| | Note | **2014 £ million** | 2013 £ million | **2014 £ million** | 2013 £ million |
| **Assets** | | | | | |
| Cash and balances at central banks | | **5,110** | 7,296 | **5,110** | 7,296 |
| Items in the course of collection from banks | | **375** | 217 | **375** | 217 |
| Trading and other financial assets at fair value through profit or loss | 12 | **13,922** | 37,317 | **13,756** | 37,139 |
| Derivative financial instruments | 13 | **23,487** | 20,895 | **23,137** | 20,628 |
| Loans and receivables: | | | | | |
| Loans and advances to banks | 14 | **734** | 1,692 | **676** | 1,633 |
| Loans and advances to customers | 15 | **271,674** | 283,638 | **262,808** | 273,556 |
| Debt securities | | **219** | 529 | **181** | 380 |
| Due from fellow Lloyds Banking Group undertakings | | **54,373** | 205,377 | **73,530** | 223,919 |
| | | **327,000** | 491,236 | **337,195** | 499,488 |
| Available-for-sale financial assets | 19 | **5,465** | 3,171 | **5,199** | 2,843 |
| Investment properties | 20 | **178** | 626 | **–** | – |
| Goodwill | 22 | **325** | 334 | **325** | 325 |
| Other intangible assets | 23 | **100** | 95 | **100** | 95 |
| Tangible fixed assets | 24 | **1,139** | 1,415 | **976** | 997 |
| Current tax recoverable | | **4** | 4 | **1** | 1 |
| Deferred tax assets | 31 | **2,432** | 2,710 | **2,585** | 3,006 |
| Investment in subsidiary undertakings | 21 | **–** | – | **250** | 325 |
| Other assets | 25 | **1,688** | 3,096 | **1,550** | 2,820 |
| **Total assets** | | **381,225** | 568,412 | **390,559** | 575,180 |

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

# Balance sheets
at 31 December 2014

| | | The Group | | The Bank | |
|---|---|---|---|---|---|
| **Equity and liabilities** | Note | **2014 £ million** | 2013 £ million | **2014 £ million** | 2013 £ million |
| **Liabilities** | | | | | |
| Deposits from banks | 26 | **2,291** | 3,175 | **2,283** | 3,171 |
| Customer deposits | 27 | **203,498** | 206,568 | **203,498** | 206,568 |
| Due to fellow Lloyds Banking Group undertakings | | **86,838** | 232,574 | **101,420** | 243,588 |
| Items in course of transmission to banks | | **275** | 262 | **275** | 262 |
| Trading and other liabilities at fair value through profit or loss | 28 | **13,769** | 36,624 | **13,764** | 36,586 |
| Derivative financial instruments | 13 | **21,410** | 20,350 | **21,043** | 19,892 |
| Notes in circulation | | **1,129** | 1,176 | **1,129** | 1,176 |
| Debt securities in issue | 29 | **20,408** | 29,462 | **17,556** | 28,106 |
| Other liabilities | 30 | **1,154** | 4,322 | **968** | 4,086 |
| Current tax liabilities | | **427** | 682 | **331** | 514 |
| Deferred tax liabilities | 31 | **–** | – | **–** | – |
| Other provisions | 32 | **1,546** | 1,489 | **1,535** | 1,473 |
| Subordinated liabilities | 33 | **7,627** | 13,354 | **7,626** | 13,416 |
| **Total liabilities** | | **360,372** | 550,038 | **371,428** | 558,838 |
| **Equity** | | | | | |
| Share capital | 34 | **5,847** | 5,847 | **5,847** | 5,847 |
| Share premium account | 35 | **–** | 27,479 | **–** | 27,479 |
| Other reserves | 36 | **2,505** | 2,816 | **2,794** | 3,059 |
| Retained profits | 37 | **12,493** | (17,788) | **10,490** | (20,043) |
| **Shareholders' equity** | | **20,845** | 18,354 | **19,131** | 16,342 |
| Non-controlling interests | | **8** | 20 | **–** | – |
| **Total equity** | | **20,853** | 18,374 | **19,131** | 16,342 |
| **Total equity and liabilities** | | **381,225** | 568,412 | **390,559** | 575,180 |

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

The directors approved the financial statements on 11 March 2015.

**Lord Blackwell**
Chairman

**António Horta-Osório**
Chief Executive

**George Culmer**
Chief Financial Officer

# Statements of changes in equity

for the year ended 31 December 2014

| The Group | Attributable to equity shareholders: Share capital and premium £ million | Other reserves £ million | Retained profits £ million | Total £ million | Non-controlling interests £ million | Total £ million |
|---|---|---|---|---|---|---|
| Balance at 1 January 2013 | 33,326 | 3,074 | (18,286) | 18,114 | 20 | 18,134 |
| **Comprehensive income** | | | | | | |
| Profit for the year | – | – | 355 | 355 | – | 355 |
| *Other comprehensive income* | | | | | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax | – | 172 | – | 172 | – | 172 |
| Movements in cash flow hedging reserve, net of tax | – | (331) | – | (331) | – | (331) |
| Currency translation differences, net of tax | – | (99) | – | (99) | – | (99) |
| Total other comprehensive income | – | (258) | – | (258) | – | (258) |
| Total comprehensive income | – | (258) | 355 | 97 | – | 97 |
| **Transactions with owners** | | | | | | |
| Capital contribution received | – | – | 143 | 143 | – | 143 |
| Balance at 31 December 2013 | 33,326 | 2,816 | (17,788) | 18,354 | 20 | 18,374 |
| **Comprehensive income** | | | | | | |
| Profit for the year | **–** | **–** | **2,666** | **2,666** | **–** | **2,666** |
| *Other comprehensive income (expense)* | | | | | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax | **–** | **106** | **–** | **106** | **–** | **106** |
| Movements in cash flow hedging reserve, net of tax | **–** | **(424)** | **–** | **(424)** | **–** | **(424)** |
| Currency translation differences, net of tax | **–** | **7** | **–** | **7** | **–** | **7** |
| Total other comprehensive income | **–** | **(311)** | **–** | **(311)** | **–** | **(311)** |
| **Total comprehensive income** | **–** | **(311)** | **2,666** | **2,355** | **–** | **2,355** |
| **Transactions with owners:** | | | | | | |
| Capital reconstruction (see note 35) | **(27,479)** | **–** | **27,479** | **–** | **–** | **–** |
| Dividends paid | **–** | **–** | **–** | **–** | **–** | **–** |
| Capital contribution received | **–** | **–** | **136** | **136** | **–** | **136** |
| Change in non-controlling interests | **–** | **–** | **–** | **–** | **(12)** | **(12)** |
| **Total transactions with owners** | **(27,479)** | **–** | **27,615** | **136** | **(12)** | **124** |
| **Balance at 31 December 2014** | **5,847** | **2,505** | **12,493** | **20,845** | **8** | **20,853** |

Further details of movements in the Group's share capital and reserves are provided in notes 34, 35, 36 and 37.

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

# Statements of changes in equity

for the year ended 31 December 2014

| The Bank | Share capital and premium £ million | Other reserves £ million | Retained profits £ million | Total £ million |
|---|---|---|---|---|
| Balance at 1 January 2013 | 33,326 | 3,288 | (20,604) | 16,010 |
| **Comprehensive income** | | | | |
| Profit for the year | – | – | 418 | 418 |
| *Other comprehensive income* | | | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax | – | 104 | – | 104 |
| Movements in cash flow hedging reserve, net of tax | – | (331) | – | (331) |
| Currency translation differences, net of tax | – | (2) | – | (2) |
| Total other comprehensive income | – | (229) | – | (229) |
| Total comprehensive income | – | (229) | 418 | 189 |
| **Transactions with owners** | | | | |
| Capital contribution received | – | – | 143 | 143 |
| Balance at 31 December 2013 | 33,326 | 3,059 | (20,043) | 16,342 |
| **Comprehensive income** | | | | |
| Profit for the year | **–** | **–** | **2,918** | **2,918** |
| *Other comprehensive income* | | | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax | **–** | **151** | **–** | **151** |
| Movements in cash flow hedging reserve, net of tax | **–** | **(424)** | **–** | **(424)** |
| Currency translation differences, net of tax | **–** | **8** | **–** | **8** |
| Total other comprehensive income | **–** | **(265)** | **–** | **(265)** |
| **Total comprehensive income** | **–** | **(265)** | **2,918** | **2,653** |
| **Transactions with owners:** | | | | |
| Capital restructuring (note 35) | **(27,479)** | **–** | **27,479** | **–** |
| Dividends paid | **–** | **–** | **–** | **–** |
| Capital contribution received | **–** | **–** | **136** | **136** |
| Total transactions with owners | **(27,479)** | **–** | **27,615** | **136** |
| **Balance at 31 December 2014** | **5,847** | **2,794** | **10 ,490** | **19,131** |

The accompanying notes are an integral part of the financial statements

# Cash flow statements

for the year ended 31 December 2014

| | Note | The Group 2014 £ million | The Group 2013 £ million | The Bank 2014 £ million | The Bank 2013 £ million |
|---|---|---|---|---|---|
| **Profit before tax** | | **3,180** | 1,450 | **3,411** | 870 |
| Adjustments for: | | | | | |
| Change in operating assets | 47(a) | **191,578** | (9,976) | **190,183** | (4,100) |
| Change in operating liabilities | 47(b) | **(183,718)** | 11,534 | **(181,491)** | 7,209 |
| Non-cash and other items | 47(c) | **(5,897)** | (4,832) | **(6,347)** | (5,484) |
| Tax (paid) received | | **(391)** | 1,230 | **(170)** | 1,439 |
| **Net cash provided by (used in) operating activities** | | **4,752** | (594) | **5,586** | (66) |
| **Cash flows from investing activities** | | | | | |
| Purchase of available-for-sale financial assets | | **(4,394)** | (2,757) | **(5,307)** | (2,130) |
| Proceeds from sale and maturity of available-for-sale financial assets | | **2,099** | 3,331 | **2,925** | 2,503 |
| Purchase of fixed assets | | **(144)** | (192) | **(146)** | (161) |
| Proceeds from sale of fixed assets | | **678** | 1,026 | **–** | 19 |
| Additional capital injections to subsidiaries | | **–** | – | **–** | – |
| Capital repayment by subsidiaries | | **–** | – | **–** | 999 |
| Acquisition of businesses, net of cash acquired | | **(1)** | (5) | **–** | – |
| Disposal of businesses, net of cash disposed | 47(e) | **76** | 944 | **74** | 7 |
| **Net cash (used in) provided by investing activities** | | **(1,686)** | 2,347 | **(2,454)** | 1,237 |
| **Cash flows from financing activities** | | | | | |
| Dividends paid to non-controlling interests | | **–** | – | | – |
| Change in non-controlling interests | | **–** | – | | – |
| Interest paid on subordinated liabilities | | **(340)** | (376) | **(340)** | (363) |
| Repayment of subordinated liabilities | | **(5,770)** | (947) | **(5,770)** | (283) |
| **Net cash used in financing activities** | | **(6,110)** | (1,323) | **(6,110)** | (646) |
| Effects of exchange rate changes on cash and cash equivalents | | **(1)** | (7) | **(1)** | (2) |
| Change in cash and cash equivalents | | **(3,045)** | 423 | **(2,979)** | 523 |
| Cash and cash equivalents at beginning of year | | **7,874** | 7,451 | **7,790** | 7,267 |
| **Cash and cash equivalents at end of year** | 47(d) | **4,829** | 7,874 | **4,811** | 7,790 |

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

# Notes to the accounts

## 1 Basis of preparation

The financial statements of Bank of Scotland plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) 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 (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB. The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

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 which are set out in the Principal risks and uncertainties section under Funding and liquidity on page 4 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

The Group has adopted the following new standards, amendments to standards and interpretations which became effective for financial years beginning on or after 1 January 2014:

*IFRIC 21 Levies*
This interpretation clarifies that the obligating event that gives rise to a liability to pay a government levy is the activity that triggers the payment of the levy as set out in the relevant legislation and that an entity's expectation of operating in a future period, irrespective of the difficulties involved in exiting a market, does not create a constructive obligation to pay a levy. The adoption of this interpretation has not had a material impact on these financial statements.

*Amendments to IAS 32 Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities*
The amendments to IAS 32 clarify the requirements for offsetting financial instruments and address inconsistencies identified in applying the offsetting criteria used in the standard.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2014 and which have not been applied in preparing these financial statements are given in note 48.

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## 2 Accounting policies

The accounting policies are set out below. These accounting policies have been applied consistently.

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

*(1) Subsidiaries*
Subsidiaries are entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through the exercise of its power. This generally accompanies a shareholding of more than one half of the voting rights although in certain circumstances a holding of less than one half of the voting rights may still result in the ability of the Group to exercise control. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of the above elements. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 21.

Structured entities are entities that are designed so that their activities are not governed by way of voting rights. In assessing whether the Group has power over such entities in which it has an interest, the Group considers factors such as the purpose and design of the entity; its practical ability to direct the relevant activities of the entity; the nature of the relationship with the entity; and the size of its exposure to the variability of returns of the entity.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

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

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see 2e(4)) or share capital (see 2p(1)). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

*(2) Joint ventures and associates*
Joint ventures are joint arrangements over which the Group has joint control with other parties and has rights to the net assets of the arrangements. Associates are entities over which the Group has significant influence, 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 but is not control of joint control of those policies and is generally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

**2 Accounting policies** (continued)

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

**b Goodwill**
Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates; goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. Goodwill arising on acquisitions of associates and joint ventures is included in the Group's investment in joint ventures and associates. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

**c Other intangible assets**
Other intangible assets include brands, purchased credit card relationships and both internally and externally generated capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

| | |
|---|---|
| Capitalised software enhancements | up to 7 years |
| Brands (which have been assessed as having finite lives) | 10-15 years |
| Purchased credit card relationships | 5 years |

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

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

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group 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 accounting policy 2h).

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

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

Revenue recognition policies specific to leases are set out in k(2) below.

**e Financial assets and liabilities**
On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. The Group initially recognises loans and receivables, deposits, debt securities in issue and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either:

– substantially all of the risks and rewards of ownership have been transferred; or
– the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

*(1) Financial instruments at fair value through profit or loss*
Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see accounting policy 2f).

**2 Accounting policies** (continued)

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

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

– it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases.
– the 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 2a(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: Fair value of financial instruments) and note 42(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

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

– if the financial assets would have met the definition of loans and receivables (but for the fact that they had to be classified as held for trading at initial recognition), they may be reclassified into loans and receivables where the Group has the intention and ability to hold the assets for the foreseeable future or until maturity; or
– if the financial assets would not have met the definition of loans and receivables, they may be reclassified out of the held for trading category into available-for-sale financial assets in 'rare circumstances'.

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

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

*(3) Loans and receivables*
Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see accounting policy 2d) less provision for impairment (see accounting policy 2h).

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. In cases where the securitisation vehicles are funded by the issue of debt, on terms whereby the majority of the risks and rewards of the portfolio of securitised lending are retained by the Group, these loans and advances continue to be recognised by the Group, together with a corresponding liability for the funding.

*(4) Borrowings*
Borrowings (which include deposits from banks, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

# Notes to the accounts

**2 Accounting policies** (continued)

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.

*(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 deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities borrowing and lending transactions are typically secured; collateral takes the form of securities or cash advanced or received. Securities lent to counterparties are retained on the balance sheet. Securities borrowed are not recognised on the balance sheet, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability. Cash collateral given or received is treated as a loan and receivable or customer deposit.

**f Derivative financial instruments and hedge accounting**
All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 42(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

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

Derivatives embedded in financial instruments 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 derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

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

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

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

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

**2 Accounting policies** (continued)

**g Offset**
Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. Cash collateral on exchange traded derivative transactions is presented gross unless the collateral cash flows are always settled net with the derivative cash flows. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

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

Where such an event has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's commercial lending portfolios. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances in the Group's retail portfolios that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

*Individual assessment*
In respect of individually significant financial assets in the Group's commercial lending portfolios, assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watch list where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that would lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower; (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate; (iii) disappearance of an active market because of financial difficulties; or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable.

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

*Collective assessment*
Impairment is assessed on a collective basis for (1) homogenous groups of loans that are not considered individually impaired; and (2) to cover losses which have been incurred but have not yet been identified on loans subject to individual impairment.

*Homogenous groups of loans*
In respect of portfolios of smaller balance, homogenous loans, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors, such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data about economic and credit conditions (including unemployment rates and borrowers' behaviour) to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

**2 Accounting policies** (continued)

*Incurred but not yet identified impairment*
The collective provision also includes provision for inherent losses, that is losses that have been incurred but have not been identified separately at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. Risk drivers for secured retail lending include the current indexed loan-to-value, previous mortgage arrears, internal cross-product delinquency data and external credit bureau data; for unsecured retail lending they include whether the account is up-to-date and, if not, the number of payments that have been missed; and for commercial lending they include factors such as observed default rates and loss given default. An assessment is made of the likelihood of each account becoming recognised as impaired within the loss emergence period, with the economic loss that each portfolio is likely to generate were it to become impaired. The loss emergence period is determined by local management for each portfolio and the Group has a range of loss emergence periods which are dependent upon the characteristics of the portfolios. Loss emergence periods are reviewed regularly and updated when appropriate. In general the periods used across the Group vary between one month and twelve months based on historical experience. Unsecured portfolios tend to have shorter loss emergence periods than secured portfolios.

*Loan renegotiations and forbearance*
In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

*Write offs*
A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. For both secured and unsecured retail balances, the write-off takes place only once an extensive set of collections processes has been completed, or the status of the account reaches a point where policy dictates that forbearance is no longer appropriate. For commercial lending, a write-off occurs if the loan facility with the customer is restructured, the asset is under administration and the only monies that can be received are the amounts estimated by the administrator, the underlying assets are disposed and a decision is made that no further settlement monies will be received, or external evidence (for example, third party valuations) is available that there has been an irreversible decline in expected cash flows.

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

*(2) Available-for-sale financial assets*
The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer, assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; although 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. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income.

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

Premises (excluding land):

– Freehold/long and short leasehold premises: shorter of 50 years and the remaining period of the lease.
– Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease.

Equipment:

– Fixtures and furnishings: 10-20 years.
– Other equipment and motor vehicles: 2-8 years.

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

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

**2 Accounting policies** (continued)

**k Leases**

*(1) As lessee*

The leases entered into by the Group are primarily operating leases. Operating lease rentals payable are charged to the income statement on a straight-line basis over the period of the lease.

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

*(2) As lessor*

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

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

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

**l Share-based compensation**

Lloyds Banking Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model or a Monte Carlo simulation. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

**m 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 substantively enacted by the balance sheet date which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the gain or loss.

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

**n Foreign currency translation**

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The consolidated financial statements are presented in sterling, which is the Company's functional and presentation currency.

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

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

- The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.
- The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

**2 Accounting policies** (continued)

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see accounting policy 2f(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.

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

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

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

Provision is made for irrevocable undrawn loan commitments if it is probable that the facility will be drawn and result in the recognition of an asset at an amount less than the amount advanced.

**p Share capital**
*(1) Share issue costs*
Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

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

**q 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.

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

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**3 Critical accounting estimates and judgements**

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

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

**Allowance for impairment losses on loans and receivables**
At 31 December 2014 gross loans and receivables of the Group totalled £332,826 million (2013: £504,241 million) against which impairment allowances of £5,826 million (2013: £13,005 million) had been made and of the Bank totalled £342,757 million (2013: £512,688 million) against which impairment allowances of £5,562 million (2013: £13,200 million) had been made (see note 18). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2h(1); this note also provides an overview of the methodologies applied.

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against commercial lending portfolios. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in assessing the borrower's cash flows and debt servicing capability together with the realisable value of collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the retail portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were ten per cent lower than those estimated at 31 December 2014, the impairment charge would increase by approximately £178 million for the Group and the Bank in respect of UK mortgages and a further £6 million for the Group and for the Bank in respect of Irish mortgages.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the commercial business, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective

**3 Critical accounting estimates and judgements** (continued)

unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £18 million for the Group and the Bank (at 31 December 2013, a one month increase in the loss emergence period would have increased the collective unimpaired provision by an estimated £57 million for the Group and for the Bank).

**Fair value of financial instruments**
In accordance with IFRS 13 *Fair Value Measurement*, the Group and the Bank categorise financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques including discounted cash flow analysis and valuation models. These valuation techniques involve management judgement and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information.

Valuation techniques for level 2 financial instruments use inputs that are largely based on observable market data. Level 3 financial instruments are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Determining the appropriate assumptions to be used for level 3 financial instruments requires significant management judgement.

At 31 December 2014, the Group classified £964 million of financial assets, including £522 million of derivatives, and £127 million of financial liabilities, including £101 million of derivatives, as level 3 (£527 million, including £522 million of derivatives, and £122 million, including £101 million of derivatives, respectively for the Bank). Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out in note 42.

**Recoverability of deferred tax assets**
At 31 December 2014 the Group carried deferred tax assets on its balance sheet of £2,432 million (2013: £2,710 million) and deferred tax liabilities of £nil (2013: £nil); and the Bank carried deferred tax assets of £2,585 million (2013: £3,006 million) and deferred tax liabilities of £nil (2013: £nil) (note 31). This presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 31 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward.

The recoverability of deferred tax assets in respect of carry forward losses is based on an assessment of future levels of taxable profit expected to arise that can be offset against these losses. The Group's expectations as to the level of future taxable profits take into account long-term financial and strategic plans, and anticipated future tax adjusting items.

In making this assessment account is taken of business plans, the five year board approved operating plan and the following future risk factors:

- The expected future economic outlook as set out in the Group Chief Executive's Review and Market Overview contained in the Annual Report of Lloyds Banking Group;
- The retail banking business disposal as required by the European Commission; and
- Future regulatory change.

The total deferred tax asset includes £2,307 million (2013: £2,855 million) for the Group and £2,307 million (2013: £2,855 million) for the Bank in respect of trading losses carried forward. All of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc and those tax losses will be used as future taxable profits arise in the Bank.

The deferred tax asset is expected to be utilised over different time periods in each of the entities in which the losses arise. Under current UK tax law there is no expiry date for unused tax losses. The losses are still expected to be fully utilised by 2019.

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

As disclosed in note 31, deferred tax assets totalling £273 million (2013: £228 million) for the Group and £158 million (2013: £122 million) for the Bank have not been recognised in respect of certain capital losses carried forward, trading losses carried forward (mainly in certain overseas companies) and unrelieved foreign tax credits as there are no predicted future capital or taxable profits against which these losses can be recognised.

**Payment protection insurance and other regulatory provisions**
At 31 December 2014, the Group carried provisions of £1,240 million (2013: £1,319 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches, principally the misselling of payment protection insurance. Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the number of future complaints, the extent to which they will be upheld and the average cost of redress. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

Note 32 contains more detail on the nature of the assumptions that have been made and key sensitivities.

# Notes to the accounts

## 4 Segmental analysis

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

Following the continuing reduction in the Group's non-UK activities, an analysis between UK and non-UK activities is no longer provided.

## 5 Net interest income

| | Weighted average effective interest rate | | | |
|---|---|---|---|---|
| | **2014 %** | 2013 % | **2014 £m** | 2013 £m |
| Interest and similar income: | | | | |
| Loans and advances to banks and customers | **2.74** | 2.71 | **11,453** | 13,583 |
| Debt securities held as loans and receivables | **5.83** | 17.60 | **26** | 217 |
| Interest receivable on loans and receivables | **2.75** | 2.75 | **11,479** | 13,800 |
| Available-for-sale financial assets | **1.17** | 1.44 | **53** | 45 |
| **Total interest and similar income** | **2.73** | 2.74 | **11,532** | 13,845 |
| Interest and similar expense: | | | | |
| Deposits from banks and customer deposits, excluding liabilities under sale and repurchase agreements | **1.31** | 1.65 | **(4,779)** | (6,579) |
| Debt securities in issue | **0.75** | 0.25 | **(175)** | (103) |
| Subordinated liabilities | **1.38** | 2.44 | **(314)** | (358) |
| Liabilities under sale and repurchase agreements | **1.01** | 0.24 | **(39)** | (21) |
| **Total interest and similar expense** | **1.28** | 1.52 | **(5,307)** | (7,061) |
| **Net interest income** | | | **6,225** | 6,784 |

Included within interest and similar income is £236 million (2013: £601 million) in respect of impaired financial assets. Net interest income also includes a credit of £474 million (2013: credit of £394 million) transferred from the cash flow hedging reserve (see note 36).

### 6 Net fee and commission income

| | 2014 £m | 2013 £m |
|---|---|---|
| Fee and commission income: | | |
| Current accounts | **268** | 284 |
| Credit and debit card fees | **290** | 256 |
| Other | **259** | 447 |
| **Total fee and commission income** | **817** | 987 |
| Fee and commission expense | **(280)** | (318) |
| **Net fee and commission income** | **537** | 669 |

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Foreign exchange translation gains (losses) | **37** | (23) |
| Gains (losses) on foreign exchange trading transactions | **50** | (10) |
| Total foreign exchange | **87** | (33) |
| Investment property gains (losses) (note 20) | **7** | (68) |
| Securities and other gains (losses) (see below) | **677** | (93) |
| **Net trading income (expense)** | **771** | (194) |

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Net income (expense) arising on assets designated at fair value through profit or loss: | | |
| Debt securities, loans and advances | **472** | 402 |
| Equity shares | **89** | (122) |
| Total net income arising on assets held at fair value through profit or loss | **561** | 280 |
| Net gains (losses) on financial instruments held for trading | **116** | (373) |
| Securities and other gains (losses) | **677** | (93) |

### 8 Other operating income

| | 2014 £m | 2013 £m |
|---|---|---|
| Operating lease rental income | **44** | 84 |
| Rental income from investment properties | **22** | 36 |
| Gains (losses) on disposal of available-for-sale financial assets (note 36) | **137** | (3) |
| Share of results of joint ventures and associates | **32** | 7 |
| Liability management losses | **–** | (81) |
| Other[1] | **(163)** | 352 |
| **Total other operating income** | **72** | 395 |

[1]On 31 December 2013, the Group completed the sale of its Australian operations (which principally comprise Capital Finance Australia Limited, a provider of motor and equipment asset finance, and BOS International (Australia) Limited, a corporate lending business).

## 9 Operating expenses

| | 2014 £m | 2013 £m |
|---|---|---|
| Staff costs: | | |
| Salaries | **1,208** | 1,272 |
| Social security costs | **122** | 123 |
| Pensions and other post-retirement benefit schemes | **222** | 210 |
| Restructuring costs | **55** | 3 |
| Other staff costs | **65** | 68 |
| | **1,672** | 1,676 |
| Premises and equipment: | | |
| Rent and rates | **179** | 180 |
| Hire of equipment | **3** | 1 |
| Repairs and maintenance | **28** | 36 |
| Other | **109** | 121 |
| | **319** | 338 |
| Other expenses: | | |
| Communications and data processing | **174** | 196 |
| Advertising and promotion | **68** | 63 |
| Professional fees | **16** | 10 |
| Other | **587** | 431 |
| | **845** | 700 |
| Depreciation and amortisation: | | |
| Depreciation of tangible fixed assets (note 24) | **158** | 210 |
| Amortisation of other intangible assets (note 23) | **21** | 14 |
| | **179** | 224 |
| Impairment of goodwill (note 22) | **–** | 51 |
| Total operating expenses, excluding regulatory provisions | **3,015** | 2,989 |
| Regulatory provisions: | | |
| Payment protection insurance (note 32) | **674** | 740 |
| Other regulatory provisions (note 32) | **244** | 60 |
| | **918** | 800 |
| **Total operating expenses** | **3,933** | 3,789 |

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

| | 2014 | 2013 |
|---|---|---|
| UK | **39,738** | 41,897 |
| Overseas | **410** | 555 |
| **Total** | **40,148** | 42,452 |

# Notes to the accounts

## 9 Operating expenses (continued)

**Fees payable to the Bank's auditors**
During the year the auditors earned the following fees:

| | 2014 £m | 2013 £m |
|---|---|---|
| Fees payable for the audit of the Bank's current year annual report | 1.1 | 3.0 |
| Fees payable for other services: | | |
| Audit of the Bank's subsidiaries pursuant to legislation | 0.9 | 1.6 |
| Other services supplied pursuant to legislation | 0.3 | 1.0 |
| Other services – audit-related fees | – | – |
| All other taxation advisory services | – | – |
| Services relating to corporate finance transactions | – | – |
| All other services | – | – |
| **Total fees payable to the Bank's auditors by the Group** | **2.3** | 5.6 |

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Reviews of the financial position of corporate and other borrowers | – | 0.5 |

## 10 Impairment

| | 2014 £m | 2013 £m |
|---|---|---|
| Impairment losses on loans and receivables: | | |
| Loans and advances to customers | 469 | 2,424 |
| Debt securities classified as loans and receivables | 2 | (24) |
| Total impairment losses on loans and receivables (note 18) | 471 | 2,400 |
| Impairment of available-for-sale financial assets | 4 | 15 |
| Other credit risk provisions | 17 | – |
| **Total impairment charged to the income statement** | **492** | 2,415 |

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

# Notes to the accounts

## 11 Taxation

### a Analysis of tax charge for the year

| | 2014 £m | 2013 £m |
|---|---|---|
| UK corporation tax: | | |
| Current tax on profit for the year | **(72)** | (83) |
| Adjustments in respect of prior years | **(54)** | (189) |
| | **(126)** | (272) |
| Foreign tax: | | |
| Current tax on profit for the year | **(5)** | (10) |
| Adjustments in respect of prior years | **(3)** | 7 |
| | **(8)** | (3) |
| Current tax charge | **(134)** | (275) |
| Deferred tax (note 31): | | |
| Origination and reversal of temporary differences | **(463)** | (612) |
| Reduction in UK corporation tax rate and related impacts | **(1)** | (430) |
| Adjustments in respect of prior years | **84** | 222 |
| | **(380)** | (820) |
| **Tax charge** | **(514)** | (1,095) |

The tax charge is based on a UK corporation tax rate of 21.5 per cent (2013: 23.25 per cent).

