HBOS plc

Report and Accounts
2017

Member of Lloyds Banking Group

Contents

Strategic report

Principal activities

HBOS plc (the Company) 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 2017, the Group recorded a profit before tax of £2,921 million, a decrease of £883 million, or 23 per cent, compared with a profit before tax in 2016 of £3,804 million. However, the Group has incurred conduct charges of £926 million in 2017 compared to £635 million in 2016 and other operating income in 2016 included a gain of £435 million arising on a restructuring of capital instruments within the Lloyds Banking Group which was not repeated in 2017. Excluding the conduct charges from both periods and the one-off gain from 2016, the Group recorded a profit before tax of £3,847 million in 2017, a decrease of £157 million, or 4 per cent, from £4,004 million in 2016.

Total income decreased by £654 million, or 9 per cent, to £7,022 million in 2017 compared with £7,676 million in 2016, comprising a £304 million decrease in net interest income together with a decrease of £350 million in other income.

Net interest income was £6,057 million in 2017; a decrease of £304 million, or 5 per cent compared to £6,361 million in 2016, reflecting pressure on mortgage margins and funding mix.

Other income was £350 million, or 27 per cent, lower at £965 million in 2017 compared to £1,315 million in 2016, which included the liability management gains of £435 million discussed above. Fee and commission income was £20 million or 3 per cent, lower at £767 million compared to £787 million in 2016 as increased levels of card fees, reflecting higher levels of card usage, were more than offset by lower current account fees, reflecting reduced volumes of added-value accounts and changes in pricing structure, and lower levels of other fees receivable. Fee and commission expense increased by £23 million, or 6 per cent, to £383 million compared with £360 million in 2016. Net trading income increased by £13 million, or 5 per cent, to £293 million in 2017 compared to £280 million in 2016. Other operating income was £320 million lower at £288 million in 2017 compared to £608 million in 2016, as a result of the liability management gains of £435 million in 2016 discussed above. Excluding the liability management gain from 2016, other operating income was £115 million higher at £288 million in 2017 compared to £173 million in 2016, reflecting an increase in gains on sale of available-for-sale financial assets from £71 million in 2016 to £134 million in 2017 as a result of the gain of £63 million on sale of the Group's investment in Vocalink.

Operating expenses increased by £278 million, or 8 per cent to £3,944 million in 2017 compared with £3,666 million in 2016; reflecting the £291 million increase in charges for redress payments to customers in respect of PPI and other conduct related matters from £635 million in 2016 to £926 million in 2017 (for further details on these charges see note 30 to the financial statements). Excluding these charges from both years, operating expenses were £13 million lower at £3,018 million in 2017 compared to £3,031 million in 2016. Staff costs were £72 million, or 5 per cent, lower at £1,440 million in 2017 compared with £1,512 million in 2016; increases in pension charges being more than offset by headcount related reductions in salaries. Premises and equipment costs were £61 million or 31 per cent, higher at £257 million in 2017 compared with £196 million in 2016. Other expenses were unchanged at £1,151 million. Depreciation and amortisation costs were £2 million lower at £170 million in 2017 compared to £172 million in 2016.

Impairment losses decreased by £49 million, or 24 per cent, to £157 million in 2017 compared with £206 million in 2016. Impairment losses in respect of loans and advances to customers were £52 million, or 24 per cent, lower at £164 million in 2017 compared with £216 million in 2016. As reduced charges in relation to retail lending more than offset some increase on corporate balances, as a result of lower levels of releases and recoveries. There was a credit of £7 million in respect of undrawn commitments in 2017, compared to a credit of £10 million in 2016.

In 2017, the Group recorded a tax expense of £827 million compared to a tax expense of £1,198 million in 2016, an effective tax rate of 28 per cent, compared to the standard UK corporation tax rate of 19.25 per cent, principally as a result of the banking surcharge and restrictions on the deductibility of conduct provisions.

Total assets were £20,402 million, or 6 per cent, higher at £364,680 million at 31 December 2017 compared to £344,278 million at 31 December 2016. Derivative assets were £3,030 million, or 21 per cent, lower at £11,634 million at 31 December 2017 compared to £14,664 million at 31 December 2016, largely as a result of exchange rate movements. Loans and advances to customers were little changed at £268,657 million at 31 December 2017 compared to £268,899 million at 31 December 2016; the impact of the reacquisition of a portfolio of mortgages from TSB has offset reductions in the larger corporate sector, as the Group focuses on optimising capital and returns, and in closed mortgage books. Amounts due from fellow Lloyds Banking Group undertakings increased by £27,938 million from £46,911 million at 31 December 2016 to £74,849 million at 31 December 2017, although this is largely matched by the increase in amounts due to fellow Lloyds Banking Group undertakings. Available-for-sale financial assets were £2,097 million lower at £937 million at 31 December 2017 compared to £3,034 million at 31 December 2016 reflecting sales and maturities of a number of investments.

Total liabilities were £21,238 million, or 6 per cent, higher at £350,681 million at 31 December 2017 compared to £329,443 million at 31 December 2016. Deposits from banks were £14,992 million higher at £21,183 million at 31 December 2017 compared to £6,191 million at 31 December 2016 as a result of an increase of £15,456 million in repurchase agreements, used as a favourable form of funding. Customer deposits were £8,119 million, or 5 per cent, lower at £171,198 million compared to £179,317 million at 31 December 2016. Amounts due to fellow Lloyds Banking Group undertakings increased by £25,960 million from £99,581 million at 31 December 2016 to £125,541 million at 31 December 2017, although this is largely matched by the increase in amounts due from fellow Lloyds Banking Group undertakings. Derivative liabilities were £2,594 million, or 20 per cent, lower at £10,631 million at 31 December 2017 compared to £13,225 million at 31 December 2016, largely as a result of exchange rate movements. Debt securities in issue were £5,760 million, or 35 per cent, lower at £10,919 million at 31 December 2017 compared to £16,679 million at 31 December 2016 following maturities of some tranches of securitisation notes and covered bonds. Subordinated liabilities were £1,529 million, or 19 per cent, lower at £6,620 million at 31 December 2017 compared to £8,149 million at 31 December 2016 reflecting redemptions in the year.

Total equity was £836 million, or 6 per cent, lower at £13,999 million at 31 December 2017 compared to £14,835 million at 31 December 2016 as retained profits for the year have been more than offset by the Group's dividend payments.

The Group's common equity tier 1 capital ratio reduced to 11.9 per cent (31 December 2016: 12.7 per cent) largely reflecting dividends paid during the year and the accrual for foreseeable dividends in respect of 2017 earnings, partially offset by the reduction in risk-weighted assets. The tier 1 capital ratio reduced to 15.8 per cent (31 December 2016: 16.6 per cent) and the total capital ratio reduced to 19.0 per cent (31 December 2016: 20.4 per cent) reflecting the reduction in common equity tier 1 capital, the annual reduction in the transitional limit applied to grandfathered instruments and the amortisation of dated tier 2 instruments, partially offset by the reduction in risk-weighted assets.

Risk-weighted assets reduced by £9,258 million, or 12 per cent, to £69,350 million at 31 December 2017 compared to £78,608 million at 31 December 2016, largely reflecting the internal transfer of equity portfolios to the new equity investment group under the ultimate parent company (Lloyds Banking Group plc) as part of ring-fencing related restructuring activities, updates made to mortgage IRB models, continued active portfolio management and a reduction in operational risk-weighted assets.

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

Over the course of 2018, in order to comply with the ring-fencing legislation, certain businesses will be transferred out of the Group to other parts of the Lloyds Banking Group, by means of statutory or other transfers. This will include the transfer of certain wholesale and international businesses to Lloyds Bank Corporate Markets plc. A number of actions are required to occur before these businesses can be transferred.

Capital position at 31 December 2017
The Group's capital position applying CRD IV transitional rules as at 31 December 2017 is set out in the following section.

Table 1.1 Capital resources

Capital resources (audited)	At 31 Dec 2017 £m	At 31 Dec 2016 £m
Common equity tier 1		
Shareholders' equity per balance sheet	**12,462**	13,298
Adjustment to retained earnings for foreseeable dividends	**(1,750)**	(500)
Cash flow hedging reserve	**(23)**	(89)
Other adjustments	**(3)**	(10)
	10,686	12,699
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	**(437)**	(424)
Prudent valuation adjustment	**(119)**	(165)
Excess of expected losses over impairment provisions and value adjustments	**(46)**	(132)
Removal of defined benefit pension surplus	**(57)**	(69)
Securitisation deductions	**(180)**	(186)
Non-significant investments	**(10)**	(61)
Deferred tax assets	**(1,581)**	(1,678)
Common equity tier 1 capital	**8,256**	9,984
Additional tier 1		
Additional tier 1 instruments	**3,012**	3,314
Less: deductions from tier 1		
Non-significant investments	**(312)**	(272)
Total tier 1 capital	**10,956**	13,026
Tier 2		
Tier 2 instruments	**2,547**	3,206
Eligible provisions	**247**	321
Less: deductions from tier 2		
Non-significant investments	**(587)**	(512)
Total tier 2 capital	**2,207**	3,015
Total capital resources	**13,163**	16,041
Risk-weighted assets	**69,350**	78,608
Common equity tier 1 capital ratio	**11.9%**	12.7%
Tier 1 capital ratio	**15.8%**	16.6%
Total capital ratio	**19.0%**	20.4%

Table 1.2: Risk-weighted assets (unaudited)

	2017 £m	2016 £m
Risk-weighted assets		
Foundation Internal Ratings Basel (IRB) Approach	**5,808**	7,626
Retail IRB Approach	**38,010**	40,295
Other IRB Approach	**3,437**	5,525
IRB Approach	**47,255**	53,446
Standardised Approach	**7,471**	8,184
Credit risk	**54,726**	61,630
Counterparty credit risk	**995**	1,574
Credit valuation adjustment risk	**167**	242
Operational risk	**11,055**	12,256
Market risk	**1,608**	1,980
Underlying risk-weighted assets	**68,551**	77,682
Threshold risk-weighted assets	**799**	926
Total risk-weighted assets	**69,350**	78,608

Principal risks and uncertainties
The most significant risks faced by the Group which could impact the delivery of our long-term strategic objectives and our approach to each risk, are detailed below.

As part of Lloyds Banking Group's ongoing assessment of the potential implications of the UK leaving the European Union, Lloyds Banking Group continues to consider the impact to its customers, colleagues and products – as well as legal, regulatory, tax, financial and capital implications. There remains continued uncertainty around both the UK and global political and macroeconomic environment. The potential impacts of external factors have been considered in all principal risks to ensure any material uncertainties continue to be monitored and are appropriately mitigated.

Principal risks and uncertainties are reviewed and reported regularly. This year we have added a new principal risk, model risk, to reflect Lloyds Banking Group's increasing use of analytics and models to make decisions.

Credit risk – The risk that parties with whom we have contracted, fail to meet their financial obligations (both on and off balance sheet).

Key mitigating actions
– Credit policy, incorporating prudent lending criteria, aligned with Lloyds Banking Group Board approved risk appetite, to effectively manage risk.
– Robust risk assessment and credit sanctioning to ensure we lend appropriately and responsibly.
– Extensive and thorough credit processes and controls to ensure effective risk identification, management and oversight.
– Effective, well-established governance process supported by independent credit risk assurance.
– Early identification of signs of stress leading to prompt action in engaging the customer.

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

Key mitigating actions
– Ensure Lloyds Banking Group develops comprehensive plans for delivery of all legal and regulatory changes and track their progress. Projects across the Lloyds Banking Group implemented to address significant impacts.
– Continued investment in people, processes, training and IT to assess impact and help meet our legal and regulatory commitments.
– Engage with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations.

Conduct risk – Conduct risk can arise from a number of areas including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; failing to promote effective competition in the interest of customers; and exhibiting behaviours which could impact on the integrity of the market or undermine wider regulatory standards.

Key mitigating actions
– Conduct risk appetite metrics provide a granular view of how our products and services are performing for customers.
– Product approval, continuous product review processes and customer outcome testing (across products and services) supported by conduct management information.
– Learning from past mistakes through root cause analysis and clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics.
– Further enhancements and embedding of our framework to support customers in vulnerable circumstances.

Operational risk – We face significant operational risks which may disrupt services to customers, cause reputational damage, and result in financial loss. These include the availability, resilience and security of our core IT systems, unlawful or inappropriate use of customer data, theft of sensitive data, fraud and financial crime threats, and the potential for failings in our customer processes.

Key mitigating actions
- Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems, and to ensure effective third party assurance.
- Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis.
- Significant investment in compliance with General Data Protection Regulation and Basel Committee on Banking Supervision standards.
- Working with industry bodies and law enforcement agencies to identify and combat fraud and money laundering.

People risk – Key people risks include the risk that we fail to maintain organisational skills, capability, resilience and capacity levels in response to organisational, political and external market change and evolving business needs.

Key mitigating actions
- Focused action to attract, retain and develop high calibre people. Delivering initiatives which reinforce behaviours to generate the best outcomes for customers and colleagues.
- Managing organisational capability and capacity to ensure there are the right skills and resources to meet our customers' needs.
- Effective remuneration arrangements to promote appropriate colleague behaviours and meet regulatory expectations.

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

Key mitigating actions
- A comprehensive capital management framework that includes setting of capital risk appetite and dividend policy.
- Close monitoring of capital and leverage ratios to ensure we meet regulatory requirements and risk appetite.
- Comprehensive stress testing analyses to evidence capital adequacy under various adverse scenarios.

Funding and liquidity risk – The risk that we have insufficient financial resources to meet our commitments as they fall due.

Key mitigating actions
- Holding liquid assets to cover potential cash and collateral outflows and to meet regulatory requirements. In addition, maintaining a further pool of assets that can be used to access central bank liquidity facilities.
- Undertaking daily monitoring against a number of market and Lloyds Banking Group specific early warning indicators.
- Maintaining a contingency funding plan detailing actions and strategies available in stressed conditions.

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

Key mitigating actions
- Leveraging our considerable change experience to meet ring-fencing requirements before the regulatory deadlines, and the continuing evolution of SM&CR.
- Programme in place to address ring-fencing. In close and regular contact with regulators to develop and deploy our planned operating and legal structure.
- Evolving risk and governance arrangements to continue to be appropriate to comply with regulatory objectives.

Market risk – The risk that our capital or earnings profile is affected by adverse market rates, in particular interest rates and credit spreads in the banking business, and credit spreads in the Group's defined benefit (DB) pension schemes.

Key mitigating actions
- Structural hedge programmes implemented to manage liability margins and margin compression.
- Equity and credit spread risks are closely monitored and, where appropriate, asset and liability matching is undertaken.
- The Group's DB pension schemes have increased their credit allocation and hedged against nominal rate and inflation movements.

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

Key mitigating actions
A comprehensive model risk management framework including:

- Defined roles and responsibilities, with clear ownership and accountability.
- Principles regarding the requirements of data integrity, development, validation, implementation and ongoing maintenance.
- Regular model monitoring.
- Independent review of models.
- Periodic validation and re-approval of models.

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. The Group's approach to risk management including risk policies, risk appetite, measurement bases and sensitivities, in particular for credit risk, market risk and liquidity risk, is aligned to those of Lloyds Banking Group plc, the Company's ultimate parent. Further information can be found in the Lloyds Banking Group plc annual report.

The 2017 Strategic Report has been approved by the Board of Directors.

On behalf of the Board

Lord Blackwell
HBOS plc
21 March 2018

Directors' report

Results
The consolidated income statement on page 21 shows a statutory profit before tax for the year ended 31 December 2017 of £2,921 million (year ended 31 December 2016: £3,804 million).

Dividends
During the year the Company paid interim dividends of £2,000 million and £900 million, a cumulative total of £2,900 million (2016: £2,610 million). The Directors have not recommended a final dividend for the year ended 31 December 2017 (2016: nil).

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

Going concern
The going concern of the Company 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 Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered the principal risks and uncertainties and capital position set out in the strategic report on pages 2 to 7 and additionally have considered projections for the Company's and the Group's capital and funding position. Accordingly, the Directors conclude that the Company and the Group have adequate resources to continue in operational existence for a period of at least 12 months from the date of the approval of the financial statements and therefore it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Directors
The names of the current Directors are shown on page 11. Changes to the composition of the Board since 1 January 2017 up to the date of this report are shown in the table below:

	Joined the Board	Retired from the Board
Nicholas Luff		10 May 2017
Anthony Watson		11 May 2017
Lord Lupton	1 June 2017	

Appointment and retirement of Directors
The appointment of Directors is governed by the Company's articles of association and the Companies Act 2006. The Company'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 Company, 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. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Director appointed in 2017. In addition, Lloyds Banking Group plc had appropriate Directors' and Officers' liability insurance cover in place throughout 2017. Deeds for existing Directors are available for inspection at the Company's registered office.

Lloyds Banking Group plc has also granted deeds of indemnity by deed poll and by way of entering into individual deeds, which constitute 'qualifying third party indemnity provisions' to the Directors of the Group's subsidiary companies, including to former Directors who retired during the year and since the year end. Such deeds were in force during the financial year ended 31 December 2017 and remain in force as at the date of this report. Qualifying pension scheme indemnities have also been granted to the Trustees of Lloyds Banking Group's Pension Schemes, which were in force for the whole of the financial year and remain in force as at the date of this report.

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
The Board has a comprehensive procedure for reviewing and, as permitted by the Companies Act 2006 and the Company's articles of association, approving actual and potential conflicts of interests. Directors have a continuing duty to notify the Chairman and Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to the commitments of all Directors are reported to 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.

Stuart Sinclair is Senior Independent Director at QBE Insurance (Europe) Limited, a general insurance and reinsurance company. Lord Lupton is a senior advisor to Greenhill Europe, an investment bank focused on providing financial advice on significant mergers, acquisitions, restructurings, financings and capital raising to corporations, partnerships, institutions and governments. The Board has recognised that potential conflicts may arise as a result of these positions. The Board has authorised the potential conflicts and requires Mr Sinclair and Lord Lupton to recuse themselves from discussions, should the need arise.

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

Share capital
Information about share capital is shown in note 32 on page 64. This information is incorporated into this report by reference.

The Company did not repurchase any of its shares during 2017 (2016: none). There are no restrictions on the transfer of shares in the Company 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 Directors manage the business of the Company under the powers set out in the Companies Act 2006 and the Company's articles of association, these powers include those in relation to the issue or buy back of the Company's shares.

Change of control
The Company 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 Company 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 Company develops new products and services within the business units.

Employees
Lloyds Banking Group (the 'Group'), of which the Company is a part, continues to promote Inclusion and Diversity ('I&D') through its Group Executive Committee. Several senior Group executives are I&D sponsors, and an Operational Committee oversees how I&D plans are implemented. During 2017, the Group continued to make good progress against its I&D strategy. The proportion of colleagues who agree that the Group is an inclusive place to work increased to 89 per cent, 3 per cent more than in 2016, and almost half of Group colleagues are members or supporters of one of its five diversity networks. The Group has committed to ensure that women hold 40 per cent of its senior roles by 2020, and to help reach this target it monitors gender diversity on candidate lists for senior appointments. Over 400 women have now completed its Women in Leadership programme, with 100 achieving promotion. The Group continued to develop and promote its Authentic Leadership Programme for Black, Asian and Minority Ethnic leaders, fostering cultural awareness through promoting role models and communication campaigns. The Group met its target to increase the engagement levels of Black, Asian and Minority Ethnic colleagues, colleagues with disabilities and Lesbian, Gay and Bisexual colleagues above 70 per cent, three years earlier than its target date of 2020.

This year, the Department for Work and Pensions designated Lloyds Banking Group as a Disability Confident Leader for its inclusive recruitment process and in November, Lloyds Banking Group won a 'Nothing about us without us' Disability Smart Award, recognising the way insights about disability are gathered from colleagues, customers and charities, then used to inform decisions. As a member of the Business Disability Forum, Lloyds Banking Group is proud to have retained Gold accreditation in the Disability Standard. The Group's colleague disability network, Access, ran a successful national event, while more than 2,300 colleagues completed our industry leading workplace adjustment process. The Group offers bespoke development programmes and recruitment processes for colleagues and job applicants with disabilities, aiming to appoint the best candidate into any role and give full and fair consideration to job applications from those with disabilities, and the Group is unbiased in the way it assesses, selects, appoints, trains and promotes people. The Group offers a guaranteed interview scheme for candidates who declare a disability and meet the minimum requirements of the role, and continues to run a Disability Work Experience Programme in partnership with Remploy. This is one of the largest disability-focused work experience initiatives in the financial services sector; the Group has increased its number of candidates from 96 in 2016 to 392 in 2017.

The Group regularly and systematically updates colleagues on its performance and changes in the economic and regulatory environment including matters that concern their role. The Group also encourages colleagues to share their ideas and views to help shape the Group's future, including through its 'Best Bank for Customers' and 'Building the Best Team' surveys that are run by an independent third party every year.

The Group offers a competitive and fair reward package that supports its aims as a responsible business – with customer-facing colleagues in its Retail division incentivised on the basis of actions and behaviours that put customers first. The Group offers colleague share schemes to encourage shared ownership of the Group.

Significant contracts
Details of related party transactions are set out in note 37 on pages 69 to 71.

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 Company and Group 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 Company and the Group and of the profit or loss of the Company and the 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 Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Company 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 Company on that website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors, who are in office as at the date of this report and whose names are shown on page 11 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 and the profit or loss of the Company and 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 Company and Group, together with a description of the principal risks and uncertainties that they face.

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 Company's performance, business model and strategy. The Directors have also separately reviewed and approved the strategic report.

Directors' 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 Company'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 Company'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 2018 annual general meeting to re-appoint PricewaterhouseCoopers LLP as auditor. The Company's Audit Committee is satisfied that the external auditor remains independent and effective.

On behalf of the Board

Malcolm Wood
Company Secretary
21 March 2018

HBOS plc
Registered in Scotland
Company Number SC218813

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 Operating Officer*

Alan Dickinson

Anita Frew

Simon Henry

Lord Lupton CBE

Deborah McWhinney

Nick Prettejohn

Stuart Sinclair

Sara Weller CBE

Forward looking statements

This Annual Report contains certain forward looking statements with respect to the business, strategy, plans and/or results of the HBOS 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 HBOS Group's or its director's 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 HBOS Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; the HBOS Group's future financial performance; the level and extent of future impairments and write-downs; statements of plans, objectives or goals of HBOS Group or its management including in respect of statements about the future business and economic environments in the 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 (including but not limited to the payment of dividends) to differ materially from forward looking statements made by the HBOS 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, inflation. exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the HBOS Group's or Lloyds Banking Group plc's or Lloyds Bank plc's credit ratings; the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, instability as a result of the exit by the UK from the European Union (EU) and the potential for other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; natural pandemic and other disasters, adverse weather and similar contingencies outside the HBOS Group's or Lloyds Banking Group plc's or Lloyds Bank plc's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of the exit by the UK from the EU, or a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside the HBOS Group's or Lloyds Banking Group plc's or Lloyds Bank 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 together with any resulting impact on the future structure of the Group; the ability to attract and retain senior management and other employees and meet its diversity objectives; actions or omissions by the HBOS Group's directors, management or employees including industrial action; changes to the HBOS Group's post-retirement defined benefit scheme obligations; 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 HBOS Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Banking Group plc's 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 the HBOS 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 the HBOS Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. The information, statements and opinions contained in this Annual Report do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

Independent auditors' report

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF HBOS PLC

Report on the audit of the financial statements
Opinion
In our opinion, HBOS plc's Group financial statements and Company financial statements (the "financial statements"):

– give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2017 and of the Group's profit and the Group's and the Company's cash flows for the year then ended;
– have been properly prepared in accordance with IFRSs as adopted by the European Union and, as regards the Company's financial statements, as applied in accordance with the provisions of the Companies Act 2006; and
– 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.

