HBOS plc

Report and Accounts
2018

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 accounts, savings, mortgages, credit cards and unsecured loans to personal and business banking customers; and lending, transactional banking, working capital management, risk management and debt capital markets services to commercial customers.

Business review

During the year, the Company's subsidiary, Bank of Scotland plc, sold the element of its commercial banking and overseas businesses required to be transferred in order to ensure compliance with the ring-fencing legislation to Lloyds Bank Corporate Markets plc, a fellow Lloyds Banking Group undertaking.

During the year ended 31 December 2018, the Group recorded a profit before tax of £2,260 million compared with a profit before tax in 2017 of £2,921 million.

Total income decreased by £1,004 million, or 14 per cent, to £6,018 million in the year ended 31 December 2018 compared with £7,022 million in 2017; a £315 million decrease in net interest income was combined with a decrease of £689 million in other income.

Net interest income was £5,742 million in the year ended 31 December 2018, a decrease of £315 million, or 5 per cent compared to £6,057 million in 2017 as the impact of reductions in the Group's balance sheet was only partly offset by margin improvements.

Other income was £689 million lower at £276 million in the year ended 31 December 2018 compared to £965 million in 2017. Net fee and commission income was £163 million lower at £221 million in the year ended 31 December 2018 compared to £384 million in 2017, in part due to a lower level of current account fees as a result of changes to overdraft charging announced in July 2017, which took effect in November, reduced corporate fee income following the transfer of some activities to Lloyds Bank Corporate Markets plc during the year and also a renegotiation of fee arrangements for the sale of insurance products through the banking network. Net trading income, which is inherently volatile, was £304 million lower at a deficit of £11 million in the year ended 31 December 2018 compared to income of £293 million in 2017. Other operating income was £222 million lower at £66 million in the year ended 31 December 2018 compared to £288 million in 2017; 2018 included a loss of £105 million on the sale of the Group's Irish residential mortgage portfolio whereas 2017 included a gain of £63 million on the sale of the Group's investment in Vocalink.

Operating expenses decreased by £380 million to £3,564 million in the year ended 31 December 2018 compared with £3,944 million in the year ended 31 December 2017. There was a £491 million reduction in regulatory provisions partly offset by a £111 million increase in other operating expenses. The charge in respect of regulatory provisions was £435 million compared to £926 million in 2017 and comprised a charge of £185 million in respect of payment protection insurance and £250 million in respect of other conduct issues. Other operating expenses were £111 million higher at £3,129 million in the year ended 31 December 2018 compared to £3,018 million in 2017 reflecting an increased level of restructuring costs.

Credit quality across the portfolio remains strong. Impairment losses increased by £37 million to £194 million in year ended to 31 December 2018 compared with £157 million in 2017, reflecting the expected lower releases and write-backs.

Total assets were £31,020 million lower at £333,660 million at 31 December 2018 compared to £364,680 million at 31 December 2017. After adjusting for the impact of adoption of IFRS 9, which required the reclassification of certain lending assets to fair value through profit or loss, loans and advances to customers decreased in the year by £5,549 million to £262,324 million, compared to £267,873 million at 1 January 2018, as a result of the transfer of lending assets to Lloyds Bank Corporate Markets plc and a reduction of some £4 billion on sale of the Group's Irish residential mortgage portfolio; the open mortgage book was broadly flat reflecting continued focus on margin in a highly competitive market environment. Amounts due from fellow Lloyds Banking Group undertakings were £21,659 million lower at £53,190 million compared to £74,849 million at 31 December 2017 as a result of a rationalisation of internal positions across the Lloyds Banking Group.

Customer deposits were £9,057 million lower at £162,141 million at 31 December 2018 compared to £171,198 million at 31 December 2017 as a result of the transfer of the Group's offshore business to Lloyds Bank Corporate Market plc; reductions in maturing retail savings products have largely offset growth in retail current account balances and in corporate products. Amounts due to fellow Lloyds Banking Group undertakings were £16,372 million lower at £109,169 million at 31 December 2018 compared to £125,541 million at the previous year end, again as a result of the rationalisation of internal positions across the Lloyds Banking Group

Total equity has decreased by £1,924 million from £13,999 million at 31 December 2017 to £12,075 million at 31 December 2018, principally due to dividends paid of £3,300 million, as the Group restructures its capital following the sale of businesses as part of the Lloyds Banking Group's programme for compliance with the ring-fencing legislation, more than offsetting retained profits of £1,458 million.

The Group's common equity tier 1 capital ratio increased to 12.9 per cent (31 December 2017: 11.9 per cent) and the tier 1 capital ratio increased to 17.2 per cent (31 December 2017: 15.8 per cent), reflecting the reduction in risk-weighted assets, offset in part by the reduction in common equity tier 1 capital. The latter largely reflected interim dividends paid, the accrual for foreseeable dividends in respect of full year earnings and an increase in the defined benefit pension surplus deduction, partially offset by retained profits for the year. The total capital ratio increased to 20.6 per cent (31 December 2017: 19.0 per cent) reflecting the reduction in risk-weighted assets and non-significant investments (the latter a reflection of the ring-fencing related restructuring activities), offset in part by the reduction in common equity tier 1 capital and regulatory adjustments applied to tier 2 instruments.

Risk-weighted assets reduced by £7,214 million, or 10 per cent, to £62,136 million at 31 December 2018 compared to £69,350 million at 31 December 2017, largely reflecting the impact of the ring-fencing related restructuring activities and the sale of the Irish residential mortgage portfolio.

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

Capital position at 31 December 2018
The Group's capital position as at 31 December 2018, applying CRD IV transitional rules and IFRS 9 transitional arrangements, is set out in the following section.

Table 1.1 Capital resources (audited)

Capital resources (transitional)	At 31 December 2018 £m	At 31 December 2017 £m
Common equity tier 1		
Shareholders' equity per balance sheet	**10,538**	12,462
Adjustment to retained earnings for foreseeable dividends	**(500)**	(1,750)
Cash flow hedging reserve	**70**	(23)
Other adjustments	**291**	(3)
	10,399	10,686
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	**(445)**	(437)
Prudent valuation adjustment	**(88)**	(119)
Excess of expected losses over impairment provisions and value adjustments	**–**	(46)
Removal of defined benefit pension surplus	**(378)**	(57)
Securitisation deductions	**–**	(180)
Non-significant investments	**–**	(10)
Deferred tax assets	**(1,497)**	(1,581)
Common equity tier 1 capital	**7,991**	8,256
Additional tier 1		
Additional tier 1 instruments	**2,710**	3,012
Less: deductions from tier 1		
Non-significant investments	**–**	(312)
Total tier 1 capital	**10,701**	10,956
Tier 2		
Tier 2 instruments	**1,943**	2,547
Eligible provisions	**165**	247
Less: deductions from tier 2		
Non-significant investments	**–**	(587)
Total tier 2 capital	**2,108**	2,207
Total capital resources	**12,809**	13,163
Risk-weighted assets (unaudited)	**62,136**	69,350
Common equity tier 1 capital ratio[1]	**12.9%**	11.9%
Tier 1 capital ratio[1]	**17.2%**	15.8%
Total capital ratio[1]	**20.6%**	19.0%

1 Reflecting the full impact of IFRS 9 at 31 December 2018, without the application of transitional arrangements, the Group's common equity tier 1 capital ratio would be 12.3 per cent, the tier 1 capital ratio would be 16.7 per cent and the total capital ratio would be 20.2 per cent.

Table 1.2: Risk-weighted assets (unaudited)

	At 31 December 2018 £m	At 31 December 2017 £m
Risk-weighted assets		
Foundation Internal Ratings Basel (IRB) Approach	**5,363**	5,808
Retail IRB Approach	**35,754**	38,010
Other IRB Approach	**1,093**	3,437
IRB Approach	**42,210**	47,255
Standardised Approach	**6,864**	7,471
Credit risk	**49,074**	54,726
Counterparty credit risk	**599**	995
Credit valuation adjustment risk	**115**	167
Operational risk	**10,539**	11,055
Market risk	**1,235**	1,608
Underlying risk-weighted assets	**61,562**	68,551
Threshold risk-weighted assets	**574**	799
Total risk-weighted assets	**62,136**	69,350

Principal risks and uncertainties

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

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.

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.

Principal risks and uncertainties are reviewed and reported regularly. As part of a review of Lloyds Banking Group's risk categories, the secondary risk categories of Change, Data management and Operational resilience have been elevated to primary risk categories, and Strategic risk has been included as a new primary risk category, in Lloyds Banking Group's Risk Management Framework. These changes will be embedded during 2019 and reflected within the Group's principal risks.

Credit risk

The risk that parties with whom we have contracted, fail to meet their financial obligations (both on and off balance sheet). Adverse changes in the economic, geopolitical and market environment could impact profitability due to an increase in delinquency, defaults, write downs and/or expected credit losses.

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.
- During the year we strengthened affordability buffers and improved controls to restrict lending to consumers with higher risk of over-indebtedness.
- Effective, well-established governance process supported by independent credit risk oversight and assurance.
- Early identification of signs of stress leading to prompt engagement with the customer.

Regulatory and legal risk

The risk that the Group is exposed to financial loss, fines, censure, or legal or enforcement action; or to civil or criminal proceedings in the courts (or equivalent) and/or the Group is unable to enforce its rights due to failing to comply with applicable laws (including codes of practice which could have legal implications), regulations, codes of conduct or legal obligations, or a failure to adequately manage actual or threatened litigation, including criminal proceedings.

Key mitigating actions
- Implementation of compliance and legal risk management policies and procedures to ensure appropriate controls and processes are in place to comply with legislation, rules and regulation.
- Embedding Group-wide processes to monitor ongoing compliance with new legislation, rules and regulation.
- Continued investment in people, processes, training and IT to help meet our legal and regulatory commitments.
- Ongoing engagement with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations, ensuring programmes are established to deliver new regulation and legislation.
- Ongoing horizon scanning to identify changes in regulatory and legal requirements.

Conduct risk

The risk of customer detriment due to poor design, distribution and execution of products and services or other activities which could undermine the integrity of the market or distort competition leading to unfair customer outcomes, regulatory censure and financial and reputational loss.

Key mitigating actions
- Conduct policies and procedures are in place to ensure appropriate controls and processes that deliver fair customer outcomes.
- Conduct risk appetite metrics provide a granular view of how our products and services are performing for customers through the customer lifecycle.
- Product approval, continuous product review processes and customer outcome testing in place (across products and services).
- Learning from past mistakes through root cause analysis.
- Clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics.
- Further enhancements and embedding of our framework to support all customers, including those in vulnerable circumstances.

Principal risks and uncertainties (continued)

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 to reinforce behaviours which 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.
- During 2018 we enhanced our colleague wellbeing strategies to ensure support is in place to meet colleague needs, and to help achieve the skills and capability growth required to build a workforce for the 'Bank of the Future'.

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 within Lloyds Banking Group that includes setting of capital risk appetite for material subsidiaries.
- Close monitoring of capital and leverage ratios of subsidiaries to ensure we meet regulatory requirements and risk appetite.
- Comprehensive stress testing analyses to evidence capital adequacy.

Funding and liquidity risk
Funding risk is the risk that we do not have sufficiently stable and diverse sources of funding. Liquidity risk is 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 business-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 ensuring that the Group continues to demonstrate compliance with the requirements to ring-fence core UK financial services and activities, the potential impact of EU exit and further requirements under the Senior Manager & Certification Regime (SM&CR).

Key mitigating actions
- To meet ring-fencing requirements, core UK financial services and activities have been ring-fenced within the Group from other activities of Lloyds Banking Group and an appropriate control environment and governance structures are in place to ensure compliance.
- A dedicated change programme is in place and addressing the additional SM&CR requirements which will come into force during 2019.
- A dedicated programme is in place to assess and address the potential impacts of EU exit on the Group's operations in Europe. The Group is in close and regular contact with regulators to develop and deploy our planned operating and legal structure to mitigate the potential impacts of EU exit.
- Evolving risk and governance arrangements to ensure they 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 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 defined benefit pension schemes continue to monitor their credit allocation as well as the hedges in place 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 models and rating systems.

Key mitigating actions
- A comprehensive model risk management framework.
- 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.

Strategic report

Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in notes 41 and 44 to the accounts. The Group's approach to risk management including risk policies, risk appetite, measurement bases and sensitivities, in particular for credit risk, market risk and liquidity risk, is aligned to those of Lloyds Banking Group plc, the Company's ultimate parent. Further information can be found in the Lloyds Banking Group plc annual report.

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

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

The 2018 Strategic Report has been approved by the Board of Directors.

On behalf of the Board

Lord Blackwell
HBOS plc
14 March 2019

Directors' report

Results

The consolidated income statement on page 20 shows a statutory profit before tax from continuing operations for the year ended 31 December 2018 of £2,260 million (year ended 31 December 2017: £2,921 million).

Dividends

During the year the Company paid interim dividends of £1,800 million and £1,500 million, a cumulative total of £3,300 million (2017: £2,900 million). The Directors have not recommended a final dividend for the year ended 31 December 2018 (2017: nil). In February 2019, the Directors approved the payment of a further interim dividend of £500 million, which will be paid on or around 30 April 2019.

Post balance sheet events

There were 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 and liquidity. 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 and funding position set out in the Strategic Report on pages 2 to 6 and additionally have considered projections for the Company's and the Group's capital and funding position. Accordingly, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts over the next 12 months, from the date of approval of the financial statements.

Directors

The names of the current Directors are shown on page 10. Changes to the composition of the Board since 1 January 2018 up to the date of this report are shown in the table below:

	Joined the Board	Retired from the Board
Amanda Mackenzie	1 October 2018	
Deborah McWhinney		31 December 2018

Directors' indemnities

The Directors of the Company, including the former Director 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 2018. In addition, Lloyds Banking Group plc had appropriate Directors' and Officers' liability insurance cover in place throughout 2018. 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 former Directors who retired during the year, and to colleagues of the Group subject to the provisions of the Senior Managers and Certification Regime. Such deeds were in force during the financial year ended 31 December 2018 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.

Information required under DTR 7.2

Certain information is incorporated into this report by reference. Information about internal control and risk management systems relating to the financial reporting process can be found on page 6.

Information about share capital is shown in note 33 on page 71. The Company is a wholly owned subsidiary of Lloyds Bank plc.

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.

The appointment and retirement 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.

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 interest. Directors have a duty to notify the Chairman and Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to commitments of all Directors are reported to the Board and a register of potential conflicts and time commitments is regularly reviewed and authorised by the Board to ensure the authorisation status remains appropriate.

Stuart Sinclair is a Senior Independent Director at QBE UK 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.

Branches, future developments and financial risk management objectives and policies

The Company does not operate any branches, either in the UK or overseas. Information regarding future developments and financial risk management objectives and policies of the Group in relation to the use of financial instruments that would otherwise be required to be disclosed in the Directors' report, and which is incorporated into this report by reference, can be found in the Strategic Report.

Share capital

Information about share capital is shown in note 33 on page 71. This information is incorporated into this report by reference.

The Company did not repurchase any of its shares during 2018 (2017: 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.

Change of control
The Company is not party to any significant agreements which take effect, alter or terminate upon a change of control of the Company following 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 ('LBG'), of which the Company is a part, continues to work toward building a culture in which everyone feels included, empowered and inspired to do the right thing for customers. LBG believes it is important that the Board engages actively with colleagues and understands the views of LBG's diverse workforce and does this in a variety of ways. During the year LBG communicated directly with colleagues detailing it's performance, changes in the economic and regulatory environment and updates on our key strategic initiatives. Regular Ask Me Anything sessions were held, providing the opportunity for colleagues and contingent workers to ask questions and receive real time responses directly from members of the Board and senior colleagues across all departments. Members of the Board visited several LBG offices, and LBG hosted regular breakfasts and informal dinners with the Chairman and Group Chief Executive, which took place in various hub locations with invitations extended to contingent workers and suppliers within these locations. LBG held its biggest ever live communication event, which was attended by 4,000 colleagues. This event, hosted by the LBG Chief Executive, Chairman and key members of the executive leadership team, provided the opportunity for colleagues to see first-hand how LBG is Helping Britain Prosper. Speeches were broadcast live on LBG's intranet and sessions were run in five key hub locations to provide opportunities for colleagues in those locations to experience the event.

LBG held meetings throughout the year with its recognised unions, attended by the Chair of the Remuneration Committee and the Group Chief Executive. Key topics included the Living Wage, which applies to the whole workforce. The Board participated in 'transforming ways of working' labs, providing them with the opportunity to see first-hand the activity underway in support of changing the way LBG works and improving colleague experience. The Board reviewed the results from annual surveys; Banking Standards Board survey and cultural assessment colleague engagement survey, and agreed specific actions as a result. LBG is committed to improving the transparency of workforce disclosure and for the first time in 2018 participated in the Workforce Disclosure Initiative. During 2018, the Board discussed how best to engage with the wider workforce; permanent employees, contingent workers and third party suppliers that work on LBG's premises. From the second quarter of 2019, the Board will receive quarterly insight into workforce related activity and support key decision making. LBG offers a competitive and fair reward package. Colleagues are eligible to participate in HMRC approved share plans which promote share ownership by giving employees an opportunity to invest in LBG shares.

Traditionally, employment of people with disabilities has focused on making changes to physical infrastructure or working practices. LBG is moving the debate from accommodating disabilities to developing talent and careers. LBG offers bespoke training, career development programmes and recruitment process adjustments for colleagues and applicants with disabilities, including those who have become disabled while employed. Training includes courses run with external disability consultants, which have been described as life changing by attendees. LBG gives full and fair consideration to applications from all candidates, offering guaranteed interviews for candidates declaring a disability, and meeting minimum role requirements. LBG is unbiased in its assessment, selection, appointment, training and promotion of people. In 2018 LBG retained its Business Disability Forum (BDF) Gold Standard, and holds Disability Confident Leader status with the Department for Work and Pensions. The BDF considers LBG's workplace adjustment process for disabled colleagues to be ground breaking, creating a best practice case study that they have shared with around 400 other BDF member organisations. LBG is set to achieve Autism Friendly Bank and Employer accreditation from the National Autistic Society in mid-2019.

Significant contracts
Details of related party transactions are set out in note 38 on pages 77 to 79.

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 10 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 2019 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
14 March 2019

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

Amanda Mackenzie (from 1 October 2018)

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 directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes,' 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered,' 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the 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; the ability to achieve strategic objectives; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; concentration of financial exposure; management and monitoring of conduct risk; instability in the global financial markets, including Eurozone instability, instability as a result of uncertainty surrounding the exit by the UK from the European Union (EU) and as a result of such exit 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; risks relating to climate change; changes in laws, regulations, practices and 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 transition from IBORs to alternative reference rates; 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 with the US Securities and Exchange Commission for a discussion of certain factors and risks 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 2018 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 International Financial Reporting Standards (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 2018; 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; the consolidated cash flow statement and company cash flow statement for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies. We have also audited the consolidated and company balance sheets as at 1 January 2018.

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 10 to the financial statements, we have provided no non-audit services to the Group or the Company in the period from 1 January 2018 to 31 December 2018.

Our audit approach
Overview
- Overall Group materiality: £150 million (2017: £200 million), based on 5 per cent of a 3 year average of adjusted profit before tax. Profit was adjusted to remove the effects of certain items which were considered to have a disproportionate impact.
- Overall Company materiality: £150 million (2017: £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 controls and analytical review procedures to mitigate the risk of material misstatement in the residual components.

The key audit matters which were of most significance in the audit and involved the greatest allocation of our resources and effort were:

- Expected credit loss allowances (Group).
- Conduct risk and provisions (Group).
- Defined benefit obligations (Group).
- Hedge accounting (Group and Company).
- Privileged access to IT systems (Group and Company).

These items were discussed with the Audit Committee as part of our audit plan in April 2018 and supplemented with updates in January 2019. These were 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.

Capability of the audit in detecting irregularities, including fraud
Based on our understanding of the Group and industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of banking laws and regulations such as, but not limited to, regulations relating to consumer credit and unethical and prohibited business practices, and we considered the extent to which non-compliance might have a material effect on the financial statements. We also considered those laws and regulations that have a direct impact on the financial statements such as the Companies Act 2006, the Consumer Credit Act 1974 and the Banking Reform Act, and we

considered the extent to which non-compliance might have a material effect on the financial statements. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to posting manual journal entries to manipulate financial performance, management bias through judgements and assumptions in significant accounting estimates and significant one-off or unusual transactions. The Group engagement team shared this risk assessment with the component auditors referred to in the scoping section of our report below, so that they could include appropriate audit procedures in response to such risks in their work. The Group engagement team shared this risk assessment with the component auditors so that they could include appropriate audit procedures in response to such risks in their work. Audit procedures performed by the Group engagement team and/or component auditors included:

– Discussions with management and those charged with governance including consideration of known or suspected instances of non-compliance with laws and regulations and fraud;
– Evaluation and testing of the operating effectiveness of management's entity level controls designed to prevent and detect irregularities, in particular their code of conduct and whistleblowing helpline;
– Assessment of matters reported on the Group's whistleblowing helpline and the results of management's investigation of such matters;
– Performed testing over period end adjustments;
– Incorporated unpredictability into the nature, timing and/or extent of our testing;
– Reviewing key correspondence with the FCA and PRA;
– Challenging assumptions and judgements made by management in their significant accounting estimates, in particular in relation to expected credit losses, conduct risk and provisions and defined benefit obligations (see related key audit matters below); and
– Identifying and testing journal entries, in particular any manual journal entries posted by infrequent users or senior management, posted on unusual days, posted with descriptions indicating a higher level of risk, or posted late with a favourable impact on financial performance.