**b Factors affecting the tax charge for the year**
A reconciliation of the charge that would result from applying the standard UK corporation tax rate to profit before tax to the actual tax charge for the year is given below:

| | 2014 £m | 2013 £m |
|---|---|---|
| Profit before tax | **3,180** | 1,450 |
| Tax charge thereon at UK corporation tax rate of 21.5 per cent (2013: 23.25 per cent) | **(684)** | (337) |
| Factors affecting credit: | | |
| UK corporation tax rate change and related impacts | **(1)** | (430) |
| Disallowed items | **(15)** | (108) |
| Non-taxable items | **114** | 17 |
| Overseas tax rate differences | **(6)** | (11) |
| Gains exempted or covered by capital losses | **42** | 22 |
| Deferred tax on losses no longer recognised following sale of Australian operations | **–** | (348) |
| Deferred tax on Australian tax losses not previously recognised | **–** | 60 |
| Adjustments in respect of previous years | **27** | 40 |
| Effect of profit or loss in joint ventures and associates | **7** | – |
| Other items | **2** | – |
| **Tax charge on profit on ordinary activities** | **(514)** | (1,095) |

The Finance Act 2013 (the Act) was substantively enacted on 2 July 2013. The Act further reduced the main rate of corporation tax to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015.

# Notes to the accounts

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Trading assets | **13,750** | 37,084 | **13,750** | 37,084 |
| Other financial assets at fair value through profit or loss | **172** | 233 | **6** | 55 |
| **Total** | **13,922** | 37,317 | **13,756** | 37,139 |

These assets are comprised as follows:

| | The Group | | | | The Bank | | | |
|---|---|---|---|---|---|---|---|---|
| | **2014** | | 2013 | | **2014** | | 2013 | |
| | **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 customers | **13,476** | **–** | 32,427 | 21 | **13,476** | **–** | 32,427 | 21 |
| Loans and advances to banks | **201** | **–** | 2,556 | – | **201** | **–** | 2,556 | – |
| Debt securities: | | | | | | | | |
| Government securities | **45** | **–** | 115 | – | **45** | **–** | 115 | – |
| Bank and building society certificates of deposit | **–** | **–** | 1,458 | – | **–** | **–** | 1,458 | – |
| Asset-backed securities: | | | | | | | | |
| Other asset-backed securities | **–** | **–** | 4 | – | **–** | **–** | 4 | – |
| Corporate and other debt securities | **28** | **–** | 518 | – | **28** | **–** | 518 | – |
| | **73** | **–** | 2,095 | – | **73** | **–** | 2,095 | – |
| Equity shares | **–** | **172** | – | 212 | **–** | **6** | – | 34 |
| Treasury and other bills | **–** | **–** | 6 | – | **–** | **–** | 6 | – |
| **Total** | **13,750** | **172** | 37,084 | 233 | **13,750** | **6** | 37,084 | 55 |

At 31 December 2014 £172 million (2013: £2,624 million) of trading and other financial assets at fair value through profit or loss of the Group and £6 million (2013: £2,529 million) of the Bank had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase and reverse repurchase agreements see note 45.

## 13 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; and
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 45.

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 42.

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.

## 13 Derivative financial instruments (continued)

– 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.

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

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| **The Group** | **Contract/ notional amount £m** | **Fair value assets £m** | **Fair value liabilities £m** | Contract/ notional amount £m | Fair value assets £m | Fair value liabilities £m |
| **Trading** | | | | | | |
| Exchange rate contracts: | | | | | | |
| Spot, forwards and futures | 1,657 | 10 | 48 | 789 | 18 | 9 |
| Currency swaps | 63,818 | 1,010 | 745 | 64,975 | 654 | 1,183 |
| Options purchased | 227 | 7 | – | 213 | 6 | – |
| Options written | 293 | – | 9 | 249 | – | 6 |
| | 65,995 | 1,027 | 802 | 66,226 | 678 | 1,198 |
| Interest rate contracts: | | | | | | |
| Interest rate swaps | 426,323 | 14,338 | 15,339 | 621,971 | 13,226 | 14,127 |
| Forward rate agreements | 21,759 | 4 | 4 | 16,052 | 7 | 1 |
| Options purchased | 9,911 | 1,047 | – | 11,480 | 516 | – |
| Options written | 9,695 | – | 721 | 12,535 | – | 490 |
| Futures | 56,149 | 1 | – | 106,035 | – | 6 |
| | 523,837 | 15,390 | 16,064 | 768,073 | 13,749 | 14,624 |
| Credit derivatives | 541 | 12 | – | 375 | – | 67 |
| Equity and other contracts | 642 | 411 | 385 | 7,441 | 833 | 750 |
| **Total derivative assets/liabilities held for trading** | 591,015 | 16,840 | 17,251 | 842,115 | 15,260 | 16,639 |
| **Hedging** | | | | | | |
| Derivatives designated as fair value hedges: | | | | | | |
| Interest rate swaps | 22,511 | 3,591 | 722 | 24,298 | 3,022 | 232 |
| Cross currency swaps | 2,178 | 75 | 30 | 18,643 | 156 | 902 |
| | 24,689 | 3,666 | 752 | 42,941 | 3,178 | 1,134 |
| Derivatives designated as cash flow hedges: | | | | | | |
| Interest rate swaps | 71,379 | 2,977 | 3,394 | 107,529 | 2,440 | 2,573 |
| Cross currency swaps | 759 | 4 | 13 | 1,135 | 12 | 4 |
| Futures | 25,297 | – | – | 92,692 | 5 | – |
| | 97,435 | 2,981 | 3,407 | 201,356 | 2,457 | 2,577 |
| **Total derivative assets/liabilities held for hedging** | 122,124 | 6,647 | 4,159 | 244,297 | 5,635 | 3,711 |
| **Total recognised derivative assets/liabilities** | 713,139 | 23,487 | 21,410 | 1,086,412 | 20,895 | 20,350 |

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 45 Credit risk.

## 13 Derivative financial instruments (continued)

**Hedged cash flows**

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

| 2014 | 0-1 years £m | 1-2 years £m | 2-3 years £m | 3-4 years £m | 4-5 years £m | 5-10 years £m | 10-20 years £m | Over 20 years £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|
| Hedged forecast cash flows expected to occur: | | | | | | | | | |
| Forecast receivable cash flows | **95** | **131** | **65** | **44** | **42** | **170** | **183** | **49** | **779** |
| Forecast payable cash flows | **(7)** | **(6)** | **(26)** | **(58)** | **(63)** | **(258)** | **(275)** | **(5)** | **(698)** |
| Hedged forecast cash flows affect profit or loss: | | | | | | | | | |
| Forecast receivable cash flows | **134** | **112** | **57** | **42** | **45** | **163** | **178** | **48** | **779** |
| Forecast payable cash flows | **(10)** | **(7)** | **(50)** | **(60)** | **(63)** | **(251)** | **(253)** | **(4)** | **(698)** |

| 2013 | 0-1 years £m | 1-2 years £m | 2-3 years £m | 3-4 years £m | 4-5 years £m | 5-10 years £m | 10-20 years £m | Over 20 years £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|
| Hedged forecast cash flows expected to occur: | | | | | | | | | |
| Forecast receivable cash flows | 43 | 216 | 314 | 125 | 44 | 258 | 204 | 76 | 1,280 |
| Forecast payable cash flows | (83) | (30) | (38) | (63) | (105) | (459) | (475) | (19) | (1,272) |
| Hedged forecast cash flows affect profit or loss: | | | | | | | | | |
| Forecast receivable cash flows | 86 | 275 | 256 | 93 | 41 | 257 | 198 | 74 | 1,280 |
| Forecast payable cash flows | (96) | (35) | (38) | (97) | (103) | (448) | (443) | (12) | (1,272) |

There were no transactions for which cash flow hedge accounting had to be ceased in 2013 or 2014 as a result of the highly probable cash flows no longer being expected to occur.

At 31 December 2014 £21,965 million of total recognised derivative assets of the Group and £20,366 million of total recognised derivative liabilities of the Group (2013: £19,772 million of assets and £18,836 million of liabilities) had a contractual residual maturity of greater than one year.

## 13 Derivative financial instruments (continued)

| The Bank | 2014 Contract/ notional amount £m | 2014 Fair value assets £m | 2014 Fair value liabilities £m | 2013 Contract/ notional amount £m | 2013 Fair value assets £m | 2013 Fair value liabilities £m |
|---|---|---|---|---|---|---|
| **Trading** | | | | | | |
| Exchange rate contracts: | | | | | | |
| Spot, forwards and futures | 665 | 10 | 15 | 789 | 18 | 9 |
| Currency swaps | 63,804 | 996 | 745 | 62,199 | 687 | 1,024 |
| Options purchased | 227 | 7 | – | 213 | 6 | – |
| Options written | 293 | – | 9 | 249 | – | 6 |
| | 64,989 | 1,013 | 769 | 63,450 | 711 | 1,039 |
| Interest rate contracts: | | | | | | |
| Interest rate swaps | 426,323 | 14,337 | 15,321 | 621,971 | 13,226 | 14,110 |
| Forward rate agreements | 21,759 | 4 | 4 | 16,052 | 7 | 1 |
| Options purchased | 9,911 | 1,047 | – | 11,480 | 516 | – |
| Options written | 9,695 | – | 721 | 12,535 | – | 490 |
| Futures | 56,149 | 1 | – | 106,035 | – | 6 |
| | 523,837 | 15,389 | 16,046 | 768,073 | 13,749 | 14,607 |
| Credit derivatives | 541 | 12 | – | 375 | – | 67 |
| Equity and other contracts | 594 | 76 | 69 | 7,390 | 533 | 468 |
| **Total derivative assets/liabilities held for trading** | 589,961 | 16,490 | 16,884 | 839,288 | 14,993 | 16,181 |
| **Hedging** | | | | | | |
| Derivatives designated as fair value hedges: | | | | | | |
| Interest rate swaps | 22,511 | 3,591 | 722 | 24,298 | 3,022 | 232 |
| Cross currency swaps | 2,178 | 75 | 30 | 18,643 | 156 | 902 |
| | 24,689 | 3,666 | 752 | 42,941 | 3,178 | 1,134 |
| Derivatives designated as cash flow hedges: | | | | | | |
| Interest rate swaps | 71,379 | 2,977 | 3,394 | 107,529 | 2,440 | 2,573 |
| Cross currency swaps | 759 | 4 | 13 | 1,135 | 12 | 4 |
| Futures | 25,297 | – | – | 92,692 | 5 | – |
| | 97,435 | 2,981 | 3,407 | 201,356 | 2,457 | 2,577 |
| **Total derivative assets/liabilities held for hedging** | 122,124 | 6,647 | 4,159 | 244,297 | 5,635 | 3,711 |
| **Total recognised derivative assets/liabilities** | 712,085 | 23,137 | 21,043 | 1,083,585 | 20,628 | 19,892 |

## 13 Derivative financial instruments (continued)

**Hedged cash flows**

For designated cash flow hedges the following table shows when the Bank's hedged cash flows are expected to occur and when they will affect income.

| 2014 | 0-1 years £m | 1-2 years £m | 2-3 years £m | 3-4 years £m | 4-5 years £m | 5-10 years £m | 10-20 years £m | Over 20 years £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|
| Hedged forecast cash flows expected to occur: | | | | | | | | | |
| Forecast receivable cash flows | **95** | **131** | **65** | **44** | **42** | **170** | **183** | **49** | **779** |
| Forecast payable cash flows | **(7)** | **(6)** | **(26)** | **(58)** | **(63)** | **(258)** | **(275)** | **(5)** | **(698)** |
| Hedged forecast cash flows affect profit or loss: | | | | | | | | | |
| Forecast receivable cash flows | **134** | **112** | **57** | **42** | **45** | **163** | **178** | **48** | **779** |
| Forecast payable cash flows | **(10)** | **(7)** | **(50)** | **(60)** | **(63)** | **(251)** | **(253)** | **(4)** | **(698)** |

| 2013 | 0-1 years £m | 1-2 years £m | 2-3 years £m | 3-4 years £m | 4-5 years £m | 5-10 years £m | 10-20 years £m | Over 20 years £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|
| Hedged forecast cash flows expected to occur: | | | | | | | | | |
| Forecast receivable cash flows | 43 | 216 | 314 | 125 | 44 | 258 | 204 | 76 | 1,280 |
| Forecast payable cash flows | (83) | (30) | (38) | (63) | (105) | (459) | (475) | (19) | (1,272) |
| Hedged forecast cash flows affect profit or loss: | | | | | | | | | |
| Forecast receivable cash flows | 86 | 275 | 256 | 93 | 41 | 257 | 198 | 74 | 1,280 |
| Forecast payable cash flows | (96) | (35) | (38) | (97) | (103) | (448) | (443) | (12) | (1,272) |

There were no transactions for which cash flow hedge accounting had to be ceased in 2013 or 2014 as a result of the highly probable cash flows no longer being expected to occur.

At 31 December 2014 £22,300 million of total recognised derivative assets and £19,999 million of total recognised derivative liabilities of the Bank (2013: £19,487 million of assets and £18,379 million of liabilities) had a contractual residual maturity of greater than one year.

## 14 Loans and advances to banks

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Lending to banks | **127** | 839 | **114** | 830 |
| Money market placements with banks | **607** | 853 | **562** | 803 |
| **Total loans and advances to banks** | **734** | 1,692 | **676** | 1,633 |

No impairment allowances are held against these exposures.

At 31 December 2014, £556 million (2013: £448 million) of loans and advances to banks of the Group and £525 million (2013: £473 million) of the Bank had a contractual residual maturity of greater than one year.

For amounts included above which are subject to reverse repurchase agreements see note 45.

## 15 Loans and advances to customers

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Agriculture, forestry and fishing | **609** | 562 | **607** | 562 |
| Energy and water supply | **345** | 361 | **345** | 361 |
| Manufacturing | **606** | 1,177 | **606** | 1,177 |
| Construction | **2,132** | 2,605 | **2,132** | 2,605 |
| Transport, distribution and hotels | **4,543** | 9,649 | **4,543** | 9,666 |
| Postal and telecommunications | **394** | 142 | **394** | 142 |
| Property companies | **10,807** | 19,340 | **11,061** | 20,495 |
| Financial, business and other services | **5,922** | 10,601 | **5,908** | 10,603 |
| Personal: | | | | |
| Mortgages | **241,191** | 240,996 | **232,830** | 231,619 |
| Other | **9,949** | 9,543 | **9,884** | 9,407 |
| Lease financing | **843** | 1,480 | **23** | 42 |
| Hire purchase | **16** | 56 | **16** | 56 |
| **Total loans and advances to customers before allowance for impairment losses** | **277,357** | 296,512 | **268,349** | 286,735 |
| Allowance for impairment losses (note 18) | **(5,683)** | (12,874) | **(5,541)** | (13,179) |
| **Total loans and advances to customers** | **271,674** | 283,638 | **262,808** | 273,556 |

At 31 December 2014 £255,958 million (2013: £261,662 million) of loans and advances to customers of the Group and £247,383 million (2013: £251,350 million) of the Bank had a contractual residual maturity of greater than one year.

For amounts included above which are subject to reverse repurchase agreements see note 45.

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Gross investment in finance leases, receivable: | | | | |
| Not later than 1 year | **262** | 166 | **8** | 17 |
| Later than 1 year and not later than 5 years | **393** | 599 | **15** | 25 |
| Later than 5 years | **449** | 1,254 | **–** | – |
| | **1,104** | 2,019 | **23** | 42 |
| Unearned future finance income on finance leases | **(242)** | (521) | **–** | – |
| Rentals received in advance | **(19)** | (18) | **–** | – |
| **Net investment in finance leases** | **843** | 1,480 | **23** | 42 |

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Not later than 1 year | **203** | 104 | **8** | 17 |
| Later than 1 year and not later than 5 years | **308** | 409 | **15** | 25 |
| Later than 5 years | **332** | 967 | **–** | – |
| **Net investment in finance leases** | **843** | 1,480 | **23** | 42 |

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 2013 and 2014 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £1 million for the Group (2013: £6 million).

## 16 Securitisations and covered bonds

**Securitisation programmes**

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

**Covered bond programmes**

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

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in note 29.

| | **2014** | | 2013 | |
|---|---|---|---|---|
| | **Loans and advances securitised £m** | **Notes in issue £m** | Loans and advances securitised £m | Notes in issue £m |
| **Securitisation programmes** | | | | |
| UK residential mortgages | **32,122** | **19,011** | 38,096 | 28,536 |
| Credit card receivables | **6,773** | **4,278** | 6,332 | 3,992 |
| Dutch residential mortgages | **3,871** | **4,010** | 4,385 | 4,516 |
| Commercial loans | **324** | **324** | 524 | 524 |
| | **43,090** | **27,623** | 49,337 | 37,568 |
| Less held by the Group | | **(20,609)** | | (24,975) |
| **Total securitisation programmes (note 29)** | | **7,014** | | 12,593 |
| | | | | |
| **Covered bond programmes** | | | | |
| Residential mortgage-backed | **22,830** | **15,747** | 30,467 | 19,622 |
| Social housing loan-backed | **2,826** | **1,800** | 2,536 | 1,800 |
| | **25,656** | **17,547** | 33,003 | 21,422 |
| Less held by the Group | | **(6,339)** | | (7,606) |
| **Total covered bond programmes (note 29)** | | **11,208** | | 13,816 |
| | | | | |
| **Total securitisation and covered bond programmes** | | **18,222** | | 26,409 |

Cash deposits of £5,035 million (2013: £9,881 million) held by the Group are restricted in use to repayment of the debt securities issued by the structured entities, the term advances relating to covered bonds and other legal obligations. Additionally, the Group had certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2014 these obligations had not been triggered and the maximum exposure under these facilities was £356 million (2013: £221 million).

The Group has a number of covered bond programmes, for which Limited Liability Partnerships have been established to ringfence asset pools and guarantee the covered bonds issued by the Group. At the reporting date the Group had overcollateralised these programmes as set out in the table above to meet the terms of the programmes, to secure the rating of the covered bonds and to provide operational flexibility. From time-to-time, the obligations of the Group to provide collateral may increase due to the formal requirements of the programmes. The Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group are limited to the cash flows generated from the underlying assets. The Group could be required to provide additional support to a number of the securitisation programmes to support the credit ratings of the debt securities issued, in the form of increased cash reserves and the holding of subordinated notes. Further, certain programmes contain contractual obligations that require the Group to repurchase assets should they become credit impaired.

The Group has not voluntarily offered to repurchase assets from any of its public securitisation programmes during 2014 (2013: none). Such repurchases are made in order to ensure that the expected maturity dates of the notes issued from these programmes are met.

# Notes to the accounts

## 17 Structured entities

The Group's interests in structured entities are consolidated. Detail of the Group's interests in consolidated structured entities are set out in note 16 for securitisations and covered bond vehicles and below.

**Asset-backed conduits**
In addition to the structured entities discussed in note 16, which are used for securitisation and covered bond programmes, the Group sponsors an asset-backed conduit, Grampian, although this is being run down. Grampian has no commercial paper in issue and no external liquidity providers. All of the external assets in this conduit are consolidated in the Group's financial statements.

## 18 Allowance for impairment losses on loans and receivables

| The Group | Loans and advances to customers £m | Debt securities £m | Total £m |
|---|---|---|---|
| Balance at 31 December 2013 | 17,881 | 988 | 18,869 |
| Exchange and other adjustments | 271 | 52 | 323 |
| Disposal of businesses | (61) | – | (61) |
| Advances written off | (7,519) | (885) | (8,404) |
| Recoveries of advances written off in previous years | 106 | – | 106 |
| Unwinding of discount | (228) | – | (228) |
| Charge (credit) to the income statement (note 10) | 2,424 | (24) | 2,400 |
| Balance at 31 December 2013 | 12,874 | 131 | 13,005 |
| Exchange and other adjustments | **(382)** | **10** | **(372)** |
| Disposal of businesses | **–** | **–** | **–** |
| Advances written off | **(7,361)** | **–** | **(7,361)** |
| Recoveries of advances written off in previous years | **112** | **–** | **112** |
| Unwinding of discount | **(29)** | **–** | **(29)** |
| Charge to the income statement (note 10) | **469** | **2** | **471** |
| **At 31 December 2014** | **5,683** | **143** | **5,826** |

Of the Group's total allowance in respect of loans and advances to customers, £4,854 million (2013: £11,932 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £1,769 million (2013: £2,583 million) was assessed on a collective basis.

| The Bank | Loans and advances to customers £m | Debt securities £m | Total £m |
|---|---|---|---|
| Balance at 1 January 2013 | 17,692 | 901 | 18,593 |
| Exchange and other adjustments | 219 | 56 | 275 |
| Advances written off | (7,297) | (940) | (8,237) |
| Recoveries of advances written off in previous years | 99 | – | 99 |
| Unwinding of discount | (247) | – | (247) |
| Charge to the income statement | 2,713 | 4 | 2,717 |
| Balance at 31 December 2013 | 13,179 | 21 | 13,200 |
| Exchange and other adjustments | **(390)** | **–** | **(390)** |
| Advances written off | **(7,678)** | **–** | **(7,678)** |
| Recoveries of advances written off in previous years | **101** | **–** | **101** |
| Unwinding of discount | **(43)** | **–** | **(43)** |
| Charge to the income statement | **372** | **–** | **372** |
| **At 31 December 2014** | **5,541** | **21** | **5,562** |

Of the Bank's total allowance in respect of loans and advances to customers, £4,770 million (2013: £12,169 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £1,561 million (2013: £2,367 million) was assessed on a collective basis.

## 19 Available-for-sale financial assets

| The Group | 2014 £m | 2013 £m |
|---|---|---|
| Debt securities: | | |
| Government securities | **31** | 28 |
| Bank and building society certificates of deposit | **15** | 12 |
| Asset-backed securities: | | |
| Mortgage-backed securities | **499** | 749 |
| Other asset-backed securities | **343** | 518 |
| Corporate and other debt securities | **4,268** | 1,451 |
| | **5,156** | 2,758 |
| Equity shares | **309** | 413 |
| Total available-for-sale financial assets | **5,465** | 3,171 |

| The Bank | 2014 £m | 2013 £m |
|---|---|---|
| Debt securities: | | |
| Government securities | **31** | 28 |
| Bank and building society certificates of deposit | **15** | 12 |
| Asset-backed securities: | | |
| Mortgage-backed securities | **499** | 749 |
| Other asset-backed securities | **343** | 518 |
| Corporate and other debt securities | **4,268** | 1,493 |
| | **5,156** | 2,800 |
| Equity shares | **43** | 43 |
| **Total available-for-sale financial assets** | **5,199** | 2,843 |

At 31 December 2014 £4,986 million (2013: £2,955 million) of available-for-sale financial assets of the Group and £4,748 million (2013: £2,656 million) of the Bank had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 45(D).

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 2h.

# Notes to the accounts

## 20 Investment properties of the Group

| | 2014 £m | 2013 £m |
|---|---|---|
| At 1 January | **626** | 705 |
| Exchange and other adjustments | **–** | 2 |
| Additions: | | |
| Acquisitions of new properties | **–** | – |
| Consolidation of new subsidiary undertakings | **–** | 805 |
| Additional expenditure on existing properties | **–** | – |
| Total additions | **–** | 805 |
| Disposals | **(455)** | (818) |
| Changes in fair value (note 7) | **7** | (68) |
| **At 31 December** | **178** | 626 |

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

The fair value of investment properties is measured using the market approach and incorporates the income approach where appropriate. The fair value of investment property is generally measured using observable inputs. Whether investment properties are categorised as level 2 or 3 (see note 42(2)) for details of levels in the fair value hierarchy) depends on the extent of the adjustments made to observable inputs and this depends on the investment property concerned. Investment property is compared to property for which there is observable market data about its realisable value on disposal. Adjustments to this observable data are applied, if necessary, for specific characteristics of the property, such as the nature, location or condition of the specific asset. If such information is not available, alternative valuation methods using unobservable inputs, such as discounted cash flow analysis or recent prices in less active markets are used. For investment property under construction, the value on disposal is considered to be at the point at which the property is fully constructed. Adjustments are made for the costs and risks associated with construction. Investment property under construction for which fair value is not yet reliably measurable is valued at cost, until the fair value can be reliably measured.

The table above analyses movements in investment properties, all of which are categorised as level 3.

## 21 Investment in subsidiary undertakings

| | 2014 £m | 2013 £m |
|---|---|---|
| At 1 January | **325** | 1,342 |
| Exchange and other adjustments | **–** | (11) |
| Additional capital injections and transfers | **–** | – |
| Disposals | **(72)** | (7) |
| Capital repayment | **–** | (999) |
| Impairment | **(3)** | – |
| **At 31 December** | **250** | 325 |

The principal group undertaking, which has prepared accounts to 31 December and whose results are included in the consolidated accounts of Bank of Scotland plc, is:

| | Share class | Country of registration/ incorporation | Percentage of equity share capital and voting rights held | Nature of business |
|---|---|---|---|---|
| Uberior Investments Limited | Ordinary | UK | 100% | Investment holding |

The principal area of operation for this group undertaking is its country of registration/incorporation.

A full list of subsidiaries will be included in the Bank's next annual return, the Bank having made use of the exemption in section 410 of the Companies Act 2006.

All regulated subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions. 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.

### 22 Goodwill

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| At 1 January | **334** | 385 | **325** | 376 |
| Impairment charged to the income statement | **–** | (51) | **–** | (51) |
| Disposal of business | **(9)** | | **–** | |
| **At 31 December** | **325** | 334 | **325** | 325 |
| | | | | |
| Cost[1] | **944** | 953 | **426** | 426 |
| Accumulated impairment losses | **(619)** | (619) | **(101)** | (101) |
| **At 31 December** | **325** | 334 | **325** | 325 |

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. This compares the recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £325 million (2013: £334 million), £325 million (the entire balance in 2014; 97 per cent of the total in 2013) has been allocated to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2014 has been based upon value in use. This calculation uses cash flow projections based upon the five year business plan where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows for the period subsequent to the term of the business plan are not considered for the purposes of impairment testing. The discount rate used in discounting the projected cash flows is 12 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 Group incurred a £51 million write-off of goodwill during 2013 following the impairment review of goodwill relating to an acquisition made in previous years.