We have audited the financial statements, included within the Report and Accounts (the "Annual Report"), which comprise: the consolidated balance sheet and company balance sheet as at 31 December 2017; the consolidated income statement and the statements of comprehensive income for the year then ended; the consolidated statement of changes in equity and company statement of changes in equity for the year then ended; and the consolidated cash flow statement and company cash flow statement for the year then ended; and the notes to the accounts, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion
We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence
We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Company.

Other than those disclosed in note 9 to the financial statements, we have provided no non-audit services to the Group or the Company in the period from 1 January 2017 to 31 December 2017.

Our audit approach
Overview
– Overall Group materiality: £200 million (2016: £200 million), based on 5 per cent of the 3 year average of adjusted profit before tax. Statutory profits were adjusted to remove the effects of certain items which are exceptional and/or one-off in nature.
– Overall Company materiality: £200 million (2016: £200 million), based on 1 per cent of total assets.
– The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of components and other qualitative factors (including history of misstatement through fraud or error).
– We performed audit procedures over components considered financially significant in the context of the Group (full scope audit) or in the context of individual primary statement account balances (audit of specific account balances). We performed other procedures including testing entity level controls, information technology general controls and analytical review procedures to mitigate the risk of material misstatement in the residual components.

The areas of focus for our audit which involved the greatest allocation of our resources and effort were:

– Loan loss impairment provisions (Group).
– Conduct risk and provisions (Group).
– Defined benefit obligation (Group).
– Hedge accounting (Group and Company).
– Privileged access to IT systems (Group and Company).
– Disclosure of the impact of IFRS 9 (Group).

These items were discussed with the Audit Committee as part of our audit plan communicated in April 2017 and updated in October 2017. These were the key audit matters for discussion at the conclusion of our audit.

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

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

The scope of our audit
As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

We gained an understanding of the legal and regulatory framework applicable to the Group and the industries in which it operates, and considered the risk of acts by the Group which were contrary to applicable laws and regulations, including fraud. We designed audit procedures at Group and significant component level to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion. We focused on laws and regulations that could give rise to a material misstatement in the Group and Company financial statements, including but not limited to, the Companies Act 2006, the Prudential Regulation Authority's regulations, the Pensions Regulator legislation, the UK tax legislation. Our tests included, but were not limited to, review of the financial statement disclosures to underlying supporting documentation, review of correspondence with and reports to the regulators, enquiries of management, review of significant components auditors' work and review of internal audit reports in so far as they related to the financial statements.

There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it.

We found conduct risks and provisions to be a key audit matter, and this is discussed further below. As in all of our audits, we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

Materiality
The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and on the financial statements as a whole.

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

	Group financial statements	**Company financial statements**
Overall materiality	£200 million (2016: £200 million).	£200 million (2016: £200 million).
How we determined it	5 per cent of the 3 year average of adjusted profit before tax. Profit was adjusted to remove the effects of certain items which are exceptional and/or one off in nature.	1 per cent of total assets.
Rationale for benchmark applied	We have used a 3 year average of adjusted profit before tax in order to reduce the potential for volatility and large changes in materiality year-on-year. This is a generally accepted auditing practice. Statutory profits before tax for 2015, 2016 and 2017 were adjusted to remove the disproportionate impact of several items which are considered exceptional and/ or one-off in nature. These adjustments included charges related to PPI and other conduct provisions.	We have selected total assets as an appropriate benchmark for Company materiality. Profit based benchmarks are not considered appropriate for Company materiality as the Group is not required to disclose a Company income statement. Company overall materiality calculated based on the total assets benchmark exceeds the Group overall materiality level. Therefore Company overall materiality is restricted to equal the Group overall materiality level (£200m).

For each component in the scope of our Group audit, we allocated a materiality that is less than our overall Group materiality. The range of materiality allocated across components was between £60 million and £120 million.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £20 million for the Group and Company audits (2016: £20 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Audit scope
We tailored the scope of our audit to ensure that we performed sufficient work to be able to give an opinion on the financial statements as a whole, taking into account the geographic structure of the Group and the Company, the accounting processes and controls, and the industry in which the Group operates.

The Group is structured into two segments being Retail and Commercial Banking. Each of the segments comprises a number of components. The consolidated financial statements are a consolidation of the components.

In establishing the overall approach to the Group audit, we determined the type of work that is required to be performed over the components by us, as the Group engagement team, or auditors within PwC UK ('component auditors').

Where the work was performed by component auditors, we determined the level of involvement we needed to have in their audit work to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the consolidated financial statements as a whole. This included regular communication with the component auditors throughout the audit, the issuance of instructions, a review of the results of their work on the key audit matters and formal clearance meetings.

Any components which were considered individually financially significant in the context of the Group's consolidated financial statements (defined as components that represent more than or equal to 10% of the total assets of the consolidated Group) were considered full scope components. We considered the individual financial significance of other components in relation to primary statement account balances. We considered the presence of any significant audit risks and other qualitative factors (including history of misstatements through fraud or error). Any component which was not already included as a full scope audit component but was identified as being individually financially significant in respect of one of more account balances was subject to specific audit procedures over those account balances. Inconsequential components (defined as components which did not represent a reasonable possibility of a risk of material misstatement either individually or in aggregate) were eliminated from further consideration for specific audit procedures although they were subject to Group level analytical review procedures. All remaining components which were neither inconsequential nor individually financially significant were within our audit scope, with the risk of material misstatement mitigated through audit procedures including testing of entity level controls, information technology general controls and Group and component level analytical review procedures.

Certain account balances were audited centrally by the Group engagement team.

Components within the scope of our audit contributed 99 per cent of Group total assets and 95 per cent of profit after tax.

Key audit matters
Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which

had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key audit matter	How our audit addressed the key audit matter
Loan loss impairment provisions *Group* *Refer to page 30 (Accounting Policies) and page 46 (Note 17 and Critical Accounting Estimates and Judgements).* The determination of impairment provisions is complex, and significant judgements are required around both the timing of recognition of impairment provisions and estimation of the amount of provisions required in relation to loss events which have occurred at the balance sheet date. Impairment provisions relating to loans and advances in the Retail division are determined on a collective basis, with the use of impairment models. These models are used to calculate impairment provisions based on key assumptions for example loss emergence period, probability of default, loss given default (including possession propensity and forced sale discounts for mortgages) and valuation of recoveries. These are estimated based on historical experience and other data as available at the reporting date. Management also applies overlays where they believe the calculated assumptions based on historical experience are not appropriate, either due to emerging trends or the models not capturing the risks in the loan portfolio. An example of this is an overlay to the impairment model output for the UK mortgage portfolio relating to the current low interest rate environment. These overlays require significant judgement and are therefore a main area of focus. Impairment provisions relating to loans and advances in the Commercial Banking division are primarily determined on an individual basis. Judgement is required to determine when a loan is considered impaired, and then to estimate the expected future cash flows related to that loan. A collective provision is also calculated to cover unidentified impairment (i.e. losses which have been incurred but not yet identified). Management apply overlays to the modelled output to address risks not captured by the model.	We understood management's process and tested key controls around the determination of impairment provision, including: – the identification of impairment events; – the governance over the impairment processes, including controls over unauthorised modifications to the models and the re-assessment by management that impairment models are still calibrated in a way which is appropriate for the impairment risks in the Group's loan portfolios; – the transfer of data between underlying source systems and the impairment models that the Group operates; and – the review, challenge and approval processes that are in place to assess the outputs of the Group's impairment models, and the overlays that are applied. We found these key controls were designed, implemented and operated effectively, and therefore determined that we could place reliance on these key controls for the purposes of our audit. In addition we have performed the following substantive procedures: Retail We understood and critically assessed the appropriateness of models used. This included challenging whether the portfolios were appropriately segmented and whether historical experience was representative of current circumstances. We also performed testing over the completeness and accuracy of data from underlying systems, assessed whether customer forbearance plans had been appropriately reflected in the impairment models and performed testing to obtain evidence over the existence and valuation of collateral. We critically assessed the completeness of overlays proposed by management, including challenging whether risk concentrations (e.g. past-term interest only loans, forborne loans, personal contract purchase loans) have been appropriately provided for. We also performed testing over the measurement of the overlays in place, including challenging the appropriateness of the calculation, the reasonableness of the assumptions used and the reliability of the underlying data. Based on the evidence obtained, we found that the methodologies, modelled assumptions, data used within the models and overlays to modelled outputs to be appropriate. Commercial Banking We critically assessed the criteria for determining whether an impairment event had occurred and therefore whether there was a requirement to calculate an individual impairment provision. We tested a sample of performing loans with characteristics that might imply an impairment indicator existed (e.g. a customer experiencing financial difficulty or in breach of covenant) as well as an additional haphazardly selected sample of performing loans to assess whether these loans had any impairment indicators that management had not identified. For a sample of individually impaired loans, we understood the latest developments in relation to each case and the basis of measuring the impairment provisions and considered whether key judgments were appropriate given the borrower's circumstances. We also re-performed management's impairment calculation, testing key inputs including the expected future cash flows, discount rates and the valuation of collateral held. Our testing of collateral valuation specifically considered whether valuations were up to date, consistent with the strategy being followed in respect of the particular borrower and assessed the appropriateness and sensitivities of key assumptions. We back-tested previous provisions by comparing them to the gains or losses crystallised when impaired loans were sold or exited.

For the collective unidentified impaired provision, we tested the completeness and accuracy of the underlying loan information used in the impairment models by agreeing details to the Group's source systems as well as re-performing the calculation of the modelled provision. For the key inputs and assumptions in the model, we obtained and tested objective evidence that supported their appropriateness. For overlays to the modelled output, we challenged management to provide objective evidence that the overlays were appropriate.

We also considered whether certain recent events and macro-economic factors (e.g. continued volatility and uncertainty around commodity prices, sterling exchange rate movements and low interest rates) had been appropriately considered and captured.

Based on the evidence obtained, we found that the methodologies, modelled assumptions, data used within the models and overlays to modelled outputs are appropriate.

Conduct risk and provisions
Group
Refer to page 30 (Accounting Policies) and page 60 (Note 30 and Critical Accounting Estimates and Judgements).

Provisions reflecting the Group's best estimate of present obligations relating to anticipated customer redress payments, operational costs and regulatory fines as a result of past events, practices and conduct continue to be significant and therefore represent a key audit matter.

The most significant provisions relate to past sales of payment protection insurance (PPI) policies, arrears handling activities and packaged bank accounts.

For the known issues that have been provided for, we focused on the use of several management assumptions including volume of future complaints and related redress costs that are key judgmental inputs into the measurement of provisions.

Given the number and volume of products sold by the Group historically, and the continued regulatory and public focus on the banking industry, there is a continuing risk that new conduct issues will emerge. Therefore, there is a financial reporting risk that such emerging risks and exposures are not appropriately identified, for which financial statement disclosure and, or, provision may be required.

We understood and tested the key controls and management's processes around:

- identifying emerging conduct risk exposures and assessing whether provisions or disclosures were necessary; and
- calculating and reviewing conduct provisions, including governance processes, challenge of key assumptions and approval of provisions.

We found these controls were designed, implemented and operated effectively and therefore we determined that we could place reliance on these controls for the purposes of our audit.

We performed the following procedures around the measurement of provisions recognised:

The majority of our detailed audit work was on the significant conduct provisions in relation to past sales of PPI policies, arrears handling activities and packaged bank accounts. We also examined other conduct provisions which are individually less material.

For significant provisions made, we understood and challenged the provisioning methodologies and underlying assumptions used by management. For example, we challenged the basis that management used for forecasting the number of PPI complaints that will be received in the future. We considered regulatory developments and management's interactions with regulators.

For those assumptions based on historic information, we challenged whether this was appropriate for future experience and challenged the appropriateness of any adjustments made by management. We independently performed sensitivity analysis on the key assumptions.

Given the inherent uncertainty in the calculation of conduct provisions and their judgemental nature, we evaluated the disclosures made in the financial statements. In particular, we focused on challenging management around whether the disclosures were sufficiently clear in highlighting the exposures that remain, significant uncertainties that exist in respect of the provisions and the sensitivity of the provisions to changes in the underlying assumptions.

Based on the procedures performed and evidence obtained, we found management's assumptions to be appropriate.

We performed the following procedures around the completeness of provisions recognised:

We met with Divisional and Group management to understand the emerging and potential issues that they had identified. We independently assessed emerging and potential areas where exposures might have arisen based upon our knowledge and experience of emerging industry issues and the regulatory environment. We used this to challenge the completeness of the issues identified by management and whether a provision was required.

We understood the nature of customer complaints received, and assessed the trends. We used this analysis to understand whether there were indicators of more systemic issues being present for which provisions or disclosures may have needed to be made in the financial statements.

	We reviewed the Group's litigation reports, to identify potentially material cases which may require provision. We also communicated with the Group's external legal representatives to confirm our understanding of significant cases. We reviewed the Group's correspondence with the Financial Conduct Authority and Prudential Regulation Authority, discussing the content of any correspondence considered to be pertinent to our audit with management. We met on a trilateral basis with the Prudential Regulation Authority and the Chair of the Audit Committee. We also met on a bilateral basis with each regulator. We read the minutes of key governance meetings including those of the Board, and of various management committees, as well as attending all Audit Committee and Board Risk Committee meetings. No additional material conduct issues that would require financial statement disclosure or provision were identified as a result of the audit work performed.
Defined benefit obligation *Group* *Refer to page 30 (Accounting Policies) and page 52 (Note 28 and Critical Accounting Estimates and Judgements).* The retirement benefit schemes in the Group are calculated and valued with reference to a number of actuarial assumptions including discount rate, rate of inflation and mortality rates. As a result of the size of these schemes, small changes in these assumptions can have a significant impact on the financial statements.	We understood and tested key controls over the completeness and accuracy of data extracted and supplied to the Group's actuary, which is used in the valuation of the Group's defined benefit obligations. We tested the controls for determining the actuarial assumptions and the approval of those assumptions by senior management. We found the key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We engaged our actuarial experts and met with management and their actuary to understand the judgements made in determining key economic assumptions used in the calculation of the liability. We assessed the reasonableness of those assumptions by comparing to our own independently determined benchmarks and concluded that the assumptions used by management were appropriate. We tested the consensus and employee data used in calculating the obligation. Where material, we also considered the treatment of curtailments, settlements, past service costs and measurements, contributions and benefits paid, and any other amendments made to obligations during the year. Based on the evidence obtained, we found that the data and assumptions used by management in the actuarial valuations for pension obligations are within a range we consider to be reasonable. We read and assessed the disclosures made in the financial statements, including disclosures of the assumptions, and found them to be appropriate.
Hedge accounting *Group and Company* *Refer to page 30 (Accounting Policies), and page 87 (Note 42).* The Group enters into derivative contracts in order to manage and hedge risks such as interest rate and foreign exchange rate risk. These arrangements create accounting mismatches which are addressed through hedge accounting, predominantly fair value hedge or cash flow hedges. The application of hedge accounting and ensuring hedge effectiveness can be highly judgemental and operationally cumbersome, and requires close monitoring from management.	We understood and tested key controls over the designation and ongoing management of hedge accounting relationships, including testing of hedge effectiveness as well as the controls around the preparation and review of hedging strategy and related documentation prior to the implementation of new hedges. We found the key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We examined hedge documentation to assess whether the documentation complied with all IAS 39 requirements. We tested key year-end reconciliations between underlying source systems and spreadsheets used to manage hedging models, including testing of hedging capacity after considering the impact of structural reform, designation of hedges and the measurement and recording of hedge effectiveness adjustments. In monitoring hedging effectiveness against stresses, we noted that despite significant market uncertainty and volatility during the year, all significant hedge accounting relationships continued to be effective. We tested a sample of manual adjustments posted to hedge reserves relating to hedge ineffectiveness arising in cash flow hedging models. We found that hedge accounting methodology was appropriately applied.

Privileged access to IT systems *Group and Company* The Group's financial reporting processes are reliant on automated processes and controls performed by IT systems. Further, the group-wide IT estate is complex in terms of the scale and nature of IT systems relied upon. The risks associated with IT are also impacted by the threat profile of IT within the banking environment, which is subject to a number of internal and external risks relating to cyber security and the resilience of IT systems. As part of the audit, we validate the design and operating effectiveness of in-scope automated and IT dependent controls over financial reporting at a point in time as well as review the supporting IT General Computer Controls (ITGCs) that provide assurance over the continued integrity of these controls for the full financial reporting period. As part of our audit work in prior periods, we identified recurring control matters in relation to the management of IT privileged access to IT systems and therefore have relied on compensating controls and performed additional procedures. While there is an ongoing programme of activities to address such control matters, the fact that these were open control matters during the period meant there was an increased risk that the data and reports from the affected systems were not reliable.	We understood and tested key controls surrounding Group IT's central process for the periodic recertification of user access entitlements across in-scope systems as well as reviewed the processes for managing privileged access to IT systems. We have obtained an understanding of management's remediation programme and observed progress in terms of their remediation of a number of the control matters. However, several of the controls continued to be ineffective for the full financial reporting period. Where these control matters affected applications and supporting IT systems within the scope of our audit, we performed a combination of additional controls testing, including compensating controls where relevant and substantive audit procedures. On the basis of our additional audit testing, we were able to place reliance on the data and reports from in-scope applications.
Disclosure of the impact of IFRS 9 *Group* *Refer to page 98 (Note 45).* On 1 January 2018, the Group transitioned to the new financial instruments accounting standard IFRS 9, which replaced IAS 39. The estimated transition impact is disclosed in Note 45 to the Financial Statements in accordance with IAS 8. Disclosures in 2017 are intended to provide users with an understanding of the estimated impact of the new standard, and as a result are more limited than the disclosure to be included in the 2018 financial statements. We have deemed the disclosure of the impact of IFRS 9 for impairment an area of focus because of the significant changes introduced by the standard. Under the new impairment model, losses are recognised on an expected credit loss basis. Expected credit losses ("ECLs") are required to incorporate forward-looking information, reflecting management's view of potential future economic environments. The complexity involved requires management to develop new methodologies involving the use of significant judgements. Separately, the standard introduces new requirements around the classification and measurement of financial instruments, potentially resulting in fair value differences. In order to meet the requirements of the new standard, significant changes have also been made to systems, processes and controls with effect from 1 January 2018.	We understood and tested key controls supporting management's estimate of the transition adjustment focussing on: – model development, validation and approval to ensure compliance with IFRS 9 requirements; – review and approval of key assumptions, judgements and forward looking information prior to use in the models; – the integrity of data used as input to the models including the transfer of data between source systems and the impairment models – review and approval of post model adjustments recorded by management; and – review and approval of the output of IFRS 9 models and related transition impacts. We noted the controls were designed and operated effectively in all material respects. We understood and critically assessed classification and measurement decisions and the ECL models developed by the Group. This included using our credit modelling experts in our assessment of judgements and assumptions supporting the ECL requirements of the standard. We re-performed certain model calculations to confirm the risk parameter outputs and the results were appropriate. We assessed the reasonableness of forward looking information incorporated into the impairment calculations by using our experts and specialists to challenge the multiple economic scenarios chosen and the weighting applied to capture non-linear losses. We considered post-model adjustments in the context of key model and data limitations identified by management, challenged their rationale and recalculated where necessary. We tested the underlying disclosures related to the transition impact and reconciled the disclosed impact to underlying accounting records. Based on the evidence obtained, we found that the methodologies, modelled assumptions, data used within the models, resulting outputs and overlays to modelled outputs are appropriate.

Independent auditors' report

Conclusions relating to going concern

In accordance with ISAs (UK) we report as follows:

Reporting obligation	Outcome
We are required to report if we have anything material to add or draw attention to in respect of the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements and the directors' identification of any material uncertainties to the Group's and the Company's ability to continue as a going concern over a period of at least twelve months from the date of approval of the financial statements.	We have nothing material to add or to draw attention to. However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and Company's ability to continue as a going concern.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Directors' report, we considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, the Companies Act 2006, (CA06) and ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic Report and Directors' report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' report for the year ended 31 December 2017 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements. (CA06)

In light of the knowledge and understanding of the Group and Company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' report. (CA06)

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of directors' responsibilities set out on page 9, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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

Use of this report

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

Independent auditors' report

Other required reporting

Companies Act 2006 exception reporting

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 Company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the Company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the audit committee, we were appointed by the directors on 28 February 2009 to audit the financial statements for the year ended 31 December 2009 and subsequent financial periods. The period of total uninterrupted engagement is 9 years, covering the years ended 31 December 2009 to 31 December 2017. The audit was tendered in 2014 and we were re-appointed with effect from 1 January 2016. There will be a mandatory rotation for the 2021 audit of the ultimate parent Lloyds Banking Group plc.

Mark Hannam (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
21 March 2018

Consolidated income statement

for the year ended 31 December 2017

	Note	2017 £ million	2016 £ million
Interest and similar income		**8,877**	9,759
Interest and similar expense		**(2,820)**	(3,398)
Net interest income	5	**6,057**	6,361
Fee and commission income		**767**	787
Fee and commission expense		**(383)**	(360)
Net fee and commission income	6	**384**	427
Net trading income	7	**293**	280
Other operating income	8	**288**	608
Other income		**965**	1,315
Total income		**7,022**	7,676
Regulatory provisions		**(926)**	(635)
Other operating expenses		**(3,018)**	(3,031)
Total operating expenses	9	**(3,944)**	(3,666)
Trading surplus		**3,078**	4,010
Impairment	10	**(157)**	(206)
Profit before tax		**2,921**	3,804
Tax expense	11	**(827)**	(1,198)
Profit for the year		**2,094**	2,606
Profit attributable to ordinary shareholders		**1,993**	2,505
Profit attributable to non-controlling interests		**101**	101
Profit for the year		**2,094**	2,606

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

Statements of comprehensive income

for the year ended 31 December 2017

	2017 £ million	2016 £ million
Profit for the year	**2,094**	2,606
Other comprehensive income		
Items that will not subsequently be reclassified to profit or loss:		
Post-retirement defined benefit scheme remeasurements:		
Remeasurements before tax	**121**	(697)
Tax	**(23)**	132
	98	(565)
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	**16**	94
Income statement transfers in respect of disposals	**(134)**	(71)
Income statement transfers in respect of impairment	**10**	1
Tax	**19**	(30)
	(89)	(6)
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	**(135)**	122
Net income statement transfers	**46**	(232)
Tax	**23**	30
	(66)	(80)
Currency translation differences (tax: nil)	**(4)**	–
Other comprehensive income for the year, net of tax	**(61)**	(651)
Total comprehensive income for the year	**2,033**	1,955

	2017 £ million	2016 £ million
Total comprehensive income attributable to ordinary shareholders	**1,932**	1,854
Total comprehensive income attributable to non-controlling interests	**101**	101
Total comprehensive income for the year	**2,033**	1,955

The Company	2017 £ million	2016 £ million
Profit for the year	**2,197**	3,899
Other comprehensive income		
Items that will not subsequently be reclassified to profit or loss:		
Post-retirement defined benefit scheme remeasurements:		
Remeasurements before taxation	**112**	(673)
Tax	**(15)**	128
	97	(545)
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	**3**	4
Tax	**–**	–
	3	4
Currency translation differences (tax: nil)	**–**	–
Other comprehensive income for the year, net of tax	**100**	(541)
Total comprehensive income for the year	**2,297**	3,358

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

Consolidated balance sheet

at 31 December 2017

	Note	2017 £ million	2016 £ million
Assets			
Cash and balances at central banks		**2,677**	2,840
Items in the course of collection from banks		**260**	188
Trading and other financial assets at fair value through profit or loss	12	**1,400**	2,397
Derivative financial instruments	13	**11,634**	14,664
Loans and receivables:			
Loans and advances to banks		**551**	1,116
Loans and advances to customers	14	**268,657**	268,899
Debt securities		**137**	169
Due from fellow Lloyds Banking Group undertakings		**74,849**	46,911
		344,194	317,095
Available-for-sale financial assets	18	**937**	3,034
Goodwill	20	**325**	325
Other intangible assets	21	**112**	100
Property, plant and equipment	22	**823**	1,106
Current tax recoverable		**2**	7
Deferred tax assets	29	**1,878**	1,998
Retirement benefit assets	28	**69**	86
Other assets	23	**369**	438
Total assets		**364,680**	344,278

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

Consolidated balance sheet

at 31 December 2017

	Note	2017 £ million	2016 £ million
Equity and liabilities			
Liabilities			
Deposits from banks		**21,183**	6,191
Customer deposits	24	**171,198**	179,317
Due to fellow Lloyds Banking Group undertakings		**125,541**	99,581
Items in course of transmission to banks		**269**	248
Trading and other financial liabilities at fair value through profit or loss	25	**50**	945
Derivative financial instruments	13	**10,631**	13,225
Notes in circulation		**1,313**	1,402
Debt securities in issue	26	**10,919**	16,679
Other liabilities	27	**285**	785
Retirement benefit obligations	28	**135**	250
Current tax liabilities		**518**	825
Other provisions	30	**2,019**	1,846
Subordinated liabilities	31	**6,620**	8,149
Total liabilities		**350,681**	329,443
Equity			
Share capital	32	**3,763**	3,763
Other reserves	33	**10,234**	10,393
Retained profits	34	**(1,535)**	(858)
Shareholders' equity		**12,462**	13,298
Non-controlling interests		**1,537**	1,537
Total equity		**13,999**	14,835
Total equity and liabilities		**364,680**	344,278

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

The directors approved the consolidated financial statements on 21 March 2018.