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. Also, 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.

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 in aggregate 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	£150 million (2017: £200 million).	£150 million (2017: £200 million).
How we determined it	5 per cent of a 3 year average of adjusted profit before tax. Profit was adjusted to remove the effects of certain items which were considered to have a disproportionate impact.	1 per cent of total assets.
Rationale for benchmark applied	Our starting point was a 3 year average of profit before tax, a generally accepted auditing practice. Profit before tax was adjusted to remove the disproportionate effect of regulatory provisions as they are considered not to reflect long term performance of the Group.	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. Where the calculated Company materiality from total assets exceeds the Group overall materiality level, the Company has been restricted to equal the Group overall materiality level.

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 £50 million and £100 million. Certain components were audited to a local statutory audit materiality that was also less than our overall Group materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £15 million (Group and Company audit) (2017: £20 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

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

The Group is structured into two business units being Retail and Commercial Banking. Both business units 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 and from other PwC network firms operating under our instruction ('component auditors'). Almost all of our audit work is undertaken by 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 or more account balances was subject to specific audit procedures over those account balances. Inconsequential components (defined as components which, in our judgement, 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 subject to procedures which mitigated the risk of material misstatement 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 96 per cent of Group total assets and 95 per cent of Group total income.

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**
Expected credit loss allowances **Group** Refer to page 30 (Accounting Policies) and page 52 (Note 17 and Critical Accounting Judgements and Estimates). The determination of expected credit loss allowances is highly subjective and judgemental. With the introduction of IFRS 9 in 2018, a number of additional judgements and assumptions are introduced and reflected in the financial statements, including the identification of significant increases in credit risk and the application of forward looking economic scenarios. *Group economics* The Group's economics team develops future economic scenarios by using a statistical model and a number of qualitative factors. Four scenarios are chosen from the model output which represent distinct economic scenarios and sensitivities of historical loss experience. These four scenarios together with relative weightings are then provided to the Retail and Commercial Banking divisions for incorporation into the Stage allocation process and the calculation of expected credit loss allowances. *Retail* Expected credit loss allowances relating to loans and advances in the Retail division are determined on a collective basis, with the use of impairment models. These models use a number of key assumptions including probability of default, loss given default (including propensity for possession and forced sale discounts for mortgages) and valuation of recoveries. Management also apply overlays where they believe the model calculated assumptions and allowances are not appropriate, either due to emerging trends or the model limitations. An example of this is an overlay to the impairment model output for the UK mortgages portfolio relating to expected credit losses on past term interest only exposures. Our work therefore focused on the appropriateness of modelling methodologies adopted and the significant judgements required to determine the requirement for overlays and the measurement of those overlays.	*Group economics* We understood management's process and tested key controls relating to the generation, selection and weighting applied to economic scenarios. We engaged our internal economic experts as well as actuarial modelling specialists to assist us as we considered: – The identification and use of appropriate external economic data – The operation of the Group's internally developed statistical model; – The approach to selection of economic scenarios representing an upside, downside and severe downside in addition to the Group's base case scenario used for internal planning; and – The review, challenge and approval of the scenarios adopted through the Group's governance process. 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. We critically assessed the assumptions adopted in the base case economic scenario and compared this both to our independent view of the economic outlook as well as market consensus, and investigated economic variables outside of our thresholds. We assessed the risk of bias in the forecasts, as well as the existence of contrary evidence. We considered the political uncertainties that existed at the year-end and how these might impact on the economic scenarios selected by the Group. We also independently ran the Group's model and performed testing to evaluate the level of non-linearity reflected in the expected credit loss allowances. Based on the evidence obtained, we consider that the economic scenarios adopted reflect an unbiased, probability weighted view that appropriately captures the impact of non-linearity. *Retail and Commercial Banking* We understood management's process and tested key controls around the determination of expected credit loss allowances, including controls relating to: – Appropriateness of modelling methodologies and monitoring of model performance; – Periodic model review, validation and approval; – The identification of credit impairment events; and – The review, challenge and approval of the expected credit loss allowances, including the impairment model outputs, key management judgements and overlays applied.

Key audit matter	How our audit addressed the key audit matter
Commercial Banking Expected credit loss allowances relating to credit impaired loans and advances (referred to herein also as being in Stage 3) in the Commercial Banking division are primarily estimated on an individual basis. Judgement is required to determine when a loan is considered to be credit impaired, and then to estimate the expected future cash flows related to that loan under multiple weighted scenario outcomes. An expected credit loss allowance is determined on Commercial Banking loans and advances which are not classified as being credit impaired at the reporting date (referred to as being in Stages 1 and 2) using impairment models based on key assumptions including probability of default and loss given default. Management apply overlays to the modelled output to address risks not captured by the model.	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. We understood and assessed the appropriateness of the impairment models developed and used by management. This included assessing and challenging the appropriateness of key modelling judgements (e.g. the transfer criteria used to determine significant increase in credit risk) and quantifying the impact of the use of proxies and simplifications, assessing whether these were appropriate. We also created our own independent models covering certain parts of the model calculation and for selected portfolios this enabled us to re-perform management's calculation and challenge their outputs. We tested the formulae applied within the calculation files. We tested the completeness and accuracy of key data inputs, sourced from underlying systems that are applied in the calculation. We tested the reconciliation of loans and advances between underlying source systems and the expected credit loss models. We performed testing over the measurement of the overlays in place, focusing on the larger overlays and those which we considered to represent the greatest level of audit risk (e.g. overlays relating to past term interest-only exposures and forbearance on the UK mortgages portfolio). We assessed the appropriateness of methodologies used to determine and quantify the overlays required and the reasonableness of key assumptions. Based on our knowledge and understanding of the weaknesses and limitations in management's models and industry emerging risks, we critically assessed the completeness of the overlays proposed by management. We used credit risk modelling specialists to support the audit team in the performance of these audit procedures. *Commercial Banking Stage 3 assets* We performed the following procedures to test the completeness of credit impaired assets requiring a Stage 3 expected credit loss allowance: – We critically assessed the criteria for determining whether a credit impairment event had occurred; – We tested a risk based sample of Stage 1 and 2 loans, utilising industry and insolvency specialists to support the audit team in identifying sectors or borrowers with risk characteristics which might imply an indicator of impairment. For each risk based sample, as well as an additional haphazardly selected sample of Stage 1 and 2 loans, we independently assessed whether they had indicators of a credit impairment event (e.g. a customer experiencing financial difficulty or in breach of covenant) and therefore whether they were appropriately categorised. For a sample of stage 3 credit impaired loans, we: – Evaluated the basis on which the allowance was determined, and the evidence supporting the analysis performed by management; – We independently challenged whether the key assumptions used, such as the recovery strategies, collateral rights and ranges of potential outcomes, were appropriate, given the borrower's circumstances; and – Re-performed management's allowance calculation, testing key inputs including expected future cash flows, discount rates, valuations of collateral held and the weightings applied to scenario outcomes. Based on the evidence obtained, we found that the methodologies, modelled assumptions, management judgements and data used within the allowance assessment to be appropriate and in line with the requirements of IFRS 9.

Independent auditors' report

Key audit matter	How our audit addressed the key audit matter
Conduct risk and provisions **Group** Refer to page 30 (Accounting Policies) and page 67 (Note 31 and Critical Accounting Judgements and Estimates). 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.	We understood and tested the key controls around the identification of matters which require provision, the estimation and review of provisions, including governance processes, challenge of key assumptions and approval of provisions. 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. Our work focused on the more significant provisions in relation to past sales of payment protection insurance (PPI) policies, arrears handling activities and packaged bank accounts. We also examined other conduct provisions which are individually less significant. For the provisions which are based on assumptions determined using management judgement with reference to historic experience, we understood and challenged the provisioning methodologies and underlying assumptions, including whether historic information had been appropriately incorporated and whether this was an appropriate indicator of future experience. For example, we challenged the basis that management used for forecasting the volume of PPI complaints that will be received in the future. For provisions which are dependent upon proactive identification and rectification of affected customers (e.g. provisions for arrears handling activities), we understood the planned management actions, understood the basis for estimating the provision and challenged key assumptions, including those around the costs of identifying and rectifying affected customers. We independently performed sensitivity analysis on the key assumptions and considered alternative scenarios which could be considered reasonably possible. We considered regulatory developments and 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 also met with each regulator. Given the inherent uncertainty in the estimation of conduct, litigation and other regulatory 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.
Defined benefit obligations **Group** Refer to page 30 (Accounting Policies) and page 58 (Note 29 and Critical Accounting Judgements and Estimates). The valuation of the retirement benefit schemes in the Group are determined with reference to various actuarial assumptions including discount rate, rate of inflation and mortality rates. Due to the size of these schemes, small changes in these assumptions can have a material impact on the estimated defined benefit obligation.	We understood and tested key controls over the pensions process involving member data, formulation of assumptions and the financial reporting process. We tested the controls for determining the actuarial assumptions and the approval of those assumptions by senior management. 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. 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. Our actuarial experts have performed testing over the Guaranteed Minimum Pension ('GMP') equalisation impact calculated by management's actuary, reviewed the approach taken and understood the key assumptions used in the calculations. We used our own independent GMP equalisation modelling tools to support this testing. We performed testing over the consensus and employee data used in calculating the obligation. Where material, we also considered the treatment of curtailments, settlements, past service costs, remeasurements, benefits paid, and any other amendments made to obligations during the year. From the evidence obtained, we found the data and assumptions used by management in the actuarial valuations for pension obligations to be appropriate. We read and assessed the disclosures made in the financial statements, including disclosures of the assumptions, and found them to be appropriate.

Independent auditors' report

Key audit matter	How our audit addressed the key audit matter
Hedge accounting **Group and Company** Refer to page 30 (Accounting Policies) and page 96 (Note 44). The Group enters into derivative contracts in order to manage and economically hedge risks such as interest and foreign exchange rate risk. These arrangements create accounting mismatches which are addressed through designating instruments into fair value or cash flow hedge accounting relationships. The Group's application of hedge accounting, including determining effectiveness, is manual in nature, which increases the risk of errors and hence the risk that financial reporting is not in line with IFRS requirements.	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 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. Our testing included the following: – examining selected hedge documentation to assess whether it complies with the requirements of IFRS; – testing the key year-end reconciliations between underlying source systems and the spreadsheets used to manage hedging models; – independently assessing whether management have captured and are monitoring all material sources of ineffectiveness; – re-performing a sample of hedge effectiveness calculations; and – testing a sample of manual adjustments posted to record ineffectiveness. Based on the evidence obtained, we determined the application of hedge accounting to be appropriate and compliant with the requirements of IFRS.
Privileged access to IT systems **Group and Company** The Group's financial reporting processes are reliant on automated processes, controls and data managed by IT systems. For the purposes of our audit, we validate the design and operating effectiveness of those automated and IT dependent controls that support the in-scope financial statement line items. We also review the supporting IT General Computer Controls (ITGCs) that provide assurance over the effective operation of these controls as well as those controls that manage the integrity of relevant data repositories for the full financial reporting period. As part of our audit work in prior periods, we identified control matters in relation to the management of IT privileged access to IT platforms supporting applications in-scope for financial reporting. While there is an ongoing programme of activities to address such control matters, the fact that these were open during the period meant there was a risk that automated functionality, reports and data from the systems were not reliable.	We tested the design and operating effectiveness of those key controls identified that manage IT privileged access across the in-scope IT platforms. Specifically we tested controls over: – The completeness and accuracy of the Access Controls Lists (ACLs) from IT platforms that are used by downstream IT security processes; – The onboarding and management of IT privileged accounts through the privileged access restriction tool (including static IT privileged accounts); – The monitoring of security events on IT platforms by the Security Operations Centre; and – Approval, recertification and timely removal of access from IT systems. As part of our review, we identified a number of IT privileged accounts that had not been onboarded to the privileged access restriction tool as at 31 December 2018. Consequently, we performed an assessment of each of the areas within our audit approach where we place reliance on automated functionality and data within IT systems. In each case we identified a combination of mitigating controls, performed additional audit procedures and assessed other mitigating factors in order to respond to the impact on our overall audit approach.

Independent auditors' report

Conclusions relating to going concern
ISAs (UK) require us to report to you when:

– the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or

– the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the Group's and Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

We have nothing to report in respect of the above matters.

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 also 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, 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 2018 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

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.

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 8, 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 also 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.

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.

Independent auditors' report

Appointment

Following the recommendation of the Audit Committee, we were appointed by the members 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 10 years, covering the years ended 31 December 2009 to 31 December 2018. 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
14 March 2019

Consolidated income statement

for the year ended 31 December 2018

	Note	2018 £ million	2017 £ million
Interest and similar income		**8,635**	8,877
Interest and similar expense		**(2,893)**	(2,820)
Net interest income	5	**5,742**	6,057
Fee and commission income		**584**	767
Fee and commission expense		**(363)**	(383)
Net fee and commission income	6	**221**	384
Net trading income	7	**(11)**	293
Other operating income	8	**66**	288
Other income		**276**	965
Total income		**6,018**	7,022
Regulatory provisions		**(435)**	(926)
Other operating expenses		**(3,129)**	(3,018)
Total operating expenses	9	**(3,564)**	(3,944)
Trading surplus		**2,454**	3,078
Impairment	11	**(194)**	(157)
Profit before tax		**2,260**	2,921
Tax expense	12	**(701)**	(827)
Profit for the year		**1,559**	2,094
Profit attributable to ordinary shareholders		**1,458**	1,993
Profit attributable to non-controlling interests		**101**	101
Profit for the year		**1,559**	2,094

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

Statements of comprehensive income

for the year ended 31 December 2018

The Group	2018 £ million	2017 £ million
Profit for the year	**1,559**	2,094
Other comprehensive income		
Items that will not subsequently be reclassified to profit or loss:		
Post-retirement defined benefit scheme remeasurements:		
Remeasurements before tax	**312**	121
Tax	**(53)**	(23)
	259	98
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income – equity shares:		
Change in fair value	**9**	
Disposals	**–**	
Tax	**–**	
	9	
Items that may subsequently be reclassified to profit or loss:		
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income – debt securities:		
Change in fair value	**2**	
Income statement transfers in respect of disposals	**(16)**	
Tax	**1**	
	(13)	
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value		16
Disposals		(134)
Impairment		10
Tax		19
		(89)
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	**(97)**	(135)
Net income statement transfers	**(28)**	46
Tax	**32**	23
	(93)	(66)
Currency translation differences (tax: nil)	**4**	(4)
Other comprehensive income for the year, net of tax	**166**	(61)
Total comprehensive income for the year	**1,725**	2,033
Total comprehensive income attributable to ordinary shareholders	**1,624**	1,932
Total comprehensive income attributable to non-controlling interests	**101**	101
Total comprehensive income for the year	**1,725**	2,033

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

Statements of comprehensive income

for the year ended 31 December 2018

The Company	**2018 £ million**	2017 £ million
Profit for the year	**2,943**	2,197
Other comprehensive income		
Items that will not subsequently be reclassified to profit or loss:		
Post-retirement defined benefit scheme remeasurements:		
Remeasurements before tax	**308**	112
Tax	**(52)**	(15)
	256	97
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income – equity shares:		
Change in fair value	**(3)**	
Disposals	**–**	
Taxation	**–**	
	(3)	
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
Tax		–
		3
Currency translation differences (tax: nil)	**–**	–
Other comprehensive income for the year, net of tax	**253**	100
Total comprehensive income for the year	**3,196**	2,297

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

Consolidated balance sheet

at 31 December 2018

The Group	Note	31 December 2018 £ million	1 January 2018[1] £ million	31 December 2017 £ million
Assets				
Cash and balances at central banks		**2,579**	2,677	2,677
Items in the course of collection from banks		**181**	260	260
Financial assets at fair value through profit or loss	13	**509**	2,211	1,400
Derivative financial instruments	14	**9,361**	11,274	11,634
Loans and advances to banks	15	**486**	551	551
Loans and advances to customers	15	**262,324**	267,873	268,657
Debt securities	15	**–**	9	137
Due from fellow Lloyds Banking Group undertakings		**53,190**	74,828	74,849
Financial assets at amortised cost		**316,000**	343,261	344,194
Financial assets at fair value through other comprehensive income	18	**1,085**	1,033	
Available-for-sale financial assets	19			937
Goodwill	20	**325**	325	325
Other intangible assets	21	**120**	112	112
Property, plant and equipment	22	**777**	823	823
Current tax recoverable		**10**	2	2
Deferred tax assets	30	**1,779**	2,010	1,878
Retirement benefit assets	29	**455**	69	69
Other assets	24	**479**	369	369
Total assets		**333,660**	364,426	364,680

1 See note 47.

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

Consolidated balance sheet (continued)

at 31 December 2018

The Group	Note	31 December 2018 £ million	1 January 2018[1] £ million	31 December 2017 £ million
Equity and liabilities				
Liabilities				
Deposits from banks		**20,908**	21,183	21,183
Customer deposits		**162,141**	171,198	171,198
Due to fellow Lloyds Banking Group undertakings		**109,169**	125,541	125,541
Items in course of transmission to banks		**274**	269	269
Financial liabilities at fair value through profit or loss	25	**103**	108	50
Derivative financial instruments	14	**9,867**	10,631	10,631
Notes in circulation		**1,104**	1,313	1,313
Debt securities in issue	26	**11,861**	10,871	10,919
Other liabilities	28	**794**	285	285
Retirement benefit obligations	29	**124**	135	135
Current tax liabilities		**2**	518	518
Other provisions	31	**1,027**	2,103	2,019
Subordinated liabilities	32	**4,211**	6,620	6,620
Total liabilities		**321,585**	350,775	350,681
Equity				
Share capital	33	**3,763**	3,763	3,763
Other reserves	34	**10,115**	10,220	10,234
Retained profits	35	**(3,340)**	(1,869)	(1,535)
Shareholders' equity		**10,538**	12,114	12,462
Non-controlling interests		**1,537**	1,537	1,537
Total equity		**12,075**	13,651	13,999
Total equity and liabilities		**333,660**	364,426	364,680

1 See note 47.

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

The directors approved the consolidated financial statements on 14 March 2019.