### 23 Other intangible assets

| | The Group | | | | The Bank | | |
|---|---|---|---|---|---|---|---|
| | **Purchased credit card relationships** | **Brands £m** | **Capitalised software enhancements £m** | **Total £m** | **Capitalised software enhancements £m** | **Purchased credit card relationships £m** | **Total £m** |
| Cost: | | | | | | | |
| At 1 January 2013 | – | 10 | 260 | 270 | 252 | – | 252 |
| Additions | 15 | – | 25 | 40 | 25 | 15 | 40 |
| Disposals | – | – | (168) | (168) | (160) | – | (160) |
| At 31 December 2013 | 15 | 10 | 117 | 142 | 117 | 15 | 132 |
| Additions | **–** | **–** | **26** | **26** | **26** | **–** | **26** |
| **At 31 December 2014** | **15** | **10** | **143** | **168** | **143** | **15** | **158** |
| Accumulated amortisation: | | | | | | | |
| At 1 January 2013 | – | 10 | 168 | 178 | 166 | – | 166 |
| Charge for the year (note 9) | 2 | – | 12 | 14 | 12 | 2 | 14 |
| Disposals | – | – | (145) | (145) | (143) | – | (143) |
| At 31 December 2013 | 2 | 10 | 35 | 47 | 35 | 2 | 37 |
| Charge for the year (note 9) | **3** | **–** | **18** | **21** | **18** | **3** | **21** |
| **At 31 December 2014** | **5** | **10** | **53** | **68** | **53** | **5** | **58** |
| **Balance sheet amount at 31 December 2014** | **10** | **–** | **90** | **100** | **90** | **10** | **100** |
| Balance sheet amount at 31 December 2013 | 13 | – | 82 | 95 | 82 | 13 | 95 |

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

**24 Tangible fixed assets**

| | The Group | | | | The Bank | | |
|---|---|---|---|---|---|---|---|
| | **Premises £m** | **Equipment £m** | **Operating lease assets £m** | **Total tangible fixed assets £m** | **Premises £m** | **Equipment £m** | **Total tangible fixed assets £m** |
| Cost: | | | | | | | |
| At 1 January 2013 | 1,428 | 1,814 | 1,020 | 4,262 | 1,374 | 1,732 | 3,106 |
| Exchange and other adjustments | 4 | 2 | (23) | (17) | 5 | (3) | 2 |
| Additions | 33 | 93 | 26 | 152 | 33 | 88 | 121 |
| Disposals | (45) | (66) | (283) | (394) | (35) | (33) | (68) |
| Disposal of businesses | – | (39) | (80) | (119) | – | – | – |
| At 31 December 2013 | 1,420 | 1,804 | 660 | 3,884 | 1,377 | 1,784 | 3,161 |
| Exchange and other adjustments | **1** | **1** | **(2)** | **–** | **1** | **1** | **2** |
| Additions | **35** | **85** | **–** | **120** | **35** | **85** | **120** |
| Disposals | **(30)** | **(39)** | **(400)** | **(469)** | **(30)** | **(39)** | **(69)** |
| Disposal of businesses | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| **At 31 December 2014** | **1,426** | **1,851** | **258** | **3,535** | **1,383** | **1,831** | **3,214** |
| Accumulated depreciation and impairment: | | | | | | | |
| At 1 January 2013 | 818 | 1,334 | 409 | 2,561 | 805 | 1,283 | 2,088 |
| Exchange and other adjustments | 1 | (10) | (18) | (27) | (7) | (7) | (14) |
| Depreciation charge for the year (note 9) | 57 | 101 | 52 | 210 | 57 | 92 | 149 |
| Disposals | (33) | (50) | (134) | (217) | (29) | (30) | (59) |
| Disposal of businesses | – | (26) | (32) | (58) | – | – | – |
| At 31 December 2013 | 843 | 1,349 | 277 | 2,469 | 826 | 1,338 | 2,164 |
| Exchange and other adjustments | **(1)** | **1** | **–** | **–** | **(1)** | **3** | **2** |
| Depreciation charge for the year (note 9) | **58** | **81** | **19** | **158** | **57** | **81** | **138** |
| Disposals | **(24)** | **(42)** | **(165)** | **(231)** | **(24)** | **(42)** | **(66)** |
| Disposal of businesses | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| **At 31 December 2014** | **876** | **1,389** | **131** | **2,396** | **858** | **1,380** | **2,238** |
| **Balance sheet amount at 31 December 2014** | **550** | **462** | **127** | **1,139** | **525** | **451** | **976** |
| Balance sheet amount at 31 December 2013 | 577 | 455 | 383 | 1,415 | 551 | 446 | 997 |

At 31 December the future minimum rentals receivable by the Group under non-cancellable operating leases were as follows:

| | **2014 £m** | 2013 £m |
|---|---|---|
| Receivable within 1 year | **23** | 49 |
| 1 to 5 years | **36** | 104 |
| Over 5 years | **–** | 177 |
| **Total future minimum rentals receivable** | **59** | 330 |

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2013 and 2014 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £nil for the Group and £nil for the Bank at 31 December 2014 (2013: £nil for the Group and £nil for the Bank) is expected to be received under non-cancellable sub-leases of the Group's premises.

## 25 Other assets

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Settlement balances | **7** | 1,935 | **7** | 1,935 |
| Investments in joint ventures and associates | **67** | 76 | **2** | 2 |
| Assets of disposal group | **–** | 169 | **–** | 100 |
| Other assets and prepayments | **1,614** | 916 | **1,541** | 783 |
| **Total other assets** | **1,688** | 3,096 | **1,550** | 2,820 |

## 26 Deposits from banks

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Liabilities in respect of securities sold under repurchase agreements | **595** | 623 | **595** | 623 |
| Other deposits from banks | **1,696** | 2,552 | **1,688** | 2,548 |
| **Total deposits from banks** | **2,291** | 3,175 | **2,283** | 3,171 |

At 31 December 2014 £1,463 million (2013: £777 million) of deposits from banks of the Group and £1,462 million (2013: £856 million) of the Bank had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 45.

## 27 Customer deposits

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Non-interest bearing current accounts | **15,926** | 13,764 | **15,926** | 13,764 |
| Interest bearing current accounts | **22,986** | 22,481 | **22,986** | 22,481 |
| Savings and investment accounts | **149,149** | 163,077 | **149,149** | 163,077 |
| Liabilities in respect of securities sold under repurchase agreements | **–** | – | **–** | – |
| Other customer deposits | **15,437** | 7,246 | **15,437** | 7,246 |
| **Total customer deposits** | **203,498** | 206,568 | **203,498** | 206,568 |

At 31 December 2014 £23,695 million (2013: £33,931 million) of customer deposits of the Group and Bank had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 45.

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Trading liabilities: | | | | |
| Liabilities in respect of securities sold under repurchase agreements | **13,717** | 31,563 | **13,717** | 31,563 |
| Short positions in securities | **47** | 5,023 | **47** | 5,023 |
| | **13,764** | 36,586 | **13,764** | 36,586 |
| Other liabilities held at fair value through profit or loss | **5** | 38 | **–** | – |
| **Trading liabilities** | **13,769** | 36,624 | **13,764** | 36,586 |

At 31 December 2014, £6 million (2013: £936 million) of trading liabilities of the Group and £1 million (2013: £897 million) of the Bank had a contractual residual maturity of greater than one year. For amounts included above which are subject to repurchase agreements see note 45.

For the fair value of collateral pledged in respect of repurchase agreements see note 45.

# Notes to the accounts

## 29 Debt securities in issue

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Medium-term notes issued | **2,074** | 2,810 | **2,074** | 2,810 |
| Covered bonds (note 16) | **11,208** | 13,816 | **11,208** | 13,816 |
| Securitisation notes (note 16) | **7,014** | 12,593 | **–** | – |
| | **20,296** | 29,219 | **13,282** | 16,626 |
| Amounts due to fellow Group undertakings | **112** | 243 | **4,274** | 11,480 |
| **Total debt securities in issue** | **20,408** | 29,462 | **17,556** | 28,106 |

At 31 December 2014 £17,567 million (2013: £25,169 million) of debt securities in issue of the Group and £13,201 million (2013: £14,424 million) of the Bank had a contractual residual maturity of greater than one year.

## 30 Other liabilities

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Settlement balances | **1** | 2,348 | **1** | 2,348 |
| Other creditors and accruals | **1,153** | 1,974 | **967** | 1,738 |
| **Total other liabilities** | **1,154** | 4,322 | **968** | 4,086 |

## 31 Deferred tax

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Asset at 1 January | **2,710** | 3,640 | **3,006** | 3,350 |
| Exchange and other adjustments | **–** | 1 | **–** | – |
| Business disposals | **(5)** | (146) | **–** | – |
| Income statement charge (note 11): | | | | |
| Due to change in UK corporation tax rate and related impacts | **(1)** | (430) | **(6)** | (431) |
| Other | **(379)** | (390) | **(505)** | 33 |
| | **(380)** | (820) | **(511)** | (398) |
| Amount charged to equity: | | | | |
| Available-for-sale financial assets (note 36) | **1** | (108) | **(16)** | (89) |
| Cash flow hedges (note 36) | **106** | 143 | **106** | 143 |
| | **107** | 35 | **90** | 54 |
| **Asset at 31 December** | **2,432** | 2,710 | **2,585** | 3,006 |

# Notes to the accounts

**31 Deferred tax** (continued)

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 | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Statutory position** | | | | |
| Deferred tax asset | **2,432** | 2,710 | **2,585** | 3,006 |
| Deferred tax liability | **–** | – | **–** | – |
| **Net deferred tax asset** | **2,432** | 2,710 | **2,585** | 3,006 |
| | | | | |
| **Tax disclosure** | | | | |
| Deferred tax asset | **2,619** | 3,069 | **2,732** | 3,300 |
| Deferred tax liability | **(187)** | (359) | **(147)** | (294) |
| **Net deferred tax asset** | **2,432** | 2,710 | **2,585** | 3,006 |

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

| | **2014 £m** | 2013 £m |
|---|---|---|
| Accelerated capital allowances | **103** | 261 |
| Tax losses carried forward | **(532)** | (688) |
| Allowances for impairment losses | **(13)** | (71) |
| Other temporary differences | **62** | (322) |
| **Deferred tax charge in the income statement** | **(380)** | (820) |

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Deferred tax assets: | | | | |
| Allowances for impairment losses | **–** | 1 | **14** | 29 |
| Capital allowances | **142** | 39 | **242** | 242 |
| Other provisions | **–** | – | **–** | – |
| Available-for-sale asset revaluation | **–** | – | **–** | – |
| Tax losses carried forward | **2,307** | 2,855 | **2,307** | 2,855 |
| Other temporary differences | **170** | 174 | **169** | 174 |
| **Total deferred tax assets** | **2,619** | 3,069 | **2,732** | 3,300 |
| | | | | |
| Deferred tax liabilities: | | | | |
| Allowances for impairment losses | **(12)** | – | **–** | – |
| Accelerated capital allowances | **–** | – | **–** | – |
| Available-for-sale asset revaluation | **(7)** | (25) | **(1)** | (3) |
| Derivatives | **(120)** | (226) | **(120)** | (226) |
| Effective interest rate | **(9)** | (18) | **(9)** | (18) |
| Other temporary differences | **(39)** | (90) | **(17)** | (47) |
| **Total deferred tax liabilities** | **(187)** | (359) | **(147)** | (294) |

The Finance Act 2013 (the Act) was substantively enacted on 2 July 2013. The Act further reduced the main rate of corporation tax to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015.

**31 Deferred tax** (continued)

*Deferred tax assets*
Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised a deferred tax asset of £2,307 million and £2,307 million for the Bank (2013: £2,855 million for the Group and the Bank) in relation to trading tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset.

Deferred tax assets of £185 million for the Group and £119 million for the Bank (2013: £140 million for the Group and £83 million for 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.

Deferred tax assets of £49 million for the Group and £nil for the Bank (2013: £49 million for the Group and £nil for the Bank) have not been recognised in respect of trading losses carried forward, arising in certain overseas companies, as there are limited predicted future trading profits to offset them. Trading losses can be carried forward indefinitely except for losses in the USA which expire after 20 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2014 of £39 million for the Group and the Bank (2013: £39 million for the Group and 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.

**32 Other provisions**

| The Group | Provisions for commitments £m | Payment protection insurance £m | Other regulatory provisions £m | Vacant leasehold property and other £m | Total £m |
|---|---|---|---|---|---|
| At 1 January 2014 | 110 | 984 | 335 | 60 | 1,489 |
| Exchange and other adjustments | (53) | – | (113) | 119 | (47) |
| Provisions applied | – | (740) | (144) | (80) | (964) |
| Charge for the year | 17 | 674 | 244 | 133 | 1,068 |
| **At 31 December 2014** | 74 | 918 | 322 | 232 | 1,546 |

| The Bank | Provisions for commitments £m | Payment protection insurance £m | Other regulatory provisions £m | Vacant leasehold property and other £m | Total £m |
|---|---|---|---|---|---|
| At 1 January 2014 | 110 | 972 | 337 | 54 | 1,473 |
| Exchange and other adjustments | (53) | – | (115) | 121 | (47) |
| Provisions applied | – | (731) | (144) | (76) | (951) |
| Charge for the year | 17 | 669 | 244 | 130 | 1,060 |
| **At 31 December 2014** | 74 | 910 | 322 | 229 | 1,535 |

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

**Payment protection insurance**
Following the unsuccessful legal challenge by the BBA against the Financial Services Authority (FSA), now known as the Financial Conduct Authority (FCA) and the Financial Ombudsman Service (FOS), the Group made provisions totaling £2,745 million to 31 December 2013 against the costs of paying redress to customers in respect of past sales of PPI policies, including the related administrative expenses.

During 2014 customer initiated complaints have continued to fall, albeit slower than expected. The proactive mailings have been substantially completed and remediation of previously defended cases commenced. A further £674 million has been added to the provision in 2014, of which £100 million was at the half year; £250 million in the third quarter and £324 million at the year end which brings the total amount provided to £3,419 million, including anticipated administrative expenses.

The total amount provided for PPI represents the Group's best estimate of the likely future costs, albeit a number of risks and uncertainties remain, including complaint volumes, uphold rates, average redress paid, the scope and cost of proactive mailings and remediation, litigation costs and the outcome of the FCA Enforcement Investigation. The cost of these factors could differ materially from the Group's estimates and the assumptions underpinning them and could result in a further provision being required.

Key sensitivities are as follows:

- the number of customer initiated complaints received: an increase of 50,000 from the level assumed would increase the provision for redress costs by £90 million;
- average uphold rate per policy: an increase of one percentage point in this assumption would increase the provision by £6 million;
- average redress paid per upheld policy: an increase of £100 in this assumption would increase the provision by £36 million.

**32 Other provisions** (continued)

**Other regulatory provisions**

*LIBOR and other trading rates*

During 2014 the Group charged £53 million to the income statement in respect of this matter. In July, the Lloyds Banking Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Lloyds Banking Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate.

On LIBOR, the Lloyds Banking Group has reached settlements with the FCA in the United Kingdom, the United States Commodity Futures Trading Commission (CFTC) and the United States Department of Justice (DOJ) in relation to investigations into submissions between May 2006 and 2009 and related systems and controls failings.

The settlements in relation to LIBOR are part of an industry-wide investigation into the setting of interbank offered rates across a range of currencies. Under the settlement, the Lloyds Banking Group has paid £35 million, £62 million and £50 million to the FCA, CFTC and DOJ respectively. As part of the settlement with the DOJ, the Lloyds Banking Group has also entered into a two-year Deferred Prosecution Agreement in relation to one count of wire fraud relating to the setting of LIBOR.

In relation to the BBA Sterling Repo Rate, the Lloyds Banking Group has reached a settlement with the FCA regarding submissions made between April 2008 and September 2009. This issue involved four individuals who the FCA has concluded manipulated BBA Repo Rate submissions to reduce fees payable under the Special Liquidity Scheme (SLS). The issue was proactively brought to the FCA's attention when it was identified by the Lloyds Banking Group as part of its internal investigation into the LIBOR issues.

The Lloyds Banking Group has paid £70 million to the FCA in connection with the resolution of the BBA Repo Rate issue and related systems and controls failings. Both the CFTC and DOJ settlements are in respect of LIBOR only and neither agency has taken action regarding the BBA Repo Rate.

The BBA Repo Rate was used by the Bank of England (BoE) to calculate the fees for the SLS. During the period that Lloyds TSB and HBOS used the SLS they paid £1,278 million in fees, just under half of all the fees payable by the industry under the Scheme. As a result of the actions of the four individuals involved, the Lloyds Banking Group has paid nearly £8 million to compensate the BoE for amounts underpaid (by Lloyds TSB and HBOS and the other banks that used the SLS).

*Interest rate hedging products*

In June 2012, a number of banks, including the Lloyds Banking Group, reached agreement with the FSA (now FCA) to carry out a review of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. As at 31 December 2014 the Lloyds Banking Group had identified 1,676 sales of IRHPs to customers within scope of the agreement with the FCA which have opted in and are being reviewed and, where appropriate, redressed. The Lloyds Banking Group agreed that on conclusion of this review it would provide redress to any in-scope customers where appropriate. The Lloyds Banking Group continues to review the remaining cases within the scope of the agreement with the FCA but has met all of the regulator's requirements to date.

During 2014, the Group has charged a further £65 million in respect of estimated redress costs, increasing the total amount provided for redress and related administration costs for in-scope customers to £204 million (31 December 2013: £139 million). This increase relates to an extension in the timetable for customers being able to opt-in to the review and the volume and complexity of claims. As at 31 December 2014, the Group has utilised £98 million (31 December 2013: £10 million), with £106 million (31 December 2013: £129 million) of the provision remaining.

*Other legal actions and regulatory matters*

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints and claims from customers in connection with its past conduct and, where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. In 2014 the provision was increased by a further £126 million, in respect of a number of matters affecting the Group's businesses, including potential claims and remediation in respect of products sold through the branch network and continuing investigation of matters highlighted through industry-wide regulatory reviews, as well as legacy product sales and historical systems and controls such as those governing legacy incentive schemes. This brings the total amount charged to £236 million of which £21 million had been utilised at 31 December 2014. This increase reflected the Group's assessment of a limited number of matters under discussion, none of which currently is individually considered financially material in the context of the Group.

**Vacant leasehold property 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 biannual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging three years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

## 33 Subordinated liabilities

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Preference shares | | – | | – |
| Preferred securities | **723** | 703 | **321** | 296 |
| Undated subordinated liabilities | **4,750** | 4,762 | **5,151** | 5,189 |
| Dated subordinated liabilities | **2,154** | 7,889 | **2,154** | 7,931 |
| **Total subordinated liabilities** | **7,627** | 13,354 | **7,626** | 13,416 |

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **At 1 January** | **13,354** | 14,404 | **13,416** | 13,848 |
| Repurchases and redemptions during the year | **(5,770)** | (947) | **(5,770)** | (283) |
| Foreign exchange and other movements | **43** | (103) | **(20)** | (149) |
| **At 31 December** | **7,627** | 13,354 | **7,626** | 13,416 |

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of the depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of the specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of the holders of the dated subordinated liabilities. Neither the Group nor the Bank has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2013: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the Prudential Regulation Authority.

| | The Group | | The Bank | |
|---|---|---|---|---|
| **Preference Shares** | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| 6% Non-cumulative Redeemable preference shares | **–** | – | **–** | – |

Since 2009, the Company has had in issue 400 6% non-cumulative preference shares of 25p each. The shares are redeemable at the option of the Company at any time and carry the rights to a fixed rate non-cumulative preferential dividend of 6% per annum; no dividend shall be paid in the event that the directors determine that prudential capital ratios would not be maintained if the dividend were paid. Upon winding up the shares rank equally with any other preference shares issued by the Company.

| | | The Group | | The Bank | |
|---|---|---|---|---|---|
| **Preferred securities** | Note | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| 8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million) | a,b | **251** | 256 | **–** | – |
| 7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million) | | **151** | 151 | **–** | – |
| 7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million) | | **151** | 150 | **151** | 150 |
| 7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million) | | **170** | 146 | **170** | 146 |
| **Total preferred securities** | | **723** | 703 | **321** | 296 |

**33 Subordinated liabilities** (continued)

| Undated subordinated liabilities | Note | The Group 2014 £m | The Group 2013 £m | The Bank 2014 £m | The Bank 2013 £m |
|---|---|---|---|---|---|
| 8.625% Perpetual Subordinated Notes (£200 million) | | **–** | – | **–** | – |
| Floating Rate Subordinated Notes (€500 million) | | **390** | 417 | **390** | 417 |
| Floating Rate Primary Capital Notes (US$250 million) | a | **116** | 109 | **116** | 109 |
| 7.375% Subordinated Undated Instruments (£150 million) | | **72** | 71 | **72** | 71 |
| 4.25% Subordinated Undated Instruments (¥17 billion) | | **96** | 109 | **96** | 109 |
| 10.25% Subordinated Undated Instruments (£100 million) | | **1** | 1 | **1** | 1 |
| Floating Rate Subordinated Notes (£300 million) | | **300** | 300 | **300** | 300 |
| Perpetual Preferred Notes (£250 million) | | **–** | – | **–** | 256 |
| Perpetual Preferred Notes (£150 million) | | **–** | – | **151** | 151 |
| Floating Rate Subordinated Notes (£150 million) | | **150** | 150 | **150** | 150 |
| Floating Rate Subordinated Notes (£500 million) | | **500** | 500 | **500** | 500 |
| 12% Perpetual Subordinated Bonds (£100 million) | | **21** | 21 | **21** | 21 |
| 8.75% Perpetual Subordinated Bonds (£100 million) | | **5** | 5 | **5** | 5 |
| 13.625% Perpetual Subordinated Bonds (£75 million) | | **14** | 14 | **14** | 14 |
| 9.375% Perpetual Subordinated Bonds (£50 million) | | **15** | 15 | **15** | 15 |
| Floating Rate Subordinated Notes (£500 million) | | **500** | 500 | **500** | 500 |
| Floating Rate Subordinated Notes (£300 million) | | **300** | 300 | **300** | 300 |
| Floating Rate Subordinated Notes (£250 million) | | **250** | 250 | **250** | 250 |
| Floating Rate Subordinated note (£2,000 million) | | **2,000** | 2,000 | **2,000** | 2,000 |
| Floating Rate Subordinated Notes (€22 million) | | **17** | – | **17** | 20 |
| 8.117% Non-cumulative Perpetual Preferred Securities series 1 of £1,000 each (Class A) (£250 million) | | **3** | – | **253** | – |
| **Total undated subordinated liabilities** | | **4,750** | 4,762 | **5,151** | 5,189 |

| Dated subordinated liabilities | The Group 2014 £m | The Group 2013 £m | The Bank 2014 £m | The Bank 2013 £m |
|---|---|---|---|---|
| 11% Subordinated Bonds 2014 (£250 million) | **–** | 275 | **–** | 275 |
| 10.5% Subordinated Bonds 2018 (£150 million) | **163** | 164 | **163** | 164 |
| 6.375% Instruments 2019 (£250 million) | **307** | 304 | **307** | 304 |
| 9.375% Subordinated Bonds 2021 (£500 million) | **645** | 626 | **645** | 626 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£330 million) | **–** | 330 | **–** | 330 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£300 million) | **–** | 300 | **–** | 300 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£700 million) | **–** | 700 | **–** | 700 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£300 million) | **–** | 300 | **–** | 300 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£520 million) | **–** | 520 | **–** | 520 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£300 million) | **–** | 300 | **–** | 300 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£300 million) | **–** | 300 | **–** | 300 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£270 million) | **–** | 270 | **–** | 270 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£500 million) | **–** | 500 | **–** | 500 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£2,000 million) | **–** | 2,000 | **–** | 2,000 |
| Floating Rate Subordinated Notes on rolling 5 year notice (£1,000 million) | **1,000** | 1,000 | **1,000** | 1,000 |
| Floating Rate Subordinated Notes on rolling 5 year notice (€55 million) | **39** | – | **39** | 42 |
| **Total dated subordinated liabilities** | **2,154** | 7,889 | **2,154** | 7,931 |

a) These securities have passed their first call date, and are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the PRA.

b) The fixed rate on this security was reset from 8.117 per cent to 6.059 per cent with effect from 31 May 2010.

At 31 December 2014 £7,373 million (2013: £13,079 million) of subordinated liabilities of the Group and £7,373 million (2013: £13,141 million) of the Bank had a contractual residual maturity of greater than one year.

## 34 Share capital

### (1) Authorised share capital

| | Group and Bank | | | |
|---|---|---|---|---|
| | **2014 Number of shares** | 2013 Number of shares | **2014 £m** | 2013 £m |
| *Sterling* | | | | |
| Ordinary shares of 25p | | | | |
| At 1 January and 31 December | **24,085,301,755** | 24,085,301,755 | **6,021** | 6,021 |
| 8.117% non-cumulative perpetual preference shares class 'A' of £10 each | **250,000** | 250,000 | **3** | 3 |
| 7.754% non-cumulative perpetual preference shares class 'B' of £10 each | **150,000** | 150,000 | **2** | 2 |
| | | | **6,026** | 6,026 |

### (2) Issued share capital

| | Group and Bank | | | |
|---|---|---|---|---|
| | **2014 Number of shares** | 2013 Number of shares | **2014 £m** | 2013 £m |
| **Ordinary shares of 25p each** | | | | |
| At 1 January and 31 December | **23,388,340,552** | 23,388,340,552 | **5,847** | 5,847 |
| **Issued and fully paid preference shares** | | | | |
| *Preference shares of 25p each* | | | | |
| At 1 January and 31 December | **400** | 400 | **–** | – |
| **Total share capital at 31 December** | **23,388,340,952** | 23,388,340,952 | **5,847** | 5,847 |

**Ordinary shares**
The holders of ordinary shares, who held 100 per cent of the total ordinary share capital at 31 December 2014, are entitled to receive the Bank's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares may also receive a dividend (subject to the provisions of the Bank's articles of association) and on a winding up may share in the assets of the Bank.

## 35 Share premium account

| | Group and Bank | |
|---|---|---|
| | **2014 £m** | 2013 £m |
| **At 1 January** | **27,479** | 27,479 |
| Capital restructuring | **(27,479)** | – |
| **At 31 December** | **–** | 27,479 |

[1]During 2014 the Bank reduced its share premium account by Special Resolution which was confirmed by an Order of the Court of Session, Scotland on 16 December 2014. The balance on the share premium account of £27,479 million has been transferred to retained profits.

## 36 Other reserves

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Other reserves comprise: | | | | |
| Merger and other reserves[1] | **1,600** | 1,600 | **1,600** | 1,600 |
| Capital redemption reserve[1] | **482** | 482 | **482** | 482 |
| Revaluation reserve in respect of available-for-sale financial assets | **133** | 27 | **120** | (31) |
| Cash flow hedging reserve | **483** | 907 | **479** | 903 |
| Foreign currency translation reserve | **(193)** | (200) | **113** | 105 |
| **At 31 December** | **2,505** | 2,816 | **2,794** | 3,059 |

[1]There have been no movements in these reserves over 2013 or 2014.

**36 Other reserves** (continued)

Movements in other reserves were as follows:

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Revaluation reserve in respect of available-for-sale financial assets** | | | | |
| At 1 January | **27** | (145) | **(31)** | (135) |
| Change in fair value of available-for-sale financial assets | **234** | 232 | **205** | 117 |
| Deferred tax | **(49)** | (60) | **(44)** | (38) |
| | **185** | 172 | **161** | 79 |
| Income statement transfers: | | | | |
| Disposals (note 8) | **(137)** | 3 | **(42)** | 74 |
| Deferred tax | **51** | (39) | **29** | (51) |
| | **(86)** | (36) | **(13)** | 23 |
| Impairment | **8** | 45 | **4** | 2 |
| Deferred tax | **(1)** | (9) | **(1)** | – |
| | **7** | 36 | **3** | 2 |
| **At 31 December** | **133** | 27 | **120** | (31) |

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Cash flow hedging reserve** | | | | |
| At 1 January | **907** | 1,238 | **903** | 1,234 |
| Change in fair value of hedging derivatives | **(56)** | (80) | **(56)** | (80) |
| Deferred tax | **11** | 64 | **11** | 64 |
| | **(45)** | (16) | **(45)** | (16) |
| Income statement transfers | **(474)** | (394) | **(474)** | (394) |
| Deferred tax | **95** | 79 | **95** | 79 |
| | **(379)** | (315) | **(379)** | (315) |
| **At 31 December** | **483** | 907 | **479** | 903 |

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Foreign currency translation reserve** | | | | |
| At 1 January | **(200)** | (101) | **105** | 107 |
| Currency translation differences arising in the year | **7** | (172) | **8** | (2) |
| Foreign currency gains on net investment hedges (tax: £nil) | **–** | 73 | **–** | – |
| **At 31 December** | **(193)** | (200) | **113** | 105 |

## 37 Retained profits

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| At 1 January | **(17,788)** | (18,286) | **(20,043)** | (20,604) |
| Capital restructuring (note 35) | **27,479** | – | **27,479** | – |
| Profit for the year[1] | **2,666** | 355 | **2,918** | 418 |
| Capital contribution received | **136** | 143 | **136** | 143 |
| **At 31 December** | **12,493** | (17,788) | **10,490** | (20,043) |

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

## 38 Dividends

No dividends were paid on the Bank's ordinary shares in 2013 or 2014. The Board have recommended a dividend of £5,000 million which, subject to approval by shareholders, will be paid in March 2015 and has not been reflected in these financial statements.