Lord Blackwell
Chairman

António Horta-Osório
Chief Executive

George Culmer
Chief Financial Officer

Consolidated statement of changes in equity

for the year ended 31 December 2017

	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 2016	3,763	10,479	(298)	13,944	1,537	15,481
Comprehensive income						
Profit for the year	–	–	2,505	2,505	101	2,606
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(565)	(565)	–	(565)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(6)	–	(6)	–	(6)
Movements in cash flow hedging reserve, net of tax	–	(80)	–	(80)	–	(80)
Currency translation differences, net of tax	–	–	–	–	–	–
Total other comprehensive income	–	(86)	(565)	(651)	–	(651)
Total comprehensive income	–	(86)	1,940	1,854	101	1,955
Transactions with owners:						
Dividends (note 35)	–	–	(2,610)	(2,610)	–	(2,610)
Capital contribution received	–	–	82	82	–	82
Distributions to non-controlling interests, net of tax	–	–	28	28	(101)	(73)
Total transactions with owners	–	–	(2,500)	(2,500)	(101)	(2,601)
Balance at 31 December 2016	3,763	10,393	(858)	13,298	1,537	14,835
Comprehensive income						
Profit for the year	**–**	**–**	**1,993**	**1,993**	**101**	**2,094**
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of tax	**–**	**–**	**98**	**98**	**–**	**98**
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	**–**	**(89)**	**–**	**(89)**	**–**	**(89)**
Movements in cash flow hedging reserve, net of tax	**–**	**(66)**	**–**	**(66)**	**–**	**(66)**
Currency translation differences, net of tax	**–**	**(4)**	**–**	**(4)**	**–**	**(4)**
Total other comprehensive income	**–**	**(159)**	**98**	**(61)**	**–**	**(61)**
Total comprehensive income	**–**	**(159)**	**2,091**	**1,932**	**101**	**2,033**
Transactions with owners:						
Dividends (note 35)	**–**	**–**	**(2,900)**	**(2,900)**	**–**	**(2,900)**
Distributions to non-controlling interests, net of tax	**–**	**–**	**27**	**27**	**(101)**	**(74)**
Capital contribution received	**–**	**–**	**105**	**105**	**–**	**105**
Total transactions with owners	**–**	**–**	**(2,768)**	**(2,768)**	**(101)**	**(2,869)**
Balance at 31 December 2017	**3,763**	**10,234**	**(1,535)**	**12,462**	**1,537**	**13,999**

Further details of movements in the Group's share capital and reserves are provided in notes 32, 33, 34 and 35.

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

Consolidated cash flow statement

for the year ended 31 December 2017

	Note	2017 £ million	2016 £ million
Profit before tax		**2,921**	3,804
Adjustments for:			
Change in operating assets	44(a)	**(22,773)**	(7,730)
Change in operating liabilities	44(b)	**22,863**	11,750
Non-cash and other items	44(c)	**(257)**	(3,096)
Tax paid		**(945)**	(633)
Net cash provided by operating activities		**1,809**	4,095
Cash flows from investing activities			
Purchase of available-for-sale financial assets		**(291)**	(297)
Proceeds from sale and maturity of available-for-sale financial assets		**1,991**	2,291
Purchase of fixed assets		**(117)**	(131)
Proceeds from sale of fixed assets		**213**	112
Disposal of businesses, net of cash disposed	44(e)	**292**	5
Net cash provided by investing activities		**2,088**	1,980
Cash flows from financing activities			
Dividends paid to ordinary shareholders	35	**(2,900)**	(2,610)
Distributions on other equity instruments		**–**	(101)
Movements in non-controlling interests		**(101)**	–
Interest paid on subordinated liabilities		**(409)**	(411)
Repayment of subordinated liabilities	31	**(1,132)**	(1,113)
Capital repayment to ultimate parent company		**–**	(1,198)
Net cash used in financing activities		**(4,542)**	(5,433)
Effects of exchange rate changes on cash and cash equivalents		**2**	18
Change in cash and cash equivalents		**(643)**	660
Cash and cash equivalents at beginning of year		**3,052**	2,392
Cash and cash equivalents at end of year	44(d)	**2,409**	3,052

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

Company balance sheet

at 31 December 2017

	Note	2017 £ million	2016 £ million
Assets			
Amounts owed by Group entities		**13,164**	14,434
Derivative financial instruments	13	**395**	499
Available-for-sale financial assets		**7**	4
Retirement benefit assets	28	**69**	86
Investments in subsidiary undertakings	19	**22,394**	22,289
Total assets		**36,029**	37,312
Liabilities			
Amounts owed to Group entities		**8,168**	7,155
Other liabilities	27	**243**	509
Current tax liabilities		**13**	22
Retirement benefit obligations	28	**130**	220
Deferred tax liabilities	29	**18**	11
Subordinated liabilities	31	**4,692**	6,132
Total liabilities		**13,264**	14,049
Equity			
Issued share capital	32	**3,763**	3,763
Other reserves	33	**9,685**	9,682
Retained profits[1]	34	**9,317**	9,818
Shareholders' equity		**22,765**	23,263
Total equity and liabilities		**36,029**	37,312

[1] The company recorded a profit after tax for the year of £2,197 million (2016: £3,899 million).

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

Approved by the Board on 21 March 2018 and signed on its behalf by:

Lord Blackwell
Chairman

António Horta-Osório
Chief Executive

George Culmer
Chief Financial Officer

Company statement of changes in equity

for the year ended 31 December 2017

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
Balance at 1 January 2016	3,763	9,678	8,992	22,433
Comprehensive income				
Profit for the year	–	–	3,899	3,899
Other comprehensive income				
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(545)	(545)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	4	–	4
Total comprehensive income	–	4	3,354	3,358
Transactions with owners				
Capital contribution received	–	–	82	82
Dividends (note 35)	–	–	(2,610)	(2,610)
Total transactions with owners	–	–	(2,528)	(2,528)
Balance at 31 December 2016	3,763	9,682	9,818	23,263
Comprehensive income				
Profit for the year	**–**	**–**	**2,197**	**2,197**
Other comprehensive income				
Post-retirement defined benefit scheme remeasurements, net of tax	**–**	**–**	**97**	**97**
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	**–**	**3**	**–**	**3**
Total comprehensive income	**–**	**3**	**2,294**	**2,297**
Transactions with owners				
Capital contribution received	**–**	**–**	**105**	**105**
Dividends (note 35)	**–**	**–**	**(2,900)**	**(2,900)**
Total transactions with owners	**–**	**–**	**(2,795)**	**(2,795)**
Balance at 31 December 2017	**3,763**	**9,685**	**9,317**	**22,765**

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

Company cash flow statement

for the year ended 31 December 2017

	Note	**2017 £ million**	2016 £ million
Profit before tax		**2,207**	3,949
Adjustments for:			
Change in operating assets		**72**	(22)
Change in operating liabilities		**747**	(3,151)
Non-cash and other items		**(2,071)**	(2,235)
Tax paid		**(28)**	(61)
Net cash used in operating activities		**927**	(1,520)
Cash flows from financing activities			
Dividends paid to ordinary shareholders	35	**(2,900)**	(2,610)
Dividends received		**2,100**	3,500
Repayment of subordinated liabilities	31	**(1,132)**	(750)
Interest paid on subordinated liabilities		**(297)**	(290)
Net cash used in financing activities		**(2,229)**	(150)
Change in cash and cash equivalents		**(1,302)**	(1,670)
Cash and cash equivalents at beginning of year		**6,992**	8,662
Cash and cash equivalents at end of year		**5,690**	6,992

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

Notes to the accounts

1 Basis of preparation

The financial statements of HBOS 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 IFRS Interpretations Committee (IFRS IC) 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.

To improve transparency and ease of reference, the capital resources disclosure required under IFRS has been included within the Strategic Report on page 4. This disclosure is covered by the Audit opinion (included on pages 13 to 20) and referenced as audited.

The going concern of the Company 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 Company 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 risk on page 5 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.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2017 and which have not been applied in preparing these financial statements are given in note 45.

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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. Details of the Group's subsidiaries and related undertakings are given on pages 100 to 102.

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

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

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

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

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see 2e(4)) or share capital (see 2o). 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 under a contractual arrangement 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 or joint control of those policies and is generally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting.

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

2 Accounting policies (continued)

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal.

c Other intangible assets
Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows: up to 7 years for capitalised software; 10 to 15 years for brands and other intangibles.

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, including 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.

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.

Dividend income is recognised when the right to receive payment is established. Revenue recognition policies specific to leases are set out in (j)(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 (f) below).

Held for trading: 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.

Classified at fair value through profit and loss: 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. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available- for-sale financial assets.
- 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.
- 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. Refer to 39(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

(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, held-to-maturity investments 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. Such assets are 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

2 Accounting policies (continued)

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 otherwise have met the definition of loans and receivables at the time of reclassification 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 d above) less provision for impairment (see h below).

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.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense. Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, net of tax, as distributions from equity in the period in which they are paid. An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the 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
Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. All derivatives are recognised at their fair value. 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 39(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, 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.

(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 Accounting policies (continued)

(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.

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, including the identification of fraud, 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, 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. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

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.

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.

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

i Property, plant and equipment
Property, plant and equipment (other than investment property) is included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows: the shorter of 50 years and the remaining period of the lease for freehold/long and short leasehold premises; the shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease for leasehold improvements; 10 to 20 years for fixtures and furnishings; and 2 to 8 years for other equipment and motor vehicles.

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

2 Accounting policies (continued)

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.

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

j Leases

(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.

k Employee benefits

Short-term employee benefits, such as salaries, paid absences, performance-based cash awards and social security costs are recognised over the period in which the employees provide the related services.

(1) Pension schemes

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. The Group's income statement charge includes the current service cost of providing pension benefits, past service costs, net interest expense (income), and plan administration costs that are not deducted from the return on plan assets. Past service costs, which represents the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment, are recognised when the plan amendment or curtailment occurs. Net interest expense (income) is calculated by applying the discount rate at the beginning of the period to the net defined benefit liability or asset.

Remeasurements, comprising actuarial gains and losses, the return on plan assets (excluding amounts included in net interest expense (income) and net of the cost of managing the plan assets), and the effect of changes to the asset ceiling (if applicable) are reflected immediately in the balance sheet with a charge or credit recognised in other comprehensive income in the period in which they occur. Remeasurements recognised in other comprehensive income are reflected immediately in retained profits and will not subsequently be reclassified to profit or loss.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes. In assessing whether a surplus is recoverable, the Group considers its current right to obtain a refund or a reduction in future contributions and does not anticipate any future acts by other parties that could change the amount of the surplus that may ultimately be recovered.

The costs of the Group's defined contribution plans are charged to the income statement in the period in which they fall due.

(2) 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

2 Accounting policies (continued)

would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

l Taxation

Tax expense comprises current and deferred tax. Current and deferred tax are charged or credited in the income statement except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside the income statement (either in other comprehensive income, directly in equity, or through a business combination), in which case the tax appears in the same statement as the transaction that gave rise to it.

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

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

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

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

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

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

m Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on 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; and the income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see f(3) above). On disposal or liquidation 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 or liquidation.

n Provisions and contingent liabilities

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

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

Provision is made for 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.

o Share capital

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

p Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

q Investment in subsidiaries

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

3 Critical accounting estimates

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 (note 17);
- Defined benefit pension scheme obligations (note 28);
- Recoverability of deferred tax assets (note 29);
- Payment protection insurance and other regulatory provisions (note 30); and
- Fair value of financial instruments (note 39).

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 HBOS Group is managed on an entity basis and not by segment. The Group Executive Committee does not assess the HBOS 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 strategic 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 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			
	2017 %	2016 %	**2017 £m**	2016 £m
Interest and similar income:				
Loans and receivables	**2.50**	3.14	**8,861**	9,722
Available-for-sale financial assets	**0.96**	0.96	**16**	37
Total interest and similar income	**2.49**	3.11	**8,877**	9,759
Interest and similar expense:				
Deposits from banks and customer deposits	**0.88**	1.30	**(2,646)**	(3,307)
Debt securities in issue[1]	**(1.82)**	(1.84)	**228**	325
Subordinated liabilities	**5.85**	5.22	**(402)**	(416)
Total interest and similar expense	**0.88**	1.22	**(2,820)**	(3,398)
Net interest income			**6,057**	6,361

[1] This line is impacted by the Group's hedging arrangements; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.42 per cent (2016: 3.13 per cent).

Included within interest and similar income is £106 million (2016: £117 million) in respect of impaired financial assets. Net interest income also includes a charge of £46 million (2016: credit of £232 million) transferred from the cash flow hedging reserve (see note 33).

6 Net fee and commission income

	2017 £m	2016 £m
Fee and commission income:		
Current accounts	**220**	231
Credit and debit card fees	**237**	229
Other	**310**	327
Total fee and commission income	**767**	787
Fee and commission expense	**(383)**	(360)
Net fee and commission income	**384**	427

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

	2017 £m	2016 £m
Foreign exchange translation (losses) gains	**(10)**	224
Gains on foreign exchange trading transactions	**36**	32
Total foreign exchange	**26**	256
Investment property gains (note 22)	**–**	2
Securities and other gains (see below)	**267**	22
Net trading income	**293**	280

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

	2017 £m	2016 £m
Net income on assets held at fair value through profit or loss:		
Debt securities, loans and advances	**108**	58
Equity shares	**17**	3
Total net income arising on assets held at fair value through profit or loss	**125**	61
Net expense arising on liabilities held at fair value through profit or loss	**–**	(1)
Total net gains arising on assets and liabilities held at fair value through profit or loss	**125**	60
Net gains (losses) on financial instruments held for trading	**142**	(38)
Securities and other gains	**267**	22

8 Other operating income

	2017 £m	2016 £m
Operating lease rental income	**14**	24
Rental income from investment properties (note 22)	**1**	3
Gains on disposal of available-for-sale financial assets (note 33)	**134**	71
Share of results of joint ventures and associates	**7**	(1)
Liability management[1]	**–**	435
Other	**132**	76
Total other operating income	**288**	608

[1] During 2016 a gain of £435 million arose on a restructuring of capital instruments within the Lloyds Banking Group.

9 Operating expenses

	2017 £m	2016 £m
Staff costs:		
Salaries	**1,057**	1,166
Social security costs	**118**	121
Pensions and other post-retirement benefit schemes (note 28):	**265**	225
	1,440	1,512
Premises and equipment:		
Rent and rates	**163**	159
Repairs and maintenance	**23**	15
Other	**71**	22
	257	196
Other expenses:		
Communications and data processing	**127**	151
Advertising and promotion	**45**	50
Professional fees	**6**	5
Other	**973**	945
	1,151	1,151
Depreciation and amortisation:		
Depreciation of property, plant and equipment (note 22)	**137**	143
Amortisation of other intangible assets (note 21)	**33**	29
	170	172
Total operating expenses, excluding regulatory provisions	**3,018**	3,031
Regulatory provisions:		
Payment protection insurance provision (note 30)	**486**	266
Other regulatory provisions (note 30)	**440**	369
	926	635
Total operating expenses	**3,944**	3,666

9 Operating expenses (continued)

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

	2017	2016
UK	33,507	35,350
Overseas	400	402
Total	**33,907**	35,752

Fees payable to the Company's auditors

During the year the auditors earned the following fees:

	2017 £m	2016 £m
Fees payable for the audit of the Company's current year annual report	1.2	1.0
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	2.7	2.8
Other services supplied pursuant to legislation	0.6	0.6
Total fees payable to the Company's auditors by the Group	**4.5**	4.4

10 Impairment

	2017 £m	2016 £m
Impairment losses on loans and receivables:		
Loans and advances to customers	164	216
Debt securities classified as loans and receivables	(6)	–
Total impairment losses on loans and receivables (note 17)	158	216
Impairment of available-for-sale financial assets	6	–
Other credit risk provisions	(7)	(10)
Total impairment charged to the income statement	**157**	206

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

11 Taxation

a Analysis of tax expense for the year

	2017 £m	2016 £m
UK corporation tax:		
Current tax on profit for the year	**(753)**	(749)
Adjustments in respect of prior years	**103**	(369)
	(650)	(1,118)
Foreign tax:		
Current tax on profit for the year	**(25)**	(12)
Adjustments in respect of prior years	**6**	13
	(19)	1
Current tax expense	**(669)**	(1,117)
Deferred tax (note 29):		
Current year	**(129)**	(403)
Adjustments in respect of prior years	**(29)**	322
	(158)	(81)
Tax expense	**(827)**	(1,198)

b Factors affecting the tax expense for the year

The UK corporation tax rate for the year was 19.25 per cent (2016: 20 per cent). An explanation of the relationship between tax expense and accounting profit is set out below:

	2017 £m	2016 £m
Profit before tax	**2,921**	3,804
UK corporation tax thereon	**(562)**	(761)
Impact of surcharge on banking profits	**(252)**	(303)
Non-deductible costs: conduct charges	**(126)**	(87)
Other non-deductible costs	**(9)**	(36)
Non-taxable income	**16**	69
Tax-exempt gains on disposals	**13**	18
Recognition of losses that arose in prior years	**–**	11
Remeasurement of deferred tax due to rate changes	**18**	(75)
Differences in overseas tax rates	**(5)**	(1)
Adjustments in respect of prior years	**80**	(34)
Other items	**–**	1
Tax expense on profit on ordinary activities	**(827)**	(1,198)

12 Trading and other financial assets at fair value through profit or loss of the Group

	2017 £m	2016 £m
Trading assets	–	943
Other financial assets at fair value through profit or loss	1,400	1,454
Total	1,400	2,397

These assets are comprised as follows:

	2017		2016	
	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	–	–	943	–
Debt securities: Corporate and other debt securities	–	1,350	–	1,335
Equity shares	–	50	–	119
Total	–	1,400	943	1,454

At 31 December 2017 £1,400 million (2016: £1,454 million) of trading and other financial assets at fair value through profit or loss 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 42.

13 Derivative financial instruments

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

	2017			2016		
	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	849	79	5	1,201	145	20
Currency swaps	47,637	662	726	46,121	1,181	1,063
Options purchased	146	7	–	165	11	–
Options written	169	–	3	208	–	9
	48,801	748	734	47,695	1,337	1,092
Interest rate contracts:						
Interest rate swaps	144,323	6,855	7,333	199,031	7,880	8,726
Forward rate agreements	2,990	–	1	5,159	–	1
Options purchased	2,523	575	9	3,213	747	–
Options written	2,945	15	638	3,839	–	868
Futures	261	–	–	5,959	–	–
	153,042	7,445	7,981	217,201	8,627	9,595
Credit derivatives	266	1	7	712	–	10
Equity and other contracts	370	361	348	276	387	360
Total derivative assets/liabilities held for trading	202,479	8,555	9,070	265,884	10,351	11,057
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	12,004	2,127	56	16,968	2,690	194
Cross currency swaps	–	–	–	11	–	–
	12,004	2,127	56	16,979	2,690	194
Derivatives designated as cash flow hedges:						
Interest rate swaps	24,617	952	1,505	39,525	1,623	1,974
Futures	–	–	–	2,817	–	–
	24,617	952	1,505	42,342	1,623	1,974
Total derivative assets/liabilities held for hedging	36,621	3,079	1,561	59,321	4,313	2,168
Total recognised derivative assets/liabilities	239,100	11,634	10,631	325,205	14,664	13,225

The notional 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 42 Credit risk.

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 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.

13 Derivative financial instruments (continued)

- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place.
- Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

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.

2017	**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	**31**	**52**	**80**	**70**	**68**	**229**	**49**	**5**	**584**
Forecast payable cash flows	**(5)**	**(13)**	**(30)**	**(25)**	**(23)**	**(128)**	**(106)**	**(6)**	**(336)**
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	**44**	**52**	**82**	**72**	**66**	**217**	**46**	**5**	**584**
Forecast payable cash flows	**(11)**	**(16)**	**(33)**	**(24)**	**(24)**	**(126)**	**(97)**	**(5)**	**(336)**

2016	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	32	40	84	89	93	404	163	12	917
Forecast payable cash flows	(4)	(5)	(21)	(19)	(22)	(136)	(126)	(3)	(336)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	45	44	87	92	96	385	157	11	917
Forecast payable cash flows	(8)	(6)	(23)	(21)	(22)	(138)	(115)	(3)	(336)

There were no transactions for which cash flow hedge accounting had to be ceased in 2016 or 2017 as a result of the highly probable cash flows no longer being expected to occur.

At 31 December 2017 £11,296 million of total recognised derivative assets of the Group and £10,247 million of total recognised derivative liabilities of the Group (2016: £13,792 million of assets and £12,665 million of liabilities) had a contractual residual maturity of greater than one year.

	2017			2016		
The Company	**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						
Interest rate swaps	**12**	**3**		12	4	–
Total derivative assets/liabilities held for trading	**12**	**3**	**–**	12	4	–
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**2,688**	**392**		2,803	495	–
Total recognised derivative assets/liabilities, held for hedging	**2,688**	**392**	**–**	2,803	495	–
Total recognised derivative asset/liabilities	**2,700**	**395**	**–**	2,815	499	–

At 31 December 2017 £375 million of total recognised derivative assets of the Company and £nil of total recognised derivative liabilities of the Company (2016: £499 million of assets and £nil of liabilities) had a contractual residual maturity of greater than one year.

Notes to the accounts

14 Loans and advances to customers of the Group

	2017 £m	2016 £m
Agriculture, forestry and fishing	**643**	616
Energy and water supply	**156**	207
Manufacturing	**266**	344
Construction	**1,248**	1,380
Transport, distribution and hotels	**2,868**	2,942
Postal and telecommunications	**272**	242
Property companies	**4,894**	6,534
Financial, business and other services	**2,415**	2,601
Personal:		
Mortgages	**247,117**	245,327
Other	**10,573**	10,667
Lease financing	**198**	342
Hire purchase	**132**	82
Total loans and advances to customers before allowance for impairment losses	**270,782**	271,284
Allowance for impairment losses (note 17)	**(2,125)**	(2,385)
Total loans and advances to customers	**268,657**	268,899

At 31 December 2017 £251,710 million (2016: £253,796 million) of loans and advances to customers had a contractual residual maturity of greater than one year.

