Bank of Scotland plc

Half-Year Management Report

For the half-year to 30 June 2016

Member of the Lloyds Banking Group

FORWARD LOOKING STATEMENTS

This document contains certain forward looking statements with respect to the business, strategy and plans of the Bank of Scotland Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the Bank of Scotland Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future. Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Bank of Scotland Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates (including low or negative rates), exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the Bank of Scotland Group's or Lloyds Banking Group plc's, Lloyds Bank plc's or HBOS plc's credit ratings; the ability to derive cost savings; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, the exit by the UK from the European Union (EU) and the potential for one or more other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to cyber security; natural, pandemic and other disasters, adverse weather and similar contingencies outside the Bank of Scotland Group's or Lloyds Banking Group plc's or Lloyds Bank plc's or HBOS plc's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of an exit by the UK from the EU, a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside the Bank of Scotland Group's or Lloyds Banking Group plc's control; the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the US or elsewhere including the implementation and interpretation of key legislation and regulation; the ability to attract and retain senior management and other employees; requirements or limitations on Lloyds Banking Group plc, Lloyds Bank plc, HBOS plc and the Bank of Scotland Group as a result of HM Treasury's investment in Lloyds Banking Group plc; actions or omissions by the Bank of Scotland Group's directors, management or employees including industrial action; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the Bank of Scotland Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services and lending companies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Banking Group plc with the US Securities and Exchange Commission for a discussion of certain factors together with examples of forward looking statements. Except as required by any applicable law or regulation, the forward looking statements contained in this document are made as of today's date, and the Bank of Scotland Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements. The information, statements and opinions contained in this document do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

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FINANCIAL REVIEW

Principal activities

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

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

Review of results

The Group recorded a profit before tax of £1,964 million for the half year to 30 June 2016, an increase of £328 million, or 20 per cent, compared with the profit before tax of £1,636 million for the half year to 30 June 2015.

Total income decreased by £108 million, or 3 per cent, to £3,750 million for the half year to 30 June 2016 from £3,858 million in the half year to 30 June 2015.

Net interest income decreased by £163 million, or 5 per cent, to £3,231 million in the half year to 30 June 2016 compared with £3,394 million in the same period in 2015.

Other income increased by £55 million to £519 million in the half year to 30 June 2016, compared with £464 million in the same period in 2015, due mainly to a £246 million increase in other operating income, more than offsetting a £158 million decrease in net trading income.

Net fee and commission income was £33 million, or 14 per cent, lower at £203 million in the half year to 30 June 2016 compared with £236 million in the half year to 30 June 2015, reduced levels of card and current account fees were more than offset by increases in other fees receivable, however fee and commission expense was £56 million, or 40 per cent, higher at £197 million in the half year to 30 June 2016 compared to £141 million in the first half of 2015.

Other operating income was £246 million higher at £255 million in the half year to 30 June 2016 compared with £9 million in the half year to 30 June 2015, in part due to a gain of £112 million arising on a restructuring of capital instruments within the Lloyds Banking Group.

There was a regulatory provisions charge of £149 million in the half-year to 30 June 2016 compared to £547 million in the same period in 2015. No further provision has been taken for PPI, where complaint levels over the first half have been broadly in line with expectations. The Group's current PPI provision reflects the Group's interpretation of the Financial Conduct Authority's (FCA) consultation paper regarding a potential time bar and the *Plevin* case and conclusion by mid-2018. The Group awaits the FCA's final decision however, should the time bar be longer than the proposed two years or the FCA's final decision be significantly delayed, then the Group may need to reassess its provision. There was a charge of £149 million to cover a range of other conduct issues, of which £139 million was in respect of arrears related activities on secured and unsecured retail products.

Other operating expenses increased by £29 million, or 2 per cent, to £1,613 million in the half year to 30 June 2016 compared with £1,584 million in the half year to 30 June 2015 as reductions in staff costs and premises and equipment costs were more than offset by increases in other expenses.

Impairment losses decreased by £67 million to £24 million in the half year to 30 June 2016 compared with £91 million in the half year to 30 June 2015. The impairment charge in respect of loans and receivables was £65 million lower at £33 million in the half year to 30 June 2016 compared to £98 million in the same period in 2015.

The tax charge for the half year to 30 June 2016 was £540 million (half year to 30 June 2015: £311 million), representing an effective tax rate of 27 per cent. The effective tax rate reflects the impact of the bank surcharge.

FINANCIAL REVIEW (continued)

Total assets were £2,229 million or 1 per cent, higher at £343,562 million at 30 June 2016, compared with £341,333 million at 31 December 2015, largely due to a £5,094 million increase in derivative assets as a result of market conditions at the end of June 2016. Loans and advances to customers decreased by £1,402 million from £270,837 million at 31 December 2015 to £269,435 million at 30 June 2016. Customer deposits decreased by £4,408 million to £185,638 million compared with £190,046 million at 31 December 2015. Shareholders' equity decreased by £452 million, or 3 per cent, from £13,611 million at 31 December 2015 to £13,159 million at 30 June 2016 as the retained profit for the period of £1,424 million and the positive impact of other reserve movements, in particular in relation to the cash flow hedging reserve, were more than offset by dividend payments in the period of £2,000 million.

The Group's transitional common equity tier 1 capital ratio decreased to 11.8 per cent at the end of June 2016 from 11.9 per cent at the end of December 2015, primarily reflecting the increase in risk-weighted assets. The transitional total capital ratio was 22.2 per cent (31 December 2015: 22.4 per cent).

FINANCIAL REVIEW (continued)

Capital ratios

Capital resources (transitional)	At 30 June 2016 £m	At 31 Dec 2015 £m
Common equity tier 1		
Shareholders' equity per balance sheet	**13,159**	13,611
Adjustment to retained earnings for foreseeable dividends	**(1,500)**	(2,000)
Cash flow hedging reserve	**(270)**	(170)
Other adjustments	**(147)**	(71)
	11,242	11,370
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	**(420)**	(425)
Excess of expected losses over impairment provisions and value adjustments	**(36)**	(175)
Securitisation deductions	**(184)**	(166)
Deferred tax assets	**(1,559)**	(1,569)
Common equity tier 1 capital	**9,043**	9,035
Additional tier 1		
Additional tier 1 instruments	**1,832**	1,966
Total tier 1 capital	**10,875**	11,001
Tier 2		
Tier 2 instruments	**5,856**	5,713
Eligible provisions	**261**	307
Total tier 2 capital	**6,117**	6,020
Total capital resources	**16,992**	17,021
Risk-weighted assets	**76,707**	76,054
Common equity tier 1 capital ratio	**11.8%**	11.9%
Tier 1 capital ratio	**14.2%**	14.5%
Total capital ratio	**22.2%**	22.4%