## 39 Share-based payments

**Share-based payment scheme details**
During the year ended 31 December 2014 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group plc are set out below; these are managed and operated on a Lloyds Banking Group-wide basis. The amount charged to the Group's income statement in respect of Lloyds Banking Group plc share-based payment schemes, and which is included within staff costs (note 9), was £136 million (2013: £143 million).

**Deferred bonus plans**
The Lloyds Banking Group operates a number of deferred bonus plans that are equity settled. Bonuses in respect of employee performance in 2014 have been recognised in the charge in line with the proportion of the deferral period completed.

**Lloyds Banking Group executive share option schemes**
The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between March 2004 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5.

**Performance conditions for executive options**
**For options granted in 2004**
The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds Banking Group plc.

The performance condition was measured over a three year period which commenced at the end of the financial year preceding the grant of the option and continued until the end of the third subsequent year. If the performance condition was not then met, it was measured at the end of the fourth financial year. If the condition was not then met, the options would lapse.

To meet the performance conditions, the Lloyds Banking Group's ranking against the comparator group was required to be at least ninth. The full grant of options only became exercisable if the Lloyds Banking Group was ranked first. A performance multiplier (of between nil and 100 per cent) was applied below this level to calculate the number of shares in respect of which options granted to Executive Directors would become exercisable, and were calculated on a sliding scale. If Lloyds Banking Group plc was ranked below median the options would not be exercisable.

Options granted to senior executives other than Executive Directors were not so highly leveraged and, as a result, different performance multipliers were applied to their options. For the majority of executives, options were granted with the performance condition but with no performance multiplier.

Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 14 per cent for Executive Directors, 24 per cent for Managing Directors, and 100 per cent for all other executives.

All options granted in 2004 lapsed on 18 March 2014 and 12 August 2014.

**39 Share-based payments** (continued)

**For options granted in 2005**
The same conditions applied as for grants made in 2004, except that:

- the performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds Banking Group plc;
- if the performance condition was not met at the end of the third subsequent year, the options would lapse; and
- the full grant of options became exercisable only if the Lloyds Banking Group was ranked in the top four places of the comparator group. A sliding scale applied between fourth and eighth positions. If Lloyds Banking Group was ranked below the median (ninth or below) the options would lapse.

Options granted in 2005 became exercisable as the performance condition was met when tested. The performance condition vested at 82.5 per cent for all options granted.

Movements in the number of share options outstanding under the executive share option schemes during 2014 and 2013 are set out below:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | **6,052,593** | **224.04** | 8,044,896 | 224.95 |
| Forfeited | **–** | **–** | (1,992,303) | 227.70 |
| Lapsed | **(3,417,306)** | **215.39** | – | – |
| **Outstanding at 31 December** | **2,635,287** | **235.26** | 6,052,593 | 224.04 |
| **Exercisable at 31 December** | **2,635,287** | **235.26** | 6,052,593 | 224.03 |

No options were exercised during 2014 or 2013. The weighted average remaining contractual life of options outstanding at the end of the year was 0.2 years (2013: 0.8 years). The fair values of the executive share options have been determined using a standard Black-Scholes model.

**Save-As-You-Earn schemes**
Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £500 per month and, at the expiry of a fixed term of three or five years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Lloyds Banking Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

Movements in the number of share options outstanding under the SAYE schemes are set out below:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | **500,969,617** | **41.16** | 314,572,023 | 48.01 |
| Granted | **326,565,564** | **60.02** | 510,414,399 | 40.62 |
| Exercised | **(7,287,899)** | **41.29** | (294,905,606) | 46.78 |
| Forfeited | **(18,949,167)** | **41.68** | (7,715,717) | 43.08 |
| Cancelled | **(15,561,144)** | **54.04** | (10,761,588) | 45.61 |
| Expired | **(2,110,588)** | **48.15** | (10,633,894) | 56.28 |
| **Outstanding at 31 December** | **783,626,383** | **48.73** | 500,969,617 | 41.16 |
| **Exercisable at 31 December** | **1,852** | **180.66** | 2,255,239 | 120.76 |

The weighted average share price at the time that the options were exercised during 2014 was £0.77 (2013: £0.65). The weighted average remaining contractual life of options outstanding at the end of the year was 2.6 years (2013: 2.9 years).

The weighted average fair value of SAYE options granted during 2014 was £0.22 (2013: £0.24). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2014 or 2013. The options outstanding at 31 December 2014 had an exercise price of £1.8066 (2013: £1.8066) and a weighted average remaining contractual life of 1.4 years (2013: 1.1 years).

**Other share option plans**
**Lloyds Banking Group Executive Share Plan 2003**
The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The Plan is used not only to compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

For options granted on 27 March 2014 under the Commercial Banking Transformation Plan (CBTP), the number of options that may be delivered in March 2017 may vary by a factor of 0-4 from the original 'on-target' award, depending on the degree to which the performance conditions have been met. An 'on-target' vesting is contingent upon Commercial Banking achieving £2.5 billion Underlying Profit and 2 per cent Return on Risk Weighted Assets ('RoRWA') on 31 December 2016. The Plan will pay out at between £1.9 billion and £3 billion underlying profit, and between 1.6 per cent and 2.5 per cent RoRWA.

**39 Share-based payments** (continued)

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

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | 37,354,979 | Nil | 45,614,150 | Nil |
| Granted | 225,424,109 | Nil | 9,284,956 | Nil |
| Exercised | (21,870,649) | Nil | (16,079,222) | Nil |
| Forfeited | (7,114,199) | Nil | (1,290,720) | Nil |
| Lapsed | (405,156) | Nil | (174,185) | Nil |
| **Outstanding at 31 December** | 233,389,084 | Nil | 37,354,979 | Nil |
| **Exercisable at 31 December** | 9,068,802 | Nil | 4,275,432 | Nil |

The weighted average fair value of options granted in the year was £0.72 (2013: £0.56). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2014 was £0.75 (2013: £0.55). The weighted average remaining contractual life of options outstanding at the end of the year was 7.0 years (2013: 3.6 years).

**Lloyds Banking Group Share Buy Out Awards**

As part of arrangements to facilitate the recruitment of certain Executives, options have been granted by individual deed and, where appropriate, in accordance with the Listing Rules of the UK Listing Authority.

The awards were granted in recognition that the Executives' outstanding awards over shares in their previous employing company lapsed on accepting employment with the Lloyds Banking Group.

Movements in the number of options outstanding are set out below:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price (pence) | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | 11,172,600 | Nil | 21,321,237 | Nil |
| Exercised | (5,173,429) | Nil | (5,953,810) | Nil |
| Forfeited | – | Nil | (4,194,827) | Nil |
| **Outstanding at 31 December** | 5,999,171 | Nil | 11,172,600 | Nil |
| **Exercisable at 31 December** | 5,999,171 | Nil | 11,083,749 | Nil |

No options were granted in 2014 or 2013. The weighted average remaining contractual life of options outstanding at the end of the year was 6.7 years (2013: 7.5 years).

The weighted average share price at the time the options were exercised during 2014 was £0.70 (2013: £0.75).

Participants are entitled to any dividends paid during the vesting period. This amount will be paid in cash unless the Remuneration Committee decides it will be paid in shares.

The fair values of the majority of options granted have been determined using a standard Black-Scholes model. The fair values of the remaining options have been determined by Monte Carlo simulation.

**HBOS share option plans**

The table below details the outstanding options for the HBOS Share Option Plan and the St James's Place Share Option Plan. The final award under the HBOS Share Option Plan was made in 2004. Under this plan, options over shares, at market value with a face value equal to 20 per cent of salary, were granted to employees with the exception of certain senior executives. A separate option plan exists for some partners of St James's Place, which granted options in respect of Lloyds Banking Group plc shares. The final award under the St James's Place Share Option Plan was made in 2009. Movements in the number of share options outstanding under these schemes are set out below:

During 2013 the Lloyds Banking Group completed the sale of all of its holding in St James's Place plc. The participants of the St James's Place Share Option Plan remain entitled to the Lloyds Banking Group plc shares awarded under the terms of this Plan and these options are included in the table below.

**39 Share-based payments** (continued)

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

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | **Number of options** | **Weighted average exercise price (pence)** | Number of options | Weighted average exercise price (pence) |
| Outstanding at 1 January | **13,119,584** | **369.76** | 19,857,692 | 363.76 |
| Exercised | **(5,222,260)** | **51.83** | (2,609,272) | 51.83 |
| Forfeited | **(103,007)** | **580** | (240,349) | 568.80 |
| Lapsed | **(321,138)** | **580** | (2,144,026) | 546.43 |
| Cancelled | **(7,473,179)** | **580** | (1,744,461) | 532.39 |
| **Outstanding at 31 December** | **–** | **–** | 13,119,584 | 369.76 |
| **Exercisable at 31 December** | **–** | **–** | 13,119,584 | 369.76 |

The weighted average share price at the time the options were exercised during 2014 was £0.77 (2013: £0.72).

The options under the HBOS Share Option Plan and St James's Place Share Option Plan lapsed on 15 March 2014 and 20 April 2014 respectively.

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

Participants may be entitled to any dividends paid during the vesting period if the performance conditions are met. An amount equal in value to any dividends paid between the award date and the date the Remuneration Committee determine that the performance conditions were met may be paid, based on the number of shares that vest. The Remuneration Committee will determine if any dividends are to be paid in cash or in shares.

The performance conditions for awards made in March and September 2011 are as follows:

(i) **EPS:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EPS outcome.

If the adjusted EPS reaches 6.4p, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted EPS reaches 7.8p, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **EP:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EP outcome.

If the adjusted EP reaches £567 million, 25 per cent of this element of the award, being the threshold, will vest. If the adjusted EP reaches £1,534 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Total Shareholder Return, relevant to one third of the award. Performance will be measured based on the annualised Absolute Total Shareholder Return over the three year performance period. If the annualised Absolute Total Shareholder Return at the end of the performance period is less than 8 per cent, none of this element of the award will vest. If the Absolute Total Shareholder Return is 8 per cent, 25 per cent of this element of the award, being the threshold, will vest. If the Absolute Total Shareholder Return is 14 per cent or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis. The EPS and EP performance conditions will each relate to 33.3 per cent of the total award.

At the end of the performance period for the EPS and EP measures, the targets had not been fully met and therefore these awards vested in 2014 at a rate of 68 per cent (54 per cent for members of the Group Executive Committee, including Executive Directors).

The performance conditions for awards made in March and September 2012 are as follows:

(i) **EP:** relevant to 30 per cent of the award. The performance target is based on 2014 adjusted EP outcome.

If the adjusted EP reaches £225 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £2,330 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2014.

If the ATSR reaches 12 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 30 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

**39 Share-based payments** (continued)

(iii) **Short-term funding as a percentage of total funding:** relevant to 10 per cent of the award. Performance will be measured relative to 2014 targets.

If the average percentage reaches 20 per cent, 25 per cent of this element of the award, being the threshold, will vest.

If the average percentage reaches 15 per cent, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iv) **Non-core assets at the end of 2014:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet non-core assets at 31 December 2014.

If non-core assets amount to £95 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If non-core assets amount to £80 billion or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(v) **Net Simplification benefits:** relevant to 10 per cent of the award. Performance will be measured by reference to the run rate achieved by the end of 2014.

If a run rate of net Simplification benefits of £1.5 billion is achieved, 25 per cent of this element of the award, being the threshold, will vest.

If a run rate of net Simplification benefits of £1.8 billion is achieved, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(vi) **FCA reportable complaints:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FSA reportable complaints per 1,000 customers (excluding PPI complaints) over the three year period to 31 December 2014.

If complaints per 1,000 customers average 1.5 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 1.3 per annum or less over three years, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

At the end of the performance period, it has been assessed that rewards will vest at 97 per cent of maximum.

The performance conditions for awards made in March and October 2013 are as follows:

(i) **EP:** relevant to 35 per cent of the award. The performance target is based on 2015 adjusted EP outcome.

If the adjusted EP reaches £1,254 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £1,881 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2015.

If the ATSR reaches 8 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 16 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iii) **Adjusted total costs:** relevant to 10 per cent of the award. The performance target is based on 2015 adjusted total costs.

If adjusted total costs are £9,323 million or less, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted total costs are £8,973 million or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iv) **Non-core assets excluding UK Retail at the end of 2015:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet non-core assets at 31 December 2015.

If non-core assets amount to £37 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If non-core assets amount to £28 billion or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(v) **FCA reportable complaints:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FCA reportable complaints per 1,000 customers over the three year period to 31 December 2015.

If complaints per 1,000 customers average 1.05 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 0.95 per annum or less over three years, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

**39 Share-based payments** (continued)

(vi) **SME lending:** relevant to 5 per cent of the award. Performance will be measured by reference to the movement in lending to SMEs relative to the market as reported by the Bank of England over the three year period ending 31 December 2015.

If the movement in SME lending equates to this market movement, 25 per cent of this element of the award, being the threshold, will vest.

If the movement in SME lending is 4 per cent or more greater than the market movement, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

In addition, short-term funding must remain within that stated in the Lloyds Banking Group's Risk Appetite throughout the three year period to 31 December 2015.

The weighted average fair value of the share awards granted in 2014 was £0.62 (2013: £0.34). The fair values of the majority of share awards granted have been determined using a standard Black-Scholes model. The fair values of the remaining share awards have been determined by Monte Carlo simulation.

The performance conditions for awards made in March and August 2014 are as follows:

(i) **EP:** relevant to 30 per cent of the award. The performance target is based on 2016 adjusted EP outcome.

If the adjusted EP reaches £2,154 million, 25 per cent of this element of the award, being the threshold will vest.

If the adjusted EP reaches £3,231 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2016.

If the ATSR reaches 8 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 16 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iii) **Cost: income ratio:** relevant to 10 per cent of the award.

Performance will be measured against the adjusted total costs (total costs excluding FSCS costs and Bank Levy on underlying basis) as a percentage of total underlying income net of insurance claims based on full year 2016 figures.

If the adjusted total costs reaches:

– 48.9 per cent, 25 per cent of this element will vest.

– 46.5 per cent, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iv) **FCA reportable complaints:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FCA reportable complaints per 1,000 accounts (excluding PPI complaints) over the three year period to 31 December 2016. If complaints per 1,000 accounts average 1.15 per annum or less, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 accounts average 1.05 per annum or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(v) **Net Promoter Score:** relevant to 10 per cent of the award. Performance will be measured against the Major Group Ranking position of Lloyds Banking Group, the position averaged over the final twelve months of the performance period.

If the final averaged ranking position of Lloyds Banking Group is third, 25 per cent of this element will vest.

If the final averaged ranking position of Lloyds Banking Group is first, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(vi) **SME lending:** relevant to 5 per cent of the award. Performance will be measured by reference to the percentage increase in net lending to SMEs over the three year period ending 31 December 2016.

If there is a 14 per cent increase in net lending, 25 per cent of this element will vest.

If there is an 18 per cent increase in net lending, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

## 39 Share-based payments (continued)

(vii) **First Time Buyer Lending:** relevant to 5 per cent of the award. Performance will be measured against percentage market shares based on Council of Mortgage Lenders Volumes data. Calculated as three point average of year-end positions over the three year period ending 31 December 2016.

If the percentage market share reaches 20 per cent, 25 per cent of this element will vest.

If the percentage market share reaches 25 per cent, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

| | **2014 Number of shares** | 2013 Number of shares |
|---|---|---|
| Outstanding at 1 January | **548,885,895** | 515,951,517 |
| Granted | **120,952,253** | 186,360,995 |
| Vested | **(73,516,122)** | – |
| Forfeited | **(73,485,915)** | (153,426,617) |
| **Outstanding at 31 December** | **522,836,111** | 548,885,895 |

**Scottish Widows Investment Partnership Long-Term Incentive Plan**

The Scottish Widows Investment Partnership (SWIP) Long-Term Incentive Plan applicable to senior executives and employees of SWIP, which had previously been a cash-only scheme, was amended in May 2012 for awards granted on or after that date. The amendment introduced the receipt of shares in Lloyds Banking Group plc as an element of the total award. For awards made in June 2012, the other element continued to be cash-based, with the split between cash-based and share-based determined by the Remuneration Committee. Awards made in June 2013 were fully share-based. The amendment was aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of SWIP over a three year period. Awards were made within limits set by the rules of the Plan, with the maximum limits for combined cash and shares awarded equating to 3.5 times annual salary. In exceptional circumstances this could increase to four times annual salary.

The 2012 and 2013 performance conditions were evaluated upon completion of the sale of SWIP to Aberdeen Asset Management PLC, and the awards were pro rated as appropriate. The 2012 award will vest at 155 per cent and 165.6 per cent for Code Staff in March 2015 and the 2013 award will vest at 165.7 per cent in March 2016.

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

| | Executive schemes | | | SAYE schemes | | | Other share option plans | | |
|---|---|---|---|---|---|---|---|---|---|
| | **Weighted average exercise price (pence)** | **Weighted average remaining life (years)** | **Number of options** | **Weighted average exercise price (pence)** | **Weighted average remaining life (years)** | **Number of options** | **Weighted average exercise price (pence)** | **Weighted average remaining life (years)** | **Number of options** |
| **At 31 December 2014** | | | | | | | | | |
| Exercise price range | | | | | | | | | |
| £0 to £1 | – | – | – | **48.63** | **2.57** | **783,025,625** | – | – | – |
| £1 to £2 | – | – | – | **180.66** | **1.41** | **600,758** | – | – | – |
| £2 to £3 | **235.26** | **0.2** | **2,635,287** | – | – | – | – | – | – |
| £3 to £4 | – | – | – | – | – | – | – | – | – |
| £5 to £6 | – | – | – | – | – | – | – | – | – |
| At 31 December 2013 | | | | | | | | | |
| Exercise price range | | | | | | | | | |
| £0 to £1 | – | – | – | 40.63 | 2.91 | 499,088,383 | 5.25 | 4.1 | 51,528,728 |
| £1 to £2 | 199.91 | 0.6 | 196,201 | 180.64 | 1.09 | 1,881,234 | – | – | – |
| £2 to £3 | 224.85 | 0.8 | 5,856,392 | – | – | – | – | – | – |
| £5 to £6 | – | – | – | – | – | – | 580.00 | 0.2 | 7,897,324 |

## 39 Share-based payments (continued)

The fair value calculations at 31 December 2014 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

| | Save-As-You-Earn | Executive Share Plan 2003 | LTIP | Commercial Banking Transformation Program |
|---|---|---|---|---|
| Weighted average risk-free interest rate | **1.30%** | **0.58%** | **1.03%** | **1.03%** |
| Weighted average expected life | **3.3 years** | **1.2 years** | **3.0 years** | **3.0 years** |
| Weighted average expected volatility | **35%** | **23%** | **41%** | **41%** |
| Weighted average expected dividend yield | **2.5%** | **2.5%** | **2.5%** | **2.5%** |
| Weighted average share price | **£0.75** | **£0.76** | **£0.79** | **£0.78** |
| Weighted average exercise price | **£0.60** | **Nil** | **Nil** | **Nil** |

Expected volatility is a measure of the amount by which the Lloyds Banking Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Lloyds Banking Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

**Matching shares**
The Lloyds Banking Group undertakes to match shares purchased by employees up to the value of £30 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100 per cent of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2014 was 16,248,562 (2013: 19,870,495), with an average fair value of £0.78 (2013: £0.63), based on market prices at the date of award.

**Fixed Share Awards**
Fixed share awards were introduced in 2014 in order to ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for certain Lloyds Banking Group employees, with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements. The Fixed Share Awards are delivered in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. The number of shares purchased in 2014 was 7,761,624.

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

## 40 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 2013 and 2014, the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

The table below details, on an aggregated basis, key management personnel compensation which has been allocated to the Bank on an estimated basis.

| | 2014 £m | 2013 £m |
|---|---|---|
| **Compensation** | | |
| Salaries and other short-term benefits | **6** | 6 |
| Post-employment benefits | **–** | – |
| Share-based payments | **7** | 8 |
| | **13** | 14 |

The aggregate of the emoluments of the key management personnel was £4.9 million (2013: £5.9 million).

Aggregate company contributions in respect of directors to defined contribution pension schemes were £0.1 million (2013: £0.1 million).

The total for the highest paid director (António Horta-Osório) was £1,913,000 (2013: (António Horta-Osório) £2,617,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in either year.

**40 Related party transactions** (continued)

| | 2014 million | 2013 million |
|---|---|---|
| **Share option plans over Lloyds Banking Group plc shares** | | |
| At 1 January | **14** | 25 |
| Granted (includes entitlements of appointed key management personnel) | **–** | 5 |
| Exercised/lapsed (includes entitlements of former key management personnel) | **(1)** | (16) |
| **At 31 December** | **13** | 14 |

| | 2014 million | 2013 million |
|---|---|---|
| **Share incentive plans settled in Lloyds Banking Group plc shares** | | |
| At 1 January | **105** | 70 |
| Granted (includes entitlements of appointed key management personnel) | **19** | 42 |
| Exercised/lapsed (includes entitlements of former key management personnel) | **(22)** | (7) |
| **At 31 December** | **102** | 105 |

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 Lloyds Banking Group and its key management personnel:

| | 2014 £m | 2013 £m |
|---|---|---|
| **Loans** | | |
| At 1 January | **2** | 2 |
| Advanced (includes loans of appointed key management personnel) | **2** | 2 |
| Repayments (includes loans of former key management personnel) | **(1)** | (2) |
| **At 31 December** | **3** | 2 |

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 0.5 per cent and 23.95 per cent in 2014 (2.5 per cent and 23.9 per cent in 2013).

No provisions have been recognised in respect of loans given to key management personnel (2013: nil).

| | 2014 £m | 2013 £m |
|---|---|---|
| **Deposits** | | |
| At 1 January | **13** | 10 |
| Placed (includes deposits of appointed key management personnel) | **32** | 29 |
| Withdrawn (includes deposits of former key management personnel) | **(29)** | (26) |
| **At 31 December** | **16** | 13 |

Deposits placed by key management personnel attracted interest rates of up to 4.7 per cent in 2014 (2013: 2.9 per cent).

At 31 December 2013 and 2014, the Group did not provide any guarantees in respect of key management personnel.

At 31 December 2014, transactions, arrangements and agreements entered into by the Lloyds Banking Group's banking subsidiaries with directors and connected persons of the Group included amounts outstanding in respect of loans and credit card transactions of £1 million with six directors and six connected persons (2013: £1 million with six directors and five connected persons).

### 40 Related party transactions (continued)

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

*Balances and transactions between members of the Bank of Scotland Group*

In accordance with IFRS10 *Consolidated financial statements*, transactions and balances between the Bank and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

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

| | **2014 £m** | 2013 £m |
|---|---|---|
| Assets, included within: | | |
| Derivative financial instruments | | – |
| Loans and receivables | **19,406** | 18,998 |
| Other assets | **–** | 42 |
| | **19,406** | 19,040 |
| Liabilities, included within: | | |
| Deposits from banks and customers | **18,135** | 11,284 |
| Derivative financial instruments | | – |
| Debt securities in issue | **15,967** | 11,236 |
| Subordinated liabilities | **402** | 462 |
| | **34,504** | 22,982 |

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2014 the Bank earned interest income on the above asset balances of £494 million (2013: £611 million) and incurred interest expense on the above liability balances of £523 million (2013: £675 million).

*Balances and transactions with Lloyds Banking Group plc and fellow subsidiaries of the Lloyds Banking Group*

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Assets, included within: | | | | |
| Derivative financial instruments | **14,867** | 9,871 | **14,867** | 9,871 |
| Loans and receivables | **54,373** | 205,377 | **54,124** | 204,921 |
| Trading and other financial assets at fair value through profit or loss | **12,537** | 25,158 | **12,537** | 25,158 |
| Other assets | **–** | – | **–** | – |
| | **81,777** | 240,406 | **81,528** | 239,950 |

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Liabilities, included within: | | | | |
| Deposits from banks and customers | **86,838** | 232,574 | **86,681** | 232,305 |
| Derivative financial instruments | **15,978** | 11,509 | **15,990** | 11,509 |
| Subordinated liabilities | **5,653** | 11,169 | **5,691** | 11,169 |
| Debt securities in issue | **665** | 861 | **215** | 244 |
| Trading liabilities | **11,598** | 10,346 | **11,598** | 10,346 |
| Other liabilities | **–** | – | **–** | – |
| | **120,732** | 266,459 | **120,175** | 265,573 |

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2014 the Group earned £696 million and the Bank earned £695 million of interest income on the above asset balances (2013: £1,556 million for the Group and £1,325 million for the Bank); the Group incurred £2,640 million and the Bank incurred £2,629 million of interest expense on the above liability balances (2013: £3,197 million for the Group and £2,982 million for the Bank).

**40 Related party transactions** (continued)

**UK Government**

In January 2009, the UK Government through HM Treasury became a related party of Lloyds Banking Group plc, the Bank's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. At 31 December 2014, HM Treasury held more than 20 per cent of Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of the Bank during the year ended 31 December 2014.

In accordance with IAS 24, UK Government-controlled entities became related parties of the Group. The Group regards the Bank of England and entities controlled by the UK Government, including The Royal Bank of Scotland Group plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc, as related parties.

During the year ended 31 December 2014, the Lloyds Banking Group participated in a number of schemes operated by the UK Government and central banks and made available to eligible banks and building societies.

*National Loan Guarantee Scheme*

The Lloyds Banking Group has participated in the UK government's National Loan Guarantee Scheme, which was launched on 20 March 2012. Through the scheme, the Lloyds Banking Group is providing eligible UK businesses with discounted funding, subject to continuation of the scheme and its financial benefits, and based on the Lloyds Banking Group's existing lending criteria. Eligible businesses who have taken up the funding benefit from a 1 per cent discount on their funding rate for a pre-agreed period of time.

*Business Growth Fund*

In May 2011 the Lloyds Banking Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to commit up to £300 million of equity investment by subscribing for shares in the Business Growth Fund plc which is the company created to fulfil the role of the Business Growth Fund as set out in the British Bankers' Association's Business Taskforce Report of October 2010. At 31 December 2014, the Lloyds Banking Group had invested £118 million (31 December 2013: £64 million) in the Business Growth Fund and carried the investment at a fair value of £105 million (31 December 2013: £52 million).

*Big Society Capital*

In January 2012 the Lloyds Banking Group agreed, together with The Royal Bank of Scotland plc (and two other non-related parties), to commit up to £50 million each of equity investment into the Big Society Capital Fund. The Fund, which was created as part of the Project Merlin arrangements, is a UK social investment fund. The Fund was officially launched on 3 April 2012 and the Lloyds Banking Group had invested £23 million in the Fund by 31 December 2013 and invested a further £8 million during the year ended 31 December 2014.

*Funding for Lending*

In August 2012, the Lloyds Banking Group announced its support for the UK government's Funding for Lending Scheme and confirmed its intention to participate in the scheme. The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Lloyds Banking Group. The initiative supported a broad range of UK based customers, providing householders with more affordable housing finance and businesses with cheaper finance to invest and grow. In November 2013, the Lloyds Banking Group entered into extension letters with the Bank of England to take part in the extension of the Funding for Lending Scheme until the end of January 2015. The extension of the Funding for Lending Scheme focuses on providing businesses with cheaper finance to invest and grow. £10 billion has been drawn down under this extension. In December 2014, the Bank of England announced a further extension to the end of January 2016 with an increased focus on supporting small businesses. At 31 December 2014, the Lloyds Banking Group had drawn down £20 billion under the Funding for Lending Scheme.