For amounts included above which are subject to reverse repurchase agreements see note 42.

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

	2017 £m	2016 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**36**	93
Later than 1 year and not later than 5 years	**94**	169
Later than 5 years	**149**	200
	279	462
Unearned future finance income on finance leases	**(67)**	(110)
Rentals received in advance	**(14)**	(10)
Net investment in finance leases	**198**	342

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

	2017 £m	2016 £m
Not later than 1 year	**16**	66
Later than 1 year and not later than 5 years	**63**	123
Later than 5 years	**119**	153
Net investment in finance leases	**198**	342

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 2016 and 2017 no contingent rentals in respect of finance leases were recognised in the income statement. There was no allowance for uncollectable finance lease receivables included in the allowance for impairment losses for the Group (2016: £nil).

15 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 subsidiary 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 subsidiary, 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 on the notes in issue at 31 December, are listed below. The notes in issue are reported in note 26.

	2017		2016	
	Loans and advances securitised £m	**Notes in issue £m**	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	**20,549**	**13,487**	24,164	15,989
Credit card receivables	**4,303**	**4,090**	4,293	5,723
Dutch residential mortgages	**–**	**–**	2,033	2,081
Commercial loans	**374**	**374**	411	411
	25,226	**17,951**	30,901	24,204
Less held by the Group		**(14,954)**		(18,642)
Total securitisation programmes (note 26)		**2,997**		5,562
Covered bond programmes				
Residential mortgage-backed	**7,525**	**6,240**	8,945	9,189
Social housing loan-backed	**1,628**	**1,200**	2,087	1,200
	9,153	**7,440**	11,032	10,389
Less held by the Group		**(700)**		(700)
Total covered bond programmes (note 26)		**6,740**		9,689
Total securitisation and covered bond programmes		**9,737**		15,251

Cash deposits of £1,712 million (2016: £5,713 million) which support the debt securities issued by the structured entities, the term advances related to covered bonds and other legal obligations are held by the Group. Additionally, the Group had certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2017 these obligations had not been triggered and the maximum exposure under these facilities was £28 million (2016: £292 million).

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

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group are limited to the cashflows 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 2017 (2016: none). Such repurchases are made in order to ensure that the expected maturity dates of the notes issued from these programmes are met.

16 Structured entities

The Group's interests in structured entities are consolidated. Details of the Group's interests in consolidated structured entities are set out in note 15 for securitisations and covered bonds.

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17 Allowance for impairment losses on loans and receivables of the Group

Critical accounting estimates and judgments
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. In determining the required level of impairment provisions, the Group uses the output from various statistical models. Management judgement is required to assess the robustness of the outputs from these models and, where necessary, make appropriate adjustments. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's commercial lending portfolios. Assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watchlist 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 could 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. 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. 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. For these portfolios, 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. 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. 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.

The value of collateral supporting the Group's UK mortgage portfolio is estimated by applying changes in the house price indices to the original assessed value of the property. Given the relative size of the portfolio, this is a key variable in determining the Group's impairment charge for loans and receivables. If average house prices were ten per cent lower than those estimated at 31 December 2017, the impairment charge would increase by approximately £180 million in respect of UK mortgages.

In addition, the collective provision also includes provision for inherent losses, that is losses that have been incurred but have not been separately identified 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 assets being impaired at the balance sheet date and being identified subsequently; the length of time taken to identify that an impairment event has occurred is known as the loss emergence period. 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. This provision is sensitive to changes in the loss emergence period. Management use a significant level of judgement when determining the collective unidentified impairment provision, including the assessment of the level of overall risk existing within particular sectors and the impact of the low interest rate environment on loss emergence periods. In the Commercial Banking division, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unidentified impairment provisions would result in an increase in the collective unidentified impairment provision of approximately £7 million (2016: £6 million).

17 Allowance for impairment losses on loans and receivables of the Group (continued)

	2017			2016		
	Loans and advances to customers £m	**Debt securities £m**	**Total £m**	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January	**2,385**	**91**	**2,476**	2,810	113	2,923
Exchange and other adjustments	**3**	**(30)**	**(27)**	23	–	23
Advances written off	**(714)**	**(44)**	**(758)**	(1,154)	(23)	(1,177)
Recoveries of advances written off in previous years	**276**	**–**	**276**	479	1	480
Unwinding of discount	**11**	**–**	**11**	11	–	11
Charge to the income statement (note 10)	**164**	**(6)**	**158**	216	–	216
At 31 December	**2,125**	**11**	**2,136**	2,385	91	2,476

Of the Group's total allowance in respect of loans and advances to customers, £1,397 million (2016: £1,609 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, £1,700 million (2016: £1,749 million) was assessed on a collective basis.

18 Available-for-sale financial assets

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Debt securities:				
Government securities	**116**	116	**–**	–
Mortgage-backed securities	**–**	13	**–**	–
Corporate and other debt securities	**786**	2,424	**–**	–
	902	2,553	**–**	–
Equity shares	**35**	481	**7**	4
Total available-for-sale financial assets	**937**	3,034	**7**	4

At 31 December 2017 £663 million (2016: £2,668 million) of available-for-sale financial assets of the Group had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 42.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2h(2).

19 Investment in subsidiary undertakings of the Company

	2017 £m	2016 £m
At 1 January	**22,289**	22,206
Additional capital injections and transfers	**105**	83
At 31 December	**22,394**	22,289

Details of the subsidiaries and related undertakings are given on pages 100 to 102 and are incorporated by reference.

Certain subsidiary companies currently have insufficient distributable reserves to make dividend payments, however, there were no further significant restrictions on any of the Company's subsidiaries in paying dividends or repaying loans and advances. All regulated subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

20 Goodwill

	2017 £m	2016 £m
At 1 January and 31 December	**325**	325
Cost[1]	**1,838**	1,838
Accumulated impairment losses	**(1,513)**	(1,513)
At 31 December	**325**	325

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. This compares the estimated recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; the entire balance of £325 million (2016: £325 million) has been allocated to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2017 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 10 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.

21 Other intangible assets of the Group

	Purchased credit card relationships £m	Brands £m	Capitalised software enhancements £m	Total £m
Cost:				
At 1 January 2016	15	10	169	194
Additions	–	–	27	27
At 31 December 2016	15	10	196	221
Additions	**–**	**–**	**47**	**47**
Disposals	**–**	**–**	**(15)**	**(15)**
At 31 December 2017	**15**	**10**	**228**	**253**
Accumulated amortisation:				
At 1 January 2016	8	10	74	92
Charge for the year (note 9)	3	–	26	29
At 31 December 2016	11	10	100	121
Charge for the year (note 9)	**3**	**–**	**30**	**33**
Disposals	**–**	**–**	**(13)**	**(13)**
At 31 December 2017	**14**	**10**	**117**	**141**
Balance sheet amount at 31 December 2017	**1**	**–**	**111**	**112**
Balance sheet amount at 31 December 2016	4	–	96	100

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

22 Property, plant and equipment

	Investment properties £m	Premises £m	Equipment £m	Operating lease assets £m	Total £m
Cost or valuation:					
At 1 January 2016	111	1,415	1,749	256	3,531
Exchange and other adjustments	–	2	2	17	21
Additions	–	26	55	4	85
Expenditure on investment properties	19	–	–	–	19
Change in fair value of investment properties (note 7)	2	–	–	–	2
Disposals	(29)	(46)	(23)	–	(98)
At 31 December 2016	103	1,397	1,783	277	3,560
Exchange and other adjustments	**(9)**	**(1)**	**–**	**16**	**6**
Additions	**–**	**24**	**23**	**–**	**47**
Expenditure on investment properties	**23**	**–**	**–**	**–**	**23**
Change in fair value of investment properties (note 7)	**–**	**–**	**–**	**–**	**–**
Disposals	**(68)**	**(546)**	**(1,147)**	**(284)**	**(2,045)**
At 31 December 2017	**49**	**874**	**659**	**9**	**1,591**
Accumulated depreciation and impairment:					
At 1 January 2016	–	902	1,299	138	2,339
Exchange and other adjustments	–	1	(5)	16	12
Depreciation charge for the year (note 9)	–	59	82	2	143
Disposals	–	(17)	(23)	–	(40)
At 31 December 2016	–	945	1,353	156	2,454
Exchange and other adjustments	**–**	**–**	**–**	**12**	**12**
Depreciation charge for the year (note 9)	**–**	**54**	**82**	**1**	**137**
Disposals	**–**	**(531)**	**(1,137)**	**(167)**	**(1,835)**
At 31 December 2017	**–**	**468**	**298**	**2**	**768**
Balance sheet amount at 31 December 2017	**49**	**406**	**361**	**7**	**823**
Balance sheet amount at 31 December 2016	103	452	430	121	1,106

The table above analyses movements in investment properties, all of which are categorised as level 3. See note 39 for details of levels in the fair value hierarchy.

Rental income of £1 million (2016: £3 million) and direct operating expenses arising from properties that generate rental income of £nil (2016: £nil) have been recognised in the income statement.

There was no capital expenditure in respect of investment properties which had been contracted for but not recognised in the financial statements (2016: £nil).

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

	2017 £m	2016 £m
Receivable within 1 year	**–**	8
1 to 5 years	**–**	9
Total future minimum rentals receivable	**–**	17

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2016 and 2017 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £24 million at 31 December 2017 (2016: £27 million) is expected to be received under non-cancellable sub-leases of the Group's premises.

Notes to the accounts

23 Other assets of the Group

	2017 £m	2016 £m
Settlement balances	**38**	117
Investments in joint ventures and associates	**7**	33
Other assets and prepayments	**324**	288
Total other assets	**369**	438

24 Customer deposits of the Group

	2017 £m	2016 £m
Non-interest bearing current accounts	**19,473**	18,139
Interest bearing current accounts	**27,442**	29,407
Savings and investment accounts	**112,570**	117,016
Other customer deposits	**11,713**	14,755
Total customer deposits	**171,198**	179,317

At 31 December 2017 £10,222 million (2016: £17,061 million) of customer deposits of the Group had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 42.

25 Trading and other financial liabilities at fair value through profit or loss of the Group

	2017 £m	2016 £m
Trading liabilities:		
Liabilities in respect of securities sold under repurchase agreements	**–**	943
Other deposits	**50**	–
Total trading liabilities	**50**	943
Other financial liabilities at fair value through profit or loss	**–**	2
Trading and other financial liabilities at fair value through profit or loss	**50**	945

At 31 December 2017 £50 million (2016: £nil) of trading and other financial liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 42.

For the fair value of collateral pledged in respect of repurchase agreements see note 42.

26 Debt securities in issue of the Group

	2017 £m	2016 £m
Medium-term notes issued	**1,182**	1,377
Covered bonds (note 15)	**6,740**	9,689
Securitisation notes (note 15)	**2,997**	5,562
	10,919	16,628
Amounts due to fellow Group undertakings	**–**	51
Total debt securities in issue	**10,919**	16,679

At 31 December 2017 £9,883 million (2016: £11,672 million) of debt securities in issue had a contractual residual maturity of greater than one year.

27 Other liabilities

	The Group		**The Company**	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Settlement balances	**19**	101	**–**	–
Other creditors and accruals	**266**	684	**243**	509
	285	785	**243**	509

28 Retirement benefit obligations

	The Group	
	2017 £m	2016 £m
Charge to the Group income statement		
Defined benefit pension schemes	**165**	123
Other post-retirement benefit schemes	**4**	5
Total defined benefit schemes	**169**	128
Defined contribution pension schemes	**96**	97
Total charge to the income statement	**265**	225

	The Group		**The Company**	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Amounts recognised in the balance sheet				
Retirement benefit assets	**69**	86	**69**	86
Retirement benefit obligations	**(135)**	(250)	**(130)**	(220)
Total amounts recognised in the balance sheet	**(66)**	(164)	**(61)**	(134)

The total amount recognised in the balance sheet relates to:

	The Group		**The Company**	
Pension schemes	**2017 £m**	2016 £m	**2017 £m**	2016 £m
Defined benefit pension schemes	**(25)**	(49)	**(20)**	(19)
Other post-retirement benefit schemes	**(41)**	(115)	**(41)**	(115)
Total amounts recognised in the balance sheet	**(66)**	(164)	**(61)**	(134)

28 Retirement benefit obligations (continued)

Pension schemes

Defined benefit schemes

Critical accounting estimates and judgments

The accounting valuation of the Group's defined benefit pension schemes' liabilities requires management to make a number of assumptions. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The discount rate is required to be set with reference to market yields at the end of the reporting period on high quality corporate bonds in the currency and with a term consistent with the defined benefit pension schemes' obligations. The average duration of the schemes' obligations is approximately 21 years. The market for bonds with a similar duration is illiquid and, as a result, significant management judgement is required to determine an appropriate yield curve on which to base the discount rate. The cost of the benefits payable by the schemes will also depend upon the life expectancy of the members. The Group considers latest market practice and actual experience in determining the appropriate assumptions for both current mortality expectations and the rate of future mortality improvement. It is uncertain whether this rate of improvement will be sustained going forward and, as a result, actual experience may differ from current expectations. The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in (iii) below.

(i) Characteristics of and risks associated with the Group's schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas. All significant schemes are based in the UK, with the most significant being the defined benefit sections of the HBOS Final Salary Pension Scheme. At 31 December 2017, this scheme represented 95 per cent of the Group's total gross defined benefit pension assets (2016: 94 per cent). These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2017 is generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The Group operates a number of funded and unfunded pension arrangements, the majority, including the most significant scheme, are funded schemes in the UK. All these schemes are operated as separate legal entities under trust law by the trustees and are in compliance with the Pensions Act 2004. The responsibility for the governance of the Group's funded defined benefit pension schemes lies with the Pension Trustees. All of the Group's funded UK defined benefit pension schemes are managed by a Trustee Board (the Trustee) whose role is to ensure that their Scheme is administered in accordance with the Scheme rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the funding valuation process. The Board of Trustees must be composed of representatives of the Company and plan participants in accordance with the Scheme's regulations.

A valuation to determine the funding status of each scheme is carried out at least every three years, whereby scheme assets are measured at market value and liabilities (technical provisions) are measured using prudent assumptions. If a deficit is identified a recovery plan is agreed between the Group and the scheme Trustee and sent to the Pensions Regulator for review. The Group has not provided for these deficit contributions as the future economic benefits arising from these contributions are expected to be available to the Group. The Group's overseas defined benefit pension schemes are subject to local regulatory arrangements.

The most recent triennial funding valuation of the Group's main scheme, based on the position as at 31 December 2016, is substantially complete and the terms have been agreed in principle with the trustees. The valuation shows an aggregate funding deficit of £2.7 billion (a funding level of 84.6 per cent) compared to a £1.4 billion deficit (a funding level of 88.5 per cent) for the previous valuation as at 30 June 2014. In the light of this funding deficit, the Group has agreed in principle a recovery plan with the trustees. Under the plan, deficit contributions of £109 million are payable during 2018, rising to £235 million in 2019, £314 million in 2020, and £508 million per annum from 2021 to 2024. Contributions in the later years will be subject to review and renegotiation at subsequent funding valuations. The next funding valuation is due to be completed by March 2021 with an effective date of 31 December 2019. The deficit contributions are in addition to the regular contributions to meet benefits accruing over the year. The Group currently expects to pay contributions of approximately £250 million to its defined benefit schemes in 2018.

The Group has also established a private limited company which hold assets to provide security for the Group's obligations to the HBOS Final Salary Pension Scheme. At 31 December 2017 this company held assets of approximately £2.6 billion in aggregate. The private limited companies are consolidated fully in the Group's balance sheet. The terms of these arrangements require the Group to maintain assets in these vehicles to agreed minimum values in order to secure obligations owed to the relevant Group pension schemes. The Group has satisfied this requirement during 2017.

The last funding valuations of other Group schemes were carried out on a number of different dates. In order to report the position under IAS 19 as at 31 December 2017 the most recent valuation results for all schemes have been updated by qualified independent actuaries. The main differences between the funding and IAS 19 valuations are the different and more prudent approach to setting the discount rate and more conservative longevity assumptions used in the funding valuations.

28 Retirement benefit obligations (continued)

(ii) Amounts in the financial statements

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Amounts included in the balance sheet				
Present value of funded obligations	**(15,330)**	(15,548)	**(15,051)**	(15,241)
Fair value of scheme assets	**15,305**	15,499	**15,031**	15,222
Net amount recognised in the balance sheet	**(25)**	(49)	**(20)**	(19)

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Net amount recognised in the balance sheet				
At 1 January	**(49)**	579	**(19)**	598
Net defined benefit pension expense	**(165)**	(123)	**(165)**	(120)
Actuarial losses on defined benefit obligation	**(340)**	(3,191)	**(346)**	(3,156)
Return on plan assets	**384**	2,514	**381**	2,503
Employer contributions	**144**	175	**129**	157
Exchange and other adjustments	**1**	(3)	**–**	(1)
At 31 December	**(25)**	(49)	**(20)**	(19)

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Movements in the defined benefit obligation				
At 1 January	**(15,548)**	(12,275)	**(15,241)**	(12,046)
Current service cost	**(137)**	(116)	**(137)**	(115)
Interest expense	**(420)**	(465)	**(414)**	(458)
Remeasurements:				
Actuarial gains – experience	**20**	156	**18**	153
Actuarial gains – demographic assumptions	**143**	70	**143**	73
Actuarial losses – financial assumptions	**(503)**	(3,417)	**(507)**	(3,382)
Benefits paid	**1,097**	544	**1,084**	537
Past service cost	**(9)**	(16)	**(9)**	(14)
Settlements	**16**	12	**16**	12
Curtailments	**(4)**	–	**(4)**	–
Exchange and other adjustments	**15**	(41)	**–**	(1)
At 31 December	**(15,330)**	(15,548)	**(15,051)**	(15,241)

28 Retirement benefit obligations (continued)

	The Group 2017 £m	The Group 2016 £m	The Company 2017 £m	The Company 2016 £m
Changes in the fair value of scheme assets				
At 1 January	**15,499**	12,854	**15,222**	12,644
Return on plan assets excluding amounts included in interest income	**384**	2,514	**381**	2,503
Interest income	**421**	490	**415**	483
Employer contributions	**144**	175	**129**	157
Benefits paid	**(1,097)**	(544)	**(1,084)**	(537)
Settlements	**(18)**	(18)	**(18)**	(18)
Administrative costs paid	**(14)**	(10)	**(14)**	(10)
Exchange and other adjustments	**(14)**	38	**–**	–
At 31 December	**15,305**	15,499	**15,031**	15,222

Composition of scheme assets:

The Group	2017 Quoted £m	2017 Unquoted £m	2017 Total £m	2016 Quoted £m	2016 Unquoted £m	2016 Total £m
Equity instruments	**391**	**1**	**392**	702	–	702
Debt instruments[1]:						
Fixed interest government bonds	**4,764**	**–**	**4,764**	4,881	–	4,881
Index-linked government bonds	**5,742**	**–**	**5,742**	3,256	–	3,256
Corporate and other debt securities	**1,969**	**–**	**1,969**	2,950	–	2,950
Asset-backed securities	**121**	**–**	**121**	100	–	100
	12,596	**–**	**12,596**	11,187	–	11,187
Property	**–**	**544**	**544**	–	484	484
Pooled investment vehicles	**2,234**	**2,950**	**5,184**	644	2,619	3,263
Money market instruments, derivatives, cash and other assets and liabilities	**940**	**(4,351)**	**(3,411)**	1,133	(1,270)	(137)
At 31 December	**16,161**	**(856)**	**15,305**	13,666	1,833	15,499

[1] Of the total debt instruments, £12,002 million (31 December 2016: £10,228 million) were investment grade (credit ratings equal to or better than 'BBB').

Company	2017 Quoted £m	2017 Unquoted £m	2017 Total £m	2016 Quoted £m	2016 Unquoted £m	2016 Total £m
Equity instruments	**347**	**1**	**348**	649	–	649
Debt instruments[1]:						
Fixed interest government bonds	**4,764**	**–**	**4,764**	4,881	–	4,881
Index-linked government bonds	**5,742**	**–**	**5,742**	3,256	–	3,256
Corporate and other debt securities	**1,969**	**–**	**1,969**	2,937	–	2,937
	12,475	**–**	**12,475**	11,074	–	11,074
Property	**–**	**537**	**537**	–	478	478
Pooled investment vehicles	**2,167**	**2,950**	**5,117**	580	2,619	3,199
Money market instruments, derivatives, cash and other assets and liabilities	**905**	**(4,351)**	**(3,446)**	1,092	(1,270)	(178)
At 31 December	**15,894**	**(863)**	**15,031**	13,395	1,827	15,222

[1] Of the total debt instruments, £12,002 million (31 December 2016: £10,228 million) were investment grade (credit ratings equal to or better than 'BBB').

The assets of all the funded plans are held independently of the Group's assets in separate trustee administered funds.

28 Retirement benefit obligations (continued)

The pension schemes' pooled investment vehicles comprise:

	The Group		The Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Equity funds	**465**	166	**465**	166
Hedge and mutual funds	**1,050**	1,173	**983**	1,109
Liquidity funds	**1,283**	469	**1,283**	469
Bond and debt funds	**640**	65	**640**	65
Other	**1,746**	1,390	**1,746**	1,390
At 31 December	**5,184**	3,263	**5,117**	3,199

The expense recognised in the income statement for the year ended 31 December comprises:

	The Group	
	2017 £m	2016 £m
Current service cost	**137**	116
Net interest amount	**(1)**	(25)
Past service credits and curtailments	**4**	–
Settlements	**2**	6
Past service cost – plan amendments	**9**	16
Plan administration costs incurred during the year	**14**	10
Total defined benefit pension expense	**165**	123

Assumptions

The principal actuarial and financial assumptions used in valuations of the defined benefit pension schemes were as follows:

	2017 %	2016 %
Discount rate	**2.59**	2.76
Rate of inflation:		
Retail Prices Index	**3.20**	3.23
Consumer Price Index	**2.15**	2.18
Rate of salary increases	**0.00**	0.00
Weighted-average rate of increase for pensions in payment	**2.93**	2.74
	2017 Years	2016 Years
Life expectancy for member aged 60, on the valuation date:		
Men	**27.9**	27.7
Women	**29.5**	28.8
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**28.9**	28.9
Women	**30.7**	30.2

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 at 31 December 2017 is assumed to live for, on average, 27.9 years for a male and 29.5 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

28 Retirement benefit obligations (continued)

(iii) Amount, timing and uncertainty of future cash flows

Risk exposure of the defined benefit schemes
Whilst the Group is not exposed to any unusual, entity specific or scheme specific risks in its defined benefit pension schemes, it is exposed to a number of significant risks, detailed below:

Inflation rate risk: the majority of the plans' benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings.

Longevity risk: The majority of the schemes obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: Scheme assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the pension expense in the Group's income statement.

The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

Sensitivity analysis
The effect of reasonably possible changes in key assumptions on the value of scheme liabilities and the resulting pension charge in the Group's income statement and on the net defined benefit pension scheme liability, for the Group's most significant scheme, is set out below. The sensitivities provided assume that all other assumptions and the value of the schemes' assets remain unchanged, and are not intended to represent changes that are at the extremes of possibility. The calculations are approximate in nature and full detailed calculations could lead to a different result. It is unlikely that isolated changes to individual assumptions will be experienced in practice. Due to the correlation of assumptions, aggregating the effects of these isolated changes may not be a reasonable estimate of the actual effect of simultaneous changes in multiple assumptions.