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 2018

	Attributable to equity shareholders					
The Group	**Share capital and premium £ million**	**Other reserves £ million**	**Retained profits £ million**	**Total £ million**	**Non-controlling interests £ million**	**Total £ million**
Balance at 1 January 2017	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 36)	–	–	(2,900)	(2,900)	–	(2,900)
Capital contribution received	–	–	105	105	–	105
Distributions to non-controlling interests, net of tax	–	–	27	27	(101)	(74)
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
Adjustment on adoption of IFRS 9 and IFRS 15[1]	**–**	**(14)**	**(334)**	**(348)**	**–**	**(348)**
Balance at 1 January 2018	**3,763**	**10,220**	**(1,869)**	**12,114**	**1,537**	**13,651**
Comprehensive income						
Profit for the year	**–**	**–**	**1,458**	**1,458**	**101**	**1,559**
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of tax	**–**	**–**	**259**	**259**	**–**	**259**
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income, net of tax – debt securities	**–**	**(13)**	**–**	**(13)**	**–**	**(13)**
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income, net of tax – equity shares	**–**	**9**	**–**	**9**	**–**	**9**
Movements in cash flow hedging reserve, net of tax	**–**	**(93)**	**–**	**(93)**	**–**	**(93)**
Currency translation differences, net of tax	**–**	**4**	**–**	**4**	**–**	**4**
Total other comprehensive income	**–**	**(93)**	**259**	**166**	**–**	**166**
Total comprehensive income	**–**	**(93)**	**1,717**	**1,624**	**101**	**1,725**
Transactions with owners:						
Dividends (note 36)	**–**	**–**	**(3,300)**	**(3,300)**	**–**	**(3,300)**
Distributions on other equity instruments issued by subsidiaries, net of tax	**–**	**–**	**27**	**27**	**(101)**	**(74)**
Capital contribution received	**–**	**–**	**73**	**73**	**–**	**73**
Total transactions with owners	**–**	**–**	**(3,200)**	**(3,200)**	**(101)**	**(3,301)**
Realised gains and losses on equity shares held at fair value through other comprehensive income	**–**	**(12)**	**12**	**–**	**–**	**–**
Balance at 31 December 2018	**3,763**	**10,115**	**(3,340)**	**10,538**	**1,537**	**12,075**

1 See note 47.

Further details of movements in the Group's share capital and reserves are provided in notes 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 2018

The Group	Note	2018 £ million	2017 £ million
Profit before tax		**2,260**	2,921
Adjustments for:			
Change in operating assets	46(a)	**29,622**	(22,773)
Change in operating liabilities	46(b)	**(25,248)**	22,863
Non-cash and other items	46(c)	**(893)**	(257)
Tax paid		**(987)**	(945)
Net cash provided by operating activities		**4,754**	1,809
Cash flows from investing activities			
Purchase of financial assets		**(550)**	(291)
Proceeds from sale and maturity of financial assets		**529**	1,991
Purchase of fixed assets		**(178)**	(117)
Proceeds from sale of fixed assets		**74**	213
Disposal of businesses, net of cash disposed	46(e)	**47**	292
Net cash (used in) provided by investing activities		**(78)**	2,088
Cash flows from financing activities			
Dividends paid to ordinary shareholders	36	**(3,300)**	(2,900)
Distributions on other equity instruments issued by subsidiaries		**(101)**	(101)
Interest paid on subordinated liabilities		**(343)**	(409)
Repayment of subordinated liabilities	32	**(2,322)**	(1,132)
Net cash used in financing activities		**(6,066)**	(4,542)
Effects of exchange rate changes on cash and cash equivalents		**–**	2
Change in cash and cash equivalents		**(1,390)**	(643)
Cash and cash equivalents at beginning of year		**2,409**	3,052
Cash and cash equivalents at end of year	46(d)	**1,019**	2,409

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

Company balance sheet

at 31 December 2018

	Note	**31 December 2018 £ million**	1 January 2018[1] £ million	31 December 2017 £ million
Assets				
Due from fellow Lloyds Banking Group undertakings		**8,483**	12,963	13,164
Derivative financial instruments	14	**341**	395	395
Financial assets at fair value through other comprehensive income		**–**	7	–
Available-for-sale financial assets		**–**	–	7
Retirement benefit assets	29	**442**	69	69
Other assets		**48**	–	–
Current tax assets		**5**	–	–
Deferred tax assets	30	**17**	35	–
Investments in subsidiary undertakings	23	**22,467**	22,394	22,394
Total assets		**31,803**	35,863	36,029
Liabilities				
Due to fellow Lloyds Banking Group undertakings		**6,483**	8,168	8,168
Other liabilities	28	**–**	243	243
Current tax liabilities		**–**	13	13
Retirement benefit obligations	29	**124**	130	130
Deferred tax liabilities	30	**–**	18	18
Subordinated liabilities	32	**2,628**	4,692	4,692
Total liabilities		**9,235**	13,264	13,264
Equity				
Share capital	33	**3,763**	3,763	3,763
Other reserves	34	**9,678**	9,685	9,685
Retained profits[2]	35	**9,127**	9,151	9,317
Shareholders' equity		**22,568**	22,599	22,765
Total equity and liabilities		**31,803**	35,863	36,029

1 See note 47.

2 The Company recorded a profit after tax for the year of £2,943 million (2017: £2,197 million).

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

Approved by the Board on 14 March 2019 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 2018

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
Balance at 1 January 2017	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 36)	–	–	(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
Adjusted on adoption of IFRS 9 and IFRS 15[1]	–	–	(166)	(166)
Balance at 1 January 2018	**3,763**	**9,685**	**9,151**	**22,599**
Comprehensive income				
Profit for the year	**–**	**–**	**2,943**	**2,943**
Other comprehensive income				
Post-retirement defined benefit scheme remeasurements, net of tax	**–**	**–**	**256**	**256**
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income, net of tax – equity shares	**–**	**(3)**	**–**	**(3)**
Total other comprehensive income	**–**	**(3)**	**256**	**253**
Total comprehensive income	**–**	**(3)**	**3,199**	**3,196**
Transactions with owners				
Capital contribution received	**–**	**–**	**73**	**73**
Dividends (note 36)	**–**	**–**	**(3,300)**	**(3,300)**
Total transactions with owners	**–**	**–**	**(3,227)**	**(3,227)**
Realised gains and losses on equity shares held at fair value through other comprehensive income	**–**	**(4)**	**4**	**–**
Balance at 31 December 2018	**3,763**	**9,678**	**9,127**	**22,568**

1 See note 47.

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

Company cash flow statement

for the year ended 31 December 2018

	Note	2018 £ million	2017 £ million
Profit before tax		**2,884**	2,207
Adjustments for:			
Change in operating assets		**2,368**	72
Change in operating liabilities		**(1,928)**	747
Non-cash and other items		**(3,069)**	(2,071)
Tax paid		**(10)**	(28)
Net cash provided by operating activities		**245**	927
Cash flows from financing activities			
Dividends paid to ordinary shareholders	36	**(3,300)**	(2,900)
Dividends received		**3,025**	2,100
Repayment of subordinated liabilities	32	**(2,106)**	(1,132)
Interest paid on subordinated liabilities		**(231)**	(297)
Net cash used in financing activities		**(2,612)**	(2,229)
Change in cash and cash equivalents		**(2,367)**	(1,302)
Cash and cash equivalents at beginning of year		**5,690**	6,992
Cash and cash equivalents at end of year		**3,323**	5,690

The accompanying notes are an integral part of the 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. As noted below, in adopting IFRS 9, the Group has elected to continue applying hedge accounting under IAS 39. 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, financial assets measured at fair value through other comprehensive income, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

To improve transparency and ease of reference, the capital resources disclosure required under IFRS has been included within the Strategic Report on page 3. This disclosure is covered by the Audit opinion (included on pages 12 to 19) 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 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.

The Group has adopted IFRS 9 and IFRS 15 with effect from 1 January 2018.

(i) IFRS 9 *Financial Instruments*

IFRS 9 replaces IAS 39 and addresses classification, measurement and derecognition of financial assets and liabilities, the impairment of financial assets measured at amortised cost or fair value through other comprehensive income, expected credit loss provisions for loan commitments and financial guarantee contracts and general hedge accounting.

Impairment: IFRS 9 replaces the IAS 39 'incurred loss' impairment approach with an 'expected credit loss' approach. The revised approach applies to financial assets including finance lease receivables, recorded at amortised cost or fair value through other comprehensive income; loan commitments and financial guarantees that are not measured at fair value through profit or loss are also in scope. The expected credit loss approach requires an allowance to be established upon initial recognition of an asset reflecting the level of losses anticipated after having regard to, amongst other things, expected future economic conditions. Subsequently the amount of the allowance is affected by changes in the expectations of loss driven by changes in associated credit risk.

Classification and measurement: IFRS 9 requires financial assets to be classified into one of the following measurement categories: fair value through profit or loss, fair value through other comprehensive income and amortised cost. Classification is made on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments. The requirements for derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities except for those designated at fair value through profit or loss whereby that part of the fair value change attributable to the entity's own credit risk is recorded in other comprehensive income. The Group early adopted this requirement with effect from 1 January 2017.

General hedge accounting: The new hedge accounting model aims to provide a better link between risk management strategy, the rationale for hedging and the impact of hedging on the financial statements. The standard does not explicitly address macro hedge accounting solutions, which are being considered in a separate IASB project – Accounting for Dynamic Risk Management. Until this project is finalised, the IASB has provided an accounting policy choice to retain IAS 39 hedge accounting in its entirety or choose to apply the IFRS 9 hedge accounting requirements. The Group has elected to continue applying hedge accounting as set out in IAS 39.

(ii) IFRS 15 *Revenue from Contracts with Customers*

IFRS 15 has replaced IAS 18 *Revenue* and IAS 11 *Construction Contracts*. 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.

Details of the impact of adoption of IFRS 9 and IFRS 15 are provided in note 47.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2018 and which have not been applied in preparing these financial statements are given in note 48.

2 Accounting policies

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

a Consolidation

The assets, liabilities and results of Group undertakings (including structured entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures. Details of the Group's subsidiaries and related undertakings are given on pages 113 to 114.

(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

2 Accounting policies (continued)

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(5)) 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 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.

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
(1) Net interest income
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 to the gross carrying amount of the financial asset (before adjusting for expected credit losses) or to the amortised cost of the financial liability, including early redemption fees, 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. Interest income from non-credit impaired financial assets is recognised by applying the effective interest rate to the gross carrying amount of the asset; for credit impaired financial assets, the effective interest rate is applied to the net carrying amount after deducting the allowance for expected credit losses. Impairment policies are set out in (h) below.

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

2 Accounting policies (continued)

(3) Other
Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to trading income are set out in e(3) below, those relating to leases are set out in (j)(2) below.

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

The Group initially recognises loans and advances, deposits, debt securities in issue and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either: substantially all of the risks and rewards of ownership have been transferred; or the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when the obligation is discharged, cancelled or expires.

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

Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value.

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

(3) Financial instruments measured at fair value through profit or loss
Financial assets are classified at fair value through profit or loss where they do not meet the criteria to be measured at amortised cost or fair value through other comprehensive income or where they are designated at fair value through profit or loss to reduce an accounting mismatch. All derivatives are carried at fair value through profit or loss.

Trading securities, which are debt securities and equity shares acquired principally for the purpose of selling in the short term or which are part of a portfolio which is managed for short-term gains, do not meet the criteria to be measured at amortised cost or fair value through other comprehensive income and are also measured at fair value through profit or loss. Financial assets measured at fair value through profit or loss are recognised in the balance sheet at their fair value. Fair value gains and losses together with interest coupons and dividend income are recognised in the income statement within net trading income.

Financial liabilities are measured at fair value through profit or loss where they are trading liabilities or where they are designated at fair value through profit or loss in order to reduce an accounting mismatch; where the liabilities are part of a group of liabilities (or assets and liabilities) which is managed, and its performance evaluated, on a fair value basis; or where the liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for. Financial liabilities measured at fair value through profit or loss are recognised in the balance sheet at their fair value. Fair value gains and losses are recognised in the income statement within net trading income in the period in which they occur, except that gains and losses attributable to changes in own credit risk are recognised in other comprehensive income.

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. The fair values of derivative financial instruments are adjusted where appropriate to reflect credit risk (via credit valuation adjustments (CVAs), debit valuation adjustments (DVAs) and funding valuation adjustments (FVAs)), market liquidity and other risks.

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

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense. Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, 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

2 Accounting policies (continued)

liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

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

(5) Sale and repurchase agreements (including securities lending and borrowing)
Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received 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 advances measured at amortised cost 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 advance measured at amortised cost or customer deposit.

f Derivative financial instruments and hedge accounting
As permitted by IFRS 9, the Group continues to apply the requirements of IAS 39 to its hedging relationships. All derivatives are recognised at their fair value. Derivatives are carried on the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 41(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 all derivative instruments, other than those in effective cash flow and net investment hedging relationships, are recognised immediately in the income statement. As noted in (2) and (3) below, the change in fair value of a derivative in an effective cash flow or net investment hedging relationship is allocated between the income statement and other comprehensive income.

Derivatives embedded in a financial asset are not considered separately; the financial asset is considered in its entirety when determining whether its cash flows are solely payments of principal and interest. Derivatives embedded in financial liabilities and insurance contracts (unless the embedded derivative is itself an insurance contract) 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. In accordance with IFRS 4 Insurance Contracts, a policyholder's option to surrender an insurance contract for a fixed amount is not treated as an embedded derivative.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item, the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued. Note 14 provides details of the types of derivatives held by the Group and presents separately those designated in hedge relationships. Further information on hedge accounting is set out below.

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

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

(3) Net investment hedges
Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instrument 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
The impairment charge in the income statement includes the change in expected credit losses and certain fraud costs. Expected credit losses are recognised for loans and advances to customers and banks, other financial assets held at amortised cost, financial assets measured at fair value through other comprehensive income, and certain loan commitments and financial guarantee contracts. Expected credit losses are calculated as an unbiased and probability-weighted estimate using an appropriate probability of default, adjusted to take into account a range of possible future economic scenarios, and applying this to the

2 Accounting policies (continued)

estimated exposure of the Group at the point of default after taking into account the value of any collateral held, repayments, or other mitigants of loss and including the impact of discounting using the effective interest rate.

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

An assessment of whether credit risk has increased significantly since initial recognition considers the change in the risk of default occurring over the remaining expected life of the financial instrument. The assessment is unbiased, probability-weighted and uses forward-looking information consistent with that used in the measurement of expected credit losses. In determining whether there has been a significant increase in credit risk, the Group uses quantitative tests based on relative and absolute probability of default (PD) movements linked to internal credit ratings together with qualitative indicators such as watchlists and other indicators of historical delinquency, credit weakness or financial difficulty. However, unless identified at an earlier stage, the credit risk of financial assets is deemed to have increased significantly when more than 30 days past due. Where the credit risk subsequently improves such that it no longer represents a significant increase in credit risk since origination, the asset is transferred back to Stage 1.

Assets are transferred to Stage 3 when they have defaulted or are otherwise considered to be credit impaired. Default is considered to have occurred when there is evidence that the customer is experiencing financial difficulty which is likely to affect significantly the ability to repay the amount due. IFRS 9 contains a rebuttable presumption that default occurs no later than when a payment is 90 days past due. The Group uses this 90 day backstop for all its products except for UK mortgages. For UK mortgages, the Group uses a backstop of 180 days past due as mortgage exposures more than 90 days past due, but less than 180 days, typically show high cure rates and this aligns with the Group's risk management practices.

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. In the latter circumstances, the loan will remain classified as either Stage 2 or Stage 3 until the credit risk has improved such that it no longer represents a significant increase since origination (for a return to Stage 1), or the loan is no longer credit impaired (for a return to Stage 2). Renegotiation may also lead to the loan and associated allowance being derecognised and a new loan being recognised initially at fair value.

Purchased or originated credit-impaired financial assets (POCI) are financial assets that are purchased or originated at a deep discount that reflects incurred credit losses. At initial recognition, POCI assets do not carry an impairment allowance; instead, lifetime expected credit losses are incorporated into the calculation of the effective interest rate. All changes in lifetime expected credit losses subsequent to the assets' initial recognition are recognised as an impairment charge.

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

i Property, plant and equipment

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

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

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

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 Accounting policies (continued)

(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 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.

2 Accounting policies (continued)

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

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

p Cash and cash equivalents
For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with 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 judgements and 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
The calculation of the Group's expected credit loss (ECL) allowances and provisions against loan commitments and guarantees under IFRS 9 requires the Group to make a number of judgements, assumptions and estimates. The most significant are set out below.

Definition of default
The probability of default (PD) of an exposure, both over a 12 month period and over its lifetime, is a key input to the measurement of the ECL allowance. Default has occurred when there is evidence that the customer is experiencing significant financial difficulty which is likely to affect the ability to repay amounts due. The definition of default adopted by the Group is described in note 2(h) Impairment of financial assets. The Group has rebutted the presumption in IFRS 9 that

3 Critical accounting judgements and estimates (continued)

default occurs no later than when a payment is 90 days past due for UK mortgages. As a result, approximately £1.4 billion of UK mortgages were classified as Stage 2 rather than Stage 3 at 31 December 2018; the impact on the Group's ECL allowance was not material.

Lifetime of an exposure
The PD of a financial asset is dependent on its expected life. A range of approaches, segmented by product type, has been adopted by the Group to estimate a product's expected life. These include using the full contractual life and taking into account behavioural factors such as early repayments and refinancing. For non-revolving retail assets, the Group has assumed the expected life for each product to be the time taken for all significant losses to be observed and for a material proportion of the assets to fully resolve through either closure or write-off. For retail revolving products, the Group has considered the losses beyond the contractual term over which the Group is exposed to credit risk. For commercial overdraft facilities, the average behavioural life has been used. Changes to the assumed expected lives of the Group's assets could have a material effect on the ECL allowance recognised by the Group.

Significant increase in credit risk
Performing assets are classified as either Stage 1 or Stage 2. An ECL allowance equivalent to 12 months expected losses is established against assets in Stage 1; assets classified as Stage 2 carry an ECL allowance equivalent to lifetime expected losses. Assets are transferred from Stage 1 to Stage 2 when there has been a significant increase in credit risk (SICR) since initial recognition.

The Group uses a quantitative test together with qualitative indicators to determine whether there has been a SICR for an asset. For retail, a deterioration in the Retail Master Scale of four grades for credit cards, personal loans or overdrafts, three grades for personal mortgages, or two grades in the Corporate Master Scale for UK motor finance accounts is treated as a SICR. For Commercial a doubling of PD with a minimum increase in PD of 1 per cent and a resulting change in the underlying grade is treated as a SICR. All financial assets are assumed to have suffered a SICR if they are more than 30 days past due.

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

Origination PDs
The assessment of whether there has been a significant increase in credit risk is a relative measure, dependent on an asset's PD at origination. For assets existing at 1 January 2018, the initial application date of IFRS 9, this information is not, generally, available and consequently management judgement has been used to determine a reasonable basis for estimating the original PD. Management used various information sources, including regulatory PDs and credit risk data available at origination, or where this is not available the first available data. In addition, the Group has not created a forward looking view of PDs at initial recognition for the back book as to do so would involve the use of hindsight and could introduce the risk of bias. The use of proxies and simplifications is not considered to materially impact the ECL allowance on transition.

Post-model adjustments
Limitations in the Group's impairment models or input data may be identified through the on-going assessment and validation of the output of the models. In these circumstances, management make appropriate adjustments to the Group's allowance for impairment losses. These adjustments are generally modelled taking into account the particular attributes of the exposure which have not been adequately captured by the primary impairment models. At 31 December 2018, post-model adjustments were mainly related to UK secured lending with no individual adjustment being material.

Forward looking information
The measurement of expected credit losses is required to reflect an unbiased probability-weighted range of possible future outcomes. In order to do this, the Group has developed an economic model to project sixteen key impairment drivers using information derived mainly from external sources. These drivers include factors such as the unemployment rate, the house price index, commercial property prices and corporate credit spreads. The model-generated economic scenarios for the six years beyond 2018 are mapped to industry-wide historical loss data by portfolio. Combined losses across portfolios are used to rank the scenarios by severity of loss. Four scenarios from specified points along the loss distribution are selected to reflect the range of outcomes; the central scenario reflects the Group's base case assumptions used for medium-term planning purposes, an upside and a downside scenario are also selected together with a severe downside scenario. Rare occurrences of adverse economic events can lead to relatively large credit losses which means that typically the most likely outcome is less than the probability-weighted outcome of the range of possible future events. To allow for this a relatively unlikely severe downside scenario is therefore included. At 1 January and 31 December 2018, the base case, upside and downside scenarios each carry a 30 per cent weighting; the severe downside scenario is weighted at 10 per cent. The choice of alternative scenarios and scenario weights is a combination of quantitative analysis and judgemental assessment to ensure that the full range of possible outcomes and material non-linearity of losses are captured. A committee under the chairmanship of the Chief Economist meets quarterly, to review and, if appropriate, recommend changes to the economic scenarios to the Chief Financial Officer and Chief Risk Officer. Findings dealing with all aspects of the expected credit loss calculation are presented to the Group Audit Committee.

For each major product grouping models have been developed which utilise historical credit loss data to produce PDs for each scenario; an overall weighted average PD is used to assist in determining the staging of financial assets and related ECL.

3 Critical accounting judgements and estimates (continued)

The key UK economic assumptions made by the Group as at 31 December 2018 averaged over a five-year period are shown below:

Economic assumptions	Base Case %	Upside %	Downside %	Severe downside %
At 31 December 2018				
Interest rate	**1.25**	**2.34**	**1.30**	**0.71**
Unemployment rate	**4.5**	**3.9**	**5.3**	**6.9**
House price growth	**2.5**	**6.1**	**(4.8)**	**(7.5)**
Commercial real estate price growth	**0.4**	**5.3**	**(4.7)**	**(6.4)**
At 1 January 2018				
Interest rate	1.18	2.44	0.84	0.01
Unemployment rate	5.0	4.0	6.1	7.1
House price growth	2.7	7.0	(2.4)	(8.2)
Commercial real estate price growth	0.0	3.0	(2.5)	(5.4)

The Group's base-case economic scenario has changed little over the year and reflects a broadly stable outlook for the economy. Although there remains considerable uncertainty about the economic consequences of the UK's planned exit from the European Union, the Group considers that at this stage the range of possible economic outcomes is adequately reflected in its choice and weighting of scenarios. The averages shown above do not fully reflect the peak to trough changes in the stated assumptions over the period. The tables below illustrate the variability of the assumptions from the start of the scenario period to the peak and trough.