*Enterprise Finance Guarantee Scheme*

The Lloyds Banking Group participates in the Enterprise Finance Guarantee Scheme which was launched in January 2009 as a replacement for the Small Firms Loan Guarantee Scheme. The scheme is a UK government-backed loan guarantee, which supports viable businesses with access to lending where they would otherwise be refused a loan due to a lack of lending security. The Department for Business, Innovation and Skills (formerly the Department for Business, Enterprise and Regulatory Reform) provides the lender with a guarantee of up to 75 per cent of the capital of each loan subject to the eligibility of the customer within the rules of the scheme. As at 31 December 2014, the Lloyds Banking Group had offered 6,250 loans to customers, worth over £500 million. The Lloyds Banking Group entities, Lloyds Bank plc, TSB Bank plc, Lloyds Commercial Finance Limited and Bank of Scotland plc contracted with The Secretary of State for Business, Innovation and Skills.

*Help to Buy*

On 7 October 2013, Bank of Scotland plc entered into an agreement with The Commissioners of Her Majesty's Treasury by which it agreed that the Halifax Division of Bank of Scotland plc would participate in the Help to Buy Scheme with effect from 11 October 2013 and that Lloyds Bank plc would participate from 3 January 2014. The Help to Buy Scheme is a scheme promoted by the UK government and is aimed to encourage participating lenders to make mortgage loans available to customers who require higher loan-to-value mortgages. Halifax and Lloyds are currently participating in the Scheme whereby customers borrow between 90 per cent and 95 per cent of the purchase price.

In return for the payment of a commercial fee, HM Treasury has agreed to provide a guarantee to the lender to cover a proportion of any loss made by the lender arising from a higher loan-to-value loan being made. £1,950 million of outstanding loans at 31 December 2014 had been advanced under this scheme.

*Central bank facilities*

In the ordinary course of business, the Lloyds Banking Group may from time to time access market-wide facilities provided by central banks.

*Other government-related entities*

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

**40 Related party transactions** (continued)

**Other related party disclosures**

*Joint ventures and associates*

The Group provided both administration and processing services to Sainsbury's Bank plc, which was its principal joint venture up until the completion of the sale of the Group's investment in that company on 31 January 2014. The amounts receivable by the Group during January 2014 were £3 million (year ended 31 December 2013: £35 million, of which £10 million was outstanding at 31 December 2013). At 31 December 2013, Sainsbury's Bank plc had also had balances with the Group that were included in loans and advances to banks of £806 million and deposits by banks of £927 million.

At 31 December 2014 there were loans and advances to customers of £1,901 million (2013: £4,448 million) outstanding and balances within customer deposits of £24 million (2013: £70 million) relating to other joint ventures and associates.

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2014, these companies had total assets of approximately £1,647 million (2013: £3,514 million), total liabilities of approximately £1,997 million (2013: £3,726 million) and for the year ended 31 December 2014 had turnover of approximately £1,503 million (2013: £2,858 million) and made a net loss of approximately £175 million (2013: net loss of £83 million). In addition, the Group has provided £918 million (2013: £2,027 million) of financing to these companies on which it received £35 million (2013: £68 million) of interest income in the year.

**41 Contingent liabilities and commitments**

**Interchange fees**

On 11 September 2014, the European Court of Justice (the ECJ) upheld the European Commission's 2007 decision that an infringement of EU competition law had arisen from arrangements whereby MasterCard issuers charged a uniform fallback multilateral interchange fee (MIF) in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card.

In parallel:

- the European Commission has proposed legislation to regulate interchange fees which continues through the EU legislative process. A political agreement has been reached between the European Parliament and the Council and the legislation is expected to be adopted and come into force in the second quarter of 2015 with certain articles applying six months or a year after that (the adoption and entry into force dates remain subject to change);
- the European Commission has adopted commitments proposed by VISA to settle an investigation into VISA's cross-border interchange arrangements and aspects of its scheme rules . VISA has, amongst other things, agreed to reduce the level of interchange fees for cross-border card transactions to: 30 basis points (for credit) and 20 basis points (for debit). VISA has also changed a number of its rules in relation to cross-border acquiring. MasterCard unilaterally undertook, amongst other things, to reduce the level of cross-border interchange fees to the same levels as agreed between the Commission and Visa;
- the Commission also continues to pursue other competition investigations into MasterCard and Visa probing, amongst other things, interchange paid in respect of cards issued outside the EEA;
- litigation continues in the English High Court against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly 'overpaid' MIFs;
- the new UK payments regulator may exercise its powers, when these come in to force (in April 2015), to regulate domestic interchange fees. In November 2014, the Competition and Markets Authority (the CMA) announced that it would not reopen the investigation into domestic interchange levels at this time following MasterCard's agreement to introduce a phased reduction of domestic interchange rates commencing in April 2015. In addition, the FCA has started a market study in relation to the UK credit cards market.

The ultimate impact on the Group of the above investigations, regulatory or legislative developments and the litigation against VISA and MasterCard can only be known at the conclusion of these matters.

**LIBOR and other trading rates**

On 28 July 2014, the Lloyds Banking Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Lloyds Banking Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The settlements in relation to LIBOR are part of an industry-wide investigation into the setting of interbank offered rates across a range of currencies.

The Lloyds Banking Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the European and Swiss Competition Commissions, and a number of US State Attorneys General, in conjunction with their investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

Certain Lloyds Banking Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar and Japanese Yen LIBOR. The claims have been asserted by plaintiffs claiming to have had an interest in various types of financial instruments linked to US Dollar and Japanese Yen LIBOR. The allegations in these cases, the majority of which have been coordinated for pre-trial purposes in multi-district litigation proceedings (MDL) in the US Federal Court for the Southern District of New York (the 'District Court'), are substantially similar to each other. The lawsuits allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act (RICO) and the Commodity Exchange Act (CEA), as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims have been dismissed by the District Court.

The Lloyds Banking Group is also reviewing its activities in relation to the setting of certain foreign exchange daily benchmark rates and related matters, following the FCA's publicised initiation of an investigation into other financial institutions in relation to this activity. The Lloyds Banking Group is co-operating with the FCA and other regulators and is providing information about the Lloyds Banking Group's review to those regulators. In addition, the Lloyds Banking Group, together with a number of other banks, was named as a defendant in several actions filed in the District Court between late 2013 and February 2014, in which the plaintiffs alleged that the defendants manipulated WM/Reuters foreign exchange rates in violation of US antitrust laws. On 31 March 2014, plaintiffs effectively withdrew their claims against the Lloyds Banking Group (but not against all defendants) by filing a superseding consolidated and amended pleading against a number of other defendants without naming any Lloyds Banking Group entity as a defendant.

**41 Contingent liabilities and commitments** (continued)

It is currently not possible to predict the scope and ultimate outcome on the Lloyds Banking Group of the various outstanding regulatory investigations not encompassed by the settlements, any private lawsuits or any related challenges to the interpretation or validity of any of the Lloyds Banking Group's contractual arrangements, including their timing and scale.

**Financial Services Compensation Scheme**
The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. At the end of the latest FSCS scheme year (31 March 2014), the principal balance outstanding on these loans was £16,591 million (31 March 2013: £17,246 million). Although the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants of the FSCS. The amount of future levies payable by the Group depends on a number of factors including the amounts recovered by the FSCS from asset sales, the Group's participation in the deposit-taking market at 31 December, the level of protected deposits and the population of deposit-taking participants.

**Investigation into Bank of Scotland and report on HBOS**
The FSA's enforcement investigation into Bank of Scotland plc's Corporate division between 2006 and 2008 concluded with the publication of a Final Notice on 9 March 2012. No financial penalty was imposed on the Lloyds Banking Group or Bank of Scotland plc. On 12 September 2012 the FSA confirmed it was starting work on a public interest report on HBOS. That report is now being produced as a joint PRA / FCA report. Although the Terms of Reference for the HBOS review (issued on 11 July 2014) stated an aim to publish the final report by the end of 2014, the report has not yet been published.

**Tax authorities**
The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities. This includes open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law which might lead to additional tax. The Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In the second half of 2013 HMRC informed the Lloyds Banking Group that their interpretation of the UK rules, permitting the offset of such losses, denies the claim; if HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Lloyds Bank Group's deferred tax asset of approximately £400 million (overall impact on the Group of approximately £200 million). The Lloyds Banking Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due.

**Residential mortgage repossessions**
In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases, concerning certain aspects of the Lloyds Banking Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. Lloyds Banking Group is reviewing the issues raised by the judgment and will respond as appropriate to any investigations or proceedings that may in due course be instigated as a result of these issues.

**Other legal actions and regulatory matters**
In addition, during the ordinary course of business the Lloyds Banking Group is subject to other complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of employees, customers, investors or other third parties, as well as regulatory reviews, challenges, investigations and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the 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 at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed properly to assess the merits of the case, and no provisions are held in relation to such matters. However the Lloyds Banking Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

**Contingent liabilities and commitments arising from the banking business**
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.

## 41 Contingent liabilities and commitments (continued)

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 | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Contingent liabilities** | | | | |
| Acceptances and endorsements | **1** | 2 | **1** | 2 |
| Other: | | | | |
| Other items serving as direct credit substitutes | **8** | 23 | **8** | 23 |
| Performance bonds and other transaction-related contingencies | **220** | 267 | **219** | 266 |
| | **228** | 290 | **227** | 289 |
| **Total contingent liabilities** | **229** | 292 | **228** | 291 |

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 | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Commitments** | | | | |
| Documentary credits and other short-term trade-related transactions | **1** | 4 | **1** | 4 |
| Undrawn formal standby facilities, credit lines and other commitments to lend: | | | | |
| Less than 1 year original maturity: | | | | |
| Mortgage offers made | **7,515** | 8,214 | **7,515** | 8,214 |
| Other commitments | **21,047** | 19,756 | **20,806** | 19,382 |
| | **28,562** | 27,970 | **28,321** | 27,596 |
| 1 year or over original maturity | **3,853** | 3,962 | **3,853** | 3,962 |
| **Total commitments** | **32,416** | 31,936 | **32,175** | 31,562 |

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £12,466 million (2013: £13,537 million) for the Group and £12,466 million (2013: £13,537 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 | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Not later than 1 year | **106** | 111 | **106** | 111 |
| Later than 1 year and not later than 5 years | **347** | 369 | **345** | 369 |
| Later than 5 years | **497** | 566 | **496** | 566 |
| **Total operating lease commitments** | **950** | 1,046 | **947** | 1,046 |

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 20), there was no capital expenditure contracted but not provided for at 31 December 2014 (2013: £nil).

## 42 Financial instruments

**(1) Measurement basis of financial assets and liabilities**

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

| The Group | Derivatives designated as hedging instruments £m | 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 |
|---|---|---|---|---|---|---|---|
| **At 31 December 2014** | | | | | | | |
| **Financial assets** | | | | | | | |
| Cash and balances at central banks | – | – | – | – | – | 5,110 | 5,110 |
| Items in the course of collection from banks | – | – | – | – | – | 375 | 375 |
| Trading and other financial assets at fair value through profit or loss | – | 13,750 | 172 | – | – | – | 13,922 |
| Derivative financial instruments | 6,647 | 16,840 | – | – | – | – | 23,487 |
| Loans and receivables: | | | | | | | |
| Loans and advances to banks | – | – | – | – | 734 | – | 734 |
| Loans and advances to customers | – | – | – | – | 271,674 | – | 271,674 |
| Debt securities | – | – | – | – | 219 | – | 219 |
| Due from fellow Lloyds Banking Group undertakings | – | – | – | – | 54,373 | – | 54,373 |
| | – | – | – | – | 327,000 | – | 327,000 |
| Available-for-sale financial assets | – | – | – | 5,465 | – | – | 5,465 |
| **Total financial assets** | 6,647 | 30,590 | 172 | 5,465 | 327,000 | 5,485 | 375,359 |
| **Financial liabilities** | | | | | | | |
| Deposits from banks | – | – | – | – | – | 2,291 | 2,291 |
| Customer deposits | – | – | – | – | – | 203,498 | 203,498 |
| Due to fellow Lloyds Banking Group undertakings | – | – | – | – | – | 86,838 | 86,838 |
| Items in course of transmission to banks | – | – | – | – | – | 275 | 275 |
| Trading and other financial liabilities at fair value through profit or loss | – | 13,764 | 5 | – | – | – | 13,769 |
| Derivative financial instruments | 4,159 | 17,251 | – | – | – | – | 21,410 |
| Debt securities in issue | – | – | – | – | – | 20,408 | 20,408 |
| Financial guarantees | – | – | 21 | – | – | – | 21 |
| Subordinated liabilities | – | – | – | – | – | 7,627 | 7,627 |
| **Total financial liabilities** | 4,159 | 31,015 | 26 | – | – | 320,937 | 356,137 |

**42 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 |
|---|---|---|---|---|---|---|---|
| **At 31 December 2013** | | | | | | | |
| **Financial assets** | | | | | | | |
| Cash and balances at central banks | – | – | – | – | – | 7,296 | 7,296 |
| Items in the course of collection from banks | – | – | – | – | – | 217 | 217 |
| Trading and other financial assets at fair value through profit or loss | – | 37,084 | 233 | – | – | – | 37,317 |
| Derivative financial instruments | 5,635 | 15,260 | – | – | – | – | 20,895 |
| Loans and receivables: | | | | | | | |
| Loans and advances to banks | – | – | – | – | 1,692 | – | 1,692 |
| Loans and advances to customers | – | – | – | – | 283,638 | – | 283,638 |
| Debt securities | – | – | – | – | 529 | – | 529 |
| Due from fellow Lloyds Banking Group undertakings | – | – | – | – | 205,377 | – | 205,377 |
| | – | – | – | – | 491,236 | – | 491,236 |
| Available-for-sale financial assets | – | – | – | 3,171 | – | – | 3,171 |
| Total financial assets | 5,635 | 52,344 | 233 | 3,171 | 491,236 | 7,513 | 560,132 |
| **Financial liabilities** | | | | | | | |
| Deposits from banks | – | – | – | – | – | 3,175 | 3,175 |
| Customer deposits | – | – | – | – | – | 206,568 | 206,568 |
| Due to fellow Lloyds Banking Group undertakings | – | – | – | – | – | 232,574 | 232,574 |
| Items in course of transmission to banks | – | – | – | – | – | 262 | 262 |
| Trading liabilities | – | 36,624 | – | – | – | – | 36,624 |
| Derivative financial instruments | 3,711 | 16,639 | – | – | – | – | 20,350 |
| Notes in circulation | – | – | – | – | – | 1,176 | 1,176 |
| Debt securities in issue | – | – | – | – | – | 29,462 | 29,462 |
| Financial guarantees | – | – | 17 | – | – | – | 17 |
| Subordinated liabilities | – | – | – | – | – | 13,354 | 13,354 |
| **Total financial liabilities** | 3,711 | 53,263 | 17 | – | – | 486,571 | 543,562 |

## 42 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 |
|---|---|---|---|---|---|---|---|
| **At 31 December 2014** | | | | | | | |
| **Financial assets** | | | | | | | |
| Cash and balances at central banks | – | – | – | – | – | 5,110 | 5,110 |
| Items in the course of collection from banks | – | – | – | – | – | 375 | 375 |
| Trading and other financial assets at fair value through profit or loss | – | 13,750 | 6 | – | – | – | 13,756 |
| Derivative financial instruments | 6,647 | 16,490 | – | – | – | – | 23,137 |
| Loans and receivables: | | | | | | | |
| Loans and advances to banks | – | – | – | – | 676 | – | 676 |
| Loans and advances to customers | – | – | – | – | 262,808 | – | 262,808 |
| Debt securities | – | – | – | – | 181 | – | 181 |
| Due from fellow Lloyds Banking Group undertakings | – | – | – | – | 73,530 | – | 73,530 |
| | – | – | – | – | 337,195 | – | 337,195 |
| Available-for-sale financial assets | – | – | – | 5,199 | – | – | 5,199 |
| **Total financial assets** | 6,647 | 30,240 | 6 | 5,199 | 337,195 | 5,485 | 384,772 |
| **Financial liabilities** | | | | | | | |
| Deposits from banks | – | – | – | – | – | 2,283 | 2,283 |
| Customer deposits | – | – | – | – | – | 203,498 | 203,498 |
| Due to fellow Lloyds Banking Group undertakings | – | – | – | – | – | 101,420 | 101,420 |
| Items in course of transmission to banks | – | – | – | – | – | 275 | 275 |
| Trading liabilities | – | 13,764 | – | – | – | – | 13,764 |
| Derivative financial instruments | 4,159 | 16,884 | – | – | – | – | 21,043 |
| Notes in circulation | – | – | – | – | – | | |
| Debt securities in issue | – | – | – | – | – | 17,556 | 17,556 |
| Financial guarantees | – | – | 21 | – | – | – | 21 |
| Subordinated liabilities | – | – | – | – | – | 7,626 | 7,626 |
| **Total financial liabilities** | 4,159 | 30,648 | 21 | – | – | 332,658 | 367,486 |

# Notes to the accounts

**42 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 |
|---|---|---|---|---|---|---|---|
| At 31 December 2013 | | | | | | | |
| **Financial assets** | | | | | | | |
| Cash and balances at central banks | – | – | – | – | – | 7,296 | 7,296 |
| Items in the course of collection from banks | – | – | – | – | – | 217 | 217 |
| Trading and other financial assets at fair value through profit or loss | – | 37,084 | 55 | – | – | – | 37,139 |
| Derivative financial instruments | 5,635 | 14,993 | – | – | – | – | 20,628 |
| Loans and receivables: | | | | | | | |
| Loans and advances to banks | – | – | – | – | 1,633 | – | 1,633 |
| Loans and advances to customers | – | – | – | – | 273,556 | – | 273,556 |
| Debt securities | – | – | – | – | 380 | – | 380 |
| Due from fellow Lloyds Banking Group undertakings | – | – | – | – | 223,919 | – | 223,919 |
| | – | – | – | – | 499,488 | – | 499,488 |
| Available-for-sale financial assets | – | – | – | 2,843 | – | – | 2,843 |
| Total financial assets | 5,635 | 52,077 | 55 | 2,843 | 499,488 | 7,513 | 567,611 |
| **Financial liabilities** | | | | | | | |
| Deposits from banks | – | – | – | – | – | 3,171 | 3,171 |
| Customer deposits | – | – | – | – | – | 206,568 | 206,568 |
| Due to fellow Lloyds Banking Group undertakings | – | – | – | – | – | 243,588 | 243,588 |
| Items in course of transmission to banks | – | – | – | – | – | 262 | 262 |
| Trading liabilities | – | 36,586 | – | – | – | – | 36,586 |
| Derivative financial instruments | 3,711 | 16,181 | – | – | – | – | 19,892 |
| Notes in circulation | – | – | – | – | – | 1,176 | 1,176 |
| Debt securities in issue | – | – | – | – | – | 28,106 | 28,106 |
| Financial guarantees | – | – | 17 | – | – | – | 17 |
| Subordinated liabilities | – | – | – | – | – | 13,416 | 13,416 |
| Total financial liabilities | 3,711 | 52,767 | 17 | – | – | 496,287 | 552,782 |

**42 Financial instruments** (continued)

**(2) Fair value measurement**
Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is a measure as at a specific date and may be significantly different from the amount which will actually be paid or received on maturity or settlement date.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

The Group manages valuation adjustments for its derivative exposures on a net basis; the Group determines their fair values on the basis of their net exposures. In all other cases, fair values of financial assets and liabilities measured at fair value are determined on the basis of their gross exposures.

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

Fair value information is not provided for items that are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group's consolidated balance sheet. These items include intangible assets, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

**Valuation control framework**
The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

**Valuation of financial assets and liabilities**
Assets and liabilities carried at fair value or for which fair values are disclosed have been classified into three levels according to the quality and reliability of information used to determine the fair values.

*Level 1*
Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise equity shares, treasury bills and other government securities.

*Level 2*
Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

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

**42 Financial instruments** (continued)

**Fair values of financial assets and liabilities**

The following table summarises the carrying values of financial assets and liabilities presented on the Group's and Bank's balance sheets. 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 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2014** | | 2013 | | **2014** | | 2013 | |
| | **Carrying value £m** | **Fair value £m** | Carrying value £m | Fair value £m | **Carrying value £m** | **Fair value £m** | Carrying value £m | Fair value £m |
| **Financial assets** | | | | | | | | |
| Trading and other financial assets at fair value through profit or loss | **13,922** | **13,922** | 37,317 | 37,317 | **13,756** | **13,756** | 37,139 | 37,139 |
| Derivative financial instruments | **23,487** | **23,487** | 20,895 | 20,895 | **23,137** | **23,137** | 20,628 | 20,628 |
| Loans and receivables: | | | | | | | | |
| Loans and advances to banks | **734** | **734** | 1,692 | 1,627 | **676** | **675** | 1,633 | 1,627 |
| Loans and advances to customers | **271,674** | **271,240** | 283,638 | 277,575 | **262,808** | **262,058** | 273,556 | 267,577 |
| Debt securities | **219** | **209** | 529 | 528 | **181** | **166** | 380 | 380 |
| Due from fellow Lloyds Banking Group undertakings | **54,373** | **54,373** | 205,377 | 205,377 | **73,530** | **73,530** | 223,919 | 223,919 |
| | **327,000** | **326,556** | 491,236 | 485,107 | **337,195** | **336,429** | 499,488 | 493,503 |
| Available-for-sale financial assets | **5,465** | **5,465** | 3,171 | 3,171 | **5,199** | **5,199** | 2,843 | 2,843 |
| Reverse repurchase agreements included in the above amounts: | | | | | | | | |
| Loans and advances to customers | **–** | **–** | – | – | **–** | **–** | – | – |
| Loans and advances to banks | **–** | **–** | – | – | **–** | **–** | – | – |
| **Financial liabilities** | | | | | | | | |
| Deposits from banks | **2,291** | **2,297** | 3,175 | 3,205 | **2,283** | **2,289** | 3,171 | 3,200 |
| Customer deposits | **203,498** | **203,637** | 206,568 | 208,050 | **203,498** | **203,636** | 206,568 | 208,056 |
| Due to fellow Lloyds Banking Group undertakings | **86,838** | **86,838** | 232,574 | 232,574 | **101,420** | **101,420** | 243,588 | 243,588 |
| Trading and other financial liabilities at fair value through profit or loss | **13,769** | **13,769** | 36,624 | 36,624 | **13,764** | **13,764** | 36,586 | 36,586 |
| Derivative financial instruments | **21,410** | **21,410** | 20,350 | 20,350 | **21,043** | **21,043** | 19,892 | 19,892 |
| Debt securities in issue | **20,408** | **20,011** | 29,462 | 28,684 | **17,556** | **13,481** | 28,106 | 16,622 |
| Financial guarantees | **21** | **21** | 17 | 17 | **21** | **21** | 17 | 17 |
| Subordinated liabilities | **7,627** | **7,689** | 13,354 | 12,952 | **7,626** | **7,666** | 13,416 | 12,945 |
| Repurchase agreements included in the above amounts: | | | | | | | | |
| Deposits from banks | **595** | **595** | 623 | 623 | **595** | **595** | 623 | 623 |
| Customer deposits | **–** | **–** | – | – | **–** | **–** | – | – |

The carrying amount of the following financial instruments is a reasonable approximation of fair value: cash and balances at central banks, items in the course of the collection from banks, items in course of transmission to banks and notes in circulation.

**42 Financial instruments** (continued)

**(3) Financial assets and liabilities carried at fair value**

**(A) Financial assets, excluding derivatives**
*Valuation hierarchy*
At 31 December 2014, the Group's financial assets carried at fair value, excluding derivatives, totalled £19,387 million (31 December 2013: £40,488 million); and for the Bank totalled £18,955 million (31 December 2013: £39,982 million). The tables below analyse these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described on page 72). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

**Valuation hierarchy**

| **The Group**<br>**At 31 December 2014** | **Level 1**<br>**£m** | **Level 2**<br>**£m** | **Level 3**<br>**£m** | **Total**<br>**£m** |
|---|---|---|---|---|
| Trading and other financial assets at fair value through profit or loss | | | | |
| Loans and advances to customers | – | 13,476 | – | 13,476 |
| Loans and advances to banks | – | 201 | – | 201 |
| Debt securities: | | | | |
| Government securities | 45 | – | – | 45 |
| Bank and building society certificates of deposit | – | – | – | – |
| Asset-backed securities: | | | | |
| Other asset-backed securities | – | – | – | – |
| Corporate and other debt securities | – | 28 | – | 28 |
| | 45 | 28 | – | 73 |
| Equity shares | – | – | 172 | 172 |
| Treasury and other bills | – | – | – | – |
| Total trading and other financial assets at fair value through profit or loss | 45 | 13,705 | 172 | 13,922 |
| Available-for-sale financial assets | | | | |
| Debt securities: | | | | |
| Government securities | 31 | – | – | 31 |
| Bank and building society certificates of deposit | – | 15 | – | 15 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 499 | – | 499 |
| Other asset-backed securities | – | 343 | – | 343 |
| Corporate and other debt securities | – | 4,268 | – | 4,268 |
| | 31 | 5,125 | – | 5,156 |
| Equity shares | 1 | 38 | 270 | 309 |
| Total available-for-sale financial assets | 32 | 5,163 | 270 | 5,465 |
| **Total financial assets carried at fair value, excluding derivatives** | 77 | 18,868 | 442 | 19,387 |

**42 Financial instruments** (continued)

| **The Group**<br>At 31 December 2013 | Level 1<br>£m | Level 2<br>£m | Level 3<br>£m | Total<br>£m |
|---|---|---|---|---|
| Trading and other financial assets at fair value through profit or loss | | | | |
| Loans and advances to customers | – | 32,448 | – | 32,448 |
| Loans and advances to banks | – | 2,556 | – | 2,556 |
| Debt securities: | | | | |
| Government securities | 115 | – | – | 115 |
| Bank and building society certificates of deposit | – | 1,458 | – | 1,458 |
| Asset-backed securities: | | | | |
| Other asset-backed securities | – | 4 | – | 4 |
| Corporate and other debt securities | – | 518 | – | 518 |
| | 115 | 1,980 | – | 2,095 |
| Equity shares | 82 | – | 130 | 212 |
| Treasury and other bills | 6 | – | – | 6 |
| Total trading and other financial assets at fair value through profit or loss | 203 | 36,984 | 130 | 37,317 |
| Available-for-sale financial assets | | | | |
| Debt securities: | | | | |
| Government securities | – | 28 | – | 28 |
| Bank and building society certificates of deposit | – | 12 | – | 12 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 749 | – | 749 |
| Other asset-backed securities | – | 518 | – | 518 |
| Corporate and other debt securities | 21 | 1,430 | – | 1,451 |
| | 21 | 2,737 | – | 2,758 |
| Equity shares | – | 38 | 375 | 413 |
| Total available-for-sale financial assets | 21 | 2,775 | 375 | 3,171 |
| Total financial assets carried at fair value, excluding derivatives | 224 | 39,759 | 505 | 40,488 |

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

**42 Financial instruments** (continued)

| **The Bank**<br>**At 31 December 2014** | **Level 1 Valuation £m** | **Level 2 Valuation £m** | **Level 3 Valuation £m** | **Total £m** |
|---|---|---|---|---|
| Trading and other financial assets at fair value through profit or loss | | | | |
| Loans and advances to customers | – | 13,476 | – | 13,476 |
| Loans and advances to banks | – | 201 | – | 201 |
| Debt securities: | | | | |
| Government securities | 45 | – | – | 45 |
| Bank and building society certificates of deposit | – | – | – | – |
| Asset-backed securities: | | | | |
| Other asset-backed securities | – | – | – | – |
| Corporate and other debt securities | – | 28 | – | 28 |
| | 45 | 28 | – | 73 |
| Equity shares | 1 | – | 5 | 6 |
| Treasury and other bills | – | – | – | – |
| Total trading and other financial assets at fair value through profit or loss | 46 | 13,705 | 5 | 13,756 |
| Available-for-sale financial assets | | | | |
| Debt securities: | | | | |
| Government securities | 31 | – | – | 31 |
| Bank and building society certificates of deposit | – | 15 | – | 15 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 499 | – | 499 |
| Other asset-backed securities | – | 343 | – | 343 |
| Corporate and other debt securities | – | 4,268 | – | 4,268 |
| | 31 | 5,125 | – | 5,156 |
| Equity shares | 1 | 42 | – | 43 |
| Total available-for-sale financial assets | 32 | 5,167 | – | 5,199 |
| **Total financial assets carried at fair value, excluding derivatives** | **78** | **18,872** | **5** | **18,955** |