	Effect of reasonably possible alternative assumptions			
	Increase (decrease) in the income statement charge		**Increase (decrease) in the net defined benefit pension scheme liability**	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Inflation (including pension increases):[1]				
Increase of 0.1 per cent	**7**	7	**167**	180
Decrease of 0.1 per cent	**(5)**	(7)	**(159)**	(172)
Discount rate:[2]				
Increase of 0.1 per cent	**(11)**	(12)	**(291)**	(310)
Decrease of 0.1 per cent	**10**	12	**290**	321
Expected life expectancy of members:				
Increase of one year	**17**	15	**487**	423
Decrease of one year	**(15)**	(14)	**(471)**	(410)

[1] At 31 December 2017, the assumed rate of RPI inflation is 3.20 per cent and CPI inflation 2.15 per cent (2016: RPI 3.23 per cent and CPI 2.18 per cent).

[2] At 31 December 2017, the assumed discount rate is 2.59 per cent (2016: 2.76 per cent).

Sensitivity analysis method and assumptions
The sensitivity analysis above reflects the impact on the Group's most significant scheme which accounts for over 90 per cent of the Group's defined benefit obligations. Whilst differences in the underlying liability profiles for the remainder of the Group's pension arrangements mean they may exhibit slightly different sensitivities to variations in these assumptions, the sensitivities provided above are indicative of the impact across the Group as a whole.

The inflation assumption sensitivity applies to both the assumed rate of increase in the Consumer Prices Index (CPI) and the Retail Prices Index (RPI), and include the impact on the rate of increases to pensions, both before and after retirement. These pension increases are linked to inflation (either CPI or RPI) subject to certain minimum and maximum limits.

The sensitivity analysis (including the inflation sensitivity) does not include the impact of any change in the rate of salary increases as pensionable salaries have been frozen since 2 April 2014.

The life expectancy assumption has been applied by allowing for an increase/decrease in life expectation from age 60 of one year, based upon the approximate weighted average age for each scheme. Whilst this is an approximate approach and will not give the same result as a one year increase in life expectancy at every age, it provides an appropriate indication of the potential impact on the schemes from changes in life expectancy.

There was no change in the methods and assumptions used in preparing the sensitivity analysis from the prior year.

28 Retirement benefit obligations (continued)

Asset-liability matching strategies
The main scheme's assets are invested in a diversified portfolio, consisting primarily of debt securities. The investment strategy is not static and will evolve to reflect the structure of liabilities within the schemes. Specific asset-liability matching strategies for each pension plan are independently determined by the responsible governance body for each scheme and in consultation with the employer.

A significant goal of the asset-liability matching strategies adopted by Group schemes is to reduce volatility caused by changes in market expectations of interest rates and inflation. In the main scheme, this is achieved by investing scheme assets in bonds, primarily fixed interest gilts and index linked gilts, and by entering into interest rate and inflation swap arrangements. These investments are structured to take into account the profile of scheme liabilities, and actively managed to reflect both changing market conditions and changes to the liability profile.

At 31 December 2017 the asset-liability matching strategy mitigated 97 per cent of the liability sensitivity to interest rate movements and 105 per cent of the liability sensitivity to inflation movements. Much of the residual interest rate sensitivity is mitigated through holdings of corporate and other debt securities.

Maturity profile of defined benefit obligation
The following table provides information on the weighted average duration of the defined benefit pension obligations and the distribution and timing of benefit payments:

	The Group		The Company	
	2017 Years	2016 Years	**2017 Years**	2016 Years
Duration of the defined benefit obligation	**21**	22	**21**	22

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Maturity analysis of benefits expected to be paid				
Benefits expected to be paid within 12 months	**332**	563	**326**	557
Benefits expected to be paid between 1 and 2 years	**342**	321	**335**	315
Benefits expected to be paid between 2 and 5 years	**1,147**	1,102	**1,124**	1,080
Benefits expected to be paid between 5 and 10 years	**2,396**	2,354	**2,351**	2,309
Benefits expected to be paid between 10 and 15 years	**2,982**	2,971	**2,927**	2,918
Benefits expected to be paid between 15 and 25 years	**6,753**	7,007	**6,636**	6,879
Benefits expected to be paid between 25 and 35 years	**6,393**	6,966	**6,289**	6,844
Benefits expected to be paid between 35 and 45 years	**4,693**	5,399	**4,632**	5,321
Benefits expected to be paid in more than 45 years	**2,564**	3,462	**2,538**	3,423

Defined contribution schemes
The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow.

During the year ended 31 December 2017 the charge to the income statement in respect of defined contribution schemes was £96 million (2016: £97 million, representing the contributions payable by the employer in accordance with each scheme's rules.

Other post-retirement benefit schemes
The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 31 December 2017 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 6.81 per cent (2016: 6.84 per cent).

Movements in the other post-retirement benefit obligation:

	The Group and Company	
	2017 £m	2016 £m
At 1 January	**(115)**	(92)
Actuarial gain (loss)	**77**	(20)
Insurance premiums paid	**2**	2
Charge for the year	**(4)**	(5)
Exchange and other adjustments	**(1)**	–
At 31 December	**(41)**	(115)

29 Deferred tax

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

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Statutory position				
Deferred tax assets	**1,878**	1,998	**–**	–
Deferred tax liabilities	**–**	–	**(18)**	(11)
Net deferred tax asset	**1,878**	1,998	**(18)**	(11)
Tax disclosure				
Deferred tax assets	**1,915**	2,048	**11**	10
Deferred tax liabilities	**(37)**	(50)	**(29)**	(21)
Net deferred tax asset	**1,878**	1,998	**(18)**	(11)

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 tables below which split the deferred tax assets and liabilities by type.

The UK corporation tax rate will reduce from 19 per cent to 17 per cent on 1 April 2020. The Group measures its deferred tax assets and liabilities at the value expected to be recoverable or payable in future periods, and re-measures them at each reporting date based on the most recent estimates of utilisation or settlement, including the impact of bank surcharge where appropriate. The deferred tax impact of this re-measurement in 2017 is a credit of £18 million in the income statement and a credit of £5 million in other comprehensive income.

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

The Group Deferred tax assets	Tax losses £m	Property, plant and equipment £m	Pension liabilities £m	Provisions £m	Share-based payments £m	Derivatives £m	Available-for-sale asset revaluation £m	Other temporary differences £m	Total £m
At 1 January 2016	1,661	261	42	–	–	–	–	220	2,184
(Charge) credit to the income statement	6	16	(550)	37	–	–	–	(211)	(702)
Credit to other comprehensive income	–	–	566	–	–	–	–	–	566
At 31 December 2016	1,667	277	58	37	–	–	–	9	2,048
Credit to the income statement	**(86)**	**(44)**	**(47)**	**(28)**	**10**	**1**	**(11)**	**1**	**(204)**
Credit to other comprehensive income	**–**	**–**	**42**	**–**	**–**	**12**	**17**	**–**	**71**
At 31 December 2017	**1,581**	**233**	**53**	**9**	**10**	**13**	**6**	**10**	**1,915**

Deferred tax liabilities	Pension assets £m	Derivatives £m	Available-for-sale asset revaluation £m	Other temporary differences £m	Total £m
At 1 January 2016	(134)	(50)	(9)	(50)	(243)
(Charge) credit to the income statement	549	9	30	33	621
(Charge) credit to other comprehensive income	(434)	30	(26)	–	(430)
Exchange and other adjustments	3	–	–	(1)	2
At 31 December 2016	(16)	(11)	(5)	(18)	(50)
Credit to the income statement	**54**	**–**	**–**	**6**	**60**
(Charge) credit to other comprehensive income	**(63)**	**11**	**5**	**–**	**(47)**
At 31 December 2017	**(25)**	**–**	**–**	**(12)**	**(37)**

29 Deferred tax (continued)

The Company **Deferred tax assets**	Pension liabilities £m	Other temporary differences £m	Total £m
At 1 January 2016	–	–	–
Charge to the income statement	(544)	–	(544)
Credit to other comprehensive income	554	–	554
At 31 December 2016	10	–	10
Charge to the income statement	**(49)**	**–**	**(49)**
Credit to other comprehensive income	**50**	**–**	**50**
At 31 December 2017	**11**	**–**	**11**

Deferred tax liabilities	Pension assets £m	Other temporary differences £m	Total £m
At 1 January 2016	(138)	–	(138)
(Charge) credit to the income statement	543	–	543
(Charge) credit to other comprehensive income	(426)	–	(426)
At 31 December 2016	(21)	–	(21)
Credit to the income statement	**57**	**–**	**57**
Charge to other comprehensive income	**(65)**	**–**	**(65)**
At 31 December 2017	**(29)**	**–**	**(29)**

Critical accounting estimates and judgments
Estimation of income taxes includes the assessment of recoverability of deferred tax assets. Deferred tax assets are only recognised to the extent they are considered more likely than not to be recoverable based on existing tax laws and forecasts of future taxable profits against which the underlying tax deductions can be utilised.

The Group has recognised a deferred tax asset of £1,581 million (2016: £1,667 million) and the Company £nil (2016: £nil) in respect of UK trading losses carried forward. Substantially all of these losses have arisen in Bank of Scotland plc and they will be utilised as taxable profits arise in those legal entities in future periods.

The Group's expectations as to the level of future taxable profits take into account the Group's long-term financial and strategic plans, and anticipated future tax-adjusting items. In making this assessment, account is taken of business plans as well as the risks associated with future regulatory change.

Under current law there is no expiry date for UK trading losses not yet utilised, although (since Finance Act 2016) banking losses that arose before 1 April 2015 can only be used against 25 per cent of taxable profits arising after 1 April 2016, and they cannot be used to reduce the surcharge on banking profits. This restriction in utilisation means that the value of the deferred tax asset is only expected to be fully recovered by 2028.

Deferred tax not recognised
No deferred tax has been recognised in respect of foreign trade losses where it is not more likely than not that we will be able to utilise them in future periods. Of the asset not recognised, £34 million for the Group and £nil for the Company (2016: £62 million for the Group and £nil for the Company) relates to losses that will expire if not used within 20 years, and £45 million for the Group and £nil for the Company (2016: £43 million for the Group and £nil for the Company) relates to losses with no expiry date.

In addition, no deferred tax asset is recognised in respect of unrelieved foreign tax credits of £40 million (2016: £39 million) for the Group and £nil (2016: £nil) for the Company, as there are no expected future taxable profits against which the credits can be utilised. These credits can be carried forward indefinitely.

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

30 Other provisions

Critical accounting estimates and judgments
At 31 December 2017, the Group carried provisions of £1,754 million (2016: £1,689 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches, principally the mis-selling of payment protection insurance (2017: £947 million; 2016: £930 million).

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 scope of reviews required by regulators, the number of future complaints, the extent to which they will be upheld, the average cost of redress and the impact of legal decisions that may be relevant to claims received. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

More detail on the nature of the assumptions that have been made and key sensitivities is set out below.

30 Other provisions (continued)

	Provisions for commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2017	35	930	759	122	1,846
Exchange and other adjustments	(25)	–	(18)	94	51
Provisions applied	–	(469)	(374)	(5)	(848)
(Release) charge for the year	(7)	486	440	51	970
At 31 December 2017	3	947	807	262	2,019

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
The Group increased the provision for PPI costs by a further £486 million in 2017, of which £270 million was in the fourth quarter, bringing the total amount provided to £5,273 million.

The charge to the provision in 2017 was largely driven by a higher volume of complaints received due to increased claims management company (CMC) marketing activity and the Financial Conduct Authority (FCA) marketing campaign.

At 31 December 2017 a provision of £947 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £469 million during the year to 31 December 2017.

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

Key sensitivities are as follows[1]:

– the number of customer initiated complaints received: an increase of 50,000 from the level assumed would increase the provision by £105 million;

[1] All sensitivities are influenced by a proportion of complaints falling under the 'Plevin' rules and guidance in the FCA's Policy Statement 17/3.

Other provisions for 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 in connection with its past conduct and claims brought by or on behalf of current and former employees, customers, investors and other third parties and is subject to legal proceedings and other legal actions. Where significant, provisions are held against the costs expected to be incurred in relation to these matters and matters arising from related internal reviews. During the year ended 31 December 2017 the Group charged a further £440 million in respect of legal actions and other regulatory matters, the unutilised balance at 31 December 2017 was £807 million (31 December 2016: £759 million). The most significant items are as follows.

Arrears handling related activities
The Group has provided an additional £122 million (bringing the total provided to date to £400 million), for the costs of identifying and rectifying certain arrears management fees and activities. Following a review of the Group's arrears handling activities, the Lloyds Banking Group has put in place a number of actions to improve further its handling of customers in these areas and the Group has made good progress in reimbursing mortgage arrears fees to the impacted customers.

Packaged bank accounts
In 2017 the Group provided an additional £100 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £191 million. A number of risks and uncertainties remain in particular with respect to future volumes.

HBOS Reading – customer review
The Group is undertaking a review into a number of customer cases from the former HBOS Impaired Assets Office based in Reading. This review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Lloyds Banking Group in 2009. The Group has provided £100 million in the year to 31 December 2017 and is in the process of paying compensation to the victims of the fraud for economic losses as well as ex-gratia payments and awards for distress and inconvenience. The review is ongoing and at 12 February 2018, the Group had made offers to 57 customers, which represents more than 80 per cent of the customers in review.

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 five years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure. At 31 December 2017 provisions of £9 million (31 December 2016: £10 million) were held.

Other provisions also include those arising in the normal course of business, whether from certain customer rectifications or provisions for dilapidation and refurbishment of properties.

31 Subordinated liabilities

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

The Group	Preference shares[1] £m	Preferred securities £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2016	–	2,639	380	5,285	8,304
Repurchases and redemptions during the year[2]:					
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019	–	–	(4)	–	(4)
7.286% Perpetual Regulatory Tier One Securities	–	(150)	–	–	(150)
7.5% Undated Subordinated Step-up Notes	–	–	(5)	–	(5)
Floating Rate Primary Capital Notes	–	–	(108)	–	(108)
4.25% Subordinated Undated Instruments	–	–	(102)	–	(102)
Callable Floating Rate Subordinated Notes 2016 (callable March 2016)	–	–	–	(186)	(186)
Callable Floating Rate Subordinated Notes 2016 (callable September 2016)	–	–	–	(144)	(144)
Subordinated Callable Notes 2016	–	–	–	(382)	(382)
4.939% Non-voting Non-cumulative Perpetual Preferred Securities	–	(32)	–	–	(32)
	–	(182)	(219)	(712)	(1,113)
Exchange and other adjustments	–	212	20	726	958
At 31 December 2016	–	2,669	181	5,299	8,149
Repurchases and redemptions during the year[2]:					
Fixed to floating rate subordinated extendable maturity notes	–	–	–	(361)	(361)
Subordinated callable notes 2017	–	–	–	(771)	(771)
	–	–	–	(1,132)	(1,132)
Exchange and other adjustments	–	(455)	(3)	61	(397)
At 31 December 2017	**–**	**2,214**	**178**	**4,228**	**6,620**

[1] Since 2009, the Company has had in issue 100 6% non-cumulative preference shares of £1 each and the Company's subsidiary, Bank of Scotland plc, has had in issue 400 6% non-cumulative preference shares of 25p each.

[2] The repurchases and redemptions in the year resulted in cash outflows of £1,132 million (2016: £1,113 million).

31 Subordinated liabilities (continued)

The Company	Preference shares[1] £m	Preferred securities £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2016	–	87	1,335	4,536	5,958
Repurchases and redemptions during the year[2]:					
7.5% Undated Subordinated Step-up Notes	–	–	(5)	–	(5)
Callable Floating Rate Subordinated Notes 2016 (callable March 2016)	–	–	–	(186)	(186)
Callable Floating Rate Subordinated Notes 2016 (callable September 2016)	–	–	–	(144)	(144)
Subordinated Callable Notes 2016	–	–	–	(382)	(382)
4.939% Non-voting Non-cumulative Perpetual Preferred Securities	–	(29)	–	–	(29)
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019	–	–	(4)	–	(4)
	–	(29)	(9)	(712)	(750)
Exchange and other adjustments	–	53	108	763	924
At 31 December 2016	–	111	1,434	4,587	6,132
Repurchases and redemptions during the year[2]:					
Fixed to floating rate subordinated extendable maturity notes	–	–	–	(361)	(361)
Subordinated callable notes 2017	–	–	–	(771)	(771)
	–	–	–	(1,132)	(1,132)
Exchange and other adjustments	–	(16)	(73)	(219)	(308)
At 31 December 2017	**–**	**95**	**1,361**	**3,236**	**4,692**

[1] Since 2009, the Company has had in issue 100 6% non-cumulative preference shares of £1 each.

[2] The repurchases and redemptions in the year resulted in cash outflows of £1,132 million (2016: £750 million).

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 Company has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2016: none).

32 Share capital

(1) Authorised share capital

	Group and Company			
	2017 Number of shares	2016 Number of shares	**2017 £m**	2016 £m
Sterling				
Ordinary shares of 25p	**15,139,999,999**	15,139,999,999	**3,785**	3,785
6.125% non-cumulative redeemable preference shares of £1	**200,000,000**	200,000,000	**200**	200
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
Preference shares of £1 each	**2,596,834,398**	2,596,834,398	**2,597**	2,597
			6,587	6,587
US dollars			**US$m**	US$m
Preference shares of US$1 each	**4,997,750,000**	4,997,750,000	**4,998**	4,998
Euro			**€m**	€m
Preference shares of €1 each	**3,000,000,000**	3,000,000,000	**3,000**	3,000
Japanese yen			**¥m**	¥m
Preference shares of ¥250 each	**400,000,000**	400,000,000	**100,000**	100,000
Canadian dollars			**CAD$m**	CAD$m
Preference shares of CAD$1 each	**1,000,000,000**	1,000,000,000	**1,000**	1,000
Australian dollars			**AUD$m**	AUD$m
Preference shares of AUD$1 each	**1,000,000,000**	1,000,000,000	**1,000**	1,000

(2) Issued share capital

	Group and Company			
	2017 Number of shares	2016 Number of shares	**2017 £m**	2016 £m
Issued and fully paid ordinary shares				
Ordinary shares of 25p each				
At 1 January and 31 December	**15,053,262,841**	15,053,262,841	**3,763**	3,763
Issued and fully paid preference shares				
Preference shares of £1 each				
At 1 January and 31 December	**100**	100	**–**	–
Total share capital at 31 December	**15,053,262,941**	15,053,262,941	**3,763**	3,763

Share capital and control
There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association, and certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws).

Ordinary shares
The holders of ordinary shares, who held 100 per cent of the total ordinary share capital at 31 December 2017, are entitled to receive the Company'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 Company's articles of association) and on a winding up may share in the assets of the Company.

33 Other reserves

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Other reserves comprise:				
Merger and other reserves[1]	**10,051**	10,051	**9,537**	9,537
Capital redemption reserve[1]	**141**	141	**141**	141
Revaluation reserve in respect of available-for-sale financial assets	**50**	139	**7**	4
Cash flow hedging reserve	**23**	89	**–**	–
Foreign currency translation reserve	**(31)**	(27)	**–**	–
At 31 December	**10,234**	10,393	**9,685**	9,682

[1] There were no movements in these reserves in 2016 or 2017.

Movements in other reserves were as follows:

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Revaluation reserve in respect of available-for-sale financial assets				
At 1 January	**139**	145	**4**	–
Change in fair value of available-for-sale financial assets	**16**	94	**3**	4
Deferred tax	**14**	(4)	**–**	–
Current tax	**(3)**	(2)	**–**	–
	27	88	**3**	4
Income statement transfers:				
Disposals (note 8)	**(134)**	(71)	**–**	–
Deferred tax	**8**	(22)	**–**	–
Current tax	**–**	(2)	**–**	–
	(126)	(95)	**–**	–
Impairment	**10**	1	**–**	–
Deferred tax	**–**	–	**–**	–
	10	1	**–**	–
At 31 December	**50**	139	**7**	4

33 Other reserves (continued)

	The Group	
	2017 £m	2016 £m
Cash flow hedging reserve		
At 1 January	**89**	169
Change in fair value of hedging derivatives	**(135)**	122
Deferred tax	**35**	(29)
	(100)	93
Income statement transfers	**46**	(232)
Deferred tax	**(12)**	59
	34	(173)
At 31 December	**23**	89

	The Group	
	2017 £m	2016 £m
Foreign currency translation reserve		
At 1 January	**(27)**	(27)
Currency translation differences arising in the year	**–**	(25)
Foreign currency (losses) gains on net investment hedges (tax: £nil)	**(4)**	25
At 31 December	**(31)**	(27)

34 Retained profits

	The Group		The Company	
	2017 £m	2016 £m	**2017 £m**	2016 £m
At 1 January	**(858)**	(298)	**9,818**	8,992
Profit for the year[1]	**1,993**	2,505	**2,197**	3,899
Tax relief on distributions to non-controlling interests	**27**	28	**–**	–
Dividends paid (note 35)	**(2,900)**	(2,610)	**(2,900)**	(2,610)
Capital contribution received	**105**	82	**105**	82
Post-retirement defined benefit scheme remeasurement	**98**	(565)	**97**	(545)
At 31 December	**(1,535)**	(858)	**9,317**	9,818

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

35 Dividends on ordinary shares

Dividends paid in the year were as follows:

	2017 £m	2016 £m
Final dividend for previous year paid during the current year	**–**	–
Interim dividends	**2,900**	2,610
	2,900	2,610

36 Share-based payments

During the year ended 31 December 2017 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the HBOS Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group are set out below; these are managed and operated on a Lloyds Banking Group-wide basis. The amount charged to the Group's income statement in respect of Lloyds Banking Group share-based payment schemes, and which is included within staff costs (note 9), was £107 million (2016: £110 million).

Deferred bonus plans
The Group operates a number of deferred bonus plans that are equity settled. Bonuses in respect of employee performance in 2017 have been recognised in the charge in line with the proportion of the deferral period completed.

Save-As-You-Earn schemes
Eligible employees may enter into contracts through the Save-As-You-Earn 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 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:

	2017		2016	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**678,692,896**	**51.76**	850,146,220	50.99
Granted	**268,653,890**	**51.03**	454,667,560	47.49
Exercised	**(13,119,229)**	**55.58**	(401,286,043)	40.74
Forfeited	**(18,545,569)**	**51.70**	(10,590,490)	56.02
Cancelled	**(41,211,075)**	**52.77**	(204,238,535)	60.23
Expired	**(13,603,825)**	**56.98**	(10,005,816)	57.08
Outstanding at 31 December	**860,867,088**	**51.34**	678,692,896	51.76
Exercisable at 31 December	**–**	**–**	–	–

The weighted average share price at the time that the options were exercised during 2017 was £0.67 (2016: £0.67). The weighted average remaining contractual life of options outstanding at the end of the year was 1.4 years (2016: 2.9 years).

The weighted average fair value of SAYE options granted during 2017 was £0.15 (2016: £0.13). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

Other share option plans
Lloyds Banking Group Executive Share Plan 2003
The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and in some instances, the grant may be subject to 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.

Options granted on 27 March 2014 under the Commercial Banking Transformation Plan (CBTP), became exercisable in March 2017 and vested at a factor of 2.1 from the original 'on-target' award, due to the degree to which the performance conditions were exceeded. The award was based upon the underlying profit and return on risk-weighted assets ('RoRWA') of Commercial Banking as at 31 December 2016.

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

	2017		2016	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**218,962,281**	**Nil**	**221,397,597**	**Nil**
Granted	**5,466,405**	**Nil**	**4,298,701**	**Nil**
Exercised	**(104,967,667)**	**Nil**	**(2,700,679)**	**Nil**
Forfeited	**(81,883)**	**Nil**	**(3,863,477)**	**Nil**
Lapsed	**(104,855,147)**	**Nil**	**(169,861)**	**Nil**
Outstanding at 31 December	**14,523,989**	**Nil**	**218,962,281**	**Nil**
Exercisable at 31 December	**7,729,919**	**Nil**	**4,504,392**	**Nil**

The weighted average fair value of options granted in the year was £0.62 (2016: £0.68). 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 2017 was £0.69 (2016: £0.64). The weighted average remaining contractual life of options outstanding at the end of the year was 4.9 years (2016: 5.1 years).