FINANCIAL REVIEW (continued)

Capital ratios (continued)

	At 30 June 2016 £m	At 31 Dec 2015 £m
Risk-weighted assets		
Foundation Internal Ratings Based (IRB) Approach	**9,149**	10,456
Retail IRB Approach	**39,251**	37,626
Other IRB Approach	**2,937**	3,128
IRB Approach	**51,337**	51,210
Standardised Approach	**8,517**	8,651
Credit risk	**59,854**	59,861
Counterparty credit risk	**1,926**	1,785
Contributions to the default fund of a central counterparty	**–**	1
Credit valuation adjustment risk	**441**	313
Operational risk	**11,379**	11,379
Market risk	**2,453**	1,579
Underlying risk-weighted assets	**76,053**	74,918
Threshold risk-weighted assets	**654**	1,136
Transitional risk-weighted assets	**76,707**	76,054

PRINCIPAL RISKS AND UNCERTAINTIES

The most significant risks faced by the Group which could impact the success of delivering against the Group's long-term strategic objectives and through which global macro-economic, regulatory developments and market liquidity dynamics could manifest, are detailed below. Except where noted, there has been no significant change to the description of these risks or key mitigating actions disclosed in the Group's 2015 Annual Report and Accounts, with any quantitative disclosures updated herein.

Lloyds Banking Group has already considered many of the potential implications following the UK's vote to leave the European Union and will now develop this work in greater detail to assess the impact to its customers, colleagues and products - as well as all legal, regulatory, tax, finance and capital implications.

Credit risk – The risk that customers to whom we have lent money or other counterparties with whom we have contracted, fail to meet their financial obligations, resulting in loss to the Group. Adverse changes in the economic and market environment or the credit quality of the Group's counterparties and customers could reduce asset values and potentially increase write-downs and allowances for impairment losses, thereby adversely impacting profitability.

Conduct risk – The Group faces significant potential conduct risks, including selling products which do not meet customer needs, failing to deal with complaints effectively and exhibiting behaviours which do not meet market or regulatory standards.

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

Operational risk – Significant operational risks which may result in financial loss, disruption or damage to the reputation of the Group, including the availability, resilience and security of core IT systems and the potential for failings in customer processes.

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

Funding and liquidity risk – The risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Regulatory and legal risk – The risks of changing legislation, regulation, policies, voluntary codes of practice and their interpretation in the markets in which the Group operates can have a significant impact on the Group, including its operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations.

Governance risk – Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from the embedding of the Senior Managers and Certification Regime (SM&CR) and the requirement to ring-fence core UK financial services and activities from January 2019.

People risk – Key people risks include the risk that the Group fails to lead responsibly in an increasingly competitive marketplace, particularly with the introduction of the SM&CR in 2016. This may dissuade capable individuals from taking up senior positions within the industry.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED INCOME STATEMENT

	Note	**Half-year to 30 June 2016 £ million**	Half-year to 30 June 2015[1] £ million
Interest and similar income		**5,023**	5,339
Interest and similar expense		**(1,792)**	(1,945)
Net interest income		**3,231**	3,394
Fee and commission income		**400**	377
Fee and commission expense		**(197)**	(141)
Net fee and commission income		**203**	236
Net trading income		**61**	219
Other operating income		**255**	9
Other income		**519**	464
Total income		**3,750**	3,858
Regulatory provisions	8	**(149)**	(547)
Other operating expenses		**(1,613)**	(1,584)
Total operating expenses	2	**(1,762)**	(2,131)
Trading surplus		**1,988**	1,727
Impairment	3	**(24)**	(91)
Profit before tax		**1,964**	1,636
Taxation	4	**(540)**	(311)
Profit for the period		**1,424**	1,325
Profit attributable to ordinary shareholders		**1,373**	1,325
Profit attributable to other equity holders[2]		**51**	–
Profit attributable to equity holders		**1,424**	1,325
Profit attributable to non-controlling interests		**–**	–
Profit for the period		**1,424**	1,325

[1] Restated – see note 1.

[2] The profit after tax attributable to other equity holders of £51 million (half-year to 30 June 2015: £nil) is offset in reserves by a tax credit attributable to ordinary shareholders of £14 million (half-year to 30 June 2015: £nil).

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Half-year to 30 June 2016 £ million	Half-year to 30 June 2015[1] £ million
Profit for the period	**1,424**	1,325
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	**80**	(14)
Income statement transfers in respect of disposals	**(48)**	(34)
Income statement transfers in respect of impairment	**1**	9
Taxation	**(17)**	2
	16	(37)
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value	**302**	155
Net income statement transfers	**(165)**	(320)
Taxation	**(37)**	33
	100	(132)
Currency translation differences (tax: nil)	**(4)**	12
Other comprehensive income for the period, net of tax	**112**	(157)
Total comprehensive income for the period	**1,536**	1,168
Total comprehensive income attributable to ordinary shareholders	**1,485**	1,168
Total comprehensive income attributable to other equity holders	**51**	–
Total comprehensive income attributable to equity holders	**1,536**	1,168
Total comprehensive income attributable to non-controlling interests	**–**	–
Total comprehensive income for the period	**1,536**	1,168

[1] Restated – see note 1.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED BALANCE SHEET

	Note	**At 30 June 2016 £ million**	At 31 Dec 2015 £ million
Assets			
Cash and balances at central banks		**2,372**	2,481
Items in course of collection from banks		**260**	172
Trading and other financial assets at fair value through profit or loss	5	**2,578**	4,456
Derivative financial instruments		**20,020**	14,926
Loans and receivables:			
Loans and advances to banks		**970**	669
Loans and advances to customers	6	**269,435**	270,837
Debt securities		**167**	182
Due from fellow Lloyds Banking Group undertakings		**40,172**	38,776
		310,744	310,464
Available-for-sale financial assets		**3,591**	4,460
Goodwill		**325**	325
Other intangible assets		**97**	102
Property, plant and equipment		**1,148**	1,192
Current tax recoverable		**9**	–
Deferred tax assets		**1,718**	2,022
Other assets		**700**	733
Total assets		**343,562**	341,333

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED BALANCE SHEET (continued)