# Notes to the accounts

**42 Financial instruments** (continued)

| **The Bank**<br>At 31 December 2013 | Level 1 Valuation £m | Level 2 Valuation £m | Level 3 Valuation £m | Total £m |
|---|---|---|---|---|
| Trading and other financial assets at fair value through profit or loss | | | | |
| Loans and advances to customers | – | 32,448 | – | 32,448 |
| Loans and advances to banks | – | 2,556 | – | 2,556 |
| Debt securities: | | | | |
| Government securities | 115 | – | – | 115 |
| Bank and building society certificates of deposit | – | 1,458 | – | 1,458 |
| Asset-backed securities: | | | | |
| Other asset-backed securities | – | 4 | – | 4 |
| Corporate and other debt securities | – | 518 | – | 518 |
| | 115 | 1,980 | – | 2,095 |
| Equity shares | 25 | – | 9 | 34 |
| Treasury and other bills | 6 | – | – | 6 |
| Total trading and other financial assets at fair value through profit or loss | 146 | 36,984 | 9 | 37,139 |
| Available-for-sale financial assets | | | | |
| Debt securities: | | | | |
| Government securities | – | 28 | – | 28 |
| Bank and building society certificates of deposit | – | 12 | – | 12 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 749 | – | 749 |
| Other asset-backed securities | – | 518 | – | 518 |
| Corporate and other debt securities | 21 | 1,472 | – | 1,493 |
| | 21 | 2,779 | – | 2,800 |
| Equity shares | – | 43 | – | 43 |
| Total available-for-sale financial assets | 21 | 2,822 | – | 2,843 |
| Total financial assets carried at fair value, excluding derivatives | 167 | 39,806 | 9 | 39,982 |

**42 Financial instruments** (continued)

**Movements in level 3 portfolio**
The table below analyses movements in level 3 financial assets, excluding derivatives (recurring measurement):

| The Group | Trading and other financial assets at fair value through profit or loss £m | Available-for-sale £m | Total financial assets, excluding derivatives £m |
|---|---|---|---|
| At 1 January 2013 | 163 | 428 | 591 |
| Exchange and other adjustments | 4 | 5 | 9 |
| Gains recognised in the income statement within other income | 84 | 8 | 92 |
| Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets | – | 30 | 30 |
| Purchases | 11 | 44 | 55 |
| Sales | (140) | (127) | (267) |
| Transfers into the level 3 portfolio | 11 | 12 | 23 |
| Transfers out of the level 3 portfolio | (3) | (25) | (28) |
| At 31 December 2013 | 130 | 375 | 505 |
| Exchange and other adjustments | **2** | **(6)** | **(4)** |
| Gains recognised in the income statement within other income | **86** | **–** | **86** |
| Losses recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets | **–** | **(61)** | **(61)** |
| Purchases | **56** | **229** | **285** |
| Sales | **(102)** | **(266)** | **(368)** |
| Transfer into the level 3 portfolio | **–** | **–** | **–** |
| Transfers out of the level 3 portfolio | **–** | **(1)** | **(1)** |
| **At 31 December 2014** | **172** | **270** | **442** |
| Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December 2014 | **27** | **–** | **27** |
| Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December 2013 | 13 | – | 13 |

## 42 Financial instruments (continued)

The table below analyses movements in level 3 financial assets:

| The Bank | Trading and other financial assets at fair value through profit or loss £m | Available-for-sale £m | Total financial assets, excluding derivatives £m |
|---|---|---|---|
| At 1 January 2013 | 24 | 33 | 57 |
| Exchange and other adjustments | (13) | – | (13) |
| Gains (losses) recognised in the income statement within other income | 35 | (1) | 34 |
| Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets | – | 1 | 1 |
| Purchases | 3 | – | 3 |
| Sales | (51) | (14) | (65) |
| Transfers into the level 3 portfolio | 11 | 3 | 14 |
| Transfers out of the level 3 portfolio | – | (22) | (22) |
| At 31 December 2013 | 9 | – | 9 |
| Exchange and other adjustments | **2** | **–** | **2** |
| Gains recognised in the income statement within other income | **17** | **–** | **17** |
| Gains recognised in other comprehensive income within the revaluation reserves in respect of available-for-sale financial assets | **–** | **–** | **–** |
| Purchases | **1** | **–** | **1** |
| Sales | **(24)** | **–** | **(24)** |
| Transfer into the level 3 portfoliio | **–** | **–** | **–** |
| Transfers out of the level 3 portfolio | **–** | **–** | **–** |
| **At 31 December 2014** | **5** | **–** | **5** |
| Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December 2014 | **4** | **–** | **4** |
| Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December 2013 | **–** | **–** | **–** |

**Valuation methodology for financial assets, excluding derivatives**

*Loans and advances and debt securities*

Loans and advances and debt securities measured at fair value and classified as level 2 are valued by discounting expected cash flows using an observable credit spread applicable to the particular instrument.

Where there is limited trading activity in debt securities, the Group uses valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes to determine an appropriate valuation. Debt securities are classified as level 3 if there is a significant valuation input that cannot be corroborated through market sources or where there are materially inconsistent values for an input. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

*Equity investments*

Unlisted equity and fund investments are valued using different techniques in accordance with the Group's valuation policy and International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

- A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

Unlisted equity investments and investments in property partnerships held in the life assurance funds are valued using third party valuations. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

**42 Financial instruments** (continued)

**(B) Financial liabilities, excluding derivatives**

*Valuation hierarchy*

At 31 December 2014, the Group's financial liabilities carried at fair value, excluding derivatives, totalled £13,790 million (31 December 2013: £36,641 million); and for the Bank totalled £13,784 million (31 December 2013: £36,603 million). The tables below analyse these financial liabilities by balance sheet classification and valuation methodology (level 1, 2 or 3, as described on page 72). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

| **The Group** | **Level 1 £m** | **Level 2 £m** | **Level 3 £m** | **Total £m** |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Trading and other financial liabilities at fair value through profit or loss | **–** | **–** | **5** | **5** |
| Trading liabilities: | | | | |
| Liabilities in respect of securities sold under repurchase agreements | **–** | **13,717** | **–** | **13,717** |
| Short positions in securities | **47** | **–** | **–** | **47** |
| | **47** | **13,717** | **–** | **13,764** |
| Total trading liabilities and other financial liabilities at fair value through profit or loss | **47** | **13,717** | **5** | **13,769** |
| Financial guarantees | **–** | **–** | **21** | **21** |
| **Total financial liabilities carried at fair value, excluding derivatives** | **47** | **13,717** | **26** | **13,790** |
| At 31 December 2013 | | | | |
| Trading and other financial liabilities at fair value through profit or loss: | | | | |
| Liabilities held at fair value through profit or loss | – | – | 38 | 38 |
| Trading liabilities: | | | | |
| Liabilities in respect of securities sold under repurchase agreements | – | 31,563 | – | 31,563 |
| Short positions in securities | 5,023 | – | – | 5,023 |
| | 5,023 | 31,563 | – | 36,586 |
| Total trading liabilities and other financial liabilities at fair value through profit or loss | 5,023 | 31,563 | 38 | 36,624 |
| Financial guarantees | – | – | 17 | 17 |
| Total financial liabilities carried at fair value, excluding derivatives | 5,023 | 31,563 | 55 | 36,641 |

| **The Bank** | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Trading liabilities | | | | |
| Liabilities in respect of securities sold under repurchase agreements | **–** | **13,717** | **–** | **13,717** |
| Short positions in securities | **47** | **–** | **–** | **47** |
| Total trading liabilities | **47** | **13,717** | **–** | **13,764** |
| Financial guarantees | **–** | **–** | **21** | **21** |
| **Total financial liabilities carried at fair value, excluding derivatives** | **47** | **13,717** | **21** | **13,785** |
| At 31 December 2013 | | | | |
| Trading liabilities | | | | |
| Liabilities in respect of securities sold under repurchase agreements | – | 31,563 | – | 31,563 |
| Short positions in securities | 5,023 | – | – | 5,023 |
| Total trading liabilities | 5,023 | 31,563 | – | 36,586 |
| Financial guarantees | – | – | 17 | 17 |
| Total financial liabilities carried at fair value, excluding derivatives | 5,023 | 31,563 | 17 | 36,603 |

**42 Financial instruments** (continued)

The table below analyses movements in level 3 financial liabilities, excluding derivatives:

| **The Group** | **Trading and other financial liabilities at fair value through profit and loss £m** | **Financial guarantees £m** | **Total financial liabilities, excluding derivatives £m** |
|---|---|---|---|
| At 1 January 2013 | – | 14 | 14 |
| Losses recognised in the income statement within other income | 10 | 3 | 13 |
| Additions | 28 | – | 28 |
| At 31 December 2013 | 38 | 17 | 55 |
| Exchange and other adjustments | **1** | **–** | **1** |
| (Gains) losses recognised in the income statement within other income | **(5)** | **4** | **(1)** |
| Additions | **–** | **–** | **–** |
| Redemptions | **(29)** | **–** | **(29)** |
| **At 31 December 2014** | **5** | **21** | **26** |
| Losses recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2014 | **1** | **4** | **5** |
| Gains recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2013 | (10) | (3) | (13) |

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

The table below analyses movements in level 3 financial liabilities, excluding derivatives:

| **The Bank** | **Financial guarantees £m** | **Total financial liabilities, excluding derivatives £m** |
|---|---|---|
| At 1 January 2013 | 14 | 14 |
| Losses recognised in the income statement within other income | 3 | 3 |
| At 31 December 2013 | 17 | 17 |
| Losses recognised in the income statement within other income | **4** | **4** |
| **At 31 December 2014** | **21** | **21** |
| Losses recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2014 | **4** | **4** |
| Losses recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December 2013 | 3 | 3 |

**42 Financial instruments** (continued)

**(C) Derivatives**
All of the Group's derivative assets and liabilities are carried at fair value. At 31 December 2014, such assets totalled £23,487 million for the Group and £23,137 million for the Bank (31 December 2013: £20,895 million for the Group and £20,628 million for the Bank) and liabilities totalled £21,410 million for the Group and £21,043 million for the Bank (31 December 2013: £20,350 million for the Group and £19,892 million for the Bank). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 72). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

| The Group | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Derivative assets | **–** | **22,965** | **522** | **23,487** |
| Derivative liabilities | **–** | **(21,309)** | **(101)** | **(21,410)** |
| At 31 December 2013 | | | | |
| Derivative assets | – | 20,455 | 440 | 20,895 |
| Derivative liabilities | – | (20,304) | (46) | (20,350) |

| The Bank | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Derivative assets | **–** | **22,615** | **522** | **23,137** |
| Derivative liabilities | **–** | **(20,942)** | **(101)** | **(21,043)** |
| At 31 December 2013 | | | | |
| Derivative assets | – | 20,188 | 440 | 20,628 |
| Derivative liabilities | – | (19,846) | (46) | (19,892) |

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

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives which are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.
- Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

**42 Financial instruments** (continued)

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

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **Derivative assets £m** | **Derivative liabilities £m** | **Derivative assets £m** | **Derivative liabilities £m** |
| At 1 January 2013 | 172 | (54) | 168 | (38) |
| Exchange and other adjustments | 6 | (1) | 7 | – |
| Gains recognised in the income statement within other income | 198 | 28 | 198 | 28 |
| Purchases (additions) | 1 | – | 1 | – |
| (Sales) redemptions | (93) | 19 | (90) | 2 |
| Transfers into the level 3 portfolio | 162 | (38) | 162 | (38) |
| Transfers out of the level 3 portfolio | (6) | – | (6) | – |
| At 31 December 2013 | 440 | (46) | 440 | (46) |
| Exchange and other adjustments | **(9)** | **1** | **(9)** | **1** |
| Gains (losses) recognised in the income statement within other income | **158** | **(58)** | **158** | **(58)** |
| Purchases (additions) | **–** | **–** | **–** | **–** |
| (Sales) redemptions | **(14)** | **2** | **(14)** | **2** |
| Transfers into the level 3 portfolio | **–** | **–** | **–** | **–** |
| Transfers out of the level 3 portfolio | **(53)** | | **(53)** | **–** |
| **At 31 December 2014** | **522** | **(101)** | **522** | **(101)** |
| Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets or liabilities held at 31 December 2014 | **158** | **(58)** | **158** | **(58)** |
| Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets or liabilities held at 31 December 2013 | 178 | (49) | 178 | (49) |

**42 Financial instruments** (continued)

**(D) Sensitivity of level 3 valuations**
**Level 3 portfolio**

| | Valuation techniques | Significant unobservable inputs[1] | At 31 December 2014 Carrying value £m | At 31 December 2014 Effect of reasonably possible alternative assumptions[2] Favourable changes £m | At 31 December 2014 Effect of reasonably possible alternative assumptions[2] Unfavourable changes £m | At 31 December 2013 Carrying value £m | At 31 December 2013 Effect of reasonably possible alternative assumptions[2] Favourable changes £m | At 31 December 2013 Effect of reasonably possible alternative assumptions[2] Unfavourable changes £m |
|---|---|---|---|---|---|---|---|---|
| **Trading and other financial assets at fair value through profit or loss:** | | | | | | | | |
| Equity and venture capital investments | | | | | | | | |
| | Underlying asset/ net asset value (incl. property prices)[3] | n/a | **172** | **26** | **(23)** | 130 | 17 | (16) |
| | | | **172** | | | 130 | | |
| **Available-for-sale financial assets** | | | | | | | | |
| Equity and venture capital investments | Underlying asset/ net asset value (incl. property prices)[3] | n/a | **270** | **10** | **(18)** | 375 | 28 | (19) |
| | | | **270** | | | 375 | | |
| **Derivative financial assets** | | | | | | | | |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (3 bps/167 bps) | **139** | **2** | **(2)** | 278 | 25 | (15) |
| | Option pricing model | Interest rate volatility (4%/120%) | **383** | **–** | **–** | 162 | 1 | (2) |
| | | | **522** | | | 440 | | |
| **Level 3 financial assets carried at fair value** | | | **964** | | | 945 | | |
| Trading and other financial liabilities at fair value through profit or loss | | | **5** | **–** | **–** | 39 | 1 | (1) |
| **Derivative financial liabilities** | | | | | | | | |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (3 bps/167 bps) | **40** | **–** | **–** | 8 | – | – |
| | Option pricing model | Interest rate volatility (4%/120%) | **61** | **–** | **–** | 38 | – | – |
| | | | **101** | | | 46 | | |
| **Financial guarantees** | | | **21** | | | 17 | | |
| **Level 3 financial liabilities carried at fair value** | | | **127** | | | 102 | | |

[1]Ranges are shown where appropriate and represent the highest and lowest inputs used in the level 3 valuations.

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

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

**Unobservable inputs**
Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are as follows:

- Interest rates and inflation rates are referenced in some derivatives where the payoff that the holder of the derivative receives depends on the behaviour of those underlying references through time.
- Credit spreads represent the premium above the benchmark reference instrument required to compensate for lower credit quality; higher spreads lead to a lower fair value.
- Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes.
- Earnings multiples are used to value certain unlisted equity investments; a higher earnings multiple will result in a higher fair value.

Reasonably possible alternative assumptions
Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships.

*Debt securities*
Reasonably possible alternative assumptions have been determined in respect of the Group's structured credit investment by flexing credit spreads.

**42 Financial instruments** (continued)

*Derivatives*
Reasonably possible alternative assumptions have been determined in respect of the Group's derivative portfolios as follows:

- Uncollateralised inflation swaps are valued using appropriate discount spreads for such transactions. These spreads are not generally observable for longer maturities. The reasonably possible alternative valuations reflect flexing of the spreads for the differing maturities to alternative values of between 3 bps and 167 bps (2013: 62 bps and 192 bps).
- Swaptions are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities have been flexed within a range of 4 per cent to 120 per cent (2013: 3 per cent and 112 per cent).

*Unlisted equity, venture capital investments and investments in property partnerships*
The valuation techniques used for unlisted equity and venture capital investments vary depending on the nature of the investment. Reasonably possible alternative valuations for these investments have been calculated by reference to the approach taken, as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

- for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;
- the discount rates used in discounted cash flow valuations; and
- in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

**(4) Financial assets and liabilities carried at amortised cost**

**(A) Financial assets**
*Valuation hierarchy*
The table below analyses the fair values of the financial assets of the Group and the Bank which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 72). Loans and receivables are mainly classified as level 3 due to significant unobservable inputs used in the valuation models where inputs are observable debt securities are classified as level 1 or 2.

| | | Valuation hierarchy | | |
|---|---|---|---|---|
| **The Group** | **Fair value £m** | **Level 1 £m** | **Level 2 £m** | **Level 3 £m** |
| **At 31 December 2014** | | | | |
| Loans and receivables: | | | | |
| Loans and advances to customers | **271,240** | **–** | **–** | **271,240** |
| Loans and advances to banks | **734** | **–** | **–** | **734** |
| Debt securities | **209** | **7** | **161** | **41** |
| Due from fellow Lloyds Banking Group undertakings | **54,373** | **–** | **–** | **54,373** |
| Reverse repos included in above amounts: | | | | |
| Loans and advances to customers | **–** | **–** | **–** | **–** |
| Loans and advances to banks | **–** | **–** | **–** | **–** |
| At 31 December 2013 | | | | |
| Loans and receivables: | | | | |
| Loans and advances to customers | 277,575 | – | – | 277,575 |
| Loans and advances to banks | 1,627 | – | – | 1,627 |
| Debt securities | 528 | 7 | 42 | 479 |
| Due from fellow Lloyds Banking Group undertakings | 205,377 | – | – | 205,377 |
| Reverse repos included in above amounts: | | | | |
| Loans and advances to customers | – | – | – | – |
| Loans and advances to banks | – | – | – | – |

**42 Financial instruments** (continued)

| The Bank | Fair value £m | Valuation hierarchy Level 1 £m | Level 2 £m | Level 3 £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Loans and receivables: | | | | |
| Loans and advances to customers | **262,058** | **–** | **–** | **262,058** |
| Loans and advances to banks | **675** | **–** | **–** | **675** |
| Debt securities | **166** | **7** | **159** | **–** |
| Due from fellow Lloyds Banking Group undertakings | **73,530** | **–** | **–** | **73,530** |
| Reverse repos included in above amounts: | | | | |
| Loans and advances to customers | **–** | **–** | **–** | **–** |
| Loans and advances to banks | **–** | **–** | **–** | **–** |
| At 31 December 2013 | | | | |
| Loans and receivables: | | | | |
| Loans and advances to customers | 267,577 | – | – | 267,577 |
| Loans and advances to banks | 1,627 | – | – | 1,627 |
| Debt securities | 380 | 7 | 42 | 331 |
| Due from fellow Lloyds Banking Group undertakings | 223,919 | – | – | 223,919 |
| Reverse repos included in above amounts: | | | | |
| Loans and advances to customers | – | – | – | – |
| Loans and advances to banks | – | – | – | – |

*Valuation methodology*
*Loans and advances to customers*
The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates due to their short term nature. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value.

To determine the fair value of loans and advances to customers, loans are segregated into portfolios of similar characteristics. A number of techniques are used to estimate the fair value of fixed rate lending; these take account of expected credit losses based on historic trends, prevailing market interest rates and expected future cash flows. For retail exposures, fair value is usually estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair value of commercial loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. No adjustment is made to put it in place by the Group to manage its interest rate exposure.

*Loans and advances to banks*
The carrying value of short dated loans and advances to banks is assumed to be their fair value. The fair value of loans and advances to banks is estimated by discounting the anticipated cash flows at a market discount rate adjusted for the credit spread of the obligor or, where not observable, the credit spread of borrowers of similar credit quality.

*Debt securities*
The fair values of debt securities, which were previously within assets held for trading and were reclassified to loans and receivables, are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

*Reverse repurchase agreements*
The carrying amount is deemed a reasonable approximation of fair value given the short-term nature of these instruments.

## 42 Financial instruments (continued)

**(B) Financial liabilities**

*Valuation hierarchy*

The table below analyses the fair values of the financial liabilities of the Group and the Bank which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 72).

| The Group | Fair value £m | Valuation hierarchy Level 1 £m | Level 2 £m | Level 3 £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Deposits from banks | **2,297** | **–** | **2,297** | **–** |
| Customer deposits | **203,637** | **–** | **188,706** | **14,931** |
| Due to fellow Lloyds Banking Group undertakings | **86,838** | **–** | **86,838** | **–** |
| Debt securities in issue | **20,011** | **–** | **20,011** | **–** |
| Subordinated liabilities | **7,689** | **–** | **7,689** | **–** |
| Repos included in above amounts: | | | | |
| Deposits from banks | **595** | **–** | **595** | **–** |
| Customer deposits | **–** | **–** | **–** | **–** |
| At 31 December 2013 | | | | |
| Deposits from banks | 3,205 | – | 3,205 | – |
| Customer deposits | 208,050 | – | 189,317 | 18,733 |
| Due to fellow Lloyds Banking Group undertakings | 232,574 | – | 232,574 | – |
| Debt securities in issue | 28,684 | – | 28,509 | 175 |
| Subordinated liabilities | 12,952 | – | 12,952 | – |
| Repos included in above amounts: | | | | |
| Deposits from banks | 623 | – | 623 | – |
| Customer deposits | – | – | – | – |

| The Bank | Fair value £m | Valuation hierarchy Level 1 £m | Level 2 £m | Level 3 £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Deposits from banks | **2,289** | **–** | **2,289** | **–** |
| Customer deposits | **203,636** | **–** | **188,705** | **14,931** |
| Due to fellow Lloyds Banking Group undertakings | **101,420** | **–** | **101,420** | **–** |
| Debt securities in issue | **13,481** | **–** | **13,481** | **–** |
| Subordinated liabilities | **7,666** | **–** | **7,666** | **–** |
| Repos included in above amounts: | | | | |
| Deposits from banks | **595** | **–** | **595** | **–** |
| Customer deposits | **–** | **–** | **–** | **–** |
| At 31 December 2013 | | | | |
| Deposits from banks | 3,200 | – | 3,200 | – |
| Customer deposits | 208,056 | – | 189,323 | 18,733 |
| Due to fellow Lloyds Banking Group undertakings | 243,588 | – | 243,588 | – |
| Debt securities in issue | 16,622 | – | 16,622 | – |
| Subordinated liabilities | 12,945 | – | 12,945 | – |
| Repos included in above amounts: | | | | |
| Deposits from banks | 623 | – | 623 | – |
| Customer deposits | – | – | – | – |

**Valuation methodology**

*Deposits from banks and customer deposits*

The fair value of bank and customer deposits repayable on demand is assumed to be equal to their carrying value.

The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

## 42 Financial instruments (continued)

*Debt securities in issue*
The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities is calculated based on quoted market prices where available. Where quoted market prices are not available, fair value is estimated using discounted cash flow techniques at a rate which reflects market rates of interest and the Group's own credit spread.

*Subordinated liabilities*
The fair value of subordinated liabilities is determined by reference to quoted market prices where available or by reference to quoted market prices of similar instruments. Subordinated liabilities are classified as level 2, since the inputs used to determine their fair value are largely observable.

*Repurchase agreements*
The carrying amount is deemed a reasonable approximation of fair value given the short term nature of these instruments.

**(5) Reclassification of financial assets**
No financial assets were reclassified in 2013 or 2014.

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 financial assets into loans and receivables.

At 31 December 2014, none of the securities reclassified as available-for-sale were retained by the Group and the securities reclassified as loans and receivables and still retained by the Group were carried on the balance sheet at £174 million.

## 43 Transfers of financial assets

**(1) Transferred financial assets that continue to be recognised in full**
The Group and the Bank enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets covered as substantially all of the risks and rewards, including credit, interest rate, prepayment and other price risks are retained by the Group. In all cases, the transferee has the right to sell or repledge the assets concerned.

As set out in note 16, included within loans and receivables are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all of a majority of the risks and rewards associated with these loans, including credit, interest rate, prepayment and liquidity risk, they remain on the Group's balance sheet. Assets transferred into the Group's securitisation and covered bond programmes are not available to be used by the Group whilst the assets are within the programmes. However, the Group retains the right to remove loans from the covered bond programmes where they are in excess of the programme's requirements. In addition, where the Group has retained some of the notes issued by securitisation and covered bond programmes, the Group has the ability to sell or pledge these retained notes.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities lending transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 29). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **Carrying value of transferred assets £m** | **Carrying value of associated liabilities £m** | **Carrying value of transferred assets £m** | **Carrying value of associated liabilities £m** |
| **At 31 December 2014** | | | | |
| **Repurchase and securities lending transactions** | | | | |
| Trading and other financial assets at fair value through profit or loss | **73** | **77** | **73** | **77** |
| Available-for-sale financial assets | **1,491** | **1,004** | **1,491** | **1,004** |
| Loans and receivables: | | | | |
| Loans and advances to customers | **27,651** | **896** | **27,651** | **896** |
| Debt securities classified as loans and receivables | **821** | **–** | **821** | **–** |
| **Securitisation programmes** | | | | |
| Loans and receivables: | | | | |
| Loans and advances to customers | **43,090** | **7,014**[1] | **–** | **–** |

[1] Excludes securitisation notes held by the Group (£20,609 million).

**43 Transfers of financial assets** (continued)

| | The Group | | The Bank | |
|---|---|---|---|---|
| | Carrying value of transferred assets £m | Carrying value of associated liabilities £m | Carrying value of transferred assets £m | Carrying value of associated liabilities £m |
| At 31 December 2013 | | | | |
| Repurchase and securities lending transactions | | | | |
| Trading and other financial assets at fair value through profit or loss | 2,073 | 149 | 2,073 | 149 |
| Available-for-sale financial assets | 1,132 | 691 | 1,132 | 691 |
| Loans and receivables: | | | | |
| Loans and advances to customers | 46,818 | 3,212 | 46,818 | 3,212 |
| Debt securities classified as loans and receivables | 1,124 | – | 1,124 | – |
| Securitisation programmes | | | | |
| Loans and receivables: | | | | |
| Loans and advances to customers[1] | 49,337 | 12,593[1] | – | – |

[1] Excludes securitisation notes held by the Group (£24,975 million).

**(2) Transferred financial assets derecognised in their entirety with ongoing exposure**
No such assets remained at 31 December 2013 or 2014.