36 Share-based payments (continued)

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 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.

For the 2015 and 2016 LTIPs 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. Details of the performance conditions for the plan are provided in the Directors' remuneration report.

At the end of the performance period for the 2014 grant, the targets had not been fully met and therefore these awards vested in 2017 at a rate of 55 per cent.

	2017 Number of shares	2016 Number of shares
Outstanding at 1 January	**358,228,028**	398,066,746
Granted	**139,812,788**	132,194,032
Vested	**(57,406,864)**	(140,879,465)
Forfeited	**(73,268,966)**	(33,713,900)
Dividend award	**3,439,929**	2,560,615
Outstanding at 31 December	**370,804,915**	358,228,028

Awards in respect of the 2015 grant will vest in 2018 at a rate of 66.3 per cent.

The weighted average fair value of awards granted in the year was £0.57 (2016: £0.64).

The fair value calculations at 31 December 2017 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**
Weighted average risk-free interest rate	**0.59%**	**0.18%**	**0.22%**
Weighted average expected life	**3.3 years**	**1.9 years**	**3.6 years**
Weighted average expected volatility	**29%**	**30%**	**31%**
Weighted average expected dividend yield	**4.0%**	**4.0%**	**0.0%**
Weighted average share price	**£0.68**	**£0.67**	**£0.68**
Weighted average exercise price	**£0.51**	**nil**	**nil**

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

Share Incentive Plan

Free Shares

An award of shares may be made annually to employees up to a maximum of £3,000. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition. If an employee leaves the Group within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited.

On 10 May 2017, the Group made an award of £200 of shares to all eligible employees. The number of shares awarded was 21,566,047, with an average fair value of £0.69 based on the market price at the date of award.

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £45 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 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 2017 was 32,025,497 (2016: 35,956,224), with an average fair value of £0.67 (2016: £0.61), 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 2017 was 9,313,314 (2016: 10,031,272).

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

37 Related party transactions

Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

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

	2017 £m	2016 £m
Compensation		
Salaries and other short-term benefits	**7**	9
Post-employment benefits	**–**	–
Share-based payments	**11**	12
Total compensation	**18**	21

The aggregate of the emoluments of the directors was £7.0 million (2016: £5.4 million).

Aggregate company contributions in respect of directors to defined contribution pension schemes were £0.05 million (2016: £0.1 million).

The total for the highest paid director (António Horta-Osório) was £3,234,000 (2016: (António Horta-Osório) £3,144,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in either year.

	2017 million	2016 million
Share option plans over Lloyds Banking Group plc shares		
At 1 January	**3**	9
Granted (includes entitlements of appointed key management personnel)	**–**	3
Exercised/lapsed (includes entitlements of former key management personnel)	**(2)**	(9)
At 31 December	**1**	3

	2017 million	2016 million
Share incentive plans settled in Lloyds Banking Group plc shares		
At 1 January	**65**	82
Granted (includes entitlements of appointed key management personnel)	**37**	29
Exercised/lapsed (includes entitlements of former key management personnel)	**(20)**	(46)
At 31 December	**82**	65

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between the Lloyds Banking Group and its key management personnel:

	2017 £m	2016 £m
Loans		
At 1 January	**4**	5
Advanced (includes loans of appointed key management personnel)	**1**	3
Repayments (includes loans of former key management personnel)	**(3)**	(4)
At 31 December	**2**	4

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 6.45 per cent and 23.95 per cent in 2017 (2016: 2.49 per cent and 23.95 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2016: £nil).

	2017 £m	2016 £m
Deposits		
At 1 January	**12**	13
Placed (includes deposits of appointed key management personnel)	**41**	41
Withdrawn (includes deposits of former key management personnel)	**(33)**	(42)
At 31 December	**20**	12

37 Related party transactions (continued)

Deposits placed by key management personnel attracted interest rates of up to 4.0 per cent in 2017 (2016: 4.0 per cent).

At 31 December 2017, the Group did not provide any guarantees in respect of key management personnel (2016: none).

At 31 December 2017, 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 £0.01 million with three directors and two connected persons. (2016: £0.4 million with five directors and two connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings

Balances and transactions between members of the HBOS group

In accordance with IFRS 10 Consolidated financial statements, transactions and balances between the Company 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 Company has a significant number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Company as follows:

	2017 £m	2016 £m
Assets, included within:		
Amounts owed by Group entities	**11,210**	12,496
Derivative financial instruments	**395**	499
	11,605	12,995
Liabilities, included within:		
Amounts owed to Group entities	**7,411**	6,382
Subordinated liabilities	**1,596**	2,025
	9,007	8,407

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 2017 the Company earned interest income on the above asset balances of £394 million (2016: £423 million) and incurred interest expense on the above liability balances of £184 million (2016: £204 million).

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

The Company and its subsidiaries have balances due to and from the Company'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 Company**	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Assets included within:				
Derivative financial instruments	**6,808**	8,502	**–**	–
Loans and receivables	**74,849**	46,911	**604**	604
Trading and other financial assets at fair value through profit or loss	**1,350**	2,278	**1,350**	1,334
	83,007	57,691	**1,954**	1,938
Liabilities included within:				
Deposits from banks and customers	**125,541**	99,581	**757**	773
Derivative financial instruments	**7,765**	9,622	**–**	–
Subordinated liabilities	**179**	383	**3**	3
Trading liabilities	**–**	943	**–**	–
Debt securities in issue	**78**	139	**–**	–
	133,563	110,668	**760**	776

These balances include Lloyds Banking Group plc's banking arrangements and, 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 2017 the Group earned £345 million and the Company earned £21 million of interest income on the above asset balances (2016: Group: £294 million; Company: £22 million); the Group incurred £1,606 million and the Company incurred £17 million of interest expense on the above liability balances (2016: Group: £1,759 million; Company: £42 million).

During the year, certain subsidiaries and fellow Lloyds Banking Group undertakings incurred expenditure for the benefit of the Group's subsidiary, Bank of Scotland plc, which has not been recharged to Bank of Scotland plc; and Bank of Scotland plc incurred expenditure for the benefit of certain Group subsidiaries and fellow Lloyds Banking Group undertakings, which has not been recharged to those entities.

During the year, the Group disposed of certain entities to fellow subsidiaries of Lloyds Banking Group plc. The ultimate controlling party of these entities remained the same following the transfer.

37 Related party transactions (continued)

Other related party disclosures

Pension funds

At 31 December 2017 there were customer deposits of £73 million (2016: £34 million) related to the Group's pension arrangements.

Joint ventures and associates

At 31 December 2017 there were loans and advances to customers of £123 million (2016: £173 million) outstanding and balances within customer deposits of £9 million (2016: £15 million) relating to joint ventures and associates.

In addition to the above balances, at 31 December 2016 the Group had a number of other associates held by its venture capital business (which it sold during 2017) that it accounted for at fair value through profit or loss. At 31 December 2016, these companies had total assets of approximately £20 million, total liabilities of approximately £80 million and for the year ended 31 December 2016 had turnover of approximately £8 million and made a net profit of £5 million. In addition, the Group had provided £6 million of financing to these companies on which it received approximately £0.1 million of interest income in 2016.

38 Contingent liabilities and commitments

Interchange fees

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

– The European Commission continues to pursue competition investigations against MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA.

– Litigation brought by retailers continues in the English Courts against both Visa and MasterCard.

– Any ultimate impact on the Lloyds Banking Group of the above investigations and litigation against Visa and MasterCard remains uncertain at this time.

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. As part of this transaction, the Lloyds Banking Group and certain other UK banks also entered into a Loss Sharing Agreement (LSA) with Visa Inc, which clarifies the allocation of liabilities between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. The maximum amount of liability to which the Lloyds Banking Group may be subject under the LSA is capped at the cash consideration which was received by the Lloyds Banking Group at completion. Visa Inc may also have recourse to a general indemnity, previously in place under Visa Europe's Operating Regulations, for damages claims concerning inter or intra-regional MIF setting activities.

LIBOR and other trading rates

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

Certain Lloyds Banking Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling LIBOR and the Australian BBSW Reference Rate. Certain of the plaintiffs' claims, including those in connection with USD and JPY LIBOR, have been dismissed by the US Federal Court for Southern District of New York, and decisions are awaited on the Lloyds Banking Group's motions to dismiss the Sterling LIBOR and BBSW claims. The decisions leading to the Group's dismissal from the USD LIBOR claims are subject to two appeals; the first took place on 25 September 2017 and a decision is expected in the first quarter of 2018, and the second is expected to take place in the first half of 2018. The decisions leading to the Lloyds Banking Group's dismissal from the JPY LIBOR claims are not presently subject to appeal.

Certain Lloyds Banking Group companies are also named as defendants in: (i) UK based claims; and (ii) in a Dutch class action, each raising LIBOR manipulation allegations. A number of the claims against the Lloyds Banking Group in relation to the alleged mis-sale of Interest Rate Hedging Products also include allegations of LIBOR manipulation.

It is currently not possible to predict the scope and ultimate outcome on the Lloyds Banking Group of 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.

UK shareholder litigation

In August 2014, the Lloyds Banking Group and a number of former directors were named as defendants in a claim by a number of claimants who held shares in Lloyds TSB Group plc (LTSB) prior to the acquisition of HBOS plc, alleging breaches of duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. The defendants refute all claims made. A trial commenced in the English High Court on 18 October 2017 and is scheduled to conclude in the first quarter of 2018 with judgment to follow. It is currently not possible to determine the ultimate impact on the Group (if any).

Financial Services Compensation Scheme

Following the default of a number of deposit takers in 2008, the Financial Services Compensation Scheme (FSCS) borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. In June 2017, the FSCS announced that following the sale of certain Bradford & Bingley mortgage assets, the principal balance outstanding on the HM Treasury loan was £4,678 million (31 December 2016: £15,655 million). Although it is anticipated that the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants, including the Group, of the FSCS. The amount of future levies payable by the Lloyds Banking Group depends on a number of factors, principally, the amounts recovered by the FSCS from asset sales.

38 Contingent liabilities and commitments (continued)

Tax authorities
The Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In 2013 HMRC informed the Lloyds Banking Group that their interpretation of the UK rules which allow the offset of such losses denies the claim. If HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £650 million (including interest) and a reduction in the Lloyds Banking Group's deferred tax asset of approximately £350 million (overall impact on the Group of £350 million). The Lloyds Banking Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due. There are a number of other open matters on which the Group is in discussion with HMRC, none of which is expected to have a material impact on the financial position of the Group.

Residential mortgage repossessions
In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases concerning certain aspects of the Lloyds Banking Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The FCA is actively engaged with the industry in relation to these considerations and has published Guidance on the treatment of customers with mortgage payment shortfalls. The Guidance covers remediation for mortgage customers who may have been affected by the way firms calculate these customers' monthly mortgage instalments. The Lloyds Banking Group is now determining its detailed approach to implementation of the Guidance and will contact affected customers during 2018.

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

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

Contingent liabilities and commitments arising from the banking business

	The Group	
	2017 £m	2016 £m
Contingent liabilities		
Acceptances and endorsements	**1**	1
Other:		
Other items serving as direct credit substitutes	**18**	19
Performance bonds and other transaction-related contingencies	**68**	83
	86	102
Total contingent liabilities	**87**	103

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	
	2017 £m	2016 £m
Commitments		
Forward asset purchases and forward deposits placed	**31**	28
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	**9,847**	9,828
Other commitments	**21,961**	21,817
	31,808	31,645
1 year or over original maturity	**2,937**	3,651
Total commitments	**34,776**	35,324

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £13,452 million (2016: £14,431 million) was irrevocable.

38 Contingent liabilities and commitments (continued)

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

	2017 £m	2016 £m
Not later than 1 year	**110**	105
Later than 1 year and not later than 5 years	**327**	332
Later than 5 years	**395**	431
Total operating lease commitments	**832**	868

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 (see note 23), there was no capital expenditure contracted but not provided for at 31 December 2017 (2016: £nil).

39 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.

		At fair value through profit or loss					
The Group	**Derivatives designated as hedging instruments £m**	**Held for trading £m**	**Designated upon initial recognition £m**	**Available-for-sale £m**	**Loans and receivables £m**	**Held at amortised cost £m**	**Total £m**
At 31 December 2017							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,677	2,677
Items in the course of collection from banks	–	–	–	–	–	260	260
Trading and other financial assets at fair value through profit or loss	–	–	1,400	–	–	–	1,400
Derivative financial instruments	3,079	8,555	–	–	–	–	11.634
Loans and receivables:							
Loans and advances to banks	–	–	–	–	551	–	551
Loans and advances to customers	–	–	–	–	268,657	–	268,657
Debt securities	–	–	–	–	137	–	137
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	74,849	–	74,849
	–	–	–	–	344,194	–	344,194
Available-for-sale financial assets	–	–	–	937	–	–	937
Total financial assets	**3,079**	**8,555**	**1,400**	**937**	**344,194**	**2,937**	**361,102**
Financial liabilities							
Deposits from banks	–	–	–	–	–	21,183	21,183
Customer deposits	–	–	–	–	–	171,198	171,198
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	125,541	125,541
Items in course of transmission to banks	–	–	–	–	–	269	269
Trading and other financial liabilities at fair value through profit or loss	–	50	–	–	–	–	50
Derivative financial instruments	1,561	9,070	–	–	–	–	10,631
Notes in circulation	–	–	–	–	–	1,313	1,313
Debt securities in issue	–	–	–	–	–	10,919	10,919
Subordinated liabilities	–	–	–	–	–	6,620	6,620
Total financial liabilities	**1,561**	**9,120**	**–**	**–**	**–**	**337,043**	**347,724**

39 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 2016							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,840	2,840
Items in the course of collection from banks	–	–	–	–	–	188	188
Trading and other financial assets at fair value through profit or loss	–	943	1,454	–	–	–	2,397
Derivative financial instruments	4,313	10,351	–	–	–	–	14,664
Loans and receivables:							
Loans and advances to banks	–	–	–	–	1,116	–	1,116
Loans and advances to customers	–	–	–	–	268,899	–	268,899
Debt securities	–	–	–	–	169	–	169
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	46,911	–	46,911
	–	–	–	–	317,095	–	317,095
Available-for-sale financial assets	–	–	–	3,034	–	–	3,034
Total financial assets	4,313	11,294	1,454	3,034	317,095	3,028	340,218
Financial liabilities							
Deposits from banks	–	–	–	–	–	6,191	6,191
Customer deposits	–	–	–	–	–	179,317	179,317
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	99,581	99,581
Items in course of transmission to banks	–	–	–	–	–	248	248
Trading and other financial liabilities at fair value through profit or loss	–	943	2	–	–	–	945
Derivative financial instruments	2,168	11,057	–	–	–	–	13,225
Notes in circulation	–	–	–	–	–	1,402	1,402
Debt securities in issue	–	–	–	–	–	16,679	16,679
Subordinated liabilities	–	–	–	–	–	8,149	8,149
Total financial liabilities	2,168	12,000	2	–	–	311,567	325,737

39 Financial instruments (continued)

The Company	**Derivatives held for trading, at fair value through profit or loss £m**	**Derivatives designated as hedging instruments, held at fair value through profit or loss £m**	**Loans and receivables £m**	**Available-for-sale £m**	**Held at amortised cost £m**	**Total £m**
At 31 December 2017						
Financial assets						
Derivative financial instruments	**3**	**392**	**–**	**–**	**–**	**395**
Loans and receivables:						
Amounts due from fellow Lloyds Banking Group undertakings	**–**	**–**	**13,164**	**–**	**–**	**13,164**
Available-for-sale financial assets	**–**	**–**	**–**	**7**	**–**	**7**
Total financial assets	**3**	**392**	**13,164**	**7**	**–**	**13,566**
Financial liabilities						
Amounts due to fellow Lloyds Banking Group undertakings	**–**	**–**	**–**	**–**	**8,168**	**8,168**
Subordinated liabilities	**–**	**–**	**–**	**–**	**4,692**	**4,692**
Total financial liabilities	**–**	**–**	**–**	**–**	**12,860**	**12,860**

The Company	Derivatives held for trading, at fair value through profit or loss £m	Derivatives designated as hedging instruments, held at fair value through profit or loss £m	Loans and receivables £m	Available-for-sale £m	Held at amortised cost £m	Total £m
At 31 December 2016						
Financial assets						
Derivative financial instruments	4	495	–	–	–	499
Loans and receivables:						
Amounts due from fellow Lloyds Banking Group undertakings	–	–	14,434	–	–	14,434
Available-for-sale financial assets	–	–	–	4	–	4
Total financial assets	4	495	14,434	4	–	14,937
Financial liabilities						
Amounts owed to fellow Lloyds Banking Group undertakings	–	–	–	–	7,155	7,155
Subordinated liabilities	–	–	–	–	6,132	6,132
Total financial liabilities	–	–	–	–	13,287	13,287

Interest rate risk and currency risk

The Company is exposed to interest rate risk and currency risk on its subordinated debt.

The Company has entered into interest rate and currency swaps with its subsidiary, Bank of Scotland plc, to manage these risks.

Credit risk
The majority of the Company's credit risk arises from amounts due from its wholly owned subsidiary and subsidiaries of that company.

(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.

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

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

Fair value information is not provided for items that are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group's consolidated balance sheet. These items include intangible assets, 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.

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.

(3) Financial assets and liabilities carried at fair value
Critical accounting estimates and judgments
The valuation techniques for level 2 and, particularly, level 3 financial instruments involve management judgement and estimates the extent of which depends on the complexity of the instrument and the availability of market observable information. In addition, in line with market practice, the Group applies credit, debit and funding valuation adjustments in determining the fair value of its uncollateralised derivative positions. A description of these adjustments is set out in this note on page 80. 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 below.

(A) Financial assets, excluding derivatives
Valuation hierarchy
At 31 December 2017, the Group's financial assets carried at fair value, excluding derivatives, totalled £2,337 million (31 December 2016: £5,431 million). The table below analyses these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described above). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

39 Financial instruments (continued)

Valuation hierarchy

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2017				
Trading and other financial assets at fair value through profit or loss				
Corporate and other debt securities	–	1,350	–	1,350
Equity shares	–	–	50	50
Total trading and other financial assets at fair value through profit or loss	–	1,350	50	1,400
Available-for-sale financial assets				
Debt securities:				
Government securities	116	–	–	116
Corporate and other debt securities	–	786	–	786
	116	786	–	902
Equity shares	–	15	20	35
Total available-for-sale financial assets	116	801	20	937
Total financial assets carried at fair value, excluding derivatives	116	2,151	70	2,337

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	943	–	943
Corporate and other debt securities	–	1,335	–	1,335
Equity shares	–	–	119	119
Total trading and other financial assets at fair value through profit or loss	–	2,278	119	2,397
Available-for-sale financial assets				
Debt securities:				
Government securities	114	2	–	116
Mortgage-backed securities	–	13	–	13
Corporate and other debt securities	–	2,424	–	2,424
	114	2,439	–	2,553
Equity shares	–	12	469	481
Total available-for-sale financial assets	114	2,451	469	3,034
Total financial assets carried at fair value, excluding derivatives	114	4,729	588	5,431

39 Financial instruments (continued)

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

The Group	2017 Trading and other financial assets at fair value through profit or loss £m	2017 Available-for-sale £m	2017 Total level 3 assets, excluding derivatives, carried at fair value (recurring basis) £m	2016 Trading and other financial assets at fair value through profit or loss £m	2016 Available-for-sale £m	2016 Total level 3 assets, excluding derivatives, carried at fair value (recurring basis) £m
At 1 January	**119**	**469**	**588**	226	339	565
Exchange and other adjustments	**–**	**(1)**	**(1)**	1	4	5
Gains (losses) recognised in the income statement within other income	**20**	**–**	**20**	(15)	–	(15)
(Losses) gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	**–**	**(64)**	**(64)**	–	32	32
Purchases	**–**	**36**	**36**	–	102	102
Disposal of businesses	**(74)**	**(375)**	**(449)**	–	–	–
Sales	**(15)**	**(45)**	**(60)**	(93)	(39)	(132)
Transfers into the level 3 portfolio	**–**	**–**	**–**	–	31	31
At 31 December	**50**	**20**	**70**	119	469	588
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December	**1**	**–**	**1**	64	–	64

Valuation methodology for financial assets, excluding derivatives
Loans and advances to customers and banks
These assets are principally reverse repurchase agreements. The fair value of these assets is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security purchased under the reserve repurchase agreement.

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

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

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.

(B) Financial liabilities, excluding derivatives

Valuation hierarchy
At 31 December 2017, the Group's financial liabilities carried at fair value, excluding derivatives, comprised its trading and other financial liabilities at fair value through profit or loss and totalled £50 million (31 December 2016: £945 million) (Financial guarantees are also recognised at fair value, on initial recognition, and are classified as level 3; but the balance is not material). The table below analyses these financial liabilities by balance sheet classification and valuation methodology (level 1, 2 or 3, as described on page 76). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

39 Financial instruments (continued)

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

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2017				
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	–	–	–
Other deposits	–	50	–	50
Short positions in securities	–	–	–	–
	–	50	–	50
Total financial liabilities carried at fair value, excluding derivatives	–	50	–	50
At 31 December 2016				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	–	–	2	2
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	943	–	943
Short positions in securities	–	–	–	–
	–	943	–	943
Total financial liabilities carried at fair value, excluding derivatives	–	943	2	945

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

Group	2017 £m	2016 £m
At 1 January	2	1
Losses recognised in the income statement within other income	(2)	1
At 31 December	–	2
Losses recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December		1

Valuation methodology for financial liabilities, excluding derivatives

Trading liabilities in respect of securities sold under repurchase agreements

The fair value of these liabilities is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security sold under the repurchase agreement.

(C) Derivatives

All of the Group's derivative assets and liabilities are carried at fair value. At 31 December 2017, such assets totalled £11,634 million (31 December 2016: £14,664 million) and liabilities totalled £10,631 million (31 December 2016: £13,225 million). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 76). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

	2017				2016			
The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Derivative assets	–	11,214	420	11,634	–	14,081	583	14,664
Derivative liabilities	–	(10,577)	(54)	(10,631)	–	(13,168)	(57)	(13,225)

Derivatives

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

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

39 Financial instruments (continued)

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.

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

	2017		2016	
The Group	**Derivative assets £m**	**Derivative liabilities £m**	Derivative assets £m	Derivative liabilities £m
At 1 January	**583**	**(57)**	342	(38)
Exchange and other adjustments	**18**	**(1)**	53	(3)
Gains (losses) recognised in the income statement within other income	**(133)**	**3**	144	(16)
(Sales) redemptions	**(4)**	**1**	–	–
Transfers into the level 3 portfolio	**–**	**–**	44	–
Transfers out of the level 3 portfolio	**(44)**	**–**	–	–
At 31 December	**420**	**(54)**	583	(57)
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	**(133)**	**3**	144	(16)

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

(i) Uncollateralised derivative valuation adjustments, excluding monoline counterparties
The following table summarises the movement on this valuation adjustment account for the Group during 2017 and 2016.

	2017 £m	2016 £m
At 1 January	**286**	191
Income statement (credit) charge	**(140)**	111
Transfers	**37**	(16)
At 31 December	**183**	286

Represented by:

	2017 £m	2016 £m
Credit Valuation Adjustment	**143**	253
Debit Valuation Adjustment	**(4)**	(15)
Funding Valuation Adjustment	**44**	48
	183	286

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking division.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

The CVA is sensitive to:

- the current size of the mark-to-market position on the uncollateralised asset;
- expectations of future market volatility of the underlying asset; and
- expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

39 Financial instruments (continued)

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £28 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. Where appropriate, the CVA for these products is calculated on an add-on basis (although no such adjustment was required at 31 December 2017).

The DVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised liability;
– expectations of future market volatility of the underlying liability; and
– the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £13 million to £17 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £70 million fall in the overall valuation adjustment to £69 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding uncollateralised derivative positions. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £7 million.

(ii) Market liquidity
The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2017, the Group's derivative trading business held mid to bid-offer valuation adjustments of £23 million (2016: £41 million).

(D) Sensitivity of level 3 valuations

			At 31 December 2017			At 31 December 2016		
				Effect of reasonably possible alternative assumptions[2]			Effect of reasonably possible alternative assumptions[2]	
	Valuation techniques	Significant unobservable inputs[1]	**Carrying value £m**	**Favourable changes £m**	**Unfavourable changes £m**	Carrying value £m	Favourable changes £m	Unfavourable changes £m
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	**50**	**5**	**(5)**	119	6	(10)
			50			119		
Available-for-sale financial assets								
Equity and venture capital investments	Underlying asset/ net asset value (incl. property prices)[3]	n/a	**20**	**1**	**(1)**	469	30	(35)
			20			469		
Derivative financial assets								
Interest rate derivatives	Option pricing model	Interest rate volatility (9%/94%)	**420**	**1**	**(2)**	583	(2)	(8)
			420			583		
Level 3 financial assets carried at fair value			**490**			1,171		
Trading and other financial liabilities at fair value through profit and loss			**–**	**–**	**–**	2	–	–
Derivative financial liabilities								
Interest rate derivatives	Option pricing model	Interest rate volatility (9%/94%)	**54**	**–**	**–**	57	–	–
			54			57		
Level 3 financial liabilities carried at fair value			**54**			59		

[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 represented fair value.

39 Financial instruments (continued)

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.

Derivatives
Reasonably possible alternative assumptions have been determined in respect of swaptions in the Group's derivative portfolios which 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 9 per cent to 94 per cent (2016: 0 per cent and 115 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 which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 76). 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	**Carrying value £m**	**Fair value £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
At 31 December 2017					
Loans and receivables:					
Loans and advances to customers	**268,657**	**270,542**	**–**	**–**	**270,542**
Loans and advances to banks	**551**	**546**	**–**	**–**	**546**
Debt securities	**137**	**136**	**–**	**129**	**7**
Due from fellow Lloyds Banking Group undertakings	**74,849**	**74,849**	**–**	**–**	**74,849**
Reverse repos included in above amounts:					
Loans and advances to customers	**–**	**–**	**–**	**–**	**–**
Loans and advances to banks	**–**	**–**	**–**	**–**	**–**
At 31 December 2016					
Loans and receivables:					
Loans and advances to customers	268,899	270,153	–	–	270,153
Loans and advances to banks	1,116	1,115	–	–	1,115
Debt securities	169	152	–	139	13
Due from fellow Lloyds Banking Group undertakings	46,911	46,911	–	–	46,911
Reverse repos included in above amounts:					
Loans and advances to customers	–	–	–	–	–
Loans and advances to banks	–	–	–	–	–

39 Financial instruments (continued)

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.

(B) Financial liabilities

Valuation hierarchy

The table below analyses the fair values of the financial liabilities of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 76).

			Valuation hierarchy		
The Group	**Carrying value £m**	**Fair value £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
At 31 December 2017					
Deposits from banks	**21,183**	**21,178**	**–**	**21,178**	**–**
Customer deposits	**171,198**	**170,905**	**–**	**164,078**	**6,827**
Due to fellow Lloyds Banking Group undertakings	**125,541**	**125,541**	**–**	**125,541**	**–**
Debt securities in issue	**10,919**	**11,001**	**–**	**11,001**	**–**
Subordinated liabilities	**6,620**	**6,560**	**–**	**6,560**	**–**
Repos included in above amounts:					
Deposits from banks	**19,977**	**19,977**	**–**	**19,977**	**–**
Customer deposits	**–**	**–**	**–**	**–**	**–**
At 31 December 2016					
Deposits from banks	6,191	6,191	–	6,191	–
Customer deposits	179,317	179,420	–	171,529	7,891
Due to fellow Lloyds Banking Group undertakings	99,581	99,581	–	99,581	–
Debt securities in issue	16,679	16,621	–	16,621	–
Subordinated liabilities	8,149	7,554	–	7,554	–
Repos included in above amounts:					
Deposits from banks	4,521	4,521	–	4,521	–

The carrying amount of items in course of transmission to banks and notes in circulation is a reasonable approximation of fair value.

39 Financial instruments (continued)

The carrying amount of items in course of transmission to banks and notes in circulation is a reasonable approximation of fair value.

Valuation methodology
Deposits from banks and customer deposits
The fair value of bank and customer deposits repayable on demand is assumed to be equal to their carrying value.

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

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

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

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

(5) Reclassification of financial assets
No financial assets were reclassified in 2016 or 2017.

40 Transfers of financial assets

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

The Group 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 15, 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 26). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

The Group	At 31 December 2017 Carrying value of transferred assets £m	At 31 December 2017 Carrying value of associated liabilities £m	At 31 December 2016 Carrying value of transferred assets £m	At 31 December 2016 Carrying value of associated liabilities £m
Repurchase and securities lending transactions				
Trading and other financial assets at fair value through profit or loss	**6**	**–**	–	–
Available-for-sale financial assets	**139**	**–**	–	–
Loans and receivables:				
Loans and advances to customers	**–**	**–**	9,916	–
Securitisation programmes				
Loans and receivables:				
Loans and advances to customers[1]	**25,226**	**2,997**	30,901	5,562

[1] The carrying value of associated liabilities for the Group excludes securitisation notes held by the Group of £14,954 million (2016: £18,642 million).

41 Offsetting of financial assets and liabilities

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

At 31 December 2017	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]: Cash collateral received/ pledged £m	Related amounts where set off in the balance sheet not permitted[3]: Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	1,400	–	1,400	–	–	1,400
Reverse repos	–	–	–	–	–	–
	1,400	–	1,400	–	–	1,400
Derivative financial instruments	11,634	–	11,634	(1,036)	(1,709)	8,889
Loans and advances to banks:						
Excluding reverse repos	551	–	551	(394)	–	157
Reverse repos	–	–	–	–	–	–
	551	–	551	(394)	–	157
Loans and advances to customers:						
Excluding reverse repos	268,657	–	268,657	(172)	(1,126)	267,359
Reverse repos	–	–	–	–	–	–
	268,657	–	268,657	(172)	(1,126)	267,359
Debt securities	137	–	137	–	–	137
Available-for-sale financial assets	937	–	937	–	–	937
Financial liabilities						
Deposits from banks:						
Excluding repos	1,206	–	1,206	(1,036)	–	170
Repos	19,977	–	19,977	–	(19,977)	–
	21,183	–	21,183	(1,036)	(19,977)	170
Customer deposits:						
Excluding repos	171,198	–	171,198	–	(1,126)	170,072
Repos	–	–	–	–	–	–
	171,198	–	171,198	–	(1,126)	170,072
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	50	–	50	–	–	50
Repos	–	–	–	–	–	–
	50	–	50	–	–	50
Derivative financial instruments	10,631	–	10,631	(566)	(1,720)	8,345

[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.

41 Offsetting of financial assets and liabilities (continued)

At 31 December 2016	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]: Cash collateral received/ pledged £m	Related amounts where set off in the balance sheet not permitted[3]: Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	1,454	–	1,454	–	–	1,454
Reverse repos	943	–	943	–	(943)	–
	2,397	–	2,397	–	(943)	1,454
Derivative financial instruments	14,664	–	14,664	(1,214)	(1,840)	11,610
Loans and advances to banks:						
Excluding reverse repos	1,116	–	1,116	(443)	–	673
Reverse repos	–	–	–	–	–	–
	1,116	–	1,116	(443)	–	673
Loans and advances to customers:						
Excluding reverse repos	268,899	–	268,899	(159)	(888)	267,852
Reverse repos	–	–	–	–	–	–
	268,899	–	268,899	(159)	(888)	267,852
Debt securities	169	–	169	–	–	169
Available-for-sale financial assets	3,034	–	3,034	–	–	3,034
Financial liabilities						
Deposits from banks:						
Excluding repos	1,670	–	1,670	(1,213)	–	457
Repos	4,521	–	4,521	–	(4,521)	–
	6,191	–	6,191	(1,213)	(4,521)	457
Customer deposits:						
Excluding repos	179,317	–	179,317	(1)	(888)	178,428
Repos	–	–	–	–	–	–
	179,317	–	179,317	(1)	(888)	178,428
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	2	–	2	–	–	2
Repos	943	–	943	–	(943)	–
	945	–	945	–	(943)	2
Derivative financial instruments	13,225	–	13,225	(602)	(2,938)	9,685

[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.

42 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 instruments below and predominantly in the United Kingdom. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems on 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 derivative based transactions.

A. Maximum credit exposure

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

	At 31 December 2017			At 31 December 2016		
The Group	**Maximum exposure £m**	**Offset[2] £m**	**Net exposure £m**	Maximum exposure £m	Offset[2] £m	Net exposure £m
Loans and receivables:						
Loans and advances to banks, net[1]	**551**	**–**	**551**	1,116	–	1,116
Loans and advances to customers, net[1]	**268,657**	**(1,126)**	**267,531**	268,899	(888)	268,011
Debt securities, net[1]	**137**	**–**	**137**	169	–	169
	269,345	**(1,126)**	**268,219**	270,184	(888)	269,296
Available-for-sale financial assets[3]	**902**	**–**	**902**	2,553	–	2,553
Trading and other financial assets at fair value through profit or loss[3]:						
Loans and advances	**–**	**–**	**–**	943	–	943
Debt securities, treasury and other bills	**1,350**	**–**	**1,350**	1,335	–	1,335
	1,350	**–**	**1,350**	2,278	–	2,278
Derivative assets	**11,634**	**(1,708)**	**9,926**	14,664	(1,838)	12,826
Financial guarantees	**127**	**–**	**127**	207	–	207
Off-balance sheet items:						
Acceptances and endorsements	**1**	**–**	**1**	1	–	1
Other items serving as direct credit substitutes	**18**	**–**	**18**	19	–	19
Performance bonds and other transaction-related contingencies	**68**	**–**	**68**	83	–	83
Irrevocable commitments	**13,452**	**–**	**13,452**	14,431	–	14,431
	13,539	**–**	**13,539**	14,534	–	14,534
	296,897	**(2,834)**	**294,063**	304,420	(2,726)	301,694

[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] Excludes 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 5.

At 31 December 2017 the most significant concentrations of exposure were in mortgages (comprising 91 per cent of total loans and advances to customers) and other personal lending (comprising 4 per cent of the total). For further information on concentrations of the Group's loans, refer to note 14.

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

42 Financial risk management (continued)

C. Credit quality of assets

Loans 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[1] £m
31 December 2017						
Neither past due nor impaired	**545**	**238,319**	**10,729**	**11,238**	**260,286**	**–**
Past due but not impaired	**6**	**5,171**	**201**	**133**	**5,505**	**–**
Impaired – no provision required	**–**	**264**	**131**	**166**	**561**	**–**
– provision held	**–**	**3,363**	**217**	**850**	**4,430**	**–**
Gross	**551**	**247,117**	**11,278**	**12,387**	**270,782**	**–**
Allowance for impairment losses (note 17)	**–**	**(1,507)**	**(188)**	**(430)**	**(2,125)**	**–**
Net balance sheet carrying value	**551**				**268,657**	**–**
31 December 2016						
Neither past due nor impaired	1,110	235,184	10,309	13,466	258,959	943
Past due but not impaired	6	6,358	133	75	6,566	–
Impaired – no provision required	–	392	162	178	732	–
– provision held	–	3,393	300	1,334	5,027	–
Gross	1,116	245,327	10,904	15,053	271,284	943
Allowance for impairment losses (note 17)	–	(1,575)	(179)	(631)	(2,385)	–
Net balance sheet carrying value	1,116				268,899	943

[1] Excludes amounts due from fellow Lloyds Banking Group undertakings.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2(h). Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £1,058 million (2016: £1,459 million).

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 2017						
Good quality	**539**	**237,316**	**9,826**	**6,443**	**253,585**	**–**
Satisfactory quality	**–**	**776**	**762**	**3,614**	**5,152**	**–**
Lower quality	**6**	**32**	**54**	**1,062**	**1,148**	**–**
Below standard, but not impaired	**–**	**195**	**87**	**119**	**401**	**–**
Total loans and advances which are neither past due nor impaired	**545**	**238,319**	**10,729**	**11,238**	**260,286**	**–**
31 December 2016						
Good quality	1,067	234,184	8,518	6,849	249,551	943
Satisfactory quality	29	797	1,542	4,387	6,726	–
Lower quality	3	39	159	2,064	2,262	–
Below standard, but not impaired	11	164	90	166	420	–
Total loans and advances which are neither past due nor impaired	1,110	235,184	10,309	13,466	258,959	943

42 Financial risk management (continued)

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 2017						
0-30 days	**6**	**2,694**	**151**	**78**	**2,923**	**–**
30-60 days	**–**	**961**	**47**	**1**	**1,009**	**–**
60-90 days	**–**	**674**	**–**	**4**	**678**	**–**
90-180 days	**–**	**842**	**–**	**3**	**845**	**–**
Over 180 days	**–**	**–**	**3**	**47**	**50**	**–**
Total loans and advances which are past due but not impaired	**6**	**5,171**	**201**	**133**	**5,505**	**–**
31 December 2016						
0-30 days	6	3,087	92	52	3,231	–
30-60 days	–	1,357	36	5	1,398	–
60-90 days	–	854	–	2	856	–
90-180 days	–	1,060	1	6	1,067	–
Over 180 days	–	–	4	10	14	–
Total loans and advances which are past due but not impaired	6	6,358	133	75	6,566	–

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

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

	2017 Investment grade[1] £m	Other[2] £m	Total £m	2016 Investment grade[1] £m	Other[2] £m	Total £m
Asset-backed securities:						
Mortgage-backed securities	**–**	**–**	**–**	30	–	30
Other asset-backed securities	**128**	**7**	**135**	122	7	129
	128	**7**	**135**	152	7	159
Corporate and other debt securities	**–**	**13**	**13**	22	79	101
Gross exposure	**128**	**20**	**148**	174	86	260
Allowance for impairment losses			**(11)**			(91)
Total debt securities classified as loans and receivables			**137**			169

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

[2] Other comprises sub-investment grade (2017: £nil; 2016: £nil) and not rated (2017: £20 million; 2016: £86 million)

42 Financial risk management (continued)

Available-for-sale financial assets (excluding equity shares) – The Group
An analysis of available-for-sale financial assets is included in note 18. The credit quality of available-for-sale financial assets (excluding equity shares) is set out below:

	2017			2016		
	Investment grade[1] £m	Other £m	Total £m	Investment grade[1] £m	Other £m	Total £m
Debt securities:						
Government securities	116	–	116	116	–	116
Asset-backed securities:						
Mortgage-backed securities	–	–	–	13	–	13
Other asset-backed securities	–	–	–	–	–	–
	–	–	–	13	–	13
Corporate and other debt securities	736	50	786	2,424	–	2,424
	852	50	902	2,553	–	2,553
Due from fellow Group undertakings			–			–
Total held as available-for-sale financial assets			902			2,553

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

Debt securities, treasury and other bills held at fair value through profit or loss – The Group
An analysis of trading and other financial assets at fair value through profit or loss is included in note 12; the debt securities, treasury and other bills held at fair value through profit or loss comprise amounts due from fellow Lloyds Banking Group undertakings of £1,350 million (2016: £1,334 million).

Derivative assets – The Group
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 net credit risk relating to derivative assets of £9,926 million (2016: £12,826 million), cash collateral of £1,036 million (2016: £1,214 million) was held and a further £79 million was due from OECD banks (2016: £162 million).

	2017			2016		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Derivative financial instruments						
Trading and other	2,763	1,255	4,018	4,201	862	5,063
Hedging	808	–	808	1,099	–	1,099
	3,571	1,255	4,826	5,300	862	6,162
Due from fellow Group undertakings			6,808			8,502
Total derivative financial instruments			11,634			14,664

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

[2] Other comprises sub-investment grade (2017: £1,255 million; 2016: £862 million) and not rated (2017: £nil; 2016: £nil).

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

D. Collateral held as security for financial assets
The 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
These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

42 Financial risk management (continued)

Loans and advances to customers

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.

	2017				2016			
	Neither past due nor impaired £m	**Past due but not impaired £m**	**Impaired £m**	**Gross £m**	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
Less than 70 per cent	**169,583**	**3,732**	**2,092**	**175,407**	170,747	4,475	2,053	177,275
70 per cent to 80 per cent	**37,405**	**688**	**520**	**38,613**	33,861	908	557	35,326
80 per cent to 90 per cent	**22,072**	**444**	**388**	**22,904**	19,546	569	430	20,545
90 per cent to 100 per cent	**6,422**	**158**	**206**	**6,786**	6,913	207	301	7,421
Greater than 100 per cent	**2,837**	**149**	**421**	**3,407**	4,117	199	444	4,760
Total	**238,319**	**5,171**	**3,627**	**247,117**	235,184	6,358	3,785	245,327

Other

The majority of non-mortgage retail lending is unsecured. At 31 December 2017, impaired non-mortgage lending amounted to £160 million, net of an impairment allowance of £188 million (2016: £283 million net of an impairment allowance of £179 million). The fair value of the collateral held in respect of this lending was £nil (2016: £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 £10,930 million (2016: £10,442 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 reassessed 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 2017, impaired secured commercial lending amounted to £231 million, net of an impairment allowance of £180 million (2016: £552 million, net of an impairment allowance of £293 million). The fair value of the collateral held in respect of impaired secured commercial lending was £345 million (2016: £657 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 £4,813 million (2016: £6,500 million).

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 £nil (2016: £943 million). Collateral is held with a fair value of £nil (2016: £996 million), all of which the Group is able to repledge. At 31 December 2017, £nil had been repledged (2016: £996 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £47,082 million (2016: £32,834 million). At 31 December 2017 £47,079 million of this amount had been resold or repledged as collateral for the Group's own transactions (2016: £2,765 million).

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

42 Financial risk management (continued)

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 £9,926 million (2016: £12,826 million), cash collateral of £1,036 million (2016: £1,214 million) was held.

Irrevocable loan commitments and other credit-related contingencies
At 31 December 2017, there were irrevocable loan commitments and other credit-related contingencies of £13,539 million (2016: £14,534 million). Collateral is held as security, in the event that lending is drawn down, on £10,294 million (2016: £10,044 million) of these balances.

Collateral repossessed
During the year, £237 million of collateral was repossessed (2016: £213 million), 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 £19,977 million (2016: £4,521 million) and a fair value of £19,927 million (2016: £5,703 million).

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 secured borrowing, where the secured party is permitted by contract or custom to repledge was £nil (2016: £943 million).

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

The Group	2017 £m	2016 £m
Trading and other assets for fair value through profit or loss	6	–
Available-for-sale financial assets	139	30
	145	30

Securitisation and covered bonds
In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's securitisation and covered bond programmes. Further details of these assets are provided in note 15.

(2) Market risk
Interest rate risk
Interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. The rates on the remaining deposits are contractually fixed for their term to maturity.

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

The Group 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 2017 the aggregate notional principal of interest rate swaps designated as fair value hedges was £12,004 million (2016: £16,968 million) with a net fair value asset of £2,071 million (2016: £2,496 million) (see note 13). The losses on the hedging instruments were £494 million (2016: losses of £250 million). The gains on the hedged items attributable to the hedged risk were £485 million (2016: gains of £239 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 2017 was £24,617 million (2016: £39,525 million) with a net fair value liability of £553 million (2016: liability of £351 million) (see note 13). In 2017, ineffectiveness recognised in the income statement that arises from cash flow hedges was £2 million (2016: £nil).

42 Financial risk management (continued)

Currency risk

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are 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 and liquidity risk function in London.

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. At 31 December 2017 the aggregate principal of these currency borrowings was £nil (2016: £135 million). In 2017, an ineffectiveness loss of £4 million before tax and £3 million after tax (2016: £3 million gain before tax and £2 million after tax) was recognised in the income statement arising from net investment hedges.

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:

Functional currency of Group operations

The Group	Euro £m	US Dollar £m	Other non-sterling £m
31 December 2017			
Gross exposure	**37**	**43**	**4**
Net investment hedge	**–**	**–**	**–**
Total structural foreign currency exposures, after net investment hedges	**37**	**43**	**4**
31 December 2016			
Gross exposure	30	110	4
Net investment hedge	(25)	(110)	–
Total structural foreign currency exposures, after net investment hedges	5	–	4

(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, tests and reports that are primarily based on contractual maturity. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The 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 2017						
Deposits from banks	**18**	**1,225**	**95**	**20,254**	**5**	**21,597**
Customer deposits	**143,885**	**4,699**	**12,402**	**9,813**	**698**	**171,497**
Trading liabilities	**–**	**–**	**–**	**50**	**–**	**50**
Debt securities in issue	**562**	**466**	**473**	**8,450**	**2,125**	**12,076**
Subordinated liabilities	**22**	**229**	**2,379**	**1,909**	**4,521**	**9,060**
Total non-derivative financial liabilities	**144,487**	**6,619**	**15,349**	**40,476**	**7,349**	**214,280**
Derivative financial liabilities:						
Gross settled derivative – outflow	**94**	**222**	**228**	**3,167**	**3,539**	**7,250**
Gross settled derivative – inflow	**(43)**	**(161)**	**(226)**	**(3,284)**	**(3,687)**	**(7,401)**
Gross settled derivative – netflow	**51**	**61**	**2**	**(117)**	**(148)**	**(151)**
Net settled derivative liabilities	**1,984**	**13**	**41**	**165**	**180**	**2,383**
Total derivative financial liabilities	**2,035**	**74**	**43**	**48**	**32**	**2,232**

42 Financial risk management (continued)

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 2016						
Deposits from banks	16	35	10	5,805	326	6,192
Customer deposits	139,084	4,284	18,982	16,891	790	180,031
Trading liabilities	943	–	–	–	2	945
Debt securities in issue	579	2,506	2,597	10,927	920	17,529
Subordinated liabilities	–	441	647	4,134	4,583	9,805
Total non-derivative financial liabilities	140,622	7,266	22,236	37,757	6,621	214,502
Derivative financial liabilities:						
Gross settled derivative – outflow	666	548	543	4,798	4,413	10,968
Gross settled derivative – inflow	(472)	(492)	(520)	(4,601)	(4,082)	(10,167)
Gross settled derivative – netflow	194	56	23	197	331	801
Net settled derivative liabilities	2,510	17	87	210	244	3,068
Total derivative financial liabilities	2,704	73	110	407	575	3,869

The Company	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 2017						
Amounts owed to fellow Group undertakings	**–**	**–**	**–**	**–**	**8,168**	**8,168**
Subordinated liabilities	**–**	**32**	**1,651**	**439**	**1,578**	**3,700**
Total non-derivative financial liabilities	**–**	**32**	**1,651**	**439**	**9,746**	**11,868**
At 31 December 2016						
Amounts owed to fellow Group undertakings	–	–	–	–	7,155	7,155
Subordinated liabilities	–	611	790	3,012	2,290	6,703
Total non-derivative financial liabilities	–	611	790	3,012	9,445	13,858

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 £127 million at 31 December 2017 (2016: £207 million) with £24 million expiring within one year; £44 million between one and three years; £25 million between three and five years; and £34 million over five years (2016: £36 million expiring within one year; £39 million between one and three years; £12 million between three and five years; and £120 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 (2016: £7 million) for the Group and £1 million (2016: £1 million) for the Company per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

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 2017					
Acceptances and endorsements	**1**	**–**	**–**	**–**	**1**
Other contingent liabilities	**68**	**1**	**–**	**17**	**86**
Total contingent liabilities	**69**	**1**	**–**	**17**	**87**
Lending commitments	**31,808**	**1,136**	**598**	**1,203**	**34,745**
Other commitments	**–**	**–**	**–**	**31**	**31**
Total commitments	**31,808**	**1,136**	**598**	**1,234**	**34,776**
Total contingents and commitments	**31,877**	**1,137**	**598**	**1,251**	**34,863**

42 Financial risk management (continued)

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2016					
Acceptances and endorsements	1	–	–	–	1
Other contingent liabilities	60	16	–	26	102
Total contingent liabilities	61	16	–	26	103
Lending commitments	31,646	1,401	698	1,551	35,296
Other commitments	1	6	10	11	28
Total commitments	31,647	1,407	708	1,562	35,324
Total contingents and commitments	31,708	1,423	708	1,588	35,427

43 Capital

Capital management
Within the Group, capital within each regulated entity is actively managed at an appropriate level of frequency. Regulatory ratios are a key factor in budgeting and planning processes with updates of expected ratios reviewed regularly by the Lloyds Banking Group Asset and Liability Committee. Capital raised takes account of evolving regulatory requirements, 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 through 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 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital.