Economic assumptions – start to peak	Base Case %	Upside %	Downside %	Severe Downside %
At 31 December 2018				
Interest rate	**1.75**	**4.00**	**1.75**	**1.25**
Unemployment rate	**4.8**	**4.3**	**6.3**	**8.6**
House price growth	**13.7**	**34.9**	**0.6**	**(1.6)**
Commercial real estate price growth	**0.1**	**26.9**	**(0.5)**	**(0.5)**

Economic assumptions – start to trough	Base Case %	Upside %	Downside %	Severe Downside %
At 31 December 2018				
Interest rate	**0.75**	**0.75**	**0.75**	**0.25**
Unemployment rate	**4.1**	**3.5**	**4.3**	**4.2**
House price growth	**0.4**	**2.3**	**(26.5)**	**(33.5)**
Commercial real estate price growth	**(0.1)**	**0.0**	**(23.8)**	**(33.8)**

Defined benefit pension scheme obligations

The net asset recognised in the balance sheet at 31 December 2018 in respect of the Group's defined benefit pension scheme obligations was £371 million (comprising an asset of £455 million and a liability of £84 million) (2017: a net liability of £25 million comprising an asset of £69 million and a liability of £94 million); and for the Company was £358 million (comprising an asset of £442 million and a liability of £84 million) (2017: a net liability of £20 million comprising an asset of £69 million and liability of £89 million). The Group's accounting policy for its defined benefit pension scheme obligations is set out in note 2(k).

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 20 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 part (iii) of note 29.

Recoverability of deferred tax assets

At 31 December 2018 the Group carried deferred tax assets on its balance sheet of £1,779 million (2017: £1,878 million) and the Company carried deferred tax assets of £17 million (2017: £nil) and deferred tax liabilities of £nil (2017: £18 million) principally relating to tax losses carried forward.

Estimation of income taxes includes the assessment of recoverability of deferred tax assets. Deferred tax assets are only recognised to the extent 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.

3 Critical accounting judgements and estimates (continued)

The Group has recognised a deferred tax asset of £1,498 million (2017: £1,581 million), and the Company £nil (2017: £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, the Board-approved operating plan and the expected future economic outlook as set out in the strategic report, as well as the risks associated with future regulatory 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 2033. It is possible that future tax law changes could materially affect the value of these losses ultimately realised by the Group.

As disclosed in note 30, deferred tax assets totalling £121 million (2017: £119 million) for the Group and £nil (2017: £nil) for the Company have not been recognised in respect of certain capital losses and trading losses carried forward, unrelieved foreign tax credits and other tax deductions, as there are currently no expected future taxable profits against which these assets can be utilised.

Payment protection insurance and other regulatory provisions
At 31 December 2018, the Group carried provisions of £834 million (2017: £1,754 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 (2018: £392 million; 2017: £947 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 in note 31.

Fair value of financial instruments
At 31 December 2018, the carrying value of the Group's financial instrument assets held at fair value was £10,955 million (2017: £13,971 million), and its financial instrument liabilities held at fair value was £9,970 million (2017: £10,681 million). Included within these balances are derivative assets of £9,361 million (2017: £11,634 million) and derivative liabilities of £9,867 million (2017: £10,631 million). The Group's accounting policy for its financial instruments is set out in note 2(e) and 2(f).

In accordance with IFRS 13 Fair Value Measurement, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques including discounted cash flow analysis and valuation models.

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 note 41. 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 also set out in note 41.

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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 2018 %	Weighted average effective interest rate 2017 %	2018 £m	2017 £m
Interest and similar income:				
Financial assets held at amortised cost	**2.71**	2.50	**8,617**	8,861
Financial assets at fair value through other comprehensive income	**1.70**		**18**	
Available-for-sale financial assets		0.96		16
Total interest and similar income	**2.70**	2.49	**8,635**	8,877
Interest and similar expense:				
Deposits from banks and customer deposits	**1.01**	0.88	**(2,730)**	(2,646)
Debt securities in issue[1]	**(1.28)**	(1.82)	**142**	228
Subordinated liabilities	**5.83**	5.85	**(305)**	(402)
Total interest and similar expense	**1.01**	0.88	**(2,893)**	(2,820)
Net interest income			**5,742**	6,057

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 3.01 per cent (2017: 2.42 per cent).

Included within interest and similar income is £142 million (2017: £106 million) in respect of impaired financial assets. Net interest income also includes a credit of £28 million (2017: charge of £46 million) transferred from the cash flow hedging reserve (see note 34).

6 Net fee and commission income

	2018 £m	2017 £m
Fee and commission income:		
Current accounts	**201**	220
Credit and debit card fees	**238**	237
Corporate banking and treasury fees	**13**	37
Other fees and commissions	**132**	273
Total fee and commission income	**584**	767
Fee and commission expense	**(363)**	(383)
Net fee and commission income	**221**	384

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.

The Group adopted IFRS 15 'Revenue from Contracts with Customers' on 1 January 2018, comparatives have not been restated. Further details on the impact of the new accounting standard, which was not significant, are set out in note 47. At 31 December 2018, the Group held on its balance sheet £16 million in respect of these services and no amounts received from customers for services to be provided after the balance sheet date. There were no unsatisfied performance obligations at 31 December 2018.

The most significant performance obligations undertaken by the Group are the provision of bank account and transactional services and other value added offerings in respect of current accounts; and card services to cardholders and merchants in respect of credit cards and debit cards.

7 Net trading income

	2018 £m	2017 £m
Foreign exchange translation (losses) gains	**(3)**	(10)
Gains on foreign exchange trading transactions	**39**	36
Total foreign exchange	**36**	26
Securities and other gains (see below)	**(47)**	267
Net trading income	**(11)**	293

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

	2018 £m	2017 £m
Net income arising on assets and liabilities mandatorily held at fair value through profit or loss:		
Financial instruments held for trading	**(47)**	142
Other financial instruments mandatorily held at fair value through profit or loss:		
Debt securities, loans and advances	**(14)**	108
Equity shares	**15**	17
	(46)	267
Net (expense) income arising on assets and liabilities designated at fair value through profit or loss	**(1)**	–
Securities and other gains	**(47)**	267

8 Other operating income

	2018 £m	2017 £m
Operating lease rental income	**4**	14
Rental income from investment properties (note 22)	**–**	1
Gains less losses on disposal of financial assets at fair value through other comprehensive income (2017: available-for-sale financial assets) (note 34)	**16**	134
Share of results of joint ventures and associates	**–**	7
Other	**46**	132
Total other operating income	**66**	288

Notes to the accounts

9 Operating expenses

	2018 £m	2017 £m
Staff costs:		
Salaries	**1,126**	1,057
Social security costs	**110**	118
Pensions and other post-retirement benefit schemes (note 29)	**267**	265
	1,503	1,440
Premises and equipment:		
Rent and rates	**162**	163
Repairs and maintenance	**63**	23
Other	**77**	71
	302	257
Other expenses:		
Communications and data processing	**115**	127
Advertising and promotion	**41**	45
Professional fees	**8**	6
Other	**998**	973
	1,162	1,151
Depreciation and amortisation:		
Depreciation of property, plant and equipment (note 22)	**126**	137
Amortisation of other intangible assets (note 21)	**36**	33
	162	170
Total operating expenses, excluding regulatory provisions	**3,129**	3,018
Regulatory provisions:		
Payment protection insurance provision (note 31)	**185**	486
Other regulatory provisions (note 31)	**250**	440
	435	926
Total operating expenses	**3,564**	3,944

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

	2018	2017
UK	**31,121**	33,507
Overseas	**382**	400
Total	**31,503**	33,907

10 Auditors' remuneration

During the year the auditors earned the following fees:

	2018 £m	2017 £m
Fees payable for the audit of the Company's current year annual report	**1.5**	1.2
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	**3.7**	2.7
Other services supplied pursuant to legislation	**0.6**	0.6
Total fees payable to the Company's auditors by the Group	**5.8**	4.5

11 Impairment

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Year ended 31 December 2018				
Impact of transfers between stages	**18**	**(37)**	**192**	**173**
Other changes in credit quality	**(41)**	**(17)**	**246**	**188**
Additions (repayments)	**(12)**	**(87)**	**(45)**	**(144)**
Other items	**–**	**–**	**(23)**	**(23)**
Other items impacting impairment charge	**(53)**	**(104)**	**178**	**21**
Total impairment	**(35)**	**(141)**	**370**	**194**
In respect of:				
Loans and advances to customers	**(14)**	**(115)**	**369**	**240**
Due from fellow Lloyds Banking Group undertakings	**(8)**	**–**	**–**	**(8)**
Impairment charge on drawn balances	**(22)**	**(115)**	**369**	**232**
Loan commitments and financial guarantees	**(13)**	**(26)**	**1**	**(38)**
Total impairment	**(35)**	**(141)**	**370**	**194**

The Group's impairment charge comprises the following items:

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

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

Additions (repayments)
Expected loss allowances are recognised on origination of new loans or further drawdowns of existing facilities. Repayments relate to the reduction of loss allowances as a result of repayments of outstanding balances.

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

Movements in the Group's impairment allowances are shown in note 17.

12 Taxation

a Analysis of tax expense for the year

	2018 £m	2017 £m
UK corporation tax:		
Current tax on profit for the year	**(485)**	(753)
Adjustments in respect of prior years	**11**	103
	(474)	(650)
Foreign tax:		
Current tax on profit for the year	**(17)**	(25)
Adjustments in respect of prior years	**–**	6
	(17)	(19)
Current tax expense	**(491)**	(669)
Deferred tax (note 30):		
Current year	**(194)**	(129)
Adjustments in respect of prior years	**(16)**	(29)
	(210)	(158)
Tax expense	**(701)**	(827)

b Factors affecting the tax expense for the year

The UK corporation tax rate for the year was 19 per cent (2017: 19.25 per cent). An explanation of the relationship between tax expense and accounting profit is set out below:

	2018 £m	2017 £m
Profit before tax	**2,260**	2,921
UK corporation tax thereon	**(429)**	(562)
Impact of surcharge on banking profits	**(184)**	(252)
Remeasurement of deferred tax due to rate changes	**(18)**	18
Non-deductible costs: conduct charges	**(34)**	(126)
Other non-deductible costs	**(18)**	(9)
Non-taxable income	**1**	16
Tax-exempt (losses) gains on disposals	**(5)**	13
(Derecognition) recognition of losses that arose in prior years	**(9)**	–
Differences in overseas tax rates	**–**	(5)
Adjustments in respect of prior years	**(5)**	80
Tax expense on profit on ordinary activities	**(701)**	(827)

13 Financial assets at fair value through profit or loss of the Group

	2018 £m	2017 £m
Trading assets	–	–
Other financial assets mandatorily at fair value through profit or loss	509	1,400
Total	509	1,400

These assets are comprised as follows:

	2018		2017	
	Trading assets £m	Other financial assets mandatorily at fair value through profit or loss £m	Trading assets £m	Other financial assets mandatorily at fair value through profit or loss £m
Loans and advances to customers	–	509	–	–
Debt securities: Corporate and other debt securities	–	–	–	1,350
Equity shares	–	–	–	50
Total	–	509	–	1,400

At 31 December 2018 £509 million (2017: £1,400 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 44.

14 Derivative financial instruments

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

	2018			2017		
	Contract/ notional amount £m	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading						
Exchange rate contracts:						
Spot, forwards and futures	**1,855**	**120**	**8**	849	79	5
Currency swaps	**41,752**	**912**	**716**	47,637	662	726
Options purchased	**74**	**3**	**–**	146	7	–
Options written	**74**	**–**	**3**	169	–	3
	43,755	**1,035**	**727**	48,801	748	734
Interest rate contracts:						
Interest rate swaps	**167,101**	**5,887**	**7,555**	144,323	6,855	7,333
Forward rate agreements	**6,514**	**1**	**1**	2,990	–	1
Options purchased	**458**	**35**	**–**	2,523	575	9
Options written	**641**	**–**	**26**	2,945	15	638
Futures	**–**	**–**	**–**	261	–	–
	174,714	**5,923**	**7,582**	153,042	7,445	7,981
Credit derivatives	**3,776**	**21**	**21**	266	1	7
Equity and other contracts	**218**	**1**	**328**	370	361	348
Total derivative assets/liabilities held for trading	**222,463**	**6,980**	**8,658**	202,479	8,555	9,070
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**9,968**	**1,693**	**31**	12,004	2,127	56
Cross currency swaps	**–**	**–**	**–**	–	–	–
	9,968	**1,693**	**31**	12,004	2,127	56
Derivatives designated as cash flow hedges:						
Interest rate swaps	**19,464**	**688**	**1,178**	24,617	952	1,505
Futures	**–**	**–**	**–**	–	–	–
	19,464	**688**	**1,178**	24,617	952	1,505
Total derivative assets/liabilities held for hedging	**29,432**	**2,381**	**1,209**	36,621	3,079	1,561
Total recognised derivative assets/liabilities	**251,895**	**9,361**	**9,867**	239,100	11,634	10,631

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 44 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 44.

The principal derivatives used by the Group are as follows:

– Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
– Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.
– Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place.

14 Derivative financial instruments (continued)

– Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

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

	Maturity					
The Group – 31 December 2018	**Up to 1 month £m**	**1-3 months £m**	**3-12 months £m**	**1-5 years £m**	**Over 5 years £m**	**Total £m**
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	67	4	1,366	4,639	3,892	9,968
Average fixed interest rate	1.17%	5.10%	4.83%	4.27%	4.04%	
Interest rate						
Interest rate swap						
Notional	87	868	1,505	8,092	8,912	19,464
Average fixed interest rate	4.91%	1.42%	1.37%	2.83%	2.73%	

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

	Carrying amount of the hedging instrument			
The Group – 31 December 2018	**Contract/notional amount £m**	**Assets £m**	**Liabilities £m**	**Changes in fair value used for calculating hedge ineffectiveness (YTD) £m**
Fair value hedges				
Interest rate				
Interest rate swaps	9,968	1,693	31	(410)
Cash flow hedges				
Interest rate				
Interest rate swaps	19,464	688	1,178	7

All amounts are held within derivative financial instruments.

14 Derivative financial instruments (continued)

The Group's hedged items are as follows:

The Group – 31 December 2018	Carrying amount of the hedged item		Accumulated amount of fair value adjustment on the hedged item		Change in fair value of hedged item for ineffectiveness assessment (YTD)	Cash flow hedge/currency translation reserve	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	£m	Continuing hedges £m	Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	–	9,128	–	754	410		
Fixed rate bonds[2]	180	–	–	–	–		
Cash flow hedges							
Interest rate							
Customer loans[3]					(25)	(179)	(39)
Customer deposits[4]					15	101	23

1 Included within debt securities in issue.

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

3 Included within loans and advances to customers.

4 Included within customer deposits.

The accumulated amount of fair value hedge adjustments remaining in the balance sheet for hedged items that have ceased to be adjusted for hedging gains and losses is a liability of £212 million.

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

The Group – 31 December 2018	Gain (loss) recognised in other comprehensive income £m	Hedge ineffectiveness recognised in the income statement[1] £m	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Income statement line item that includes reclassified amount
Fair value hedges				
Interest rate				
Fixed rate issuance		–		
Cash flow hedges				
Interest rate				
Customer loans	(300)	6	(67)	Interest income
Customer deposits	175	(4)	39	Interest expense

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

There were no forecast transactions for which cash flow hedge accounting had to cease in 2018 as a result of the highly probable cash flows no longer being expected to occur.

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

At 31 December 2018 £9,200 million of total recognised derivative assets of the Group and £9,741 million of total recognised derivative liabilities of the Group (2017: £11,296 million of assets and £10,247 million of liabilities) had a contractual residual maturity of greater than one year.

14 Derivative financial instruments (continued)

The Company	2018 Contract/notional amount £m	2018 Fair value assets £m	2018 Fair value liabilities £m	2017 Contract/notional amount £m	2017 Fair value assets £m	2017 Fair value liabilities £m
Trading						
Interest rate swaps	**12**	**4**	**–**	12	3	–
Total derivative assets/liabilities held for trading	**12**	**4**	**–**	12	3	–
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**973**	**337**	**–**	2,688	392	–
Total recognised derivative assets/liabilities, held for hedging	**973**	**337**	**–**	2,688	392	–
Total recognised derivative asset/liabilities	**985**	**341**	**–**	2,700	395	–

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

The Company – 31 December 2018	Maturity Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	–	–	–	**300**	**673**	**973**
Average fixed interest rate	–	–	–	**6.26%**	**4.50%**	

The carrying amount of the Company's hedging instruments are as follows:

The Company – 31 December 2018	Carrying amount of the hedging instrument Contract/notional amount £m	Assets £m	Liabilities £m	Changes in fair value used for calculating hedge ineffectiveness (YTD) £m
Fair value hedges				
Interest rate				
Interest rate swaps	**973**	**337**	**–**	**(39)**

All amounts are held within derivative financial instruments.

The Company's hedged items are as follows:

The Company – 31 December 2018	Carrying amount of the hedged item Assets £m	Carrying amount of the hedged item Liabilities £m	Accumulated amount of fair value adjustment on the hedged item Assets £m	Accumulated amount of fair value adjustment on the hedged item Liabilities £m	Change in fair value of hedged item for ineffectiveness assessment (YTD) £m	Cash flow hedge/currency translation reserve Continuing hedges £m	Cash flow hedge/currency translation reserve Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	–	**648**	–	**87**	**43**		

1 Included within debt securities in issue.

The accumulated amount of fair value hedge adjustments remaining in the balance sheet for hedged items that have ceased to be adjusted for hedging gains and losses is an asset of £11 million.

14 Derivative financial instruments (continued)

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

			Amounts reclassified from reserves to income statement as:		
The Company – 31 December 2018	**Gain (loss) recognised in other comprehensive income £m**	**Hedge ineffectiveness recognised in the income statement[1] £m**	**Hedged cash flows will no longer occur £m**	**Hedged item affected income statement £m**	**Income statement line item that includes reclassified amount**
Fair value hedges					
Interest rate					
Fixed rate issuance		4			

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

There were no forecast transactions for which cash flow hedge accounting had to cease in 2018 as a result of the highly probable cash flows no longer being expected to occur.

At 31 December 2018 £341 million of total recognised derivative assets of the Company and £nil of total recognised derivative liabilities of the Company (2017: £375 million of assets and £nil of liabilities) had a contractual residual maturity of greater than one year.

15 Financial assets at amortised cost

The Group
A. Loans and advances to customers

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2017				270,782
Adjustment on adoption of IFRS 9 (note 47)				(442)
At 1 January 2018	226,533	37,768	6,039	270,340
Exchange and other movements	108	(20)	(2)	86
Additions (repayments)	2,903	(2,104)	(1,287)	(488)
Transfers to Stage 1	11,361	(11,350)	(11)	–
Transfers to Stage 2	(6,731)	7,470	(739)	–
Transfers to Stage 3	(680)	(2,395)	3,075	–
	3,950	(6,275)	2,325	–
Recoveries			218	218
Disposal of businesses	(543)	(4,024)	(553)	(5,120)
Financial assets that have been written off during the year			(597)	(597)
At 31 December 2018	232,951	25,345	6,143	264,439
Allowance for impairment losses	(149)	(858)	(1,108)	(2,115)
Total loans and advances to customers	232,802	24,487	5,035	262,324

Stage 2 balances show a large reduction in the year largely as a result of the refinements to the transfer criteria approach in mortgages. There is also a reduction from the disposal of the Irish mortgage portfolio together with improvements in credit quality.

15 Financial assets at amortised cost (continued)

B. Loans and advances to banks

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2017				551
Adjustment on adoption of IFRS 9 (note 47)				–
At 1 January 2018	551	–	–	551
Exchange and other movements	1	–	–	1
Additions (repayments)	(66)	–	–	(66)
At 31 December 2018	486	–	–	486
Allowance for impairment losses	–	–	–	–
Total loans and advances to banks	486	–	–	486

C. Debt securities

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2017				148
Adjustment on adoption of IFRS 9 (note 47)				(128)
At 1 January 2018	–	–	20	20
Financial assets that have been written off during the year			(7)	(7)
At 31 December 2018	–	–	13	13
Allowance for impairment losses	–	–	(13)	(13)
Total debt securities	–	–	–	–
Due from fellow Lloyds Banking Group undertakings	53,190	–	–	53,190
Total financial assets at amortised cost	286,478	24,487	5,035	316,000

Transfers between stages are deemed to have taken place at the start of the reporting period, with all other movements shown in the stage in which the asset is held at 31 December.

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

At 31 December 2018 £246,381 million (2017: £251,710 million) of loans and advances to customers of the Group had a contractual residual maturity of greater than one year.

16 Finance lease receivables

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

	2018 £m	2017 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	27	36
Later than 1 year and not later than 5 years	143	94
Later than 5 years	219	149
	389	279
Unearned future finance income on finance leases	(120)	(67)
Rentals received in advance	(1)	(14)
Net investment in finance leases	268	198

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

	2018 £m	2017 £m
Not later than 1 year	8	16
Later than 1 year and not later than 5 years	89	63
Later than 5 years	171	119
Net investment in finance leases	268	198

16 Finance lease receivables (continued)

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 2017 and 2018 no contingent rentals in respect of finance leases were recognised in the income statement. There was an allowance for uncollectable finance lease receivables included in the allowance for impairment losses for the Group of £1 million (2017: £nil).

17 Allowance for impairment losses

Analysis of movement in the allowance for impairment losses by Stage.

The Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of drawn balances				
Balance at 31 December 2017				2,136
Adjustment on adoption of IFRS 9 (note 47)				363
Balance at 1 January 2018	163	1,076	1,260	2,499
Exchange and other adjustments	17	(1)	41	57
Transfers to Stage 1	137	(134)	(3)	–
Transfers to Stage 2	(14)	92	(78)	–
Transfers to Stage 3	(8)	(111)	119	–
Impact of transfers between stages	(95)	120	152	177
	20	(33)	190	177
Other items charged to the income statement	(42)	(82)	179	55
Charge to the income statement (note 11)	(22)	(115)	369	232
Advances written off			(604)	(604)
Disposal of businesses[1]	–	(102)	(162)	(264)
Recoveries of advances written off in previous years			218	218
Discount unwind			(1)	(1)
At 31 December 2018	158	858	1,121	2,137
In respect of undrawn balances				
Balance at 31 December 2017				3
Adjustment on adoption of IFRS 9 (note 47)				84
Balance at 1 January 2018	37	50	–	87
Exchange and other adjustments	–	(1)	2	1
Transfers to Stage 1	11	(11)	–	–
Transfers to Stage 2	(2)	2	–	–
Transfers to Stage 3	(1)	(2)	3	–
Impact of transfers between stages	(10)	7	(1)	(4)
	(2)	(4)	2	(4)
Other income statement items	(11)	(22)	(1)	(34)
Charge to the income statement	(13)	(26)	1	(38)
At 31 December 2018	24	23	3	50
Total	182	881	1,124	2,187
In respect of:				
Loans and advances to customers	149	858	1,108	2,115
Debt securities	–	–	13	13
Due from fellow Lloyds Banking Group undertakings	9	–	–	9
Financial assets at amortised cost	158	858	1,121	2,137
Provisions in relation to loan commitments and financial guarantees	24	23	3	50
Total	182	881	1,124	2,187

1 Reflects the transfer of assets to Lloyds Bank Corporate Markets plc and the sale of the Group's Irish mortgage portfolio.

17 Allowance for impairment losses (continued)

The Group income statement charge comprises:

	£m
Drawn balances	**232**
Undrawn balances	**(38)**
Total	**194**

Transfers between stages are deemed to have taken place at the start of the reporting period, with all other movements shown in the stage in which the asset is held at 31 December. As assets are transferred between stages, the resulting change in expected credit loss of £177 million for drawn balances, and £4 million for undrawn balances, is presented separately as Impacts of transfers between stages, in the stage in which the expected credit loss is recognised at the end of the reporting period.

Net increase and decrease in balances comprise the movements in the expected credit loss as a result of new loans originated and repayments of outstanding balances throughout the reporting period. Loans which are written off in the period are first transferred to Stage 3 before acquiring a full allowance and subsequent write-off. Consequently, recoveries on assets previously written-off also occur in Stage 3 only.

For the year ended 31 December 2017

The Group	Loans and advances to customers £m	Debt securities £m	Total £m
At 1 January 2017	2,385	91	2,476
Exchange and other adjustments	3	(30)	(27)
Advances written off	(714)	(44)	(758)
Recoveries of advances written off in previous years	276	–	276
Unwinding of discount	11	–	11
Charge (release) to the income statement (note 11)	164	(6)	158
At 31 December 2017	2,125	11	2,136

Of the total allowance in respect of loans and advances to customers at 31 December 2017 £1,397 million for the Group related to lending that had been determined to be impaired (either individually or on a collective basis) at that reporting date.

Of the total allowance in respect of loans and advances to customers at 31 December 2017 £1,700 million for the Group was assessed on a collective basis.

18 Financial assets at fair value through other comprehensive income of the Group

31 December 2018	**The Group £m**
Debt securities:	
Government securities	**117**
Corporate and other debt securities	**968**
	1,085
Equity shares	**–**
Total financial assets at fair value through other comprehensive income	**1,085**

At 31 December 2018 £976 million of financial assets at fair value through other comprehensive income had a contractual residual maturity of greater than one year.

All assets have been assessed at Stage 1 at 1 January and 31 December 2018.

19 Available-for-sale financial assets

31 December 2017	The Group £m	The Company £m
Debt securities:		
Government securities	116	–
Corporate and other debt securities	786	–
	902	–
Equity shares	35	7
Total available-for-sale financial assets	937	7

At 31 December 2017 £663 million of available-for-sale financial assets of the Group had a contractual residual maturity of greater than one year.

Notes to the accounts

20 Goodwill

	2018 £m	2017 £m
At 1 January and 31 December	**325**	325
Cost[1]	**325**	1,838
Accumulated impairment losses	**–**	(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 (2017: £325 million) has been allocated to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2018 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 2017	15	10	196	221
Additions	–	–	47	47
Disposals	–	–	(15)	(15)
At 31 December 2017	15	10	228	253
Exchange and other adjustments	**–**	**–**	**34**	**34**
Additions	**–**	**–**	**43**	**43**
Disposals and write-offs	**(15)**	**–**	**(10)**	**(25)**
At 31 December 2018	**–**	**10**	**295**	**305**
Accumulated amortisation:				
At 1 January 2017	11	10	100	121
Charge for the year (note 9)	3	–	30	33
Disposals	–	–	(13)	(13)
At 31 December 2017	14	10	117	141
Exchange and other adjustments	**–**	**–**	**30**	**30**
Charge for the year (note 9)	**1**	**–**	**35**	**36**
Disposals and write-offs	**(15)**	**–**	**(7)**	**(22)**
At 31 December 2018	**–**	**10**	**175**	**185**
Balance sheet amount at 31 December 2018	**–**	**–**	**120**	**120**
Balance sheet amount at 31 December 2017	1	–	111	112

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 2017	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
Disposals	(68)	(546)	(1,147)	(284)	(2,045)
At 31 December 2017	49	874	659	9	1,591
Additions	**–**	**13**	**67**	**38**	**118**
Expenditure on investment properties	**17**	**–**	**–**	**–**	**17**
Disposals	**(31)**	**(137)**	**(185)**	**(1)**	**(354)**
At 31 December 2018	**35**	**750**	**541**	**46**	**1,372**
Accumulated depreciation and impairment:					
At 1 January 2017	–	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
Exchange and other adjustments	**–**	**(11)**	**(8)**	**6**	**(13)**
Depreciation charge for the year (note 9)	**–**	**54**	**68**	**4**	**126**
Disposals	**–**	**(137)**	**(148)**	**(1)**	**(286)**
At 31 December 2018	**–**	**374**	**210**	**11**	**595**
Balance sheet amount at 31 December 2018	**35**	**376**	**331**	**35**	**777**
Balance sheet amount at 31 December 2017	49	406	361	7	823

The table above analyses movements in investment properties, all of which are categorised as level 3. See note 41 for details of levels in the fair value hierarchy.

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2017 and 2018 no contingent rentals in respect of operating leases were recognised in the income statement.

Total future minimum sub-lease income of £19 million at 31 December 2018 (2017: £24 million) is expected to be received under non-cancellable sub-leases of premises.

23 Investment in subsidiary undertakings of the Company

	2018 £m	2017 £m
At 1 January	**22,394**	22,289
Capital contributions	**73**	105
At 31 December	**22,467**	22,394

Details of the subsidiaries and related undertakings are given on pages 113 to 114 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.

24 Other assets of the Group

	2018 £m	2017 £m
Settlement balances	**63**	38
Investments in joint ventures and associates	**1**	7
Other assets and prepayments	**415**	324
Total other assets	**479**	369

25 Financial liabilities at fair value through profit or loss of the Group

	2018 £m	2017 £m
Trading liabilities:		
Liabilities in respect of securities sold under repurchase agreements	**–**	–
Other deposits	**50**	50
Total trading liabilities	**50**	50
Other financial liabilities at fair value through profit or loss: debt securities	**53**	–
Total financial liabilities at fair value through profit or loss	**103**	50

At 31 December 2018 £53 million (2017: £50 million) of trading and other financial liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

26 Debt securities in issue of the Group

	2018 £m	2017 £m
Medium-term notes issued	**1,168**	1,182
Covered bonds (note 27)	**6,017**	6,740
Securitisation notes (note 27)	**4,676**	2,997
	11,861	10,919
Amounts due to fellow Group undertakings	**–**	–
Total debt securities in issue	**11,861**	10,919

At 31 December 2018 £10,179 million (2017: £9,883 million) of debt securities in issue had a contractual residual maturity of greater than one year.

27 Securitisations and covered bonds

Securitisation programmes
The Group's balance sheet includes 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 notes 25 and 26.

	2018		2017	
	Loans and advances securitised £m	**Notes in issue £m**	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	**24,433**	**21,897**	20,549	13,487
Credit card receivables	**4,502**	**5,263**	4,303	4,090
Commercial loans	**395**	**395**	374	374
	29,330	**27,555**	25,226	17,951
Less held by the Group		**(22,826)**		(14,954)
Total securitisation programmes[1]		**4,729**		2,997
Covered bond programmes				
Residential mortgage-backed	**7,195**	**5,517**	7,525	6,240
Social housing loan-backed	**1,839**	**1,200**	1,628	1,200
	9,034	**6,717**	9,153	7,440
Less held by the Group		**(700)**		(700)
Total covered bond programmes (note 26)		**6,017**		6,740
Total securitisation and covered bond programmes		**10,746**		9,737

1 Includes £53 million (2017: £nil) of securitisation notes held at fair value through profit or loss.

Cash deposits of £1,843 million (2017: £1,712 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 2018 these obligations had not been triggered and the maximum exposure under these facilities was £21 million (2017: £28 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 2018 (2017: none).

28 Other liabilities

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Settlement balances	**1**	19	**–**	–
Other creditors and accruals	**793**	266	**–**	243
Total other liabilities	**794**	285	**–**	243

29 Retirement benefit obligations

	The Group	
	2018 £m	2017 £m
Charge to the Group income statement		
Defined benefit pension schemes	**169**	165
Other post-retirement benefit schemes	**1**	4
Total defined benefit schemes	**170**	169
Defined contribution pension schemes	**97**	96
Total charge to the income statement	**267**	265

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Amounts recognised in the balance sheet				
Retirement benefit assets	**455**	69	**442**	69
Retirement benefit obligations	**(124)**	(135)	**(124)**	(130)
Total amounts recognised in the balance sheet	**331**	(66)	**318**	(61)

The total amount recognised in the balance sheet relates to:

	The Group		The Company	
Pension schemes	**2018 £m**	2017 £m	**2018 £m**	2017 £m
Defined benefit pension schemes	**371**	(25)	**358**	(20)
Other post-retirement benefit schemes	**(40)**	(41)	**(40)**	(41)
Total amounts recognised in the balance sheet	**331**	(66)	**318**	(61)

Pension schemes
Defined benefit schemes
(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 section of the HBOS Final Salary Pension Scheme. At 31 December 2018, this scheme represented 94 per cent of the Group's total gross defined benefit pension assets (2017: 95 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 2018 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 and are in compliance with the Pensions Act 2004. 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.

29 Retirement benefit obligations (continued)

The most recent triennial funding valuation of the Group's main scheme, based on the position as at 31 December 2016 was completed during 2018. The valuation showed 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 agreed a recovery plan with the trustees. Under the plan, deficit contributions of £109 million were paid during 2018, and these will rise 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 £370 million to its defined benefit schemes in 2019.

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 2018 this company held assets of approximately £3.0 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 2018.

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 2018 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.

In July 2018 a decision was sought from the High Court in respect of the requirement to equalise the Guaranteed Minimum Pension (GMP) benefits accrued between 1990 and 1997 from contracting out of the State Earnings Related Pension Scheme. In its judgment handed down on 26 October 2018 the High Court confirmed the requirement to treat men and women equally with respect to these benefits and a range of methods that the Trustee is entitled to adopt to achieve equalisation. Although the Group is continuing to work with the Trustee on the detail of implementing this judgement, it has recognised a past service cost of £31 million consistent with the principles outlined within the judgment. This is based on a number of assumptions and the actual impact may be different.

Notes to the accounts

29 Retirement benefit obligations (continued)

(ii) Amounts in the financial statements

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Amounts included in the balance sheet				
Present value of funded obligations	**(14,148)**	(15,330)	**(13,880)**	(15,051)
Fair value of scheme assets	**14,519**	15,305	**14,238**	15,031
Net amount recognised in the balance sheet	**371**	(25)	**358**	(20)

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Net amount recognised in the balance sheet				
At 1 January	**(25)**	(49)	**(20)**	(19)
Net defined benefit pension expense	**(169)**	(165)	**(169)**	(165)
Actuarial gains (losses) on defined benefit obligation	**782**	(340)	**770**	(346)
Return on plan assets	**(471)**	384	**(463)**	381
Employer contributions	**254**	144	**239**	129
Exchange and other adjustments	**–**	1	**1**	–
At 31 December	**371**	(25)	**358**	(20)

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Movements in the defined benefit obligation				
At 1 January	**(15,330)**	(15,548)	**(15,051)**	(15,241)
Current service cost	**(119)**	(137)	**(119)**	(137)
Interest expense	**(391)**	(420)	**(385)**	(414)
Remeasurements:				
Actuarial (losses) gains – experience	**(76)**	20	**(78)**	18
Actuarial (losses) gains – demographic assumptions	**(15)**	143	**(15)**	143
Actuarial gains (losses) – financial assumptions	**873**	(503)	**863**	(507)
Benefits paid	**934**	1,097	**925**	1,084
Past service cost	**(31)**	(9)	**(31)**	(9)
Settlements	**17**	16	**17**	16
Curtailments	**(6)**	(4)	**(6)**	(4)
Exchange and other adjustments	**(4)**	15	**–**	–
At 31 December	**(14,148)**	(15,330)	**(13,880)**	(15,051)

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Analysis of the defined benefit obligations:				
Active members	**(2,607)**	(3,159)	**(2,607)**	(3,159)
Deferred members	**(4,984)**	(5,491)	**(4,847)**	(5,347)
Pensioners	**(6,155)**	(6,268)	**(6,024)**	(6,133)
Dependants	**(402)**	(412)	**(402)**	(412)
	(14,148)	(15,330)	**(13,880)**	(15,051)

29 Retirement benefit obligations (continued)

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Changes in the fair value of scheme assets				
At 1 January	**15,305**	15,499	**15,031**	15,222
Return on plan assets excluding amounts included in interest income	**(471)**	384	**(463)**	381
Interest income	**392**	421	**386**	415
Employer contributions	**254**	144	**239**	129
Benefits paid	**(934)**	(1,097)	**(925)**	(1,084)
Settlements	**(18)**	(18)	**(18)**	(18)
Administrative costs paid	**(13)**	(14)	**(13)**	(14)
Exchange and other adjustments	**4**	(14)	**1**	–
At 31 December	**14,519**	15,305	**14,238**	15,031

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

	The Group	
	2018 £m	2017 £m
Current service cost	**119**	137
Net interest amount	**(1)**	(1)
Past service credits and curtailments	**6**	4
Settlements	**1**	2
Past service cost – plan amendments	**31**	9
Plan administration costs incurred during the year	**13**	14
Total defined benefit pension expense	**169**	165

(iii) Composition of scheme assets

	2018			2017		
The Group	**Quoted £m**	**Unquoted £m**	**Total £m**	Quoted £m	Unquoted £m	Total £m
Equity instruments	**335**	**4**	**339**	391	1	392
Debt instruments[1]:						
Fixed interest government bonds	**4,655**	**–**	**4,655**	4,764	–	4,764
Index-linked government bonds	**5,708**	**–**	**5,708**	5,742	–	5,742
Corporate and other debt securities	**2,748**	**–**	**2,748**	1,969	–	1,969
Asset-backed securities	**137**	**–**	**137**	121	–	121
	13,248	**–**	**13,248**	12,596	–	12,596
Property	**–**	**557**	**557**	–	544	544
Pooled investment vehicles	**1,814**	**2,616**	**4,430**	2,234	2,950	5,184
Money market instruments, derivatives, cash and other assets and liabilities	**310**	**(4,365)**	**(4,055)**	940	(4,351)	(3,411)
At 31 December	**15,707**	**(1,188)**	**14,519**	16,161	(856)	15,305

1 Of the total debt instruments, £11,753 million (31 December 2017: £12,002 million) were investment grade (credit ratings equal to or better than 'BBB').

29 Retirement benefit obligations (continued)

Company	2018 Quoted £m	2018 Unquoted £m	2018 Total £m	2017 Quoted £m	2017 Unquoted £m	2017 Total £m
Equity instruments	**318**	**4**	**322**	347	1	348
Debt instruments[1]:						
Fixed interest government bonds	**4,655**	**–**	**4,655**	4,764	–	4,764
Index-linked government bonds	**5,708**	**–**	**5,708**	5,742	–	5,742
Corporate and other debt securities	**2,747**	**–**	**2,747**	1,969	–	1,969
	13,110	**–**	**13,110**	12,475	–	12,475
Property	**–**	**549**	**549**	–	537	537
Pooled investment vehicles	**1,697**	**2,616**	**4,313**	2,167	2,950	5,117
Money market instruments, derivatives, cash and other assets and liabilities	**308**	**(4,364)**	**(4,056)**	905	(4,351)	(3,446)
At 31 December	**15,433**	**(1,195)**	**14,238**	15,894	(863)	15,031

1 Of the total debt instruments, £11,753 million (31 December 2017: £12,002 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.

The pension schemes' pooled investment vehicles comprise:

	The Group 2018 £m	The Group 2017 £m	The Company 2018 £m	The Company 2017 £m
Equity funds	**395**	465	**395**	465
Hedge and mutual funds	**970**	1,050	**854**	983
Liquidity funds	**948**	1,283	**948**	1,283
Bond and debt funds	**28**	640	**28**	640
Other	**2,089**	1,746	**2,088**	1,746
At 31 December	**4,430**	5,184	**4,313**	5,117

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

	2018 %	2017 %
Discount rate	**2.90**	2.59
Rate of inflation:		
Retail Prices Index	**3.20**	3.20
Consumer Price Index	**2.15**	2.15
Rate of salary increases	**0.00**	0.00
Weighted-average rate of increase for pensions in payment	**3.03**	2.93
	2018 Years	2017 Years
Life expectancy for member aged 60, on the valuation date:		
Men	**27.8**	27.9
Women	**29.4**	29.5
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**28.8**	28.9
Women	**30.6**	30.7

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 2018 is assumed to live for, on average, 27.8 years for a male and 29.4 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.

29 Retirement benefit obligations (continued)

(v) 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 materially 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 materially 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 asset 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**	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Inflation (including pension increases):[1]				
Increase of 0.1 per cent	**6**	7	**145**	167
Decrease of 0.1 per cent	**(5)**	(5)	**(138)**	(159)
Discount rate:[2]				
Increase of 0.1 per cent	**(10)**	(11)	**(252)**	(291)
Decrease of 0.1 per cent	**10**	10	**258**	290
Expected life expectancy of members:				
Increase of one year	**16**	17	**451**	487
Decrease of one year	**(15)**	(15)	**(437)**	(471)

1 At 31 December 2018, the assumed rate of RPI inflation is 3.20 per cent and CPI inflation 2.15 per cent (2017: RPI 3.20 per cent and CPI 2.15 per cent).

2 At 31 December 2018, the assumed discount rate is 2.90 per cent (2017: 2.59 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 94 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.

29 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 2018 the asset-liability matching strategy mitigated 106 per cent of the liability sensitivity to interest rate movements and 113 per cent of the liability sensitivity to inflation movements. In addition a small amount of interest rate sensitivity arises 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	
	2018 Years	2017 Years	**2018 Years**	2017 Years
Duration of the defined benefit obligation	**20**	21	**20**	21

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Maturity analysis of benefits expected to be paid:				
Within 12 months	**341**	332	**334**	326
Between 1 and 2 years	**358**	342	**351**	335
Between 2 and 5 years	**1,216**	1,147	**1,191**	1,124
Between 5 and 10 years	**2,486**	2,396	**2,442**	2,351
Between 10 and 15 years	**3,034**	2,982	**2,984**	2,927
Between 15 and 25 years	**6,589**	6,753	**6,480**	6,636
Between 25 and 35 years	**6,027**	6,393	**5,936**	6,289
Between 35 and 45 years	**4,246**	4,693	**4,194**	4,632
More than 45 years	**2,138**	2,564	**2,116**	2,538

Maturity analysis method and assumptions
The projected benefit payments are based on the assumptions underlying the assessment of the obligations, including allowance for expected future inflation. They are shown in their undiscounted form and therefore appear large relative to the discounted assessment of the defined benefit obligations recognised in the Group's balance sheet. They are in respect of benefits that have been accrued prior to the respective year-end date only and make no allowance for any benefits that may have been accrued subsequently.

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 2018 the charge to the income statement in respect of defined contribution schemes was £97 million (2017: £96 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 (2017: 6.81 per cent).