	Note	**At 30 June 2016 £ million**	At 31 Dec 2015 £ million
Equity and liabilities			
Liabilities			
Deposits from banks		**2,904**	1,541
Customer deposits		**185,638**	190,046
Due to fellow Lloyds Banking Group undertakings		**89,250**	86,273
Items in course of transmission to banks		**384**	342
Trading and other financial liabilities at fair value through profit or loss		**2,476**	4,415
Derivative financial instruments		**17,822**	13,329
Notes in circulation		**1,090**	1,112
Debt securities in issue	7	**18,628**	18,492
Other liabilities		**1,370**	1,098
Current tax liabilities		**697**	307
Other provisions		**1,561**	1,899
Subordinated liabilities		**7,075**	7,360
Total liabilities		**328,895**	326,214
Equity			
Share capital		**5,847**	5,847
Other reserves		**2,380**	2,268
Retained profits		**4,932**	5,496
Shareholders' equity		**13,159**	13,611
Other equity instruments		**1,500**	1,500
Total equity excluding non-controlling interests		**14,659**	15,111
Non-controlling interests		**8**	8
Total equity		**14,667**	15,119
Total equity and liabilities		**343,562**	341,333

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

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

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (continued)

	Attributable to equity shareholders						
	Share capital £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2015	5,847	2,505	12,983	21,335	–	8	21,343
Comprehensive income							
Profit for the period[1]	–	–	1,325	1,325	–	–	1,325
Other comprehensive income							
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(37)	–	(37)	–	–	(37)
Movements in cash flow hedging reserve, net of tax	–	(132)	–	(132)	–	–	(132)
Currency translation differences (tax: nil)	–	12	–	12	–	–	12
Total other comprehensive income	–	(157)	–	(157)	–	–	(157)
Total comprehensive income	–	(157)	1,325	1,168	–	–	1,168
Transactions with owners							
Capital contribution received	–	–	82	82	–	–	82
Dividends paid	–	–	(5,000)	(5,000)	–	–	(5,000)
Total transactions with owners	–	–	(4,918)	(4,918)	–	–	(4,918)
Balance at 30 June 2015[1]	5,847	2,348	9,390	17,585	–	8	17,593
Comprehensive income							
Profit for the period	–	–	599	599	–	–	599
Other comprehensive income							
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	29	–	29	–	–	29
Movements in cash flow hedging reserve, net of tax	–	(182)	–	(182)	–	–	(182)
Currency translation differences (tax: nil)	–	73	–	73	–	–	73
Total other comprehensive income	–	(80)	–	(80)	–	–	(80)
Total comprehensive income	–	(80)	599	519	–	–	519
Transactions with owners							
Capital contribution received	–	–	7	7	–	–	7
Dividends paid	–	–	(4,500)	(4,500)	–	–	(4,500)
Issue of Additional Tier 1 securities	–	–	–	–	1,500	–	1,500
Total transactions with owners	–	–	(4,493)	(4,493)	1,500	–	(2,993)
Balance at 31 December 2015	5,847	2,268	5,496	13,611	1,500	8	15,119

[1] Restated – see note 1.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED CASH FLOW STATEMENT

	Half-year to 30 June 2016 £ million	Half-year to 30 June 2015[1] £ million
Profit before tax	**1,964**	1,636
Adjustments for:		
Change in operating assets	**(1,713)**	12,075
Change in operating liabilities	**4,353**	(9,422)
Non-cash and other items	**(1,863)**	461
Tax received	**95**	169
Net cash provided by operating activities	**2,836**	4,919
Cash flows from investing activities		
Purchase of available-for-sale financial assets	**(235)**	(6,673)
Proceeds from sale and maturity of available-for-sale financial assets	**1,455**	7,411
Purchase of fixed assets	**(56)**	(56)
Proceeds from sale of fixed assets	**24**	23
Disposal of businesses, net of cash disposed	**5**	11
Net cash provided by investing activities	**1,193**	716
Cash flows from financing activities		
Dividends paid to equity shareholders	**(2,000)**	(5,000)
Distributions on other equity instruments	**(51)**	–
Interest paid on subordinated liabilities	**(142)**	(141)
Repayment of subordinated liabilities	**(361)**	(250)
Capital repayment to HBOS plc	**(1,350)**	–
Net cash used in financing activities	**(3,904)**	(5,391)
Effects of exchange rate changes on cash and cash equivalents	**13**	(1)
Change in cash and cash equivalents	**138**	243
Cash and cash equivalents at beginning of period	**2,389**	4,829
Cash and cash equivalents at end of period	**2,527**	5,072

[1] Restated – see note 1.

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

NOTES

1. Accounting policies, presentation and estimates

These condensed consolidated half-year financial statements as at and for the period to 30 June 2016 have been prepared in accordance with the Disclosure Rules and Transparency Rules of the Financial Conduct Authority (FCA) and with International Accounting Standard 34 (IAS 34), *Interim Financial Reporting* as adopted by the European Union and comprise the results of Bank of Scotland plc (the Bank) together with its subsidiaries (the Group). They do not include all of the information required for full annual financial statements and should be read in conjunction with the Group's consolidated financial statements as at and for the year ended 31 December 2015 which were prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. Copies of the 2015 Annual Report and Accounts are available on the Lloyds Banking Group's website and are available upon request from Investor Relations, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN.

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

The accounting policies are consistent with those applied by the Group in its 2015 Annual Report and Accounts.

During the second half of 2015 the Bank identified an error in its accounting for an intra-group hedging transaction and the correcting entries were applied retrospectively, increasing retained earnings at 1 January 2015 by £490 million. The Group's income statement for the half-year to 30 June 2015 shown in these half-year financial statements has been restated; the effect having been to decrease interest expense by £123 million and to increase the tax charge by £19 million.

Future accounting developments

Details of those IFRS pronouncements which will be relevant to the Group but which will not be effective at 31 December 2016 and which have not been applied in preparing these condensed consolidated half-year financial statements are set out in note 13.

Critical accounting estimates and judgements

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions that impact the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may include amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. There have been no significant changes in the basis upon which estimates have been determined, compared to that applied at 31 December 2015.

2. Operating expenses

	Half-year to 30 June 2016 £m	Half-year to 30 June 2015 £m
Administrative expenses:		
Staff costs	**766**	781
Premises and equipment	**121**	126
Other expenses	**637**	591
	1,524	1,498
Depreciation and amortisation	**89**	86
Total operating expenses, excluding regulatory provisions	**1,613**	1,584
Regulatory provisions:		
Payment protection insurance provision (note 8)	**–**	341
Other regulatory provisions (note 8)	**149**	206
	149	547
Total operating expenses	**1,762**	2,131

3. Impairment

	Half-year to 30 June 2016 £m	Half-year to 30 June 2015 £m
Impairment losses on loans and receivables:		
Loans and advances to customers	**33**	100
Debt securities classified as loans and receivables	**–**	(2)
Impairment losses on loans and receivables	**33**	98
Other credit risk provisions	**(9)**	(7)
Total impairment charged to the income statement	**24**	91

4. Taxation

A reconciliation of the tax charge that would result from applying the standard UK corporation tax rate to the profit before tax to the actual tax charge is given below:

	Half-year to 30 June 2016 £m	Half-year to 30 June 2015[1] £m
Profit before tax	**1,964**	1,636
Tax charge thereon at UK corporation tax rate of 20 per cent (2015: 20.25 per cent)	**(393)**	(331)
Factors affecting tax charge:		
Impact of bank surcharge	**(151)**	–
Difference in UK corporation tax rates	**11**	15
Disallowed items	**(38)**	(18)
Non-taxable items	**25**	–
Overseas tax rate differences	**(1)**	1
Gains exempted or covered by capital losses	**16**	24
Adjustments in respect of previous years	**(9)**	(2)
Tax charge	**(540)**	(311)

[1] Restated – see note 1.