## 44 Offsetting of financial assets and liabilities

The following information relates to financial assets and liabilities which have been offset in the balance sheet and those which have not been offset but for which the Group has enforceable master netting agreements in place with counterparties.

| The Group<br>At 31 December 2014 | Gross amounts of assets and liabilities[1]<br>£m | Amounts offset in the balance sheet[2]<br>£m | Net amounts presented in the balance sheet<br>£m | Related amounts where set off in the balance sheet not permitted[3]<br>Cash collateral received/ pledged<br>£m | Non-cash collateral received/ pledged<br>£m | Potential net amounts if offset of related amounts permitted<br>£m |
|---|---|---|---|---|---|---|
| **Financial assets** | | | | | | |
| Trading and other financial assets at fair value through profit or loss: | | | | | | |
| Excluding reverse repos | 245 | – | 245 | – | (45) | 200 |
| Reverse repos | 13,747 | (70) | 13,677 | – | (13,677) | – |
| | 13,992 | (70) | 13,922 | – | (13,722) | 200 |
| Derivative financial instruments | 23,487 | – | 23,487 | (1,286) | (3,773) | 18,428 |
| Loans and advances to banks: | | | | | | |
| Excluding reverse repos | 734 | – | 734 | (414) | – | 320 |
| Reverse repos | – | – | – | – | – | – |
| | 734 | – | 734 | (414) | – | 320 |
| Loans and advances to customers: | | | | | | |
| Excluding reverse repos | 271,674 | – | 271,674 | (205) | (1,730) | 269,739 |
| Reverse repos | – | – | – | – | – | – |
| | 271,674 | – | 271,674 | (205) | (1,730) | 269,739 |
| Debt securities | 219 | – | 219 | – | – | 219 |
| Available-for-sale financial assets | 5,465 | – | 5,465 | – | (13) | 5,452 |
| **Financial liabilities** | | | | | | |
| Deposits from banks: | | | | | | |
| Excluding repos | 1,696 | – | 1,696 | (1,264) | – | 432 |
| Repos | 595 | – | 595 | – | (595) | – |
| | 2,291 | – | 2,291 | (1,264) | (595) | 432 |
| Customer deposits: | | | | | | |
| Excluding repos | 203,498 | – | 203,498 | (22) | (1,147) | 202,329 |
| Repos | – | – | – | – | – | – |
| | 203,498 | – | 203,498 | (22) | (1,147) | 202,329 |
| Trading and other financial liabilities at fair value through profit or loss: | | | | | | |
| Excluding repos | 52 | – | 52 | – | – | 52 |
| Repos | 13,787 | (70) | 13,717 | – | (13,717) | – |
| | 13,839 | (70) | 13,769 | – | (13,717) | 52 |
| Derivative financial instruments | 21,410 | – | 21,410 | (619) | (3,760) | 17,031 |

**44 Offsetting of financial assets and liabilities** (continued)

| **The Group**<br>At 31 December 2013 | **Gross amounts of assets and liabilities[1] £m** | **Amounts offset in the balance sheet[2] £m** | **Net amounts presented in the balance sheet £m** | **Related amounts where set off in the balance sheet not permitted[3]**<br>**Cash collateral received/ pledged £m** | **Non-cash collateral received/ pledged £m** | **Potential net amounts if offset of related amounts permitted £m** |
|---|---|---|---|---|---|---|
| Trading and other financial assets at fair value through profit or loss: | | | | | | |
| Excluding reverse repos | 2,463 | – | 2,463 | – | (6) | 2,457 |
| Reverse repos | 39,291 | (4,437) | 34,854 | – | (34,854) | – |
| | 41,754 | (4,437) | 37,317 | – | (34,860) | 2,457 |
| Derivative financial instruments | 20,895 | – | 20,895 | (1,162) | (6,563) | 13,170 |
| Loans and advances to banks: | | | | | | |
| Excluding reverse repos | 1,692 | – | 1,692 | (682) | – | 1,010 |
| Reverse repos | – | – | – | – | – | – |
| | 1,692 | – | 1,692 | (682) | – | 1,010 |
| Loans and advances to customers: | | | | | | |
| Excluding reverse repos | 283,589 | – | 283,589 | (169) | (2,474) | 280,946 |
| Reverse repos | 49 | – | 49 | – | (49) | – |
| | 283,638 | – | 283,638 | (169) | (2,523) | 280,946 |
| Debt securities | 529 | – | 529 | – | – | 529 |
| Available-for-sale financial assets | 3,171 | – | 3,171 | – | (13) | 3,158 |
| **Financial liabilities** | | | | | | |
| Deposits from banks: | | | | | | |
| Excluding repos | 2,552 | – | 2,552 | (1,130) | – | 1,422 |
| Repos | 623 | – | 623 | – | (623) | – |
| | 3,175 | – | 3,175 | (1,130) | (623) | 1,422 |
| Customer deposits: | | | | | | |
| Excluding repos | 206,152 | – | 206,152 | (32) | (1,851) | 204,269 |
| Repos | 416 | – | 416 | – | (416) | – |
| | 206,568 | – | 206,568 | (32) | (2,267) | 204,269 |
| Trading and other financial liabilities at fair value through profit or loss: | | | | | | |
| Excluding repos | 5,061 | – | 5,061 | – | – | 5,061 |
| Repos | 36,000 | (4,437) | 31,563 | – | (31,563) | – |
| | 41,061 | (4,437) | 36,624 | – | (31,563) | 5,061 |
| Derivative financial instruments | 20,350 | – | 20,350 | (851) | (6,796) | 12,703 |

[1] After impairment allowance.

[2] The amounts set off in the balance sheet as shown above represent balances with central clearing houses which meet the criteria for offsetting under IAS 32.

[3] The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respective of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over collateralisation have not been taken into account in the above table.

**45 Financial risk management**

Financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The primary risks affecting the Group through its use of financial instruments are: 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.

(1) Credit risk

The Group's credit risk exposure arises in respect of the instrument below and predominantly in the United Kingdom. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems as inputs and measure the credit risk of loans and advances to customers and banks at a counterparty level using three components: (i) the probability of default by the counterparty on its contractual obligations; (ii) the current exposures to the counterparty and their likely future development, from which the Group derives the exposure at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default. The Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivatives based transactions.

**A. Maximum credit exposure**

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

| | **At 31 December 2014** | | | At 31 December 2013 | | |
|---|---|---|---|---|---|---|
| | **Maximum exposure £m** | **Offset[2] £m** | **Net exposure £m** | Maximum exposure £m | Offset[2] £m | Net exposure £m |
| **The Group** | | | | | | |
| Loans and receivables: | | | | | | |
| Loans and advances to banks, net[1] | **734** | **–** | **734** | 1,692 | – | 1,692 |
| Loans and advances to customers, net[1] | **271,674** | **(1,147)** | **270,527** | 283,638 | (1,879) | 281,759 |
| Debt securities, net[1] | **219** | **–** | **219** | 529 | – | 529 |
| | **272,627** | **(1,147)** | **271,480** | 285,859 | (1,879) | 283,980 |
| Available-for-sale financial assets[3] | **5,156** | **–** | **5,156** | 2,758 | – | 2,758 |
| Trading and other financial assets at fair value through profit or loss[3]: | | | | | | |
| Loans and advances | **13,677** | **–** | **13,677** | 35,004 | – | 35,004 |
| Debt securities, treasury and other bills | **73** | **–** | **73** | 2,101 | – | 2,101 |
| | **13,750** | **–** | **13,750** | 37,105 | – | 37,105 |
| Derivative assets | **23,487** | **(3,713)** | **19,774** | 20,895 | (19,616) | 1,279 |
| | | | | | | |
| Financial guarantees | **440** | **–** | **440** | 659 | – | 659 |
| Off-balance sheet items: | | | | | | |
| Acceptances and endorsements | **1** | **–** | **1** | 2 | – | 2 |
| Other items serving as direct credit substitutes | **8** | **–** | **8** | 23 | – | 23 |
| Performance bonds and other transaction-related contingencies | **220** | **–** | **220** | 267 | – | 267 |
| Irrevocable commitments | **12,466** | – | **12,466** | 13,537 | – | 13,537 |
| | **12,695** | **–** | **12,695** | 13,829 | – | 13,829 |
| | **328,155** | **(4,860)** | **323,295** | 361,105 | (21,495) | 339,610 |

**45 Financial risk management** (continued)

| | At 31 December 2014 | | | At 31 December 2013 | | |
|---|---|---|---|---|---|---|
| | Maximum exposure £m | Offset[2] £m | Net exposure £m | Maximum exposure £m | Offset[2] £m | Net exposure £m |
| **The Bank** | | | | | | |
| Loans and receivables: | | | | | | |
| Loans and advances to banks, net[1] | 676 | – | 676 | 1,633 | – | 1,633 |
| Loans and advances to customers, net[1] | 262,808 | (1,147) | 261,661 | 273,556 | (1,879) | 271,677 |
| Debt securities, net[1] | 181 | – | 181 | 380 | – | 380 |
| | 263,665 | (1,147) | 262,518 | 275,569 | (1,879) | 273,690 |
| Available-for-sale financial assets [3] | 5,156 | – | 5,156 | 2,800 | – | 2,800 |
| Trading and other financial assets at fair value through profit or loss[3]: | | | | | | |
| Loans and advances | 13,677 | – | 13,677 | 35,004 | – | 35,004 |
| Debt securities, treasury and other bills | 73 | – | 73 | 2,101 | – | 2,101 |
| | 13,750 | – | 13,750 | 37,105 | – | 37,105 |
| Derivative assets | 23,137 | (3,713) | 19,424 | 20,628 | (19,616) | 1,012 |
| Financial guarantees | 440 | – | 440 | 659 | – | 659 |
| Off-balance sheet items: | | | | | | |
| Acceptances and endorsements | 1 | – | 1 | 2 | – | 2 |
| Other items serving as direct credit substitutes | 8 | – | 8 | 23 | – | 23 |
| Performance bonds and other transaction-related contingencies | 219 | – | 219 | 266 | – | 266 |
| Irrevocable commitments | 12,466 | – | 12,466 | 13,537 | – | 13,537 |
| | 12,694 | – | 12,694 | 13,828 | – | 13,828 |
| | 318,842 | (4,860) | 313,982 | 350,589 | (21,495) | 329,094 |

[1]Amounts shown net of related impairment allowances.

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

[3]Excluding equity shares.

**B. Concentrations of exposure**

The Group's management of concentration risk includes single name, industry sector and country limits as well as controls over the Group's overall exposure to certain products. Further information on the Group's management of this risk is included within Credit risk on page 4.

At 31 December 2014 the most significant concentrations of exposure were in mortgages (comprising 87 per cent of total loans and advances to customers) and to property companies (comprising 4 per cent of the total). For further information on concentrations of the Group's loans, refer to note 15.

Following the continuing reduction in the Group's non-UK activities, an analysis of credit risk exposures by geographical region has not been provided.

**45 Financial risk management** (continued)

**C. Credit quality of assets**

*Loan and receivables*

The analysis of lending between retail and commercial has been prepared based upon the type of exposure. Included within retail are exposures to personal customers and small businesses, whilst included within commercial are exposures to corporate customers and other large institutions.

**Loans and advances – The Group**

| | Loans and advances to banks £m | Loans and advances to customers: Retail – mortgages £m | Retail – other £m | Commercial £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| **31 December 2014** | | | | | | |
| Neither past due nor impaired | **706** | **229,040** | **8,445** | **21,256** | **258,741** | **1,140** |
| Past due but not impaired | **28** | **8,479** | **133** | **172** | **8,784** | **–** |
| Impaired – no provision required | **–** | **273** | **275** | **271** | **819** | **–** |
| – provision held | **–** | **3,399** | **241** | **5,373** | **9,013** | **–** |
| Gross | **734** | **241,191** | **9,094** | **27,072** | **277,357** | **1,140** |
| Allowance for impairment losses (note 18) | **–** | **(1,483)** | **(200)** | **(4,000)** | **(5,683)** | **–** |
| **Net balance sheet carrying value** | **734** | | | | **271,674** | **1,140** |
| 31 December 2013 | | | | | | |
| Neither past due nor impaired | 1,687 | 225,104 | 9,170 | 26,396 | 260,670 | 9,846 |
| Past due but not impaired | 5 | 9,977 | 163 | 660 | 10,800 | – |
| Impaired – no provision required | – | 326 | 442 | 914 | 1,682 | – |
| – provision held | – | 5,589 | 291 | 17,480 | 23,360 | – |
| Gross | 1,692 | 240,996 | 10,066 | 45,450 | 296,512 | 9,846 |
| Allowance for impairment losses (note 18) | – | (1,980) | (239) | (10,655) | (12,874) | – |
| Net balance sheet carrying value | 1,692 | | | | 283,638 | 9,846 |

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2h. 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 £5,748 million (2013: £18,433 million).

**45 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 | Commercial £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| **31 December 2014** | | | | | | |
| Good quality | **594** | **227,750** | **6,435** | **7,654** | | **1,140** |
| Satisfactory quality | **43** | **1,096** | **1,712** | **5,503** | | **–** |
| Lower quality | **48** | **71** | **186** | **6,786** | | **–** |
| Below standard, but not impaired | **21** | **123** | **112** | **1,313** | | **–** |
| **Total loans and advances which are neither past due nor impaired** | **706** | **229,040** | **8,445** | **21,256** | **258,741** | **1,140** |
| 31 December 2013 | | | | | | |
| Good quality | 1,666 | 221,484 | 6,202 | 9,455 | | 9,839 |
| Satisfactory quality | 21 | 2,659 | 2,399 | 8,351 | | 5 |
| Lower quality | – | 301 | 275 | 7,144 | | 2 |
| Below standard, but not impaired | – | 660 | 294 | 1,446 | | – |
| Total loans and advances which are neither past due nor impaired | 1,687 | 225,104 | 9,170 | 26,396 | 260,670 | 9,846 |

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

**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 | Commercial £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| **31 December 2014** | | | | | | |
| 0-30 days | **28** | **3,976** | **90** | **114** | **4,180** | **–** |
| 30-60 days | **–** | **1,901** | **38** | **15** | **1,954** | **–** |
| 60-90 days | **–** | **1,175** | **5** | **38** | **1,218** | **–** |
| 90-180 days | **–** | **1,427** | **–** | **4** | **1,431** | **–** |
| Over 180 days | **–** | **–** | **–** | **1** | **1** | **–** |
| **Total loans and advances which are past due but not impaired** | **28** | **8,479** | **133** | **172** | **8,784** | **–** |
| 31 December 2013 | | | | | | |
| 0-30 days | 5 | 4,556 | 142 | 261 | 4,959 | – |
| 30-60 days | – | 2,165 | 20 | 61 | 2,246 | – |
| 60-90 days | – | 1,447 | 1 | 47 | 1,495 | – |
| 90-180 days | – | 1,809 | – | 40 | 1,849 | – |
| Over 180 days | – | – | – | 251 | 251 | – |
| Total loans and advances which are past due but not impaired | 5 | 9,977 | 163 | 660 | 10,800 | – |

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

**45 Financial risk management** (continued)

**Loans and advances – The Bank**

| | Loans and advances to banks £m | Loans and advances to customers: Retail – mortgages £m | Retail – other £m | Commercial £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| **31 December 2014** | | | | | | |
| Neither past due nor impaired | **647** | **221,810** | **8,415** | **20,531** | **250,756** | **1,140** |
| Past due but not impaired | **29** | **7,794** | **133** | **199** | **8,126** | **–** |
| Impaired – no provision required | **–** | **240** | **239** | **393** | **872** | **–** |
| – provision held | **–** | **2,986** | **238** | **5,371** | **8,595** | **–** |
| Gross | **676** | **232,830** | **9,025** | **26,494** | **268,349** | **1,140** |
| Allowance for impairment losses (note 18) | **–** | **(1,272)** | **(204)** | **(4,065)** | **(5,541)** | **–** |
| **Net balance sheet carrying value** | **676** | | | | **262,808** | **1,140** |
| 31 December 2013 | | | | | | |
| Neither past due nor impaired | 1,628 | 217,222 | 8,307 | 25,797 | 251,326 | 9,846 |
| Past due but not impaired | 5 | 9,150 | 163 | 660 | 9,973 | – |
| Impaired – no provision required | – | 282 | 392 | 914 | 1,588 | – |
| – provision held | – | 4,965 | 290 | 18,593 | 23,848 | – |
| Gross | 1,633 | 231,619 | 9,152 | 45,964 | 286,735 | 9,846 |
| Allowance for impairment losses (note 18) | – | (1,752) | (245) | (11,182) | (13,179) | – |
| Net balance sheet carrying value | 1,633 | | | | 273,556 | 9,846 |

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

| | Loans and advances to banks £m | Loans and advances to customers: Retail – mortgages £m | Retail – other £m | Commercial £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| **31 December 2014** | | | | | | |
| Good quality | **546** | **220,643** | **6,407** | **7,272** | | **1,140** |
| Satisfactory quality | **39** | **978** | **1,709** | **5,185** | | **–** |
| Lower quality | **42** | **67** | **186** | **6,786** | | **–** |
| Below standard, but not impaired | **20** | **122** | **113** | **1,288** | | **–** |
| **Total loans and advances which are neither past due nor impaired** | **647** | **221,810** | **8,415** | **20,531** | **250,756** | **1,140** |
| 31 December 2013 | | | | | | |
| Good quality | 1,609 | 213,634 | 5,351 | 8,987 | | 9,839 |
| Satisfactory quality | 19 | 2,641 | 2,388 | 8,193 | | 5 |
| Lower quality | – | 299 | 275 | 7,144 | | 2 |
| Below standard, but not impaired | – | 648 | 293 | 1,473 | | – |
| Total loans and advances which are neither past due nor impaired | 1,628 | 217,222 | 8,307 | 25,797 | 251,326 | 9,846 |

**45 Financial risk management** (continued)

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

| | Loans and advances to banks £m | Loans and advances to customers: Retail – mortgages £m | Retail – other £m | Commercial £m | Total £m | Loans and advances designated at fair value through profit or loss £m |
|---|---|---|---|---|---|---|
| **31 December 2014** | | | | | | |
| 0-30 days | **29** | **3,683** | **90** | **140** | **3,913** | **–** |
| 30-60 days | **–** | **1,753** | **38** | **15** | **1,806** | **–** |
| 60-90 days | **–** | **1,072** | **5** | **38** | **1,115** | **–** |
| 90-180 days | **–** | **1,286** | **–** | **4** | **1,290** | **–** |
| Over 180 days | **–** | **–** | **–** | **2** | **2** | **–** |
| **Total loans and advances which are past due but not impaired** | **29** | **7,794** | **133** | **199** | **8,126** | **–** |
| 31 December 2013 | | | | | | |
| 0-30 days | 5 | 4,217 | 143 | 261 | 4,621 | – |
| 30-60 days | – | 1,979 | 19 | 61 | 2,059 | – |
| 60-90 days | – | 1,321 | 1 | 47 | 1,369 | – |
| 90-180 days | – | 1,633 | – | 40 | 1,673 | – |
| Over 180 days | – | – | – | 251 | 251 | – |
| Total loans and advances which are past due but not impaired | 5 | 9,150 | 163 | 660 | 9,973 | – |

**Debt securities classified as loans and receivables**

An analysis by credit rating of debt securities classified as loans and receivables is provided below:

| The Group | Investment grade[1] £m | Sub-investment grade £m | Not rated £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | **30** | **–** | **–** | **30** |
| Other asset-backed securities | **143** | **–** | **7** | **150** |
| | **173** | **–** | **7** | **180** |
| Corporate and other debt securities | **1** | **–** | **181** | **182** |
| | **174** | **–** | **188** | **362** |
| Due from fellow Group undertakings: | | | | |
| Mortgage-backed securities | | | | **–** |
| Corporate and other debt securities | | | | **–** |
| **Total debt securities classified as loans and receivables** | | | | **362** |
| | | | | |
| At 31 December 2013 | | | | |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | 158 | – | – | 158 |
| Other asset-backed securities | 199 | 22 | 7 | 228 |
| | 357 | 22 | 7 | 386 |
| Corporate and other debt securities | 25 | – | 249 | 274 |
| | 382 | 22 | 256 | 660 |
| Due from fellow Group undertakings: | | | | |
| Mortgage-backed securities | | | | – |
| Corporate and other debt securities | | | | – |
| Total debt securities classified as loans and receivables | | | | 660 |

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

**45 Financial risk management** (continued)

| **The Bank** | **Investment grade[1] £m** | **Sub-investment grade £m** | **Not rated £m** | **Total £m** |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | **30** | **–** | **–** | **30** |
| Other asset-backed securities | **143** | **–** | **7** | **150** |
| | **173** | **–** | **7** | **180** |
| Corporate and other debt securities | **1** | **–** | **21** | **22** |
| | **174** | **–** | **28** | **202** |
| Due from fellow Group undertakings: Mortgage-backed securities | | | | **–** |
| **Total debt securities classified as loans and receivables** | | | | **202** |
| | | | | |
| At 31 December 2013 | | | | |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | 148 | – | – | 148 |
| Other asset-backed securities | 199 | 22 | 7 | 228 |
| | 347 | 22 | 7 | 376 |
| Corporate and other debt securities | 25 | – | – | 25 |
| | 372 | 22 | 7 | 401 |
| Due from fellow Group undertakings: Mortgage-backed securities | | | | – |
| Total debt securities classified as loans and receivables | | | | 401 |

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

**45 Financial risk management** (continued)

**Available-for-sale financial assets (excluding equity shares)**
An analysis of available-for-sale financial assets is included in note 19. The credit quality of available-for-sale financial assets (excluding equity shares) is set out below:

| The Group | Investment grade[1] £m | Sub-investment grade £m | Not rated £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Debt securities: | | | | |
| Government securities | **31** | **–** | **–** | **31** |
| Bank and building society certificates of deposit | **15** | **–** | **–** | **15** |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | **499** | **–** | **–** | **499** |
| Other asset-backed securities | **343** | **–** | **–** | **343** |
| | **842** | **–** | **–** | **842** |
| Corporate and other debt securities | **4,268** | **–** | **–** | **4,268** |
| | **5,156** | **–** | **–** | **5,156** |
| Due from fellow Group undertakings: Corporate and other debt securities | | | | **–** |
| **Total held as available-for-sale financial assets** | | | | **5,156** |
| | | | | |
| At December 2013 | | | | |
| Debt securities: | | | | |
| Government securities | 28 | – | – | 28 |
| Bank and building society certificates of deposit | 12 | – | – | 12 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | 749 | – | – | 749 |
| Other asset-backed securities | 518 | – | – | 518 |
| | 1,267 | – | – | 1,267 |
| Corporate and other debt securities | 1,396 | 37 | 18 | 1,451 |
| | 2,703 | 37 | 18 | 2,758 |
| Due from fellow Group undertakings: Corporate and other debt securities | | | | – |
| Total held as available-for-sale financial assets | | | | 2,758 |

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

**45 Financial risk management** (continued)

| **The Bank** | **Investment grade[1] £m** | **Sub-investment grade £m** | **Not rated £m** | **Total £m** |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| Debt securities: | | | | |
| Government securities | **31** | **–** | **–** | **31** |
| Bank and building society certificates of deposit | **15** | **–** | **–** | **15** |
| Asset backed securities: | | | | |
| Mortgage-backed securities | **499** | **–** | **–** | **499** |
| Other asset-backed securities | **343** | **–** | **–** | **343** |
| | **842** | **–** | **–** | **842** |
| Corporate and other debt securities | **4,268** | **–** | **–** | **4,268** |
| | **5,156** | **–** | **–** | **5,156** |
| Due from fellow Group undertakings: Corporate and other debt securities | | | | **–** |
| **Total held as available-for-sale financial assets** | | | | **5,156** |
| | | | | |
| At 31 December 2013 | | | | |
| Debt securities: | | | | |
| Government securities | 28 | – | – | 28 |
| Bank and building society certificates of deposit | 12 | – | – | 12 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | 749 | – | – | 749 |
| Other asset-backed securities | 518 | – | – | 518 |
| | 1,267 | – | – | 1,267 |
| Corporate and other debt securities | 1,397 | 37 | 18 | 1,452 |
| | 2,704 | 37 | 18 | 2,759 |
| Due from fellow Group undertakings: Corporate and other debt securities | | | | 41 |
| Total held as available-for-sale financial assets | | | | 2,800 |

[1]Credit ratings equal to or better than ‘BBB’.

**45 Financial risk management** (continued)

**Debt securities, treasury and other bills held at fair value through profit or loss**
An analysis of trading and other financial assets at fair value through profit or loss is included in note 12. The credit quality of debt securities, treasury and other bills held at fair value through profit or loss is set out below.

| The Group | Investment grade[1] £m | Sub-investment grade £m | Not rated £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| *Trading assets* | | | | |
| Government securities | **45** | **–** | **–** | **45** |
| Bank and building society certificates of deposit | **–** | **–** | **–** | **–** |
| Asset-backed securities | **–** | **–** | **–** | **–** |
| Corporate and other debt securities | **28** | **–** | **–** | **28** |
| Total debt securities held as trading assets | **73** | **–** | **–** | **73** |
| Treasury and other bills | **–** | **–** | **–** | **–** |
| Total held as trading assets | **73** | **–** | **–** | **73** |
| *Other assets held at fair value through profit or loss* | | | | |
| Corporate and other debt securities | **–** | **–** | **–** | **–** |
| **Total held at fair value through profit or loss** | **73** | **–** | **–** | **73** |
| | | | | |
| At 31 December 2013 | | | | |
| *Trading assets* | | | | |
| Government securities | 115 | – | – | 115 |
| Bank and building society certificates of deposit | 1,458 | – | – | 1,458 |
| Asset-backed securities | – | 4 | – | 4 |
| Corporate and other debt securities | 518 | – | – | 518 |
| Total debt securities held as trading assets | 2,091 | 4 | – | 2,095 |
| Treasury and other bills | 6 | – | – | 6 |
| Total held as trading assets | 2,097 | 4 | – | 2,101 |
| *Other assets held at fair value through profit or loss* | | | | |
| Corporate and other debt securities | – | – | – | – |
| Total held at fair value through profit or loss | 2,097 | 4 | – | 2,101 |

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

**45 Financial risk management** (continued)

| The Bank | Investment grade[1] £m | Sub-investment grade £m | Not rated £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2014** | | | | |
| *Trading assets* | | | | |
| Government securities | **45** | **–** | **–** | **45** |
| Bank and building society certificates of deposit | **–** | **–** | **–** | **–** |
| Asset-backed securities | **–** | **–** | **–** | **–** |
| Corporate and other debt securities | **28** | **–** | **–** | **28** |
| Total debt securities held as trading assets | **73** | **–** | **–** | **73** |
| Treasury and other bills | **–** | **–** | **–** | **–** |
| Total held as trading assets | **73** | **–** | **–** | **73** |
| *Other assets held at fair value through profit or loss* | | | | |
| Corporate and other debt securities | **–** | **–** | **–** | **–** |
| **Total held at fair value through profit or loss** | **73** | **–** | **–** | **73** |
| | | | | |
| At 31 December 2013 | | | | |
| *Trading assets* | | | | |
| Government securities | 115 | – | – | 115 |
| Bank and building society certificates of deposit | 1,458 | – | – | 1,458 |
| Asset-backed securities | – | 4 | – | 4 |
| Corporate and other debt securities | 518 | – | – | 518 |
| Total debt securities held as trading assets | 2,091 | 4 | – | 2,095 |
| Treasury and other bills | 6 | – | – | 6 |
| Total held as trading assets | 2,097 | 4 | – | 2,101 |
| *Other assets held at fair value through profit or loss* | | | | |
| Corporate and other debt securities | – | – | – | – |
| Total held at fair value through profit or loss | 2,097 | 4 | – | 2,101 |

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

**45 Financial risk management** (continued)

**Derivative assets**
An analysis of derivative assets is given in note 13. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's maximum credit risk relating to derivative assets of £19,774 million for the Group and £19,424 million for the Bank (2013: £14,343 million for the Group and £14,077 million for the Bank), cash collateral of £1,286 million for the Group and the Bank (2013: £1,162 million for the Group and the Bank) was held and a further £216 million for the Group and the Bank was due from OECD banks (2013: £266 million for the Group and £236 million for the Bank).

| | Investment grade[1] £m | Sub-investment grade £m | Not rated £m | Total £m |
|---|---|---|---|---|
| **Derivative financial instruments** | | | | |
| **The Group** | | | | |
| **At 31 December 2014** | | | | |
| Trading and other | **5,165** | **923** | **425** | **6,513** |
| Hedging | **2,082** | **22** | **–** | **2,104** |
| | **7,247** | **945** | **425** | **8,617** |
| Due from fellow Group undertakings | | | | **14,870** |
| **Total derivative financial instruments** | | | | **23,487** |
| At 31 December 2013 | | | | |
| Trading and other | 6,474 | 1,712 | 1 | 8,187 |
| Hedging | 2,829 | 2 | 5 | 2,836 |
| | 9,303 | 1,714 | 6 | 11,023 |
| Due from fellow Group undertakings | | | | 9,872 |
| Total derivative financial instruments | | | | 20,895 |
| **The Bank** | | | | |
| **At 31 December 2014** | | | | |
| Trading and other | **4,815** | **923** | **425** | **6,163** |
| Hedging | **2,082** | **22** | **–** | **2,104** |
| | **6,897** | **945** | **425** | **8,267** |
| Due from fellow Group undertakings | | | | **14,870** |
| **Total derivative financial instruments** | | | | **23,137** |
| At 31 December 2013 | | | | |
| Trading and other | 6,207 | 1,712 | 1 | 7,920 |
| Hedging | 2,829 | 2 | 5 | 2,836 |
| | 9,036 | 1,714 | 6 | 10,756 |
| Due from fellow Group undertakings | | | | 9,872 |
| Total derivative financial instruments | | | | 20,628 |

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

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

**45 Financial risk management** (continued)

**D. Collateral held as security for financial assets**
The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

**Loans and receivables**
The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as loans and receivables.

*Loans and advances to banks*
The Group may require collateral before entering into a credit commitment with another bank, depending on the type of financial product and the counterparty involved, and netting arrangements are obtained whenever possible and to the extent that such agreements are legally enforceable. Collateral is held as part of reverse repurchase or securities borrowing transactions.

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

*Loans and advances to customers*
The Group holds collateral against loans and advances to customers in the form of mortgages over residential and commercial real estate, charges over business assets such as premises, inventory and accounts receivable, charges over financial instruments such as debt securities and equities, and guarantees received from third parties.

**Retail lending**
**Mortgages**
An analysis by loan-to-value ratio of the Group's residential mortgage lending is provided below. The value of collateral used in determining the loan-to-value ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations.