29 Retirement benefit obligations (continued)

Movements in the other post-retirement benefit obligation:

	The Group and Company	
	2018 £m	2017 £m
At 1 January	**(41)**	(115)
Actuarial gains	**1**	77
Insurance premiums paid	**1**	2
Charge for the year	**(1)**	(4)
Exchange and other adjustments	**–**	(1)
At 31 December	**(40)**	(41)

30 Deferred tax

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

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Statutory position				
Deferred tax assets	**1,779**	1,878	**17**	–
Deferred tax liabilities	**–**	–	**–**	(18)
Net deferred tax asset	**1,779**	1,878	**17**	(18)
Tax disclosure				
Deferred tax assets	**1,881**	1,915	**92**	11
Deferred tax liabilities	**(102)**	(37)	**(75)**	(29)
Net deferred tax asset	**1,779**	1,878	**17**	(18)

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

As a result of legislation enacted in 2016, 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 2018 is a charge of £18 million in the income statement and a charge of £2 million in other comprehensive income.

30 Deferred tax (continued)

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	Other revaluations[1] £m	Other temporary differences £m	Total £m
At 1 January 2017	1,667	277	58	37	–	–	–	9	2,048
(Charge) 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
Adjustment on adoption of IFRS 9 (note 47)	–	–	–	132	–	–	–	–	132
At 1 January 2018	1,581	233	53	141	10	13	6	10	2,047
(Charge) credit to the income statement	**(83)**	**(71)**	**(33)**	**(13)**	**(5)**	**–**	**(4)**	**6**	**(203)**
Credit to other comprehensive income	**–**	**–**	**4**	**–**	**–**	**32**	**1**	**–**	**37**
At 31 December 2018	**1,498**	**162**	**24**	**128**	**5**	**45**	**3**	**16**	**1,881**

Deferred tax liabilities	Pension assets £m	Derivatives £m	Other revaluations[1] £m	Other temporary differences £m	Total £m
At 1 January 2017	(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)
(Charge) credit to the income statement	**5**	–	–	**(12)**	**(7)**
(Charge) to other comprehensive income	**(57)**	–	–	**–**	**(57)**
Exchange and other adjustments	**–**	–	–	**(1)**	**(1)**
At 31 December 2018	**(77)**	–	–	**(25)**	**(102)**

1 Financial assets at fair value through other comprehensive income (2017: available-for-sale financial assets).

30 Deferred tax (continued)

The Company **Deferred tax assets**	Pension liabilities £m	Provisions £m	Other temporary differences £m	Total £m
At 1 January 2017	10	–	–	10
Charge to the income statement	(49)	–	–	(49)
Credit to other comprehensive income	50	–	–	50
At 31 December 2017	11	–	–	11
Adjustment on adoption of IFRS 9 (note 47)	–	35	–	35
At 1 January 2018	**11**	**35**	**–**	**46**
Credit to the income statement	**7**	**27**	**8**	**42**
Credit to other comprehensive income	**4**	**–**	**–**	**4**
At 31 December 2018	**22**	**62**	**8**	**92**

Deferred tax liabilities	Pension assets £m	Other temporary differences £m	Total £m
At 1 January 2017	(21)	–	(21)
Credit to the income statement	57	–	57
Charge to other comprehensive income	(65)	–	(65)
At 31 December 2017	(29)	–	(29)
Credit to the income statement	**10**	**–**	**10**
Charge to other comprehensive income	**(56)**	**–**	**(56)**
At 31 December 2018	**(75)**	**–**	**(75)**

Deferred tax not recognised

No deferred tax asset is recognised in respect of unrelieved foreign tax credits of £40 million (2017: £40 million) for the Group and £nil (2017: £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.

No deferred tax has been recognised in respect of foreign trade losses of £36 million (2017: £34 million) for the Group and £nil (2017: £nil) for the Company which will expire if not used within 20 years, nor £45 million (2017: £45 million) for the Group and £nil (2017: £nil) for the Company which 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.

31 Other provisions

The Group	**Provisions for financial commitments and guarantees £m**	**Payment protection insurance £m**	**Other regulatory provisions £m**	**Vacant leasehold property £m**	**Other £m**	**Total £m**
At 31 December 2017	3	947	807	16	246	2,019
Adjustment on adoption of IFRS 9 (note 47)	84					84
Balance at 1 January 2018	87					2,103
Exchange and other adjustments	**1**	**–**	**–**	**–**	**(55)**	**(54)**
Provisions applied	**–**	**(740)**	**(615)**	**(27)**	**(47)**	**(1,429)**
Charge (release) for the year	**(38)**	**185**	**250**	**33**	**(23)**	**407**
At 31 December 2018	**50**	**392**	**442**	**22**	**121**	**1,027**

Provisions for financial commitments and guarantees

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. See note 17.

Payment protection insurance

The Group increased the provision for PPI costs by a further £185 million in the year ended 31 December 2018, bringing the total amount provided to £5,458 million.

The charge in 2018 related to a number of factors including higher expected complaint volumes and associated administration costs, an increase in average redress per complaint and additional operational costs to deal with potential complaint volatility.

31 Other provisions (continued)

At 31 December 2018 a provision of £392 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £740 million during the year ended 31 December 2018.

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 including with respect to future complaint 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 also uncertainty around the impact of the regulatory changes, Financial Conduct Authority (FCA) media campaign and Claims Management Company and customer activity, and potential additional remediation arising from the continuous improvement of the Group's operational practices.

For every additional 1,000 reactive complaints per week from January 2019 through to the industry deadline of the end of August 2019, the Group would expect an additional charge of £80 million.

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 2018 the Group charged a further £250 million in respect of legal actions and other regulatory matters, and the unutilised balance at 31 December 2018 was £442 million (31 December 2017: £807 million). The most significant items are as follows.

Arrears handling related activities
The Group has provided an additional £54 million in the year ended 31 December 2018 for the costs of identifying and rectifying certain arrears management fees and activities, taking the total provided to date to £454 million. The Lloyds Banking Group has put in place a number of actions to improve its handling of customers in these areas and has made good progress in reimbursing arrears fees to impacted customers.

Packaged bank accounts
The Group has provided a further £13 million in the year ended 31 December 2018 (£100 million was provided in the year ended 31 December 2017) in respect of complaints relating to alleged mis-selling of packaged bank accounts, raising the total amount provided to £204 million. A number of risks and uncertainties remain particularly with respect to future volumes.

HBOS Reading – customer review
As at the end of February 2019, the Group had completed its compensation assessment for all 71 business customers within the customer review, with more than 96 per cent of these offers accepted. In total, more than £96 million had been offered of which £78 million had been accepted, in addition to £9 million for ex-gratia payments and £5 million for the reimbursements of legal fees.

The 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 a further £15 million in the year ended 31 December 2018 for customer settlements, raising the total amount provided to £115 million and is now nearing the end of the process of paying compensation to the victims of the fraud, including ex-gratia payments and re-imbursements of legal fees.

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

Other
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 2018 provisions of £nil (31 December 2017: £9 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.

32 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 2017	–	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
Repurchases and redemptions during the year[2]:					
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities	**–**	**(600)**	**–**	**–**	**(600)**
Undated Perpetual Preferred Securities	**–**	**(14)**	**–**	**–**	**(14)**
10.5% Subordinated Bonds callable 2018	**–**	**–**	**–**	**(150)**	**(150)**
6.75% Subordinated Fixed Rate Notes callable 2018	**–**	**–**	**–**	**(1,492)**	**(1,492)**
Floating Rate Subordinated Notes callable 2018	**–**	**–**	**–**	**(44)**	**(44)**
	–	**(614)**	**–**	**(1,686)**	**(2,300)**
Foreign exchange movements	**–**	**21**	**(18)**	**45**	**48**
Other moments (all non-cash)	**–**	**(49)**	**(2)**	**(106)**	**(157)**
At 31 December 2018	**–**	**1,572**	**158**	**2,481**	**4,211**

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 £2,322 million (2017: £1,132 million).

32 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 2017	–	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
Repurchases and redemptions during the year[2]:					
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities	**–**	**–**	**(600)**	**–**	**(600)**
Undated Perpetual Preferred Securities	**–**	**–**	**(14)**	**–**	**(14)**
6.75% Subordinated Fixed Rate Notes callable 2018	**–**	**–**	**–**	**(1,492)**	**(1,492)**
	–	**–**	**(614)**	**(1,492)**	**(2,106)**
Foreign exchange movements	**–**	**–**	**42**	**44**	**86**
Other moments (all non-cash)	**–**	**(10)**	**(3)**	**(31)**	**(44)**
At 31 December 2018	**–**	**85**	**786**	**1,757**	**2,628**

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 £2,106 million (2017: £1,132 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 (2017: none).

33 Share capital

(1) Authorised share capital

	Group and Company			
	2018 Number of shares	2017 Number of shares	**2018 £m**	2017 £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			
	2018 Number of shares	2017 Number of shares	**2018 £m**	2017 £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 limitations on voting rights or 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 2018, 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.

34 Other reserves

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £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 debt securities held at fair value through other comprehensive income	**20**		**–**	
Revaluation reserve in respect of equity shares held at fair value through other comprehensive income	**–**		**–**	
Revaluation reserve in respect of available-for-sale financial assets		50		7
Cash flow hedging reserve	**(70)**	23	**–**	–
Foreign currency translation reserve	**(27)**	(31)	**–**	–
At 31 December	**10,115**	10,234	**9,678**	9,685

1 There were no movements in these reserves in 2017 or 2018.

Movements in other reserves were as follows:

	The Group 2018 £m	**The Company 2018 £m**
Revaluation reserve in respect of debt securities held at fair value through other comprehensive income		
At 31 December 2017		
Adjustment on adoption of IFRS 9 (note 47)	**33**	**–**
At 1 January 2018	**33**	**–**
Change in fair value	**2**	**–**
Deferred tax	**(3)**	**–**
Current tax	**–**	**–**
	(1)	**–**
Income statement transfers:		
Disposals	**(16)**	**–**
Deferred tax	**4**	**–**
Current tax	**–**	**–**
	(12)	**–**
At 31 December 2018	**20**	**–**

34 Other reserves (continued)

	The Group 2018 £m	The Company 2018 £m
Revaluation reserve in respect of equity shares held at fair value through other comprehensive income		
At 31 December 2017		
Adjustment on adoption of IFRS 9 (note 47)	3	7
At 1 January 2018	3	7
Change in fair value	9	(3)
Deferred tax	–	–
Current tax	–	–
	9	(3)
Realised gains and losses transferred to retained profits		
Gross gains and losses	(12)	(4)
Deferred tax	–	–
Current tax	–	–
	(12)	(4)
At 31 December 2018	–	–

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

34 Other reserves (continued)

	The Group	
	2018 £m	2017 £m
Cash flow hedging reserve		
At 1 January	**23**	89
Change in fair value of hedging derivatives	**(97)**	(135)
Deferred tax	**25**	35
	(72)	(100)
Income statement transfers	**(28)**	46
Deferred tax	**7**	(12)
	(21)	34
At 31 December	**(70)**	23

	The Group	
	2018 £m	2017 £m
Foreign currency translation reserve		
At 1 January	**(31)**	(27)
Currency translation differences arising in the year	**4**	–
Foreign currency losses on net investment hedges (tax: £nil)	**–**	(4)
At 31 December	**(27)**	(31)

35 Retained profits

	The Group		The Company	
	2018 £m	2017 £m	**2018 £m**	2017 £m
At 31 December	**(1,535)**		**9,317**	
Adjustment on adoption of IFRS 9 and IFRS 15 (note 47)	**(334)**		**(166)**	
At 1 January	**(1,869)**	(858)	**9,151**	9,818
Profit for the year[1]	**1,458**	1,993	**2,943**	2,197
Tax relief on distributions to non-controlling interests	**27**	27	**–**	–
Dividends paid (note 36)	**(3,300)**	(2,900)	**(3,300)**	(2,900)
Capital contribution received	**73**	105	**73**	105
Post-retirement defined benefit scheme remeasurement	**259**	98	**256**	97
Realised gains and losses on equity shares held at fair value through other comprehensive income	**12**	–	**4**	–
At 31 December	**(3,340)**	(1,535)	**9,127**	9,317

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

36 Dividends on ordinary shares

Dividends paid in the year were as follows:

	2018 £m	2017 £m
Final dividend for previous year paid during the current year	**–**	–
Interim dividends	**3,300**	2,900
	3,300	2,900

37 Share-based payments

During the year ended 31 December 2018 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 £98 million (2017: £107 million).

Group Performance Share plan
The Group operates a Group Performance Share plan that is equity settled. Bonuses in respect of employee performance in 2018 have been recognised in the charge in line with the proportion of the deferral period completed.

Save-As-You-Earn schemes
Eligible employees may enter into contracts through the Save-As-You-Earn (SAYE) schemes to save up to £500 per month and, at the expiry of a fixed term of three 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:

	2018		2017	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**860,867,088**	**51.34**	678,692,896	51.76
Granted	**188,866,162**	**47.92**	268,653,890	51.03
Exercised	**(135,721,404)**	**59.00**	(13,119,229)	55.58
Forfeited	**(22,909,999)**	**49.85**	(18,545,569)	51.70
Cancelled	**(78,073,042)**	**50.66**	(41,211,075)	52.77
Expired	**(10,033,887)**	**55.20**	(13,603,825)	56.98
Outstanding at 31 December	**802,994,918**	**49.30**	860,867,088	51.34
Exercisable at 31 December	**68,378**	**60.02**	–	–

The weighted average share price at the time that the options were exercised during 2018 was £0.67 (2017: £0.67). The weighted average remaining contractual life of options outstanding at the end of the year was 2.16 years (2017: 1.4 years).

The weighted average fair value of SAYE options granted during 2018 was £0.13 (2017: £0.15). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

Other share option plans
Lloyds Banking Group Executive Share Plan 2003
The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment (to compensate new recruits for any lost share awards), and also to make grants to key individuals for retention purposes. In some instances, grants may be made subject to individual performance conditions.

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

	2018		2017	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**14,523,989**	**Nil**	218,962,281	Nil
Granted	**3,914,599**	**Nil**	5,466,405	Nil
Exercised	**(6,854,043)**	**Nil**	(104,967,667)	Nil
Vested	**(148,109)**	**Nil**	–	–
Forfeited	**(662,985)**	**Nil**	(81,883)	Nil
Lapsed	**(510,423)**	**Nil**	(104,855,147)	Nil
Outstanding at 31 December	**10,263,028**	**Nil**	14,523,989	Nil
Exercisable at 31 December	**3,305,442**	**Nil**	7,729,919	Nil

The weighted average fair value of options granted in the year was £0.55 (2017: £0.62). 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 2018 was £0.65 (2017: £0.69). The weighted average remaining contractual life of options outstanding at the end of the year was 5.2 years (2017: 4.9 years).

Other share plans
Lloyds Banking Group Executive Share Ownership Plan
The plan, introduced in 2006, is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the 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.

37 Share-based payments (continued)

For the 2016 and 2017 plan 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 2015 grant, the targets had not been fully met and therefore these awards vested in 2018 at a rate of 66.3 per cent.

	2018 Number of shares	2017 Number of shares
Outstanding at 1 January	**370,804,915**	358,228,028
Granted	**160,586,201**	139,812,788
Vested	**(73,270,301)**	(57,406,864)
Forfeited	**(48,108,870)**	(73,268,966)
Dividend award	**7,373,691**	3,439,929
Outstanding at 31 December	**417,385,636**	370,804,915

Awards in respect of the 2016 grant vested in 2019 at a rate of 68.7 per cent.

The weighted average fair value of awards granted in the year was £0.48 (2017: £0.57).

The fair value calculations at 31 December 2018 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	**0.96%**	**0.74%**	**0.94%**
Weighted average expected life	**3.3 years**	**1.3 years**	**3.7 years**
Weighted average expected volatility	**28%**	**21%**	**29%**
Weighted average expected dividend yield	**4.0%**	**4.0%**	**4.0%**
Weighted average share price	**£0.59**	**£0.58**	**£0.67**
Weighted average exercise price	**£0.48**	**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 2018, the Group made an award of £200 (2017: £200) of shares to all eligible employees. The number of shares awarded was 21,513,300 (2017: 21,566,047), with an average fair value of £0.67 (2017: £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 2018 was 34,174,161 (2017: 32,025,497), with an average fair value of £0.63 (2017: £0.67), 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 2018 was 8,965,562 (2017: 9,313,314).

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.

38 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.

	2018 £m	2017 £m
Compensation		
Salaries and other short-term benefits	7	7
Post-employment benefits	–	–
Share-based payments	9	11
Total compensation	16	18

The aggregate of the emoluments of the directors was £6.1 million (2017: £7.0 million).

Aggregate company contributions in respect of directors to defined contribution pension schemes were £nil (2017: £0.05 million).

The total for the highest paid director (António Horta-Osório) was £2,736,000 (2017: (António Horta-Osório) £3,234,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in either year.

	2018 million	2017 million
Share options over Lloyds Banking Group plc shares		
At 1 January	1	3
Granted (includes entitlements of appointed key management personnel)	–	–
Exercised/lapsed (includes entitlements of former key management personnel)	(1)	(2)
At 31 December	–	1

	2018 million	2017 million
Share incentive plans settled in Lloyds Banking Group plc shares		
At 1 January	82	65
Granted (includes entitlements of appointed key management personnel)	39	37
Exercised/lapsed (includes entitlements of former key management personnel)	(37)	(20)
At 31 December	84	82

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:

	2018 £m	2017 £m
Loans		
At 1 January	2	4
Advanced (includes loans of appointed key management personnel)	1	1
Repayments (includes loans of former key management personnel)	(1)	(3)
At 31 December	2	2

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 6.70 per cent and 24.2 per cent in 2018 (2017: 6.45 per cent and 23.95 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2017: £nil).

38 Related party transactions (continued)

	2018 £m	2017 £m
Deposits		
At 1 January	**20**	12
Placed (includes deposits of appointed key management personnel)	**33**	41
Withdrawn (includes deposits of former key management personnel)	**(33)**	(33)
At 31 December	**20**	20

Deposits placed by key management personnel attracted interest rates of up to 3.5 per cent in 2018 (2017: 4.0 per cent).

At 31 December 2018, the Group did not provide any guarantees in respect of key management personnel (2017: none).

At 31 December 2018, 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 £0.5 million with three directors and three connected persons. (2017: £0.01 million with five directors and two connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings
Transfers of operations
During the year, the Company's subsidiary, Bank of Scotland plc, sold the element of its commercial banking and overseas businesses required to be transferred in order to ensure compliance with the ring-fencing legislation to Lloyds Bank Corporate Markets plc, a fellow Lloyds Banking Group undertaking.

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:

	2018 £m	2017 £m
Assets, included within:		
Due to fellow Lloyds Banking Group undertakings	**8,483**	11,210
Derivative financial instruments	**341**	395
	8,824	11,605
Liabilities, included within:		
Due to fellow Lloyds Banking Group undertakings	**5,742**	7,411
Subordinated liabilities	**1,022**	1,596
	6,764	9,007

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 2018 the Company earned interest income on the above asset balances of £313 million (2017: £394 million) and incurred interest expense on the above liability balances of £193 million (2017: £184 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**	
	2018 £m	2017 £m	**2018 £m**	2017 £m
Assets included within:				
Derivative financial instruments	**6,201**	6,808	**–**	–
Due from fellow Lloyds Banking Group undertakings	**53,190**	74,849	**–**	604
Financial assets at fair value through profit or loss	**–**	1,350	**–**	1,350
	59,391	83,007	**–**	1,954
Liabilities included within:				
Due to fellow Lloyds Banking Group undertakings	**109,169**	125,541	**741**	757
Derivative financial instruments	**7,674**	7,765	**–**	–
Subordinated liabilities	**93**	179	**6**	3
Debt securities in issue	**61**	78	**–**	–
	116,997	133,563	**747**	760

38 Related party transactions (continued)

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 2018 the Group earned £358 million and the Company earned £17 million of interest income on the above asset balances (2017: Group: £345 million; Company: £21 million); the Group incurred £1,825 million and the Company incurred £17 million of interest expense on the above liability balances (2017: Group: £1,606 million; Company: £17 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.

Other related party disclosures
Pension funds
At 31 December 2018 there were customer deposits of £48 million (2017: £73 million) related to the Group's pension arrangements.

Joint ventures and associates
At 31 December 2018 there were loans and advances to customers of £57 million (2017: £123 million) outstanding and balances within customer deposits of £2 million (2017: £9 million) relating to joint ventures and associates.

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39 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/licensee 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 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, have been dismissed by the US Federal Court for Southern District of New York (subject to appeals).

Certain Lloyds Banking Group companies are also named as defendants in (i) UK based claims; and (ii) in 2 Dutch class actions, 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 concluded on 5 March 2018 with judgment to follow. It is currently not possible to determine the ultimate impact on the Lloyds Banking Group (if any).

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 £770 million (including interest) and a reduction in the Lloyds Banking Group's deferred tax asset of approximately £250 million (overall impact on the Group of £360 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 (including the tax treatment of certain costs arising from the divestment of TSB Banking Group plc), none of which is expected to have a material impact on the financial position of the Group.

39 Contingent liabilities and commitments (continued)

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 has been 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 implementing the Guidance and has now contacted nearly all affected customers with any remaining customers anticipated to be contacted by the end of March 2019.

Mortgage arrears handling activities – FCA investigation
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 the Lloyds Banking Group continues to cooperate with the FCA. It is not currently possible to make a reliable assessment of any liability that may result from the investigation including any financial penalty or public censure.