In accordance with IAS 34, the Group's income tax expense for the half-year to 30 June 2016 is based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. The tax effects of one-off items are not included in the weighted-average annual income tax rate, but are recognised in the relevant period.

The Finance (No. 2) Act 2015 introduced an additional surcharge of 8 per cent on banking profits from 1 January 2016.

On 16 March 2016, the Government announced a reduction in the corporation tax rate applicable from 1 April 2020 to 17 per cent and a further restriction to the amount of banks' profits that can be offset by carried forward losses for the purposes of calculating corporation tax liabilities from 50 per cent to 25 per cent. The proposed reduction in the rate of corporation tax and the further bank loss relief restriction are expected to be enacted, and accounted for, in the second half of 2016.

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

	At 30 June 2016 £m	At 31 Dec 2015 £m
Trading assets	**2,459**	4,230
Other financial assets at fair value through profit or loss (equity shares)	**119**	226
Total trading and other financial assets at fair value through profit or loss	**2,578**	4,456

6. Loans and advances to customers

	At 30 June 2016 £m	At 31 Dec 2015 £m
Agriculture, forestry and fishing	**594**	596
Energy and water supply	**155**	237
Manufacturing	**372**	624
Construction	**1,818**	1,570
Transport, distribution and hotels	**2,753**	3,227
Postal and communications	**299**	217
Property companies	**6,726**	7,107
Financial, business and other services	**3,353**	3,392
Personal:		
Mortgages	**245,038**	245,900
Other	**10,420**	10,191
Lease financing	**528**	546
Hire purchase	**69**	40
	272,125	273,647
Allowance for impairment losses on loans and advances to customers	**(2,690)**	(2,810)
Total loans and advances to customers	**269,435**	270,837

Loans and advances to customers include advances securitised under the Group's securitisation and covered bond programmes.

7. Debt securities in issue

	At 30 June 2016 £m	At 31 Dec 2015 £m
Medium-term notes issued	**1,761**	1,882
Covered bonds	**11,240**	10,168
Securitisation notes	**5,563**	6,417
	18,564	18,467
Amounts due to fellow Lloyds Banking Group undertakings	**64**	25
Total debt securities in issue	**18,628**	18,492

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

Securitisation programmes

At 30 June 2016, external parties held £5,563 million (31 December 2015: £6,417 million) and the Group’s subsidiaries held £18,526 million (31 December 2015: £19,208 million) of total securitisation notes in issue of £24,089 million (31 December 2015: £25,625 million). The notes are secured on loans and advances to customers and debt securities classified as loans and receivables amounting to £36,199 million (31 December 2015: £35,807 million), the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. The structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet.

7. Debt securities in issue (continued)

Covered bond programmes

At 30 June 2016, external parties held £11,240 million (31 December 2015: £10,168 million) and the Group's subsidiaries held £3,601 million (31 December 2015: £4,197 million) of total covered bonds in issue of £14,841 million (31 December 2015: £14,365 million). The bonds are secured on certain loans and advances to customers that have been assigned to bankruptcy remote limited liability partnerships. These loans are retained on the Group's balance sheet.

Cash deposits of £5,147 million (31 December 2015: £5,801 million) which support the debt securities issued by the structured entities, the term advances related to covered bonds and other legal obligations are held by the Group.

8. Provisions for liabilities and charges

Payment protection insurance

The Group made provisions totalling £4,521 million since 2011 against the costs of paying redress to customers in respect of past sales of PPI policies, including the related administrative expenses.

No additional charge has been made in the first half of 2016.

As at 30 June 2016, £839 million or 19 per cent of the total provision remained unutilised relating predominantly to reactive complaints and associated administration costs.

Total cash payments were £371 million in the first half of 2016 which included remediation. The re-review of previously handled cases is now complete.

On 26 November 2015, the Financial Conduct Authority (FCA) published a consultation paper (CP15/39: Rules and guidance on payment protection insurance complaints) proposing (i) the introduction of a deadline by which consumers would need to make their PPI complaints including an FCA led communications campaign, and (ii) rules and guidance about how firms should handle PPI complaints in light of the Supreme Court's decision in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61 *(Plevin)*. The Group awaits the FCA's final decision and should the time bar be longer than the proposed two years or the FCA's final decision be significantly delayed, then the Group may need to reassess its provision.

In 2015, the Group increased the total expected reactive complaints (including complaints falling under the *Plevin* rules and guidance) in light of the FCA proposals. There is no change in the total expected reactive complaints in 2016.

Monthly complaint trends could vary significantly, given they are likely to be impacted by a number of factors including seasonality, the potential impact of the FCA's proposed communication campaign as well as changes in the regulation of CMCs.

The provision includes an estimate to cover redress that would be payable under the FCA's proposed new rules and guidance in light of *Plevin*.

8. Provisions for liabilities and charges (continued)

The total amount provided for PPI represents the Group's best estimate of the likely future cost. However a number of risks and uncertainties remain in particular with respect to future volumes. The cost could differ materially from the Group's estimates and the assumptions underpinning them, and could result in a further provision being required. There is significant uncertainty around the impact of the proposed FCA media campaign, CMC and customer activity and the deadline for PPI complaints may be later than originally expected.

Key sensitivities are as follows[1]:

- the number of customer initiated complaints received: an increase of 50,000 from the level assumed would increase the provision by £95 million;
- average uphold rate per policy: an increase of one percentage point in this assumption would increase the provision by £12 million;
- average redress paid per upheld policy: an increase of £100 in this assumption would increase the provision by £50 million.

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

Other regulatory provisions

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 30 June 2016 the Lloyds Banking Group had identified 1,739 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 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 and has met all of the regulator's requirements to date.

By the end of 2015, the Group had charged a total of £216 million in respect of redress and related administration costs for in-scope customers. An additional £3 million has been provided in the half-year to 30 June 2016 raising the total amount provided to £219 million. As at 30 June 2016, the Group has utilised £208 million (31 December 2015: £200 million), with £11 million (31 December 2015: £16 million) of the provision remaining.