**45 Financial risk management** (continued)

**The Group**

| | **Neither past due nor impaired £m** | **Past due but not impaired £m** | **Impaired £m** | **Gross £m** |
|---|---|---|---|---|
| **31 December 2014** | | | | |
| Less than 70 per cent | **137,305** | **3,907** | **1,314** | **142,526** |
| 70 per cent to 80 per cent | **45,475** | **1,674** | **616** | **47,765** |
| 80 per cent to 90 per cent | **25,382** | **1,271** | **594** | **27,247** |
| 90 per cent to 100 per cent | **12,417** | **846** | **416** | **13,679** |
| Greater than 100 per cent | **8,461** | **781** | **732** | **9,974** |
| **Total** | **229,040** | **8,479** | **3,672** | **241,191** |

| | Neither past due nor impaired £m | Past due but not impaired £m | Impaired £m | Gross £m |
|---|---|---|---|---|
| 31 December 2013 | | | | |
| Less than 70 per cent | 105,228 | 3,224 | 1,431 | 109,883 |
| 70 per cent to 80 per cent | 48,961 | 1,932 | 836 | 51,729 |
| 80 per cent to 90 per cent | 35,155 | 1,843 | 939 | 37,937 |
| 90 per cent to 100 per cent | 18,253 | 1,423 | 877 | 20,553 |
| Greater than 100 per cent | 17,507 | 1,555 | 1,832 | 20,894 |
| Total | 225,104 | 9,977 | 5,915 | 240,996 |

**The Bank**

| | **Neither past due nor impaired £m** | **Past due but not impaired £m** | **Impaired £m** | **Gross £m** |
|---|---|---|---|---|
| **31 December 2014** | | | | |
| Less than 70 per cent | **134,372** | **3,679** | **1,231** | **139,282** |
| 70 per cent to 80 per cent | **43,950** | **1,526** | **549** | **46,025** |
| 80 per cent to 90 per cent | **24,047** | **1,136** | **504** | **25,687** |
| 90 per cent to 100 per cent | **11,537** | **742** | **344** | **12,623** |
| Greater than 100 per cent | **7,904** | **711** | **598** | **9,213** |
| **Total** | **221,810** | **7,794** | **3,226** | **232,830** |

| | Neither past due nor impaired £m | Past due but not impaired £m | Impaired £m | Gross £m |
|---|---|---|---|---|
| 31 December 2013 | | | | |
| Less than 70 per cent | 102,999 | 3,047 | 1,350 | 107,396 |
| 70 per cent to 80 per cent | 47,595 | 1,800 | 765 | 50,160 |
| 80 per cent to 90 per cent | 33,178 | 1,660 | 825 | 35,663 |
| 90 per cent to 100 per cent | 16,799 | 1,239 | 745 | 18,783 |
| Greater than 100 per cent | 16,651 | 1,404 | 1,562 | 19,617 |
| Total | 217,222 | 9,150 | 5,247 | 231,619 |

**45 Financial risk management** (continued)

**Other**
No collateral is held in respect of retail credit cards, or overdrafts, or unsecured personal loans. For non-mortgage retail lending to small businesses, collateral will often include second charges over residential property and the assignment of life cover.

The majority of non-mortgage retail lending is unsecured. At 31 December 2014, impaired non-mortgage lending amounted to £316 million, net of an impairment allowance of £200 million (2013: £494 million, net of an impairment allowance of £239 million). The fair value of the collateral held in respect of this lending was £nil (2013: £nil). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £8,578 million (2013: £9,333 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are thereafter monitored in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is re-assessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

**Commercial lending**
*Impaired secured lending*
The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt.

At 31 December 2014, impaired secured commercial lending amounted to £1,525 million, net of an impairment allowance of £3,614 million (2013: £7,414 million, net of an impairment allowance of £9,423 million). The fair value of the collateral held in respect of impaired secured commercial lending was £1,619 million (2013: £5,186 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured commercial lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Impaired secured commercial lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

*Unimpaired secured lending*
Unimpaired secured commercial lending amounted to £10,526 million (2013: £19,428 million). Commercial lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination. The types of collateral taken and the frequency with which collateral is required at origination is dependent upon the size and structure of the borrower. For exposures to corporate customers and other large institutions, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a mortgage debenture over the company's undertaking and one or more of its assets, and keyman insurance. The Group maintains policies setting out acceptable collateral, maximum loan-to-value ratios and other criteria to be considered when reviewing a loan application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the customer. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, the provision of collateral will not determine the outcome of a credit application. The fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay debt.

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor. Although lending decisions are predominantly based on expected cash flows, any collateral provided may impact the pricing and other terms of a loan or facility granted; this will have a financial impact on the amount of net interest income recognised and on internal loss-given-default estimates that contribute to the determination of asset quality.

For unimpaired secured commercial lending, the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

Unimpaired secured commercial lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for impaired lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured commercial lending portfolio is provided to key management personnel.

**Trading and other financial assets at fair value through profit or loss (excluding equity shares)**
Included in trading and other financial assets at fair value through profit or loss are repurchase agreements treated as collateralised loans with a carrying value of £13,677 million for the Group and £13,677 million for the Bank (2013: £34,854 million for the Group the Bank). Collateral is held with a fair value of £13,422 million for the Group and the Bank (2013: £37,746 million for the Group and the Bank), all of which the Group is able to repledge. At 31 December 2014, £3,759 million for the Group and the Bank had been repledged (2013: £20,595 million for the Group and the Bank).

In addition, securities held as collateral in the form of stock borrowed amounted to £24,554 million for the Group and the Bank (2013: £50,365 million for the Group and the Bank). Of this amount, £20,245 million for the Group and the Bank (2013: £49,668 million for the Group and the Bank) had been resold or repledged as collateral for the Group's own transactions.

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

**Derivative assets, after offsetting of amounts under master netting arrangements**
The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £19,774 million for the Group and £19,424 million for the Bank (2013: £14,343 million for the Group and £14,077 million for the Bank), cash collateral of £1,286 million for the Group and the Bank (2013: £1,162 million for the Group and the Bank) was held.

**45 Financial risk management** (continued)

**Irrevocable loan commitments and other credit-related contingencies**
At 31 December 2014, there were irrevocable loan commitments and other credit-related contingencies of £12,695 million for the Group and £12,694 million for the Bank (2013: £13,829 million for the Group and £13,828 million for the Bank). Collateral is held as security, in the event that lending is drawn down, on £8,395 million for the Group and the Bank (2013: £2,194 million for the Group and the Bank) of these balances.

Lending decisions in respect of irrevocable loan commitments are based on the obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. For commercial commitments, it is the Group's practice to request collateral whose value is commensurate with the nature of the commitment. For retail mortgage commitments, the majority are for mortgages with a loan-to-value ratio of less than 100 per cent. Aggregated collateral information covering the entire balance of irrevocable loan commitments over which security will be taken is not provided to key management personnel.

**Collateral repossessed**
During the year, £720 million for the Group and £606 million for the Bank of collateral was repossessed (2013: £773 million for the Group and £622 million for the Bank), consisting primarily of residential property. In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against commercial lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

**E. Collateral pledged as security**

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

**Repurchase transactions**
*Deposits from banks*
Included in deposits from banks are deposits held as collateral for facilities granted, with a carrying value of £595 million for the Group and £595 million for the Bank (2013: £623 million for the Group and Bank) and a fair value of £595 million for the Group and £595 million for the Bank (2013: £623 million for the Group and Bank). In addition, collateral balances in the form of cash provided in respect of repurchase agreements amounted to £nil for the Group and £nil for the Bank (2013: £nil for the Group and Bank).

*Trading and other financial liabilities at fair value through profit or loss*
The fair value of collateral pledged in respect of repurchase transactions, accounted for as secure borrowing, where the secured party is permitted by contract or custom to repledge was £13,935 million for the Group and the Bank (2013: £40,911 million for the Group and the Bank).

**Securities lending transactions**
The following financial assets on the balance sheet have been pledged as collateral as part of securities lending transactions:

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Trading and other financial assets at fair value through profit or loss | **–** | 1,925 | **–** | 1,925 |
| Loans and advances to customers | **26,703** | 43,424 | **26,703** | 43,424 |
| Debt securities classified as loans and receivables | **821** | 1,124 | **821** | 1,124 |
| Available-for-sale financial assets | **464** | 396 | **464** | 396 |
| | **27,988** | 46,869 | **27,988** | 46,869 |

**Securitisations and covered bonds**
In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these are provided in notes 16 and 17.

**45 Financial risk management** (continued)

**(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.

At 31 December 2014 the aggregate notional principal of interest rate swaps designated as fair value hedges was £22,511 million (2013: £24,298 million) with a net fair value asset of £2,869 million (2013: £2,790 million) (see note 13). The gains on the hedging instruments were £433 million (2013: losses of £1,242 million). The losses on the hedged items attributable to the hedged risk were £414 million (2013: gains of £1,263 million).

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 commercial business. These cash flows are expected to occur over the next five 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 2014 was £71,379 million (2013: £107,529 million) with a net fair value liability of £417 million (2013: liability of £133 million) (see note 13). In 2014, ineffectiveness recognised in the income statement that arises from cash flow liability was £nil (2013: a loss of £68 million).

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

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the 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 and Europe. Details of the Group's structural foreign currency exposures, after net investment hedges, are as follows:

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Functional currency of Group operations** | | | | |
| Euro: | | | | |
| Gross exposure | **120** | 31 | **–** | – |
| Net investment hedge | **(60)** | (464) | **–** | – |
| | **60** | (433) | **–** | – |
| US dollar: | | | | |
| Gross exposure | **108** | 59 | **108** | 49 |
| Net investment hedge | **(110)** | (62) | **(110)** | (62) |
| | **(2)** | (3) | **(2)** | (13) |
| Australian Dollar: | | | | |
| Gross exposure | **–** | 13 | **–** | – |
| Net investment hedge | **–** | (13) | **–** | – |
| | **–** | – | **–** | – |
| Other non-sterling | **1** | 1 | **–** | – |
| **Total structural foreign currency exposures, after net investment hedges** | **59** | (435) | **(2)** | (13) |

**45 Financial risk management** (continued)

**(3) Liquidity risk**
Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Liquidity risk is managed through a series of measures, texts and reports that are primarily based on contractual maturity. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses 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. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

| The Group | Up to 1 month £m | 1-3 months £m | 3-12 months £m | 1-5 years £m | Over 5 years £m | Total £m |
|---|---|---|---|---|---|---|
| **At 31 December 2014** | | | | | | |
| Deposits from banks | **16** | **585** | **179** | **1,300** | **163** | **2,243** |
| Customer deposits | **146,908** | **4,572** | **29,232** | **24,156** | **70** | **204,938** |
| Trading liabilities | **12,224** | **604** | **633** | **303** | **5** | **13,769** |
| Debt securities in issue | **1,619** | **142** | **3,066** | **12,348** | **6,726** | **23,901** |
| Subordinated liabilities | **298** | **17** | **357** | **983** | **939** | **2,594** |
| **Total non-derivative financial liabilities** | **161,065** | **5,920** | **33,467** | **39,090** | **7,903** | **247,445** |
| Derivative financial liabilities: | | | | | | |
| Gross settled derivatives – outflow | **986** | **1,617** | **2,808** | **6,863** | **7,573** | **19,847** |
| Gross settled derivatives – inflow | **(789)** | **(1,466)** | **(2,779)** | **(6,667)** | **(6,941)** | **(18,642)** |
| Gross settled derivatives – netflow | **197** | **151** | **29** | **196** | **632** | **1,205** |
| Gross settled derivatives liabilities | **3,697** | **32** | **142** | **451** | **441** | **4,763** |
| **Total derivative financial liabilities** | **3,894** | **183** | **171** | **647** | **1,073** | **5,968** |
| | | | | | | |
| At 31 December 2013 | | | | | | |
| Deposits from banks | 2,178 | 24 | 133 | 850 | 88 | 3,273 |
| Customer deposits | 110,262 | 6,195 | 26,669 | 32,437 | 33,854 | 209,417 |
| Trading liabilities | 22,010 | 9,889 | 4,433 | 252 | 40 | 36,624 |
| Debt securities in issue | 3,919 | 630 | 5,339 | 12,766 | 8,402 | 31,056 |
| Subordinated liabilities | 280 | 18 | 89 | 1,066 | 14,098 | 15,551 |
| Total non-derivative financial liabilities | 138,649 | 16,756 | 36,663 | 47,371 | 56,482 | 295,921 |
| Derivative financial liabilities: | | | | | | |
| Gross settled derivatives – outflow | 1,684 | 593 | 7,432 | 15,387 | 9,917 | 35,013 |
| Gross settled derivatives – inflow | (1,341) | (346) | (7,366) | (15,191) | (9,806) | (34,050) |
| Gross settled derivatives – netflow | 343 | 247 | 66 | 196 | 111 | 963 |
| Net settled derivative liabilities | 6,597 | 86 | 288 | 686 | 219 | 7,876 |
| Total derivative financial liabilities | 6,940 | 333 | 354 | 882 | 330 | 8,839 |

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £440 million at 31 December 2014 (2013: £659 million) with £338 million expiring within one year; £48 million between one and three years; £27 million between three and five years; and £27 million over five years (2013: £269 million expiring within one year; £nil between one and three years; £206 million between three and five years; and £184 million over five years).

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £7 million (2013: £7 million) for 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.

# Notes to the accounts

**45 Financial risk management** (continued)

| The Bank | Up to 1 month £m | 1-3 months £m | 3-12 months £m | 1-5 years £m | Over 5 years £m | Total £m |
|---|---|---|---|---|---|---|
| **At 31 December 2014** | | | | | | |
| Deposits from banks | **24** | **585** | **179** | **1,300** | **163** | **2,251** |
| Customer deposits | **146,908** | **4,572** | **29,232** | **24,156** | **70** | **204,938** |
| Trading liabilities | **12,223** | **604** | **633** | **303** | **–** | **13,763** |
| Debt securities in issue | **1,587** | **141** | **489** | **7,658** | **5,526** | **15,401** |
| Subordinated liabilities | **298** | **17** | **88** | **936** | **771** | **2,110** |
| **Total non-derivative financial liabilities** | **161,040** | **5,919** | **30,621** | **34,353** | **6,530** | **238,463** |
| Derivative financial liabilities: | | | | | | |
| Gross settled derivatives – outflow | **980** | **1,617** | **2,792** | **5,863** | **7,238** | **18,490** |
| Gross settled derivatives – inflow | **(785)** | **(1,466)** | **(2,766)** | **(5,698)** | **(6,939)** | **(17,654)** |
| Gross settled derivatives – netflow | **195** | **151** | **26** | **165** | **299** | **836** |
| Net settled derivative liabilities | **3,697** | **32** | **142** | **451** | **441** | **4,763** |
| **Total derivative financial liabilities** | **3,892** | **183** | **168** | **616** | **740** | **5,599** |
| | | | | | | |
| At 31 December 2013 | | | | | | |
| Deposits from banks | 2,174 | 24 | 133 | 850 | 13 | 3,194 |
| Customer deposits | 110,268 | 6,195 | 26,669 | 32,437 | 33,725 | 209,294 |
| Trading liabilities | 22,011 | 9,889 | 4,433 | 252 | – | 36,585 |
| Debt securities in issue | 12,120 | 133 | 1,943 | 7,898 | 7,827 | 29,921 |
| Subordinated liabilities | 280 | 18 | 89 | 1,109 | 13,649 | 15,145 |
| Total non-derivative financial liabilities | 146,853 | 16,259 | 33,267 | 42,546 | 55,214 | 294,139 |
| Derivative financial liabilities: | | | | | | |
| Gross settled derivatives – outflow | 445 | 593 | 6,732 | 14,370 | 9,619 | 31,759 |
| Gross settled derivatives – inflow | (118) | (346) | (6,718) | (14,258) | (9,803) | (31,243) |
| Gross settled derivatives – netflow | 327 | 247 | 14 | 112 | (184) | 516 |
| Net settled derivative liabilities | 6,597 | 86 | 288 | 686 | 219 | 7,876 |
| Total derivative financial liabilities | 6,924 | 333 | 302 | 798 | 35 | 8,392 |

**45 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 2014** | | | | | |
| Acceptances and endorsements | **–** | **–** | **–** | **1** | **1** |
| Other contingent liabilities | **216** | **2** | **6** | **4** | **228** |
| Total contingent liabilities | **216** | **2** | **6** | **5** | **229** |
| Lending commitments | **28,431** | **920** | **538** | **2,526** | **32,415** |
| Other commitments | **1** | **–** | **–** | **–** | **1** |
| Total commitments | **28,432** | **920** | **538** | **2,526** | **32,416** |
| **Total contingents and commitments** | **28,648** | **922** | **544** | **2,531** | **32,645** |

| | Within 1 year £m | 1-3 years £m | 3-5 years £m | Over 5 years £m | Total £m |
|---|---|---|---|---|---|
| 31 December 2013 | | | | | |
| Acceptances and endorsements | 2 | – | – | – | 2 |
| Other contingent liabilities | 242 | 15 | 28 | 5 | 290 |
| Total contingent liabilities | 244 | 15 | 28 | 5 | 292 |
| Lending commitments | 27,807 | 1,080 | 1,509 | 1,536 | 31,932 |
| Other commitments | 4 | – | – | – | 4 |
| Total commitments | 27,811 | 1,080 | 1,509 | 1,536 | 31,936 |
| Total contingents and commitments | 28,055 | 1,095 | 1,537 | 1,541 | 32,228 |

| **The Bank** | **Within 1 year £m** | **1-3 years £m** | **3-5 years £m** | **Over 5 years £m** | **Total £m** |
|---|---|---|---|---|---|
| **31 December 2014** | | | | | |
| Acceptances and endorsements | **–** | **–** | **–** | **1** | **1** |
| Other contingent liabilities | **216** | **1** | **6** | **4** | **227** |
| Total contingent liabilities | **216** | **1** | **6** | **5** | **228** |
| Lending commitments | **28,320** | **860** | **478** | **2,516** | **32,174** |
| Other commitments | **1** | **–** | **–** | **–** | **1** |
| Total commitments | **28,321** | **860** | **478** | **2,516** | **32,175** |
| **Total contingents and commitments** | **28,537** | **861** | **484** | **2,521** | **32,403** |

| | Within 1 year £m | 1-3 years £m | 3-5 years £m | Over 5 years £m | Total £m |
|---|---|---|---|---|---|
| 31 December 2013 | | | | | |
| Acceptances and endorsements | 2 | – | – | – | 2 |
| Other contingent liabilities | 242 | 14 | 28 | 5 | 289 |
| Total contingent liabilities | 244 | 14 | 28 | 5 | 291 |
| Lending commitments | 27,626 | 1,007 | 1,449 | 1,476 | 31,558 |
| Other commitments | 4 | – | – | – | 4 |
| Total commitments | 27,630 | 1,007 | 1,449 | 1,476 | 31,562 |
| Total contingents and commitments | 27,874 | 1,021 | 1,477 | 1,481 | 31,853 |

## 46 Capital

**Capital management**
Within the Group, capital within each regulated entity is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in 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 measures the amount of capital it holds using the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation Authority (PRA) policy statement PS7/13. Application of CRD IV requirements is subject to transitional phasing permitted by PS7/13.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is determined as 8 per cent of the aggregate risk-weighted assets calculated in respect of credit risk, counterparty credit risk, operational risk and market risk. At least 4 per cent of risk-weighted assets were required to be covered by Common Equity Tier 1 (CET1) capital in 2014, increasing to 4.5 per cent from 1 January 2015.

The minimum requirement for capital is supplemented by Pillar 2 of the framework. Under Pillar 2A, additional requirements are set through the issuance of bank specific Individual Capital Guidance (ICG), which adjusts the Pillar 1 minimum for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICG process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process (ICAAP).

A range of additional bank specific regulatory capital buffers apply under CRD IV, though these do not currently apply to the Group as they are either subject to phase in periods (commencing 2016), are time-varying in nature or are applied at the discretion of the regulator.

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

**Regulatory capital developments**
The regulatory framework within which the Group operates continues to be developed at a global level through the Financial Stability Board (FSB) and Basel Committee, at a European level mainly through the issuance of CRD IV technical standards and guidelines and within the UK by the PRA and through directions from the Financial Policy Committee (FPC).The Group continues to monitor these developments very closely, analysing potential capital impacts to ensure the Group and individual regulated entities continue to maintain a strong capital position that exceeds the minimum regulatory requirements and the Group's risk appetite and is consistent with market expectations.

**Capital resources**
Regulatory capital is divided into tiers depending on the degree of permanency and ability to absorb losses.

- Common equity tier 1 capital represents the strongest form of capital consisting of shareholders' equity after a number of regulatory adjustments and deductions are applied. These include deductions for deferred tax assets, subject to threshold requirements under CRD IV, and the elimination of the cash flow hedging reserve, goodwill and other intangible assets.
- Fully qualifying additional tier 1 (AT1) capital comprises non-cumulative perpetual securities containing specific provisions to write down the security or convert it to equity should the CET1 ratio fall to a defined trigger limit. Under transitional rules, securities that do not qualify in their own right but were issued and eligible as tier 1 capital prior to CRD IV can be partially included within AT1, until they are phased out altogether in 2022. To the extent these securities do not qualify as AT1 they may nevertheless still qualify as tier 2 capital.
- Tier 2 (T2) capital comprises certain other subordinated debt securities that do not qualify as AT1. They must have an original term of at least 10 years, cannot normally be redeemed within their first 5 years and are phased out as T2 regulatory capital in the final 5 years before maturity. Transitional rules under CRD IV allow securities that do not qualify in their own right as T2 capital, but which were issued and eligible as T2 capital prior to CRD IV, to be partially included as T2 capital until they are phased out altogether in 2022.

The Group's CRD IV transitional capital resources are summarised as follows:

| | **2014 £m** | 2013 £m |
|---|---|---|
| Common equity/tier 1 capital | **12,042** | 16,792 |
| Additional tier 1 capital | **569** | 658 |
| Tier 2 capital | **7,214** | 12,492 |
| | **19,825** | 29,942 |
| Supervisory deductions | **–** | (2,029) |
| **Total capital** | **19,825** | 27,913 |

## 47 Cash flow statements

### a Change in operating assets

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Change in loans and receivables | **18,584** | 23,028 | **17,781** | 21,635 |
| Change in amounts due from Group undertakings | **151,004** | (43,260) | **150,389** | (35,790) |
| Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss | **20,751** | 10,133 | **20,903** | 9,962 |
| Change in other operating assets | **1,239** | 123 | **1,110** | 93 |
| **Change in operating assets** | **191,578** | (9,976) | **190,183** | (4,100) |

### b Change in operating liabilities

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Change in deposits from banks | **(884)** | (3,938) | **(888)** | (3,813) |
| Change in customer deposits | **(3,069)** | 5,288 | **(3,069)** | 1,311 |
| Change in amount due to Group undertakings | **(145,736)** | 39,787 | **(142,168)** | 34,173 |
| Change in debt securities in issue | **(9,047)** | (19,595) | **(10,543)** | (14,730) |
| Change in derivative financial instruments and trading liabilities | **(21,795)** | (9,778) | **(21,671)** | (9,779) |
| Change in other operating liabilities | **(3,187)** | (230) | **(3,152)** | 47 |
| **Change in operating liabilities** | **(183,718)** | 11,534 | **(181,491)** | 7,209 |

### c Non-cash and other items

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Depreciation and amortisation | **179** | 224 | **159** | 164 |
| Revaluation of investment properties | **(7)** | 68 | **–** | – |
| Allowance for loan losses | **470** | 2,400 | **372** | 2,717 |
| Write-off of allowance for loan losses | **(7,249)** | (8,298) | **(7,577)** | (8,138) |
| Impairment of available-for-sale financial assets | **8** | 45 | **4** | 2 |
| Impairment of Goodwill | **–** | 51 | **–** | 51 |
| Impairment losses on investments in subsidiaries | **–** | – | **3** | – |
| Payment protection insurance provision | **674** | 740 | **669** | 740 |
| Other provision movements | **314** | 122 | **315** | 62 |
| Unwind of discount on impairment allowances | **(29)** | (228) | **(43)** | (247) |
| Foreign exchange element on balance sheet[1] | **828** | 621 | **692** | (305) |
| Interest expense on subordinated liabilities | **314** | 358 | **314** | 344 |
| Loss (profit) on disposal of businesses | **7** | (35) | **(2)** | – |
| Other non-cash items | **(549)** | (339) | **(378)** | (338) |
| **Total non-cash items** | **(5,040)** | (4,271) | **(5,472)** | (4,948) |
| Payments in respect of other provisions | **(144)** | (61) | **(144)** | (23) |
| Payments in respect of payment protection insurance provision | **(740)** | (507) | **(731)** | (513) |
| Other | **27** | 7 | **–** | – |
| **Total other items** | **(857)** | (561) | **(875)** | (536) |
| **Non-cash and other items** | **(5,897)** | (4,832) | **(6,347)** | (5,484) |

[1]When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

**47 Cash flow statements** (continued)

**d Analysis of cash and cash equivalents as shown in the balance sheet**

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Cash and balances with central banks | **5,110** | 7,296 | **5,110** | 7,296 |
| Less: mandatory reserve deposits[1] | **(449)** | (407) | **(449)** | (407) |
| | **4,661** | 6,889 | **4,661** | 6,889 |
| Loans and advances to banks | **734** | 1,692 | **676** | 1,633 |
| Less: amounts with a maturity of three months or more and amounts due from fellow Lloyds Banking Group undertakings | **(566)** | (707) | **(526)** | (732) |
| | **168** | 985 | **150** | 901 |
| **Total cash and cash equivalents** | **4,829** | 7,874 | **4,811** | 7,790 |

[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 Disposal and closure of group undertakings, joint ventures and associates**

| | The Group | | The Bank | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Loans and advances to customers | **–** | 4,983 | **–** | – |
| Loans and receivables debt securities | **–** | 60 | **–** | – |
| Tangible fixed assets | **–** | 63 | **–** | – |
| Trading and other financial assets at fair price through profit or loss | **75** | – | **–** | – |
| Interest in joint ventures and associates | **26** | – | **–** | – |
| Goodwill | **9** | – | **–** | – |
| | **110** | 5,106 | **–** | – |
| | | | **–** | – |
| Customer deposits | **–** | (3,989) | **–** | – |
| Debt securities in issue | **–** | (292) | **–** | – |
| Subordinated liabilities | **–** | (60) | **–** | – |
| Non-controlling interests | **(12)** | – | **–** | – |
| Other net assets (liabilities) | **(15)** | 185 | **72** | 7 |
| | **(27)** | (4,156) | **72** | 7 |
| | | | | |
| Net assets | **83** | 950 | **72** | 7 |
| | | | | |
| Cash and cash equivalents disposed | **–** | (41) | **–** | – |
| Profit (loss) on sale | **(7)** | 35 | **2** | – |
| **Net cash inflow (outflow)** | **76** | 944 | **74** | 7 |

### 48 Future accounting developments

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2014 and have not been applied in preparing these financial statements. Save as disclosed below, the full impact of these accounting changes is being assessed by the Group.

| Pronouncement | Nature of change | IASB effective date |
|---|---|---|
| IFRS 9 *Financial Instruments*[1] | Replaces IAS 39 *Financial Instruments: Recognition and Measurement.* IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments. The requirements for derecognition are broadly unchanged from IAS 39. The standard retains most of the existing requirements for financial liabilities except for those designated at fair value through profit or loss whereby that part of the fair value change attributable to the entity's own credit risk is recorded in other comprehensive income. These changes are not expected to have a significant impact on the Group.<br><br>IFRS 9 also replaces the existing 'incurred loss' impairment approach with an expected credit loss approach. This change is likely to result in an increase in the Group's balance sheet provisions for credit losses although the extent of any increase will depend upon, amongst other things, the composition of the Group's lending portfolios and prevailing and forecast economic conditions at the date of implementation.<br><br>The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The revised requirements are not expected to have a significant impact on the Group. | Annual periods beginning on or after 1 January 2018 |
| IFRS 15 *Revenue from Contracts with Customers*[1] | Replaces IAS 18 *Revenue* and IAS 11 *Construction Contracts*. IFRS 15 establishes principles for reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognised at an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods and services. Financial instruments, leases and insurance contracts are out of scope and so this standard is not expected to have a significant impact on the Group. | Annual periods beginning on or after 1 January 2017 |

[1]As at 11 March 2015, these pronouncements are awaiting EU endorsement.

### 49 Other information

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

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

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