HBOS Reading – FCA investigation
On 7 April 2017 the FCA announced that it had resumed its investigation into the events surrounding the discovery of misconduct within the Reading-based Impaired Assets team of HBOS. The investigation is ongoing and the Lloyds Banking Group continues to cooperate with the FCA. It is not currently possible to make a reliable assessment of any liability that may result from the investigation including any financial penalty or public censure.

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	
	2018 £m	2017 £m
Contingent liabilities		
Acceptances and endorsements	**1**	1
Other:		
Other items serving as direct credit substitutes	**36**	18
Performance bonds and other transaction-related contingencies	**192**	68
	228	86
Total contingent liabilities	**229**	87

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	
	2018 £m	2017 £m
Commitments and guarantees		
Documentary credits and other short-term trade-related transactions	**1**	–
Forward asset purchases and forward deposits placed	**47**	31
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	**10,059**	9,847
Other commitments and guarantees	**23,024**	21,985
	33,083	31,832
1 year or over original maturity	**3,211**	3,040
Total commitments and guarantees	**36,342**	34,903

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £13,937 million (2017: £13,579 million) was irrevocable.

39 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:

	2018 £m	2017 £m
Not later than 1 year	**111**	110
Later than 1 year and not later than 5 years	**351**	327
Later than 5 years	**430**	395
Total operating lease commitments	**892**	832

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 22), there was no capital expenditure contracted but not provided for at 31 December 2018 (2017: £nil).

40 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 27 for securitisations and covered bonds and in note 29 for structured entities associated with the Group's pension schemes.

41 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.

		Mandatorily held at fair value through profit or loss					
The Group	**Derivatives designated as hedging instruments £m**	**Held for trading £m**	**Other £m**	**Designated at fair value through profit or loss £m**	**At fair value through other comprehensive income £m**	**Held at amortised cost £m**	**Total £m**
At 31 December 2018							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	**2,579**	**2,579**
Items in the course of collection from banks	–	–	–	–	–	**181**	**181**
Financial assets at fair value through profit or loss	–	–	**509**	–	–	–	**509**
Derivative financial instruments	**2,381**	**6,980**	–	–	–	–	**9,361**
Loans and advances to banks	–	–	–	–	–	**486**	**486**
Loans and advances to customers	–	–	–	–	–	**262,324**	**262,324**
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	–	**53,190**	**53,190**
Financial assets at amortised cost	–	–	–	–	–	**316,000**	**316,000**
Financial assets at fair value through other comprehensive income	–	–	–	–	**1,085**	–	**1,085**
Total financial assets	**2,381**	**6,980**	**509**	–	**1,085**	**318,760**	**329,715**
Financial liabilities							
Deposits from banks	–	–	–	–	–	**20,908**	**20,908**
Customer deposits	–	–	–	–	–	**162,141**	**162,141**
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	**109,169**	**109,169**
Items in course of transmission to banks	–	–	–	–	–	**274**	**274**
Financial liabilities at fair value through profit or loss	–	**50**	–	**53**	–	–	**103**
Derivative financial instruments	**1,209**	**8,658**	–	–	–	–	**9,867**
Notes in circulation	–	–	–	–	–	**1,104**	**1,104**
Debt securities in issue	–	–	–	–	–	**11,861**	**11,861**
Subordinated liabilities	–	–	–	–	–	**4,211**	**4,211**
Total financial liabilities	**1,209**	**8,708**	–	**53**	–	**309,668**	**319,638**

41 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 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

41 Financial instruments (continued)

The Company	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Held at amortised cost £m	Total £m
At 31 December 2018					
Financial assets					
Due from fellow Lloyds Banking Group undertakings	–	–	–	8,483	8,483
Derivative financial instruments	337	4	–	–	341
Total financial assets	337	4	–	8,483	8,824
Financial liabilities					
Due to fellow Lloyds Banking Group undertakings	–	–	–	6,483	6,483
Subordinated liabilities	–	–	–	2,628	2,628
Total financial liabilities	–	–	–	9,111	9,111

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

41 Financial instruments (continued)

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.

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 judgements
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

41 Financial instruments (continued)

note on page 88. 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 2018, the Group's financial assets carried at fair value, excluding derivatives, totalled £1,594 million (31 December 2017: £2,337 million). The table below analyses these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described on page 84). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

Valuation hierarchy

The Group	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
At 31 December 2018				
Financial assets at fair value through profit or loss				
Loans and advances to customers	**–**	**399**	**110**	**509**
Total financial assets at fair value through profit or loss	**–**	**399**	**110**	**509**
Financial assets at fair value through other comprehensive income				
Debt securities:				
Government securities	**117**	**–**	**–**	**117**
Corporate and other debt securities	**–**	**968**	**–**	**968**
	117	**968**	**–**	**1,085**
Total financial assets at fair value through other comprehenisve income	**117**	**968**	**–**	**1,085**
Total financial assets carried at fair value, excluding derivatives	**117**	**1,367**	**110**	**1,594**

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

41 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):

	2018				2017		
The Group	**Financial assets at fair value through profit or loss £m**	**At fair value through other comprehensive income £m**	**Available-for-sale £m**	**Total level 3 assets carried at fair value, excluding derivatives (recurring basis) £m**	Financial assets at fair value through profit or loss £m	Available-for-sale £m	Total level 3 assets carried at fair value, excluding derivatives (recurring basis) £m
At 31 December 2017	**50**		**20**	**70**			
Adjustment on adoption of IFRS 9 (note 47)	**13**	**7**	**(20)**	**–**			
At 1 January	**63**	**7**		**70**	119	469	588
Exchange and other adjustments	**1**	**–**		**1**	–	(1)	(1)
(Losses) gains recognised in the income statement within other income	**(1)**	**–**		**(1)**	20	–	20
Losses recognised in other comprehensive income within the revaluation reserve in respect of financial assets at fair value through other comprehensive income (2017: available-for-sale financial assets)	**–**	**(5)**		**(5)**	–	(64)	(64)
Purchases	**18**	**–**		**18**	–	36	36
Sales	**(67)**	**(128)**		**(195)**	(15)	(45)	(60)
Disposal of businesses	**–**	**–**		**–**	(74)	(375)	(449)
Transfers into the level 3 portfolio	**96**	**126**		**222**	–	–	–
Transfers out of the level 3 portfolio	**–**	**–**		**–**	–	–	–
At 31 December	**110**	**–**		**110**	50	20	70
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

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.

41 Financial instruments (continued)

(B) Financial liabilities, excluding derivatives

Valuation hierarchy

At 31 December 2018, 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 £103 million (31 December 2017: £50 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 84). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

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 2018				
Financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	**–**	**53**	**–**	**53**
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	**–**	**–**	**–**	**–**
Other deposits	**–**	**50**	**–**	**50**
	–	**50**	**–**	**50**
Total financial liabilities carried at fair value, excluding derivatives	**–**	**103**	**–**	**103**
At 31 December 2017				
Financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	–	–	–	–
Trading liabilities:				
Other deposits	–	50	–	50
Short positions in securities	–	–	–	–
	–	50	–	50
Total financial liabilities carried at fair value, excluding derivatives	–	50	–	50

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

Group	2018 £m	2017 £m
At 1 January	**–**	2
Losses recognised in the income statement within other income	**–**	(2)
Transfers into the level 3 portfolio	**–**	–
Transfers out of the level 3 portfolio	**–**	–
At 31 December	**–**	–
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 2018, such assets totalled £9,361 million (31 December 2017: £11,634 million) and liabilities totalled £9,867 million (31 December 2017: £10,631 million). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 84). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

	2018				2017			
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	**–**	**9,361**	**–**	**9,361**	–	11,214	420	11,634
Derivative liabilities	**–**	**(9,867)**	**–**	**(9,867)**	–	(10,577)	(54)	(10,631)

41 Financial instruments (continued)

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

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

Complex interest rate and foreign exchange products where 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.

	2018		2017	
The Group	**Derivative assets £m**	**Derivative liabilities £m**	Derivative assets £m	Derivative liabilities £m
At 1 January	**420**	**(54)**	583	(57)
Exchange and other adjustments	**4**	**–**	18	(1)
Gains (losses) recognised in the income statement within other income	**(14)**	**6**	(133)	3
(Sales) redemptions	**(410)**	**48**	(4)	1
Transfers into the level 3 portfolio	**–**	**–**	–	–
Transfers out of the level 3 portfolio	**–**	**–**	(44)	–
At 31 December	**–**	**–**	420	(54)
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

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 2018 and 2017.

	2018 £m	2017 £m
At 1 January	**183**	286
Income statement (credit) charge	**(36)**	(140)
Transfers	**(7)**	37
At 31 December	**140**	183

Represented by:

	2018 £m	2017 £m
Credit Valuation Adjustment	**106**	143
Debit Valuation Adjustment	**(5)**	(4)
Funding Valuation Adjustment	**39**	44
	140	183

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.

41 Financial instruments (continued)

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.

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 £24 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 2018).

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 £9 million to £14 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 £37 million fall in the overall valuation adjustment to £64 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 £5 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 2018, the Group's derivative trading business held mid to bid-offer valuation adjustments of £3 million (2017: £23 million).

41 Financial instruments (continued)

(D) Sensitivity of level 3 valuations

			At 31 December 2018			At 31 December 2017		
				Effect of reasonably possible alternative assumptions[2]			Effect of reasonably possible alternative assumptions[2]	
	Valuation basis/ techniques	Significant unobservable inputs[1]	Carrying value £m	Favourable changes £m	Unfavourable changes £m	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Financial assets at fair value through profit or loss								
Loans and advances to customers	Discounted cash flows	Inferred spreads (bps) (99bps/101bps)	110	1	(1)	–	–	–
Equity and venture capital investments	Underlying asset/ net asset value (incl. property prices)[3]	n/a	–	–	–	50	5	(5)
			110			50		
Financial assets at fair value through other comprehensive income/available-for-sale financial assets								
Equity and venture capital investments	Underlying asset/ net asset value (incl. property prices)[3]	n/a	–	–	–	20	1	(1)
			–			20		
Derivative financial assets								
Interest rate derivatives	Option pricing model	n/a	–	–	–	420	1	(2)
			–			420		
Level 3 financial assets carried at fair value			110			490		
Derivative financial liabilities								
Interest rate derivatives	Option pricing model	n/a	–	–	–	54	–	–
			–			54		
Level 3 financial liabilities carried at fair value			–			54		

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.

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 were flexed within a range of 9 per cent and 94 per cent at 31 December 2017.

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.

41 Financial instruments (continued)

(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 84). 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 2018					
Financial assets at amortised cost					
Loans and advances to customers	**262,324**	**264,320**	**–**	**–**	**264,320**
Loans and advances to banks	**486**	**487**	**–**	**–**	**487**
Debt securities	**–**	**–**	**–**	**–**	**–**
Due from fellow Lloyds Banking Group undertakings	**53,190**	**53,190**	**–**	**–**	**53,190**
Reverse repos included in above amounts:					
Loans and advances to customers	**–**	**–**	**–**	**–**	**–**
Loans and advances to banks	**–**	**–**	**–**	**–**	**–**
At 31 December 2017					
Financial assets at amortised cost					
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	–	–	–	–	–

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.

41 Financial instruments (continued)

(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 84).

			Valuation hierarchy		
The Group	**Carrying value £m**	**Fair value £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
At 31 December 2018					
Deposits from banks	**20,908**	**20,908**	**–**	**20,908**	**–**
Customer deposits	**162,141**	**161,908**	**–**	**155,741**	**6,167**
Due to fellow Lloyds Banking Group undertakings	**109,169**	**109,169**	**–**	**109,169**	**–**
Debt securities in issue	**11,861**	**11,821**	**–**	**11,821**	**–**
Subordinated liabilities	**4,211**	**3,963**	**–**	**3,963**	**–**
Repos included in above amounts:					
Deposits from banks	**19,977**	**19,977**	**–**	**19,977**	**–**
Customer deposits	**–**	**–**	**–**	**–**	**–**
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	–

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
Other than the reclassifications on adoption of IFRS 9 on 1 January 2018 (note 47), there have been no reclassifications of financial assets in 2017 or 2018.

42 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 27, included within financial assets measured at amortised cost are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all 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 27). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

	At 31 December 2018		At 31 December 2017	
The Group	**Carrying value of transferred assets £m**	**Carrying value of associated liabilities £m**	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
Repurchase and securities lending transactions				
Financial assets at fair value through profit or loss	**9**	**–**	6	–
Financial assets at fair value through other comprehensive income (2017: available-for-sale financial assets)	**296**	**–**	139	–
Securitisation programmes				
Loans and advances to customers[1]	**29,330**	**4,729**	25,226	2,997

1 The carrying value of associated liabilities for the Group excludes securitisation notes held by the Group of £22,826 million (2017: £14,954 million).

43 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.

The Group At 31 December 2018	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						
Financial assets at fair value through profit or loss:						
Excluding reverse repos	509	–	509	–	–	509
Reverse repos	–	–	–	–	–	–
	509	–	509	–	–	509
Derivative financial instruments	9,361	–	9,361	(836)	(1,183)	7,342
Loans and advances to banks:						
Excluding reverse repos	486	–	486	(287)	–	199
Reverse repos	–	–	–	–	–	–
	486	–	486	(287)	–	199
Loans and advances to customers:						
Excluding reverse repos	262,324	–	262,324	(144)	(842)	261,338
Reverse repos	–	–	–	–	–	–
	262,324	–	262,324	(144)	(842)	261,338
Financial assets at fair value through other comprehensive income	1,085	–	1,085	–	–	1,085
Financial liabilities						
Deposits from banks:						
Excluding repos	931	–	931	(836)	–	95
Repos	19,977	–	19,977	–	(19,977)	–
	20,908	–	20,908	(836)	(19,977)	95
Customer deposits:						
Excluding repos	162,141	–	162,141	–	(842)	161,299
Repos	–	–	–	–	–	–
	162,141	–	162,141	–	(842)	161,299
Financial liabilities at fair value through profit or loss:						
Excluding repos	103	–	103	–	–	103
Repos	–	–	–	–	–	–
	103	–	103	–	–	103
Derivative financial instruments	9,867	–	9,867	(431)	(1,117)	8,319

43 Offsetting of financial assets and liabilities (continued)

The Group 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	Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
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
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.

44 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 2018			At 31 December 2017		
The Group	**Maximum exposure £m**	**Offset[2] £m**	**Net exposure £m**	Maximum exposure £m	Offset[2] £m	Net exposure £m
Loans and advances to banks, net[1]	**486**	**–**	**486**	551	–	551
Loans and advances to customers, net[1]	**262,324**	**(842)**	**261,482**	268,657	(1,126)	267,531
Debt securities, net[1]	**–**	**–**	**–**	137	–	137
Financial assets at amortised cost	**262,810**	**(842)**	**261,968**	269,345	(1,126)	268,219
Financial assets at fair value through other comprehenisve income/available-for-sale financial assets[3]	**1,085**	**–**	**1,085**	902	–	902
Financial assets at fair value through profit or loss[3]:						
Loans and advances	**509**	**–**	**509**	–	–	–
Debt securities, treasury and other bills	**–**	**–**	**–**	1,350	–	1,350
	509	**–**	**509**	1,350	–	1,350
Derivative assets	**9,361**	**(1,117)**	**8,244**	11,634	(1,708)	9,926
Off-balance sheet items:						
Acceptances and endorsements	**1**	**–**	**1**	1	–	1
Other items serving as direct credit substitutes	**36**	**–**	**36**	18	–	18
Performance bonds and other transaction-related contingencies	**192**	**–**	**192**	68	–	68
Irrevocable commitments and guarantees	**13,937**	**–**	**13,937**	13,579	–	13,579
	14,166	**–**	**14,166**	13,666	–	13,666
	287,931	**(1,959)**	**285,972**	296,897	(2,834)	294,063

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.

44 Financial risk management (continued)

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.

At 31 December 2018 the most significant concentrations of exposure were in mortgages (comprising 92 per cent of total loans and advances to customers) and other personal lending (comprising 4 per cent of the total).

Loans and advances to customers

	The Group	
	2018 £m	2017 £m
Agriculture, forestry and fishing	**633**	643
Energy and water supply	**94**	156
Manufacturing	**222**	266
Construction	**1,338**	1,248
Transport, distribution and hotels	**2,738**	2,868
Postal and telecommunications	**144**	272
Property companies	**3,973**	4,894
Financial, business and other services	**1,663**	2,415
Personal:		
Mortgages	**242,816**	247,117
Other	**10,398**	10,573
Lease financing	**268**	198
Hire purchase	**152**	132
Total loans and advances to customers before allowance for impairment losses	**264,439**	270,782
Allowance for impairment losses (note 17)	**(2,115)**	(2,125)
Total loans and advances to customers	**262,324**	268,657

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

44 Financial risk management (continued)

C. Credit quality of assets

Loans and advances

The analysis of lending has been prepared based on the division in which the asset is held; with the business segment in which the exposure is recorded reflected in the ratings system applied. The internal credit ratings systems used by the Group differ between Retail and Commercial, reflecting the characteristics of these exposures and the way that they are managed internally; these credit ratings are set out below. All probabilities of default (PDs) include forward-looking information and are based on 12 month values, with the exception of credit impaired. The definitions of good, satisfactory, lower quality and below standard applying to Retail and Commercial are not the same and consequently totals are not provided.

	Retail		Corporate	
	Grade	IFRS 9 PD%	Grade	IFRS 9 PD%
Good quality	1–6	0.00–4.50	1–10	0.00–0.50
Satisfactory quality	7–9	4.51–14.00	11–14	0.51–3.00
Lower quality	10	14.01–20.00	15–18	3.01–20.00
Below standard	11–13	20.01–99.99	19	20.01–99.99
Credit impaired	14	100.00	20–23	100.000

The Group **Gross carrying amount**	**Loans and advances to banks £m**	**Loans and advances to customers £m**	**Loan commitments and financial guarantees £m**
At 31 December 2018			
Stage 1			
Good quality	486	229,200	33,379
Satisfactory quality	–	3,266	1,044
Lower quality	–	190	30
Below standard, but not credit-impaired	–	295	360
	486	232,951	34,813
Stage 2			
Good quality	–	18,173	1,316
Satisfactory quality	–	3,878	66
Lower quality	–	1,258	80
Below standard, but not credit-impaired	–	2,036	30
	–	25,345	1,492
Stage 3			
Credit-impaired	–	6,143	37
Total	486	264,439	36,342

Stage 3 assets include balances of approximately £100 million (with outstanding amounts due of approximately £900 million) which have been subject to a partial write-off and where the Group continues to enforce recovery action.

Stage 2 and Stage 3 assets with a carrying amount of approximately £1,000 million were modified during the year. No material gain or loss was recognised by the Group.

Loans and advances carried at fair value through profit or loss comprise £509 million for the Group of other financial assets mandatorily held at fair value through profit or loss, all of which is viewed by the business as investment grade.

44 Financial risk management (continued)

Debt securities held at amortised cost – The Group

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

	2018			2017		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Asset-backed securities:						
Mortgage-backed securities	–	–	–	–	–	–
Other asset-backed securities	–	–	–	128	7	135
	–	–	–	128	7	135
Corporate and other debt securities	–	13	13	–	13	13
Gross exposure	–	13	13	128	20	148
Allowance for impairment losses			(13)			(11)
Total debt securities held at amortised cost			–			137

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

2 Other comprises sub-investment grade (2018: £nil; 2017: £nil) and not rated (2018: £13 million; 2017: £20 million).

Financial assets at fair value through other comprehensive income/available-for-sale financial assets (excluding equity shares)

An analysis of financial assets at fair value through other comprehensive income (available-for-sale financial assets at 31 December 2017) is included in note 18. The credit quality of financial assets at fair value through other comprehensive income (available-for-sale financial assets at 31 December 2017) (excluding equity shares) is set out below:

	2018			2017		
The Group	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Debt securities						
Government securities	117	–	117	116	–	116
Corporate and other debt securities	783	185	968	736	50	786
Total debt securities	900	185	1,085	852	50	902
Treasury and other bills	–	–	–	–	–	–
Total financial assets at fair value through other comprehensive income/available-for-sale financial assets	900	185	1,085	852	50	902

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

2 Other comprises sub-investment grade (2018: £nil; 2017: £nil) and not rated (2018: £185 million; 2017: £50 million).

Debt securities held at fair value through profit or loss – The Group

An analysis of financial assets at fair value through profit or loss is included in note 13; the debt securities held at fair value through profit or loss at 31 December 2017 comprised amounts due from fellow Lloyds Banking Group undertakings of £1,350 million.

44 Financial risk management (continued)

Derivative assets – The Group
An analysis of derivative assets is given in note 14. 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 £8,244 million (2017: £9,926 million), cash collateral of £836 million (2017: £1,036 million) was held and a further £62 million was due from OECD banks (2017: £79 million).