Arrears handling related activities

Following a review of the Lloyds Banking Group's secured and unsecured arrears handling activities, the Lloyds Banking Group has put in place a number of actions to further improve its handling of customers in these areas. As a result, the Group has provided an additional £139 million in the first half of 2016 (bringing the total provision to £254 million), for the costs of identifying and rectifying certain arrears management fees and activities. As at 30 June 2016, the unutilised provision was £254 million (31 December 2015: £115 million).

Other legal actions and regulatory matters

In the course of its business, the Lloyds Banking 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 Lloyds Banking Group also receives complaints and claims from customers in connection with its past conduct and, where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. In the half-year to 30 June 2016, the Group charged an additional £7 million.

At 30 June 2016, provisions for other legal actions and regulatory matters of £308 million (31 December 2015: £317 million) remained unutilised, principally in relation to the sale of bancassurance products and packaged bank accounts and other Retail provisions.

9. Contingent liabilities and commitments

Interchange fees

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

- The European Commission continues to pursue certain competition investigations into MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA;
- Litigation continues in the English Courts against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly 'overpaid' MIFs. From publicly available information, it is understood these damages claims are running to different timescales with respect to the litigation process. It is also possible that new claims may be issued. Judgment in the Sainsbury's v MasterCard case was handed down on 14 July 2016. Sainsbury's is entitled to recover approximately £69 million (plus interest) in damages from MasterCard. It is unclear whether MasterCard will seek to appeal the judgment. However, the judgment considers a number of important matters that are likely to influence the conduct of ongoing (and future) litigation in relation to both Visa and MasterCard.
- Any ultimate impact on the Group of the above investigations and the litigation against Visa and MasterCard remains uncertain at this time.

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. The Group's share of the sale proceeds comprised cash consideration of approximately £330 million (of which approximately £300 million was received on completion of the sale and £30 million is deferred for three years) and preferred stock, which the Group measures at fair value. The preferred stock is convertible into Class A Common Stock of Visa Inc or its equivalent upon the occurrence of certain events. As part of this transaction, the Group and certain other UK banks also entered into a Loss Sharing Agreement (LSA) with Visa Inc, which clarifies the allocation of liabilities between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. Visa Inc only has recourse to the LSA once more than €1 billion of losses relating to UK domestic MIFs have arisen or once the total value of the preferred stock issued by Visa to certain UK banks on completion has been reduced to zero. This would be effected by a downward adjustment to the conversion ratio. In determining the fair value of the preferred stock, the Group includes adjustments for both the stock's illiquidity and the potential for changes in the conversion ratio. The maximum amount of liability to which the Group may be subject under the LSA is capped at the cash consideration which was received by the Group at completion. Visa Inc may also have recourse to a general indemnity, currently in place under Visa Europe's Operating Regulations, for damages claims concerning inter or intra-regional MIF setting activities.

LIBOR and other trading rates

In July 2014, the Lloyds Banking Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Lloyds Banking Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The Lloyds Banking Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the Swiss Competition Commission, and a number of US State Attorneys General, in conjunction with their investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

Certain Lloyds Banking Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling LIBOR. The lawsuits, which contain broadly similar allegations, allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act and the Commodity Exchange Act, as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims, including those asserted under US anti-trust laws, have been dismissed by the US Federal Court for Southern District of New York (the District Court). The New York Federal Court of Appeal overturned the District Court's dismissal of plaintiffs' antitrust claims in May 2016. The anti-trust claims have now been revived. An application to dismiss these claims for lack of personal jurisdiction will be made following the positive November 2015 decision which dismissed OTC and exchange-based plaintiffs' claims against the Group for lack of personal jurisdiction.

9. Contingent liabilities and commitments (continued)

Certain Lloyds Banking Group companies are also named as defendants in UK based claims raising LIBOR manipulation allegations in connection with interest rate hedging products.

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 31 March 2016, the end of the latest FSCS scheme year for which it has published accounts, the principal balance outstanding on these loans was £15,655 million (31 March 2015: £15,797 million). Although it is anticipated that the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants 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.

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 including open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law. The Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In 2013 HMRC informed the Lloyds Banking Group that their interpretation of the UK rules, 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 Banking Group's deferred tax asset of approximately £400 million (overall impact on the Bank of Scotland 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. There are a number of other open matters on which the Group is in discussion with HMRC; none of these is expected to have a material impact on the financial position of the Group.

Residential mortgage repossessions

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

9. Contingent liabilities and commitments (continued)

The Financial Conduct Authority's announcement on time-barring for PPI complaints and Plevin v Paragon Personal Finance Limited

On 26 November 2015 the FCA issued a Consultation Paper on the introduction of a deadline by which consumers would need to make their PPI complaints or else lose their right to have them assessed by firms or the Financial Ombudsman Service, and proposed rules and guidance concerning the handling of PPI complaints in light of the Supreme Court's decision in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61 (*Plevin*). The next step is for the FCA to issue a policy statement. The Financial Ombudsman Service is also considering the implications of *Plevin* for PPI complaints. The implications of potential time-barring and the *Plevin* decision in terms of the scope of any court proceedings or regulatory action remain uncertain.

Mortgage arrears handling activities

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

Other legal actions and regulatory matters

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

Contingent liabilities and commitments arising from the banking business

	At 30 June 2016 £m	At 31 Dec 2015 £m
Contingent liabilities		
Performance bonds and other transaction-related contingencies	**78**	90
Other items serving as direct credit substitutes	**20**	15
Total contingent liabilities	**98**	105
Commitments		
Forward asset purchases and forward deposits placed	**7**	23
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	**9,561**	9,092
Other commitments	**21,810**	21,099
	31,371	30,191
1 year or over original maturity	**3,424**	3,992
Total commitments	**34,802**	34,206

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £13,458 million (31 December 2015: £13,592 million) was irrevocable.

10. Fair values of financial assets and liabilities

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine those fair values. Note 42 to the Group's 2015 financial statements describes the definitions of the three levels in the fair value hierarchy.

Valuation control framework

Key elements of the valuation control framework, which covers processes for all levels in the fair value hierarchy including level 3 portfolios, include model validation (incorporating pre-trade and post-trade testing), product implementation review and independent price verification. Formal committees meet quarterly to discuss and approve valuations in more judgemental areas.

Transfers into and out of level 3 portfolios

Transfers out of level 3 portfolios arise when inputs that could have a significant impact on the instrument's valuation become market observable; conversely, transfers into the portfolios arise when consistent sources of data cease to be available.

Valuation methodology

For level 2 and level 3 portfolios, there is no significant change to what was disclosed in the Group's 2015 Annual Report and Accounts in respect of the valuation methodology (techniques and inputs) applied to such portfolios.