The minimum requirement for capital is supplemented by Pillar 2 of the regulatory 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. These include a capital conservation buffer of 1.25 per cent of risk-weighted assets (increasing to 2.5 per cent by 2019) and a time-varying countercyclical capital buffer for which the Group currently has a negligible requirement based on its minimal exposures to those jurisdictions that have set countercyclical buffer rates. Other capital buffers do not currently apply to the Group as they are either not applicable 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 on Banking Supervision (BCBS), at a European level mainly through the European Commission (EC) and the issuance of CRD IV technical standards and guidelines by the European Banking Authority (EBA) 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, other intangible assets and defined benefit pension surpluses.
- Fully qualifying additional tier 1 (AT1) capital comprises non-cumulative perpetual securities containing specific provisions to write down the security should the CET1 ratio fall to a defined trigger limit. Under transitional rules, 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 5 years, cannot normally be redeemed within their first 5 years and are phased out as T2 regulatory capital in the final 5 years before maturity. 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.

43 Capital (continued)

The Group's CRD IV transitional capital resources are summarised as follows:

	2017 £m	2016 £m
Common equity tier 1 capital	**8,256**	9,984
Additional tier 1 capital	**2,700**	3,042
Tier 2 capital	**2,207**	3,015
Total capital	**13,163**	16,041

44 Cash flow statements

a Change in operating assets

	The Group	
	2017 £m	2016 £m
Change in loans and receivables	**1,004**	3,733
Change in amounts due from Group undertakings	**(27,536)**	(15,351)
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**3,800**	3,806
Change in other operating assets	**(41)**	82
Change in operating assets	**(22,773)**	(7,730)

b Change in operating liabilities

	The Group	
	2017 £m	2016 £m
Change in deposits from banks	**14,992**	4,651
Change in customer deposits	**(8,121)**	(9,271)
Change in amounts due to Group undertakings	**25,809**	21,219
Change in debt securities in issue	**(5,761)**	(1,795)
Change in derivative financial instruments and trading and other financial liabilities at fair value through profit or loss	**(3,489)**	(2,989)
Change in other operating liabilities	**(567)**	(65)
Change in operating liabilities	**22,863**	11,750

44 Cash flow statements (continued)

c Non-cash and other items

	The Group	
	2017 £m	2016 £m
Depreciation and amortisation	**170**	172
Revaluation of investment properties	**–**	(2)
Allowance for loan losses	**158**	216
Write-off of allowance for loan losses, net of recoveries	**(482)**	(697)
Impairment of available-for-sale financial assets	**10**	1
Payment protection insurance provision	**486**	266
Other provision movements	**479**	259
Net charge (credit) in respect of defined benefit schemes	**169**	128
Unwind of discount on impairment allowances	**11**	11
Foreign exchange element on balance sheet[1]	**(534)**	(2,416)
Interest expense on subordinated liabilities	**408**	415
Other non-cash items	**(143)**	(670)
Total non-cash items	**732**	(2,317)
Contributions to defined benefit schemes	**(146)**	(177)
Payments in respect of other provision	**(374)**	(58)
Payments in respect of payment protection insurance provision	**(469)**	(546)
Other	**–**	2
Total other items	**(989)**	(779)
Non-cash and other items	**(257)**	(3,096)

[1] When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

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

	The Group	
	2017 £m	2016 £m
Cash and balances with central banks	**2,677**	2,840
Less: mandatory reserve deposits[1]	**(422)**	(455)
	2,255	2,385
Loans and advances to banks	**551**	1,116
Less: amounts with a maturity of three months or more	**(397)**	(449)
	154	667
Total cash and cash equivalents	**2,409**	3,052

[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.

44 Cash flow statements (continued)

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

	The Group	
	2017 £m	2016 £m
Due from fellow group undertakings	**151**	–
Trading and other financial assets at fair value through profit or loss	**123**	–
Available-for-sale financial assets	**375**	–
Property, plant and equipment	**9**	–
	658	–
Due to fellow group undertakings	**(402)**	–
Other net assets (liabilities)	**10**	–
	(392)	–
Net assets (liabilities) disposed of	**266**	–
Disposal of investment in joint ventures	**26**	5
Profit on sale of business	**–**	–
Cash consideration received on losing control of group undertakings and business	**292**	5
Cash and cash equivalents disposed	**–**	–
Net cash inflow (outflow)	**292**	5

45 Future accounting developments

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

With the exception of IFRS 17 'Insurance Contracts', the amendment to IFRS 9 'Prepayment Features with Negative Compensation' and certain other minor amendments as at 21 March 2018 these pronouncements have been endorsed by the EU.

IFRS 9 Financial Instruments
IFRS 9 replaces IAS 39 'Financial Instruments: Recognition and Measurement' and is effective for annual periods beginning on or after 1 January 2018. The Group has chosen 1 January 2018 as its initial application date of IFRS 9 and has not restated comparative periods.

Classification and measurement
IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income or amortised cost. Financial assets will be measured at amortised cost if they are held within a business model the objective of which is to hold financial assets in order to collect contractual cash flows, and their contractual cash flows represent solely payments of principal and interest. Financial assets will be measured at fair value through other comprehensive income if they are held within a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets and their contractual cash flows represent solely payments of principal and interest. Financial assets not meeting either of these two business models; and all equity instruments (unless designated at inception to fair value through other comprehensive income); and all derivatives are measured at fair value through profit or loss. An entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch.

In October 2017 the IASB issued an Amendment to IFRS 9, 'Prepayment Features with Negative Compensation' which has an effective date of 1 January 2019. This Amendment changes the requirements of IFRS 9 so that certain prepayment features meet the solely payments of principal and interest test. The Group has some loans in its Commercial Banking division that have these features and so the Group has decided to apply the Amendment in 2018 in order to avoid further changes to accounting for financial assets in 2019. The Amendment is still subject to EU endorsement and the Group assumes this will occur during 2018.

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

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

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

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

45 Future accounting developments (continued)

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

Impact on 31 December 2017 balance sheet
It is estimated that the new impairment methodology will result in higher impairment provisions of approximately £0.5 billion, predominantly for loans and advances to customers, recognised on the Group's balance sheet. The re-classification and measurement of assets under IFRS 9 also results in a reduction to the carrying value of financial assets of approximately £0.1 billion gross of tax. The total net of tax impact on shareholders' equity is a reduction of approximately £0.4 billion.

The ongoing impact on the financial results will only become clearer after running the IFRS 9 credit risk models over a period of time and under different economic environments, however, it could result in impairment charges being more volatile when compared to the current IAS 39 impairment model, due to the forward looking nature of expected credit losses.

Hedge accounting
The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The standard does not address macro hedge accounting, which is being considered in a separate IASB project. There is an option to retain the existing IAS 39 hedge accounting requirements until the IASB completes its project on macro hedging. The Group expects to continue applying IAS 39 hedge accounting in accordance with this accounting policy choice.

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

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

In nearly all cases the Group's current accounting policy is consistent with the requirements of IFRS 15.

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

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

Minor amendments to other accounting standards
The IASB has issued a number of minor amendments to IFRSs effective 1 January 2018 (including IFRS 2 Share-based Payment and IAS 40 Investment Property) and effective 1 January 2019 (including IAS 19 Employee Benefits, IAS 12 Income Taxes and IFRIC 23 Uncertainty over Income Tax Treatments). These revised requirements are not expected to have a significant impact on the Group.

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46 Other information

HBOS 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.

HBOS plc's immediate parent undertaking is Lloyds Bank 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.

GROUP COMPANIES

In compliance with Section 409 of the Companies Act 2006, the following comprises a list of all related undertakings of the Company, as at 31 December 2017. The list includes each undertaking's registered office and the percentage of the class(es) of shares held by the Group. All shares held are ordinary shares unless indicated otherwise in the notes.

Subsidiary undertakings

The Company directly or indirectly holds 100% of the share class and a majority of voting rights (including where the undertaking does not have share capital as indicated) in the following undertakings.

Name of undertaking	Notes
Alexanderplatz 2017 GmbH	24
Anglo Scottish Utilities Partnership 1	+ *
Automobile Association Personal Finance Ltd	3
Bank of Scotland (B G S) London Nominees Ltd	4 *
Bank of Scotland (Stanlife) London Nominees Ltd	4 *
Bank of Scotland Branch Nominees Ltd	4
Bank of Scotland Capital Funding (Jersey) Ltd	6
Bank of Scotland Central Nominees Ltd	4 *
Bank of Scotland Edinburgh Nominees Ltd	4 *
Bank of Scotland Equipment Finance Ltd	2
Bank of Scotland HongKong Nominees Ltd	7 *
Bank of Scotland Leasing Ltd	2
Bank of Scotland LNG Leasing (No 1) Ltd (In liquidation)	8
Bank of Scotland London Nominees Ltd	5 *
Bank of Scotland Nominees (Unit Trusts) Ltd	4 *
Bank of Scotland P.E.P. Nominees Ltd	4 *
Bank of Scotland plc	4
	iv
Bank of Scotland Structured Asset Finance Ltd	1
Bank of Scotland Transport Finance 1 Ltd (In liquidation)	2
Bank of Wales Ltd	2
Barents Leasing Ltd	1
Bedfont Lakes Business Park (No.2) LP	14 *
Birmingham Midshires Asset Management Ltd (In liquidation)	3
Birmingham Midshires Financial Services Ltd	3
Birmingham Midshires Land Development Ltd	3
Birmingham Midshires Mortgage Services Ltd	3
BOS (Ireland) Property Services 2 Ltd	11
BOS (Shared Appreciation Mortgages (Scotland) No. 2) Ltd	3
BOS (Shared Appreciation Mortgages (Scotland) No. 3) Ltd	3
BOS (Shared Appreciation Mortgages (Scotland)) Ltd	3
BOS (Shared Appreciation Mortgages) No. 1 plc	3 #
BOS (Shared Appreciation Mortgages) No. 2 plc	3 #
BOS (Shared Appreciation Mortgages) No. 3 plc	3 #
BOS (Shared Appreciation Mortgages) No. 4 plc	3 #
BOS (Shared Appreciation Mortgages) No. 5 plc	3
BOS (Shared Appreciation Mortgages) No. 6 plc	3
BOS (USA) Fund Investments Inc.	9 xiii
BOS (USA) Inc.	9
BOS Mistral Ltd	2
BOSIC Inc.	13
BOSSAF Rail Ltd	1
Britannia Personal Lending Ltd	3 i #
British Linen Leasing (London) Ltd	4
British Linen Leasing Ltd	4
British Linen Shipping Ltd	4
Capital 1945 Ltd	2
Capital Bank Insurance Services Ltd (In liquidation)	8
Capital Bank Leasing 1 Ltd	2
Capital Bank Leasing 2 Ltd	2
Capital Bank Leasing 3 Ltd	2
Capital Bank Leasing 4 Ltd	2
Capital Bank Leasing 5 Ltd	2
Capital Bank Leasing 6 Ltd	2
Capital Bank Leasing 7 Ltd	2
Capital Bank Leasing 8 Ltd	2
Capital Bank Leasing 9 Ltd	2
Capital Bank Leasing 10 Ltd	2
Capital Bank Leasing 11 Ltd	2
Capital Bank Leasing 12 Ltd	5
Capital Bank Property Investments (3) Ltd	2
Capital Bank Vehicle Management Ltd	2
Capital Leasing (Edinburgh) Ltd	12
Capital Leasing Ltd (In liquidation)	23
Capital Personal Finance Ltd	3
Cartwright Finance Ltd	2 viii
	vii #
CBRail S.A.R.L.	26
CF Asset Finance Ltd	2
Chariot Finance Ltd (In liquidation)	8
First Retail Finance (Chester) Ltd	3
Flexifly Ltd (In liquidation)	23
Forthright Finance Ltd	2
Freeway Ltd (In liquidation)	2
Glosstrips Ltd (In liquidation)	23
Godfrey Davis (Contract Hire) Ltd	2
Halifax Credit Card Ltd	3 i
	ii
	vii
Halifax Group Ltd	3
Halifax Leasing (June) Ltd	1
Halifax Leasing (March No.2) Ltd	1
Halifax Leasing (September) Ltd	1
Halifax Ltd	3
Halifax Loans Ltd	3
Halifax Mortgage Services (Holdings) Ltd	3
Halifax Mortgage Services Ltd	3
Halifax Nominees Ltd	3
Halifax Premises Ltd	1
Halifax Share Dealing Ltd	3
Halifax Vehicle Leasing (1998) Ltd	3
HBOS Canada Inc.	13
HBOS Capital Funding (Jersey) Ltd	6
HBOS Covered Bonds LLP	3 *
HBOS Directors Ltd (In liquidation)	8
HBOS Final Salary Trust Ltd	4
HBOS Management (Jersey) Ltd	6
HBOS Social Housing Covered Bonds LLP	2 *
HBOS Treasury Services Ltd (In liquidation)	8
HBOS UK Ltd	4
Hill Samuel (USA), Inc.	9
HL Group (Holdings) Ltd (In liquidation)	8
Home Shopping Personal Finance Ltd	3
Horizon Capital Ltd (In liquidation)	23
HSDL Nominees Ltd	3
IBOS Finance Ltd	2
ICC Enterprise Partners Ltd (In liquidation)	15
ICC Equity Partners Ltd (In liquidation)	15
ICC ESOP Trustee Ltd (In liquidation)	16
ICC Holdings Unlimited Company	11
ICC Software Partners Ltd (In liquidation)	15
IF Covered Bonds Limited Liability Partnership (In liquidation)	22 *
Intelligent Finance Financial Services Ltd	3
Intelligent Finance Software Ltd	3
Kanto Leasing Ltd (In liquidation)	8
Katrine Leasing Ltd	17
Legacy Renewal Company Ltd	4
Lex Vehicle Finance Ltd (In liquidation)	8
Lex Vehicle Leasing (Holdings) Ltd	2 i
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Lex Vehicle Leasing Ltd	2
Lex Vehicle Partners (1) Ltd (In liquidation)	8
Lex Vehicle Partners (2) Ltd (In liquidation)	8
Lex Vehicle Partners (3) Ltd (In liquidation)	8
Lex Vehicle Partners (4) Ltd (In liquidation)	8
Lex Vehicle Partners Ltd (In liquidation)	8
Lloyds Bank (Fountainbridge 1) Ltd	4
Lloyds Bank (Fountainbridge 2) Ltd	4
Lloyds Secretaries Ltd	1
London Uberior (L.A.S. Group) Nominees Ltd	4 *
Meadowfield Investments Ltd (In liquidation)	23
Membership Services Finance Ltd	3
Moray Investments Ltd (In liquidation)	8
NFU Mutual Finance Ltd	2 i #
	vii
Nordic Leasing Ltd	1
NWS Trust Ltd	4
Ocean Leasing (July) Ltd (In liquidation)	1
Ocean Leasing (No 1) Ltd (In liquidation)	8
Ocean Leasing (No 2) Ltd (In liquidation)	8
Pacific Leasing Ltd	1
Peony Eastern Leasing Ltd	1
Peony Leasing Ltd	1
Peony Western Leasing Ltd	1
Quion 6 BV	19

Group companies

Saleslease Purchase Ltd (In liquidation)	23
Sapphire Cards Limited (In liquidation)	29
Scotmar Commercial Equipment Finance Ltd (In liquidation)	8 i #
Seabreeze Leasing Ltd	
Seaforth Maritime (Highlander) Ltd (In liquidation)	29
Seaforth Maritime (Jarl) Ltd (In liquidation)	29
Seaspirit Leasing Ltd	1
Seaspray Leasing Ltd (In liquidation)	8
Share Dealing Nominees Ltd	3
Standard Property Investment (1987) Ltd	12 i
	ii
Standard Property Investment Ltd	21 #
Sussex County Homes Ltd	3
The British Linen Company Ltd	4
The Mortgage Business plc	3
Thistle Leasing	+ *
Tower Hill Property Investments (7) Ltd	2 #
Tower Hill Property Investments (10) Ltd	2 #
Tranquility Leasing Ltd	1
Uberior Canada LP Ltd	21
Uberior ENA Ltd	12
Uberior Infrastructure Investments Ltd	4
Uberior Infrastructure Investments (No.2) Ltd	1
Uberior Nominees Ltd	4*
Uberior Trustees Ltd	4 *
Universe, The CMI Global Network Fund	31 *
Vehicle Leasing (1) Ltd (In liquidation)	8
Vehicle Leasing (2) Ltd (In liquidation)	8
Vehicle Leasing (3) Ltd (In liquidation)	8
Vehicle Leasing (4) Ltd (In liquidation)	8
Warwick Leasing Ltd (In liquidation)	8
Western Trust & Savings Holdings Ltd (In liquidation)	8
Western Trust Holdings Ltd (In liquidation)	8

Subsidiary Undertakings (continued)

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

Name of undertaking	Notes
Addison Social Housing Holdings Ltd	21
Candide Financing 2007 NHG BV	18
Candide Financing 2008-1 BV	18
Candide Financing 2008-2 BV	18
Candide Financing 2011-1 BV	18
Candide Financing 2012-1 BV	18
Deva Financing Holdings Ltd	29
Deva Financing plc	29
Edgbaston RMBS 2010-1 plc	29
Edgbaston RMBS Holdings Ltd	29
Molineux RMBS 2016-1 plc	29
Molineux RMBS Holdings Ltd	29
Penarth Asset Securitisation Holdings Ltd	29
Penarth Funding 1 Ltd	21
Penarth Funding 2 Ltd	21
Penarth Master Issuer plc	29
Penarth Receivables Trustee Ltd	21
Permanent Funding (No. 1) Ltd	29
Permanent Funding (No. 2) Ltd	29
Permanent Holdings Ltd	29
Permanent Master Issuer plc	29
Permanent Mortgages Trustee Ltd	29
Permanent PECOH Holdings Ltd	29
Permanent PECOH Ltd	29
Stichting Candide Financing Holdings	18
Swan Funding 2 Ltd	21
Trinity Financing Holdings Ltd	29
Trinity Financing plc	29
Lloyds Bank Foundation for England & Wales •	27
The Halifax Foundation for Northern Ireland •	10
Lloyds Bank Foundation for the Channel Islands•	27
Lloyds TSB Foundation for Scotland •	28
Bank of Scotland Foundation •	4
• A charitable foundation funded but not owned by Lloyds Banking Group	

Group companies

Associated undertakings

The Group has a participating interest in the following undertakings.

Name of undertaking	% of share class held by immediate parent company (or by the Group where this varies)	Registered office address (UK unless stated otherwise)	Notes
Addison Social Housing Ltd	20%	35 Great St Helen's, London, EC3A 6AP	
Aspire Oil Services Ltd	28.4%	Bishop's Court, 29 Albyn Place, Aberdeen, AB10 1YL, United Kingdom	&
Cary Towne Parke Holdings LLC	n/a	Jeffrey Cohen, 1066 Woodward Avenue, Detroit, MI 48226, United States	*
Cary Towne Parke LLC	n/a	100 Galleria Officentre, Suite 419, Southfield MI 48034, United States	*
Connery Ltd	20%	44 Esplanade St Helier Jersey JE4 9WG	&
Motability Operations Group plc	20% (40%) 20% (40%)	City Gate House, 22 Southwark Bridge Road, London, SE1 9HB	iv
Northern Edge Ltd	39.4%	The Beacon, 176 St. Vincent Street, Glasgow, G2 5SG	ii &
Thread Real Estate Cary Towne Park LLC	n/a	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	

* The undertaking does not have share capital
\+ The undertaking does not have a registered office
\# In relation to Subsidiary Undertakings, an undertaking external to the Group holds shares
& The Group holds voting rights of between 20% and 49.9%

(i) A Ordinary shares
(ii) B Ordinary shares
(iii) Deferred shares
(iv) Preference shares
(v) Preferred ordinary shares
(vi) Non-voting shares
(vii) C Ordinary shares
(viii) N Ordinary shares
(ix) Callable preference shares
(x) Redeemable preference shares
(xi) Ordinary limited voting shares
(xii) Redeemable ordinary shares
(xiii) Common stock

Registered office addresses

(1) 25 Gresham Street, London, EC2V 7HN
(2) Charterhall House, Charterhall Drive, Chester, CH88 3AN
(3) Trinity Road, Halifax, HX1 2RG
(4) The Mound, Edinburgh, EH1 1YZ
(5) 116 Cockfosters Road, Barnet, Hertfordshire, EN4 0DY
(6) Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT
(7) 26th Floor, Oxford House, Taikoo Place, Quarry Bay, Hong Kong
(8) 1 More London Place, London, SE1 2AF
(9) 1095 Avenue of the America's, 34th Floor, New York, NY 10036, United States
(10) 2nd Floor, 14 Cromac Place, Gasworks, Belfast, BT7 2JB
(11) Rineanna House, Shannon Free Zone, Co. Clare, Ireland
(12) Level 1, Citymark, 150 Fountainbridge, Edinburgh, EH3 9PE
(13) Cox and Palmer, Suite 400, 371 Queen Street, Phoenix Square, Fredericton, NB E3B 4Y9, Canada
(14) 33 Old Broad Street, London, EC2N 1HZ
(15) McStay Luby, Dargan House, 21-23 Fenian Street, Dublin 2, Ireland
(16) 124-127 St. Stephen's Green, Dublin 2, Ireland
(17) 47 Esplanade, St. Helier, Jersey, JE1 0BD
(18) Fred. Roeskestraat 123, 1076 EE, Amsterdam, Netherlands
(19) Lichtenauerlann 170, 3062ME, Rotterdam, Netherlands
(20) Caledonian Exchange, 19A Canning Street, Edinburgh, EH3 8HE
(21) 44 Esplanade, St Helier, Jersey, JE4 9WG, Jersey
(22) 40a Station Road, Upminster, Essex, RM14 2TR
(23) EY Atria One, 144 Morrison Street, Edinburgh, EH3 8EB
(24) Sitz, Niederlassung, Inländische Geschäftsanschrift, Empfangsberechtigte Person, Zweigniederlassungen, Berlin
(25) 106 Route d'Arlon, Mamer, L-8210, Luxembourg
(26) 6 Rue Jean Monnet, L-2180 Luxembourg,
(27) Pentagon House, 52-54 Southwark Street, London, SE1 1UN
(28) Riverside House, 502 Gorgie Road, Edinburgh, EH11 3AF
(29) 35 Great St Helen's, London, EC3A 6AP
(30) 44 Chipman Hill, Suite 1000, St. John, NB E2L 2A9, Canada

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