	2018			2017		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Derivative financial instruments						
Trading and other	**1,712**	**796**	**2,508**	2,763	1,255	4,018
Hedging	**652**	**–**	**652**	808	–	808
	2,364	**796**	**3,160**	3,571	1,255	4,826
Due from fellow Lloyds Banking Group undertakings			**6,201**			6,808
Total derivative financial instruments			**9,361**			11,634

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

2 Other comprises sub-investment grade (2018: £794 million; 2017: £1,255 million) and not rated (2018: £2 million; 2017: £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 advances and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for financial assets at fair value through profit or loss and for derivative assets is also shown below.

The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as financial assets held at amortised cost.

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

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

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

The Group	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total gross £m**
At 31 December 2018				
Less than 70 per cent	**145,283**	**17,434**	**2,680**	**165,397**
70 per cent to 80 per cent	**34,197**	**2,774**	**570**	**37,541**
80 per cent to 90 per cent	**24,019**	**1,458**	**408**	**25,885**
90 per cent to 100 per cent	**4,609**	**372**	**188**	**5,169**
Greater than 100 per cent	**393**	**481**	**374**	**1,248**
Total	**208,501**	**22,519**	**4,220**	**235,240**

44 Financial risk management (continued)

The Group	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
At 31 December 2017				
Less than 70 per cent	169,583	3,732	2,092	175,407
70 per cent to 80 per cent	37,405	688	520	38,613
80 per cent to 90 per cent	22,072	444	388	22,904
90 per cent to 100 per cent	6,422	158	206	6,786
Greater than 100 per cent	2,837	149	421	3,407
Total	238,319	5,171	3,627	247,117

Commercial lending

Stage 3 secured lending

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

At 31 December 2018, Stage 3 secured commercial lending amounted to £469 million, net of an impairment allowance of £58 million (2017: impaired secured commercial lending £231 million, net of an impairment allowance of £180 million). The fair value of the collateral held in respect of impaired secured commercial lending was £182 million (2017: £345 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.

Stage 3 secured commercial lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

Stage 1 and Stage 2 secured lending

For Stage 1 and Stage 2 secured commercial lending, the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

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

There were no reverse repurchase agreements included in financial assets at fair value through profit or loss at either 31 December 2018 or 31 December 2017.

In addition, securities held as collateral in the form of stock borrowed amounted to £35,743 million (2017: £47,082 million). At 31 December 2018 £35,639 million of this amount had been resold or repledged as collateral for the Group's own transactions (2017: £47,079 million).

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

Derivative assets, after offsetting of amounts under master netting arrangements

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £8,244 million (2017: £9,926 million), cash collateral of £836 million (2017: £1,036 million) was held.

Irrevocable loan commitments and other credit-related contingencies

At 31 December 2018, there were irrevocable loan commitments and other credit-related contingencies of £14,166 million (2017: £13,666 million). Collateral is held as security, in the event that lending is drawn down, on £9,962 million (2017: £10,294 million) of these balances.

Collateral repossessed

During the year, £218 million of collateral was repossessed (2017: £237 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 (2017 £19,977 million); the fair value of the collateral provided under these agreements at 31 December 2018 was £18,427 million (2017: £19,927 million).

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

There were no repurchase transactions included in financial liabilities at fair value through profit or loss at either 31 December 2018 or 31 December 2017.

44 Financial risk management (continued)

Securities lending transactions

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

The Group	2018 £m	2017 £m
Financial assets for fair value through profit or loss	**9**	6
Financial assets at fair value through other comprehensive income (2017: available-for-sale financial assets)	**296**	139
	305	145

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 27.

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

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

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

At 31 December 2018 the aggregate notional principal of interest rate swaps designated as fair value hedges was £9,968 million (2017: £12,004 million) with a net fair value asset of £1,662 million (2017: £2,071 million) (see note 14). The losses on the hedging instruments were £410 million (2017: losses of £494 million). The gains on the hedged items attributable to the hedged risk were £410 million (2017: gains of £485 million). The gains and losses related to the fair value hedges are recorded in net trading income.

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 2018 was £19,464 million (2017: £24,617 million) with a net fair value liability of £490 million (2017: liability of £553 million) (see note 14). In 2018, ineffectiveness recognised in the income statement that arises from cash flow hedges was a gain of £2 million (2017: loss of £2 million).

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. The Group also manages foreign currency risk via cashflow hedge accounting, utilising currency swaps.

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

The Group ceased all hedging of the currency translation risk of the net investment in foreign operations on 1 January 2018. In 2017, an ineffectiveness gain of £4 million before tax and £3 million after tax was recognised in the income statement arising from net investment hedges.

44 Financial risk management (continued)

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 2018			
Gross exposure	**131**	**–**	**–**
Net investment hedge	**–**	**–**	**–**
Total structural foreign currency exposures, after net investment hedges	**131**	**–**	**–**
31 December 2017			
Gross exposure	37	43	4
Net investment hedge	–	–	–
Total structural foreign currency exposures, after net investment hedges	37	43	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 2018						
Deposits from banks	**43**	**925**	**162**	**20,191**	**–**	**21,321**
Customer deposits	**142,017**	**2,453**	**8,111**	**9,131**	**727**	**162,439**
Financial liabilities at fair value through profit or loss	**–**	**–**	**–**	**50**	**54**	**104**
Debt securities in issue	**463**	**678**	**1,556**	**8,877**	**1,034**	**12,608**
Subordinated liabilities	**58**	**722**	**446**	**1,483**	**5,419**	**8,128**
Total non-derivative financial liabilities	**142,581**	**4,778**	**10,275**	**39,732**	**7,234**	**204,600**
Derivative financial liabilities:						
Gross settled derivatives – outflow	**78**	**74**	**139**	**3,367**	**1,298**	**4,956**
Gross settled derivatives – inflow	**(40)**	**(62)**	**(131)**	**(3,181)**	**(1,155)**	**(4,569)**
Gross settled derivatives – netflow	**38**	**12**	**8**	**186**	**143**	**387**
Net settled derivative liabilities	**1,476**	**9**	**32**	**134**	**225**	**1,876**
Total derivative financial liabilities	**1,514**	**21**	**40**	**320**	**368**	**2,263**

44 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 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 derivatives – outflow	94	222	228	3,167	3,539	7,250
Gross settled derivatives – inflow	(43)	(161)	(226)	(3,284)	(3,687)	(7,401)
Gross settled derivatives – 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

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 2018						
Amounts owed to fellow Lloyds Banking Group undertakings	**–**	**–**	**–**	**–**	**6,483**	**6,483**
Subordinated liabilities	**–**	**661**	**498**	**416**	**1,974**	**3,549**
Total non-derivative financial liabilities	**–**	**661**	**498**	**416**	**8,457**	**10,032**
At 31 December 2017						
Amounts owed to fellow Lloyds Banking 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

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £7 million (2017: £7 million) for the Group and £1 million (2017: £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.

44 Financial risk management (continued)

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

The Group	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2018					
Acceptances and endorsements	**1**	**–**	**–**	**–**	**1**
Other contingent liabilities	**84**	**20**	**–**	**124**	**228**
Total contingent liabilities	**85**	**20**	**–**	**124**	**229**
Lending commitments and guarantees	**33,083**	**1,118**	**725**	**1,368**	**36,294**
Other commitments	**1**	**–**	**–**	**47**	**48**
Total commitments and guarantees	**33,084**	**1,118**	**725**	**1,415**	**36,342**
Total contingents and commitments	**33,169**	**1,138**	**725**	**1,539**	**36,571**

	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 and guarantees	31,832	1,180	623	1,237	34,872
Other commitments	–	–	–	31	31
Total commitments and guarantees	31,832	1,180	623	1,268	34,903
Total contingents and commitments	31,901	1,181	623	1,285	34,990

45 Capital

Capital management

Capital is actively managed on an ongoing basis, covering the Group and its regulated subsidiaries, in particular Bank of Scotland plc. Regulatory capital ratios are a key factor in budgeting and planning processes with updates on forecast ratios reviewed regularly by the Lloyds Banking Group Asset and Liability Committee. Target capital levels take account of evolving regulatory requirements, capacity for growth and to cover uncertainties. Capital policies and procedures are subject to independent oversight.

The Group measures the amount of capital it holds in accordance with the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV), as implemented in the UK by the Prudential Regulation Authority (PRA) and supplemented through additional regulation under the PRA Rulebook. Application of CRD IV requirements is subject to transitional phasing.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is set at 8 per cent of total 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 for Bank of Scotland plc through the issuance of a bank specific Individual Capital Requirement (ICR), which adjusts the Pillar 1 minimum requirement for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICR process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process (ICAAP).

A range of additional bank specific regulatory capital buffers apply under CRD IV, which are required to be met with CET1 capital. These include a capital conservation buffer (1.875 per cent of risk-weighted assets during 2018, increasing to 2.5 per cent from 1 January 2019) and a time-varying countercyclical capital buffer (currently 0.9 per cent of risk-weighted assets).

The Group has adopted the IFRS 9 transitional arrangements for capital set out under the relevant CRD IV amendment. The arrangements allow for the initial net impact of IFRS 9 on CET1 capital, resulting from the increase in accounting impairment provisions on 1 January 2018, plus the capital impact of any subsequent increases in Stage 1 and Stage 2 expected credit losses (net of movements in regulatory expected losses), to be phased in over a five year transition period. For 2018 the phase in factor allowed 95 per cent of the resultant transitional adjustment to be added back to CET1 capital. The phase in factor will reduce to 85 per cent in 2019. As at 31 December 2018 no additional capital relief in respect of post 1 January 2018 increases in Stage 1 and Stage 2 expected credit losses (net of movements in regulatory expected losses) has been recognised.

During the year, the individual regulated entities within the Group, including Bank of Scotland plc, complied with all of the externally imposed capital requirements to which they are subject.

Regulatory capital development

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

45 Capital (continued)

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 loss absorbency exhibited.

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

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

	2018 £m	2017 £m
Common equity tier 1 capital	**7,991**	8,256
Additional tier 1 capital	**2,710**	2,700
Tier 2 capital	**2,108**	2,207
Total capital	**12,809**	13,163

46 Cash flow statements

a Change in operating assets

	The Group	
	2018 £m	2017 £m
Change in financial assets held at amortised cost	**4,549**	1,004
Change in amounts due from fellow Lloyds Banking Group undertakings	**21,727**	(27,536)
Change in derivative financial instruments and financial assets at fair value through profit or loss	**3,384**	3,800
Change in other operating assets	**(38)**	(41)
Change in operating assets	**29,622**	(22,773)

b Change in operating liabilities

	The Group	
	2018 £m	2017 £m
Change in deposits from banks	**(275)**	14,992
Change in customer deposits	**(9,058)**	(8,121)
Change in amounts due to fellow Lloyds Banking Group undertakings	**(16,441)**	25,809
Change in debt securities in issue	**990**	(5,761)
Change in derivative financial instruments and financial liabilities at fair value through profit or loss	**(769)**	(3,489)
Change in other operating liabilities	**305**	(567)
Change in operating liabilities	**(25,248)**	22,863

46 Cash flow statements (continued)

c Non-cash and other items

	The Group	
	2018 £m	2017 £m
Depreciation and amortisation	**162**	170
Impairment charge relating to undrawn balances	**(38)**	(7)
Allowance for loan losses	**232**	158
Write-off of allowance for loan losses, net of recoveries	**(386)**	(482)
Impairment of financial assets at fair value through other comprehensive income (2017: available-for-sale financial assets)	**–**	10
Payment protection insurance provision	**185**	486
Other provision movements	**186**	486
Net charge (credit) in respect of defined benefit schemes	**170**	169
Unwind of discount on impairment allowances	**(1)**	11
Foreign exchange element on balance sheet[1]	**4**	(534)
Interest expense on subordinated liabilities	**305**	408
Other non-cash items	**(108)**	(143)
Total non-cash items	**711**	732
Contributions to defined benefit schemes	**(255)**	(146)
Payments in respect of other provision	**(615)**	(374)
Payments in respect of payment protection insurance provision	**(740)**	(469)
Other	**6**	–
Total other items	**(1,604)**	(989)
Non-cash and other items	**(893)**	(257)

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	
	2018 £m	2017 £m
Cash and balances with central banks	**2,579**	2,677
Less: mandatory reserve deposits[1]	**(1,738)**	(422)
	841	2,255
Loans and advances to banks	**486**	551
Less: amounts with a maturity of three months or more	**(308)**	(397)
	178	154
Total cash and cash equivalents	**1,019**	2,409

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.

46 Cash flow statements (continued)

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

	The Group	
	2018 £m	2017 £m
Due from fellow Lloyds Banking Group undertakings	**69**	151
Financial assets at fair value through profit or loss	**66**	123
Financial assets at fair value through other comprehensive income/available-for-sale financial assets	**–**	375
Property, plant and equipment	**–**	9
	135	658
Due to fellow Lloyds Banking Group undertakings	**(89)**	(402)
Other net assets (liabilities)	**1**	10
	(88)	(392)
Net assets (liabilities) disposed of	**47**	266
Disposal of investment in joint ventures	**–**	26
Profit on sale of business	**–**	–
Cash consideration received on losing control of group undertakings and business	**47**	292
Cash and cash equivalents disposed	**–**	–
Net cash inflow	**47**	292

47 Adoption of IFRS 9 and IFRS 15

The following table summarises the adjustments arising on the adoption of IFRS 9 to the Group's balance sheet as at 1 January 2018.

	As at 31 December 2017 £m	IFRS 9: Classification £m	IFRS 9: Measurement £m	IFRS 9: Impairment £m	**Adjusted as at 1 January 2018 £m**
Assets					
Cash and balances at central banks	2,677	–	–	–	**2,677**
Items in course of collection from banks	260	–	–	–	**260**
Financial assets at fair value through profit or loss	1,400	823	(12)	–	**2,211**
Derivative financial instruments	11,634	(360)	–	–	**11,274**
Loans and advances to banks	551	–	–	–	**551**
Loans and advances to customers	268,657	(442)	–	(342)	**267,873**
Debt securities	137	(128)	–	–	**9**
Due from fellow Lloyds Banking Group undertakings	74,849	–	–	(21)	**74,828**
Financial assets at amortised cost	344,194	(570)	–	(363)	**343,261**
Financial assets at fair value through other comprehensive income		1,044	(11)	–	**1,033**
Available-for-sale financial assets	937	(937)	–	–	
Goodwill	325	–	–	–	**325**
Other intangible assets	112	–	–	–	**112**
Property, plant and equipment	823	–	–	–	**823**
Current tax recoverable	2	–	–	–	**2**
Deferred tax assets	1,878	–	20	112	**2,010**
Retirement benefit assets	69	–	–	–	**69**
Other assets	369	–	–	–	**369**
Total assets	364,680	–	(3)	(251)	**364,426**
Equity and liabilities					
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**
Financial liabilities at fair value through profit or loss	50	48	10	–	**108**
Derivative financial instruments	10,631	–	–	–	**10,631**
Notes in circulation	1,313	–	–	–	**1,313**
Debt securities in issue	10,919	(48)	–	–	**10,871**
Other liabilities	285	–	–	–	**285**
Retirement benefit obligations	135	–	–	–	**135**
Current tax liabilities	518	–	–	–	**518**
Other provisions	2,019	–	–	84	**2,103**
Subordinated liabilities	6,620	–	–	–	**6,620**
Total liabilities	350,681	–	10	84	**350,775**
Equity					
Shareholders' equity	12,462	–	(13)	(335)	**12,114**
Non-controlling interests	1,537	–	–	–	**1,537**
Total equity	13,999	–	(13)	(335)	**13,651**
Total equity and liabilities	364,680	–	(3)	(251)	**364,426**

47 Adoption of IFRS 9 and IFRS 15 (continued)

The following table summarises the adjustments arising on the adoption of IFRS 9 to the Company's balance sheet as at 1 January 2018.

	As at 31 December 2017 £m	IFRS 9: Classification and measurement[1] £m	IFRS 9: Impairment £m	**Adjusted as at 1 January 2018 £m**
Assets				
Amounts owed by Group entities	13,164	(200)	(1)	**12,963**
Derivative financial instruments	395	–	–	**395**
Financial assets at fair value through other comprehensive income		7	–	**7**
Available-for-sale financial assets	7	(7)	–	
Retirement benefit assets	69	–	–	**69**
Other assets	–	–	–	**–**
Deferred tax assets	–	35	–	**35**
Investment in subsidiary undertakings	22,394	–	–	**22,394**
Total assets	36,029	(165)	(1)	**35,863**
Equity and liabilities				
Liabilities				
Amounts owed to Group entities	8,168	–	–	8,168
Other liabilities	243	–	–	243
Current tax liabilities	13	–	–	13
Retirement benefit obligations	130	–	–	130
Deferred tax liabilities	18	–	–	18
Subordinated liabilities	4,692	–	–	4,692
Total liabilities	13,264	–	–	13,264
Equity				
Shareholders' equity	22,765	(165)	(1)	**22,599**
Total equity	22,765	(165)	(1)	**22,599**
Total equity and liabilities	36,029	(165)	(1)	**35,863**

1 These amounts included remeasurement adjustments on transition to IFRS 9 of £200 million in relation to amounts owed by Group entities and £35 million in relation to deferred tax assets.

IFRS 9 Financial Instruments
Impairment
The Group adopted IFRS 9 from 1 January 2018. In accordance with the transition requirements of IFRS 9, comparative information for 2017 has not been restated and transitional adjustments have been accounted for through retained earnings as at 1 January 2018, the date of initial application; and as a result shareholders' equity reduced by £348 million, driven by the effects of additional impairment provisions following the implementation of the expected credit loss methodology and measurement adjustments following the reclassification of certain financial assets to be measured at fair value rather than amortised cost. It is not practicable to quantify the impact of adoption of IFRS 9 on the results for the current period.

The following table summarises the impact of the transitional adjustment on the Group's loss allowances at 1 January 2018:

The Group	IAS 39 allowance at 31 December 2017 £m	Transitional adjustment to loss allowance £m	**IFRS 9 loss allowance at 1 January 2018 £m**
Loans and advances to customers	2,125	342	**2,467**
Debt securities	11	–	**11**
Due from fellow Lloyds Banking Group undertakings	–	21	**21**
Drawn balances	2,136	363	**2,499**
Provisions for undrawn commitments and financial guarantees	3	84	**87**
Total loss allowance	2,139	447	**2,586**

There were no impacts on the Group's loss allowances as a result of changes in the measurement category of financial assets at 1 January 2018.

The following table summarises the impact of the transitional adjustment on the Company's loss allowances at 1 January 2018:

47 Adoption of IFRS 9 and IFRS 15 (continued)

The Company	IAS 39 allowance at 31 December 2017 £m	Transitional adjustment to loss allowance £m	**IFRS 9 loss allowance at 1 January 2018 £m**
Due from fellow Lloyds Banking Group undertakings	–	1	**1**

There were no impacts on the Company's loss allowances as a result of changes in the measurement category of financial assets at 1 January 2018.

The key drivers for the provision movements from IAS 39 to IFRS 9 for the Group are as follows:

- Latent risk: under IAS 39 provisions were held against losses that had been incurred at the balance sheet date but had either not been specifically identified or not been adequately captured in the provisioning models. Under IFRS 9 assets which had not defaulted are allocated to Stages 1 and 2 and an appropriate expected credit loss allowance made.
- 12-month expected loss: IFRS 9 requires that for financial assets where there has been no significant increase in credit risk since origination (Stage 1) a loss allowance equivalent to 12-month expected credit losses should be held. Under IAS 39 these balances would not be specifically provided against although a provision for latent risk would be held.
- Lifetime expected credit loss: financial assets that have experienced a significant increase in credit risk since initial recognition (Stage 2) and credit impaired assets (Stage 3) are required to carry a lifetime expected credit loss allowance. Under IAS 39, Stage 2 assets were treated as performing and consequently no specific impairment provision was held, although a proportion of the provision held against latent risks was held against these assets. Assets treated as impaired under IAS 39 carried a provision reducing the carrying value to the estimated recoverable amount.
- Undrawn commitments: IFRS 9 requires a loss allowance to be held against undrawn lending commitments. Previously, an impairment provision would only have been held in the event that the commitment was irrevocable and a loss event had occurred.
- Multiple economic scenarios: IFRS 9 requires that the expected credit loss allowance should reflect an unbiased range of possible future economic outcomes. This was not required under IAS 39.

Reclassifications
On transition to IFRS 9, the Group assessed its business models in order to determine the appropriate classification. The Retail and Commercial Banking loan books are generally held to collect contractual cash flows until the lending matures and met the criteria to remain at amortised cost. Certain portfolios which are subject to higher levels of sales were reclassified as fair value through other comprehensive income. Within the Group's insurance business, assets are managed on a fair value basis and so continued to be accounted for at fair value through profit or loss.

Remeasurements
There has been a pre-tax charge of £33 million (£13 million net of tax) arising from the reclassification of financial assets and liabilities to fair value through profit or loss and fair value through other comprehensive income and consequent remeasurement to fair value.

IFRS 15 Revenue from Contracts with Customers
The Group has adopted IFRS 15 from 1 January 2018. The Group's existing accounting policy