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

	30 June 2016		31 December 2015	
	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	**2,578**	**2,578**	4,456	4,456
Derivative financial instruments	**20,020**	**20,020**	14,926	14,926
Loans and receivables:				
Loans and advances to banks	**970**	**961**	669	669
Loans and advances to customers	**269,435**	**271,149**	270,837	272,000
Debt securities	**167**	**145**	182	160
Due from fellow Lloyds Banking Group undertakings	**40,172**	**40,172**	38,776	38,776
	310,744	**312,427**	310,464	311,605
Available-for-sale financial instruments	**3,591**	**3,591**	4,460	4,460
Financial liabilities				
Deposits from banks	**2,904**	**2,904**	1,541	1,541
Customer deposits	**185,638**	**185,233**	190,046	189,764
Due to fellow Lloyds Banking Group undertakings	**89,250**	**89,250**	86,273	86,273
Trading and other financial liabilities at fair value through profit or loss	**2,476**	**2,476**	4,415	4,415
Derivative financial instruments	**17,822**	**17,822**	13,329	13,329
Debt securities in issue	**18,628**	**18,411**	18,492	18,159
Subordinated liabilities	**7,075**	**7,031**	7,360	7,416

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

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

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

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

Financial assets

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 30 June 2016				
Trading and other financial assets at fair value through profit or loss:				
Loans and advances to customers	**–**	**2,354**	**–**	**2,354**
Debt securities	**105**	**–**	**–**	**105**
Equity shares	**–**	**–**	**119**	**119**
Total trading and other financial assets at fair value through profit or loss	**105**	**2,354**	**119**	**2,578**
Available-for-sale financial assets:				
Debt securities	**–**	**3,125**	**–**	**3,125**
Equity shares	**–**	**7**	**459**	**466**
Total available-for-sale financial assets	**–**	**3,132**	**459**	**3,591**
Derivative financial instruments	**–**	**19,340**	**680**	**20,020**
Total financial assets carried at fair value	**105**	**24,826**	**1,258**	**26,189**
At 31 December 2015				
Trading and other financial assets at fair value through profit or loss:				
Loans and advances to customers	–	4,230	–	4,230
Equity shares	–	–	226	226
Total trading and other financial assets at fair value through profit or loss	–	4,230	226	4,456
Available-for-sale financial assets:				
Debt securities	–	4,083	–	4,083
Equity shares	1	37	339	377
Total available-for-sale financial assets	1	4,120	339	4,460
Derivative financial instruments	–	14,584	342	14,926
Total financial assets carried at fair value	1	22,934	907	23,842

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

Financial liabilities

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 30 June 2016				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	**–**	**–**	**2**	**2**
Trading liabilities	**23**	**2,451**	**–**	**2,474**
Total trading and other financial liabilities at fair value through profit or loss	**23**	**2,451**	**2**	**2,476**
Derivative financial instruments	**–**	**17,758**	**64**	**17,822**
Total financial liabilities carried at fair value	**23**	**20,209**	**66**	**20,298**
At 31 December 2015				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	–	–	1	1
Trading liabilities	–	4,414	–	4,414
Total trading and other financial liabilities at fair value through profit or loss	–	4,414	1	4,415
Derivative financial instruments	–	13,291	38	13,329
Total financial liabilities carried at fair value	–	17,705	39	17,744

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

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

Movements in level 3 portfolio

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

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

	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale financial assets £m	Derivative assets £m	Total financial assets carried at fair value £m
At 1 January 2015	172	270	522	964
Exchange and other adjustments	1	–	(30)	(29)
Gains recognised in the income statement within other income	62	–	19	81
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	–	1	–	1
Purchases	–	38	–	38
Sales	(33)	(6)	(49)	(88)
Transfers out of the level 3 portfolio	–	–	(36)	(36)
At 30 June 2015	202	303	426	931
Gains recognised in the income statement within other income relating to those assets held at 30 June 2015	26	–	19	45

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

Movements in level 3 portfolio

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

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

	Trading and other financial liabilities at fair value through profit or loss £m	Derivative liabilities £m	Total financial liabilities carried at fair value £m
At 1 January 2015	5	101	106
Exchange and other adjustments	–	(3)	(3)
Gains recognised in the income statement within other income	–	(3)	(3)
Redemptions	(4)	(43)	(47)
At 30 June 2015	1	52	53
Gains recognised in the income statement within other income relating to those liabilities held at 30 June 2015	–	(3)	(3)

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

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

				At 30 June 2016		
					Effect of reasonably possible alternative assumptions[1]	
	Valuation technique(s)	**Significant unobservable inputs**	**Range[2]**	**Carrying value £m**	**Favourable changes £m**	**Unfavourable changes £m**
Trading and other financial assets at fair value through profit or loss:						
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[3]	n/a	**n/a**	**119**	**5**	**(13)**
				119		
Available for sale financial assets				**459**	**27**	**(30)**
Derivative financial assets:						
Interest rate derivatives	Option pricing model	Interest rate volatility	**2%/115%**	**680**	**7**	**(3)**
				680		
Financial assets carried at fair value				**1,258**		
Trading and other financial liabilities at fair value through profit or loss				**2**	**–**	**–**
Derivative financial liabilities:						
Interest rate derivatives	Option pricing model	Interest rate volatility	**2%/115%**	**64**		
				64		
Financial liabilities carried at fair value				**66**		

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

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

3 Underlying asset/net asset values represent fair value.

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

				At 31 December 2015		
					Effect of reasonably possible alternative assumptions[1]	
	Valuation technique(s)	Significant unobservable inputs	Range[2]	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss:						
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[3]	n/a	n/a	226	21	(26)
				226		
Available for sale financial assets				339	25	(27)
Derivative financial assets:						
Interest rate derivatives	Option pricing model	Interest rate volatility	1%/63%	342	3	(1)
				342		
Financial assets carried at fair value				907		
Trading and other financial liabilities at fair value through profit or loss				1	–	–
Derivative financial liabilities:						
Interest rate derivatives	Option pricing model	Interest rate volatility	1%/63%	38	–	–
				38		
Financial liabilities carried at fair value				39		

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

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

3 Underlying asset/net asset values represent fair value.

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are unchanged from those described in the Group's 2015 financial statements.

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 and are unchanged from those described in the Group's 2015 financial statements.

11. Related party transactions

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

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

	At 30 June 2016 £m	At 31 Dec 2015 £m
Assets		
Derivative financial instruments	**12,147**	9,205
Loans and receivables: Due from fellow Lloyds Banking Group undertakings	**40,172**	38,776
Trading and other financial assets at fair value through profit or loss	**2,354**	4,230
Liabilities		
Due to fellow Lloyds Banking Group undertakings	**89,250**	86,273
Trading and other financial liabilities at fair value through profit or loss	**2,437**	4,112
Derivative financial instruments	**13,850**	10,093
Debt securities in issue	**241**	598
Subordinated liabilities	**5,584**	5,634

During the half-year ended 30 June 2016 the Group earned £178 million (half-year ended 30 June 2015: £236 million) of interest income and incurred £1,085 million (half-year ended 30 June 2015: £1,091 million, as restated – see note 1) of interest expense on balances and transactions with Lloyds Banking Group plc and fellow Lloyds Banking Group undertakings.

In addition, during the half-year to 30 June 2016 the Group incurred expenditure of £41 million (half-year ended 30 June 2015: £14 million) on behalf of fellow Lloyds Banking Group undertakings which was recharged to those undertakings; and fellow Lloyds Banking Group undertakings incurred expenditure of £409 million (half-year ended 30 June 2015: £272 million) on behalf of the Group which has been recharged to the Group.

UK government

In January 2009, the UK government through HM Treasury became a related party of the Lloyds Banking Group plc, the Bank's ultimate parent undertaking, following its subscription for ordinary shares issued under a placing and open offer. As at 30 June 2016, HM Treasury held an interest of 9.1 per cent in the Lloyds Banking Group plc's ordinary share capital, with its interest having fallen below 20 per cent on 11 May 2015. As a consequence of HM Treasury no longer being considered to have a significant influence, it ceased to be a related party of Lloyds Banking Group plc and therefore of the Group, for IAS 24 purposes at that date.

In accordance with IAS 24, UK government-controlled entities were related parties of the Group until 11 May 2015. The Group also regarded the Bank of England and entities controlled by the UK government, including The Royal Bank of Scotland Group plc (RBS), NRAM plc and Bradford & Bingley plc, as related parties.

The Lloyds Banking Group has 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 participates in the UK government's National Loan Guarantee Scheme, providing eligible UK businesses with discounted funding 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.

11. Related party transactions (continued)

Funding for Lending

The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Lloyds Banking Group. The initiative supports a broad range of UK based customers, focussing primarily on providing small businesses with cheaper finance to invest and grow. In November 2015, the Bank of England announced that the deadline for banks to draw down their borrowing allowance would be extended for a further two years until 31 January 2018. At 30 June 2016, the Lloyds Banking Group had drawn down £33.1 billion (31 December 2015: £32.1 billion) under the Scheme.

Enterprise Finance Guarantee Scheme

The Lloyds Banking Group participates in the Enterprise Finance Guarantee Scheme 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 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. As at 30 June 2016, the Lloyds Banking Group had offered 6,647 loans to customers, worth over £568 million. Under the most recent renewal of the terms of the scheme, Lloyds Bank plc and Bank of Scotland plc, on behalf of the Lloyds Banking Group, contracted with The Secretary of State for Business, Innovation and Skills.

Help to Buy

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. £3,383 million of outstanding loans at 30 June 2016 (31 December 2015: £3,133 million) had been advanced under this scheme.

Business Growth Fund

The Lloyds Banking Group has invested £222 million (31 December 2015: £176 million) in the Business Growth Fund (under which an agreement was entered into with RBS amongst others) and, as at 30 June 2016, carries the investment at a fair value of £216 million (31 December 2015: £170 million).

Big Society Capital

The Lloyds Banking Group has invested £38 million (31 December 2015: £36 million) in the Big Society Capital Fund under which an agreement was entered into with RBS amongst others and, as at 30 June 2016, carries the investment at a fair value of £37 million (31 December 2015: £33 million).

Housing Growth Partnership

The Lloyds Banking Group has invested £11 million (31 December 2015: £4 million) and has committed to invest up to a further £39 million into the Housing Growth Partnership under which an agreement was entered into with the Homes and Communities Agency.

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 significant transactions with the UK government and UK government-controlled entities (including UK government-controlled banks) during the year that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Other related party transactions

Other related party transactions for the half-year to 30 June 2016 are similar in nature to those for the year ended 31 December 2015.

12. Dividends on ordinary shares

The Bank paid a dividend of £2,000 million on 12 May 2016; the Bank paid dividends of £5,000 million on 26 March 2015 and a further £4,500 million on 15 December 2015.

13. Future accounting developments

The following pronouncements are not applicable for the year ending 31 December 2016 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. As at 27 July 2016, these pronouncements are awaiting EU endorsement.

IFRS 9 *Financial Instruments*

IFRS 9 replaces IAS 39 Financial Instruments: Recognition and Measurement.

Classification and Measurement
IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income 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 Group has undertaken an assessment to determine the potential impact of changes in classification and measurement of financial assets. The adoption of IFRS 9 is unlikely to result in a significant change to current asset measurement bases, however, the final impact will be dependent on the facts and circumstances that exist on 1 January 2018.

IFRS 9 retains most of the existing requirements for financial liabilities. However, for financial liabilities designated at fair value through profit or loss, gains or losses attributable to changes in own credit risk may be presented in other comprehensive income. This change is expected to be immaterial to the Group.

Impairment
IFRS 9 also replaces the existing 'incurred loss' impairment approach with an expected credit loss approach, resulting in earlier recognition of credit losses. The IFRS 9 impairment model has three stages. Entities are required to recognise a 12 month expected loss allowance on initial recognition (stage 1) and a lifetime expected loss allowance when there has been a significant increase in credit risk (stage 2). The assessment of whether a significant increase in credit risk has occurred is a key aspect of the IFRS 9 methodology and involves quantitative and qualitative measures and therefore requires considerable management judgement. Stage 3 requires objective evidence that an asset is credit-impaired, which is similar to the guidance on incurred losses in IAS 39. Loan commitments and financial guarantees not measured at fair value through profit or loss are also in scope.

IFRS 9 requires the use of more forward looking information including reasonable and supportable forecasts of future economic conditions. The need to consider multiple economic scenarios and how they could impact the loss allowance is a subjective feature of the IFRS 9 impairment model. The final methodology for multiple economic scenarios is still under development, however, economic scenarios are likely to consider the Group's five year operating plan and stress testing scenarios. Appropriate governance and oversight will be established around the process. It is important that the linkage between expected credit losses, economic scenarios, and stress testing is understood and transparent.

These changes may result in a material increase in the Group's balance sheet provisions for credit losses and may therefore negatively impact the Group's regulatory capital position. The extent of any increase in provisions will depend upon, amongst other things, the composition of the Group's lending portfolios and forecast economic conditions at the date of implementation. The requirement to transfer assets between stages and to incorporate forward looking data into the expected credit loss calculation, including multiple economic scenarios, is likely to result in impairment charges being more volatile when compared to the current IAS 39 impairment model.

13. Future accounting developments (continued)

Hedge Accounting

The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39, however, there is an option to maintain the existing IAS 39 hedge accounting rules until the IASB completes its project on macro hedging. The Group currently expects to continue applying IAS 39 hedge accounting in accordance with this accounting policy choice.

Transition

IFRS 9 is effective for annual periods beginning on or after 1 January 2018 with no requirement to restate prior periods. If comparative periods are not restated, at the date of initial application, any difference between the carrying amount of financial assets and the change in loss allowance shall be recognised in opening retained earnings.

IFRS 9 implementation programme

The Group has an established IFRS 9 programme to ensure a high quality implementation in compliance with the standard and regulatory guidance. The programme involves Finance and Risk functions across the Group with Divisional and Group steering committees providing oversight. The key responsibilities of the programme include defining IFRS 9 methodology and accounting policy, development of expected loss models, identifying data and system requirements, and establishing an appropriate operating model and governance framework.

Impairment methodologies have been documented and, in addition to IFRS 9, assessed against the expectations of the Basel Committee on Banking Supervision paper 'Guidance on Credit Risk and Accounting for Expected Credit Losses', and the Global Public Policy Committee paper 'The implementation of IFRS 9 impairment requirements by banks'.

The build phase of the programme is underway for the core credit risk models. Systems, processes and model testing will take place in 2017 to embed the changes, enhance business readiness and help improve the understanding of the new impairment models. The programme is progressing in line with its delivery plans.

For all material portfolios, IFRS 9 expected credit loss calculation will leverage the systems, data and models used to calculate regulatory expected credit losses. IFRS 9 expected credit loss models will use the three key input parameters for the computation of expected loss: probability of default; loss given default; and exposure at default.

However, given the conservatism inherent in the regulatory expected losses calculation, a number of adjustments to these components must be made to ensure compliance with IFRS 9 requirements.

IFRS 9 models differ from the regulatory models in a number of conceptual ways, for example stage 2 assets under IFRS 9, for which there has been a significant increase in credit risk, carry a lifetime expected loss amount; whereas regulatory models generate 12 month expected losses for non-defaulted loans, even though they may have experienced a significant increase in credit risk. In addition, different assets are in scope for each reporting base. As a result, the size of the regulatory expected losses should not be taken as a proxy for the size of the loss allowance under IFRS 9.

13. Future accounting developments (continued)

IFRS 15 *Revenue from Contracts with Customers*
IFRS 15 replaces IAS 18 Revenue and IAS 11 Construction Contracts. Financial instruments, leases and insurance contracts are out of scope and so this standard is not currently expected to have a significant impact on the Group's profitability.

IFRS 15 is effective for annual periods beginning on or after 1 January 2018.

IFRS 16 *Leases*
On 13 January 2016 the IASB issued IFRS 16 to replace IAS 17 Leases. IFRS 16 requires lessees to recognise a right of use asset and a liability for future payments arising from a lease contract. Lessor accounting requirements remain aligned to the current approach under IAS 17.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019.

Amendments to IAS 7 Statement of Cash Flows, IAS 12 Income Taxes and IFRS 2 Share-based Payment
During 2016, the IASB has issued amendments to IAS 7 *Statement of Cash Flows* which require additional disclosure about an entity's financing activities, IAS 12 *Income Taxes* which clarify when a deferred tax asset should be recognised for unrealised losses and IFRS 2 Share-based Payment which provide guidance on accounting for cash and certain net-settled schemes. These revised requirements, which are effective for annual periods beginning on or after 1 January 2017 for IAS 7 and IAS 12 and 1 January 2018 for IFRS 2, are not expected to have a significant impact on the Group.

14. Ultimate parent undertaking

Bank of Scotland plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Lloyds Banking Group plc has published consolidated accounts for the year ended 31 December 2015 and copies may be obtained from Investor Relations, Lloyds Banking Group, 25 Gresham Street, London EC2V 7HN and are available for download from www.lloydsbankinggroup.com

15. Other information

The financial information in these condensed consolidated half-year financial statements does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006. Statutory accounts for the year ended 31 December 2015 have been delivered to the Registrar of Companies. The auditors' report on those accounts was unqualified, did not include an emphasis of matter paragraph and did not include a statement under section 498 of the Companies Act 2006.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

- an indication of important events that have occurred during the six months ended 30 June 2016 and their impact on the condensed consolidated half-year financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year; and
- material related party transactions in the six months ended 30 June 2016 and any material changes in the related party transactions described in the last annual report.

Signed on behalf of the board by

António Horta-Osório
Group Chief Executive
27 July 2016

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

INDEPENDENT REVIEW REPORT TO BANK OF SCOTLAND PLC

Report on the condensed consolidated half-year financial statements

Our conclusion

We have reviewed Bank of Scotland plc's condensed consolidated half-year financial statements (the "interim financial statements") in the 2016 half-year management report of Bank of Scotland plc for the six month period ended 30 June 2016. Based on our review, nothing has come to our attention that causes us to believe that the interim financial statements are not prepared, in all material respects, in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union and the Disclosure Rules and Transparency Rules of the United Kingdom's Financial Conduct Authority.

What we have reviewed

The interim financial statements comprise:

- the consolidated balance sheet as at 30 June 2016;
- the consolidated income statement for the six months ended 30 June 2016
- the consolidated statement of comprehensive income for the six months ended 30 June 2016;
- the consolidated cash flow statement for the six months ended 30 June 2016;
- the consolidated statement of changes in equity for the six months ended 30 June 2016; and
- the explanatory notes to the interim financial statements.

The interim financial statements included in the 2016 half-year management report have been prepared in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union and the Disclosure Rules and Transparency Rules of the United Kingdom's Financial Conduct Authority.

As disclosed in note 1 to the interim financial statements, the financial reporting framework that has been applied in the preparation of the full annual financial statements of the Group is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Responsibilities for the interim financial statements and the review

Our responsibilities and those of the directors

The 2016 half-year management report, including the interim financial statements, is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the 2016 half-year management report in accordance with the Disclosure Rules and Transparency Rules of the United Kingdom's Financial Conduct Authority.

Our responsibility is to express a conclusion on the interim financial statements in the 2016 half-year management report based on our review. This report, including the conclusion, has been prepared for and only for the company for the purpose of complying with the Disclosure Rules and Transparency Rules of the United Kingdom's Financial Conduct Authority and for no other purpose. We do not, in giving this conclusion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

INDEPENDENT REVIEW REPORT TO BANK OF SCOTLAND PLC (continued)

What a review of interim financial statements involves

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

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

We have read the other information contained in the 2016 half-year management report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the interim financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants
London
27 July 2016

Notes:

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

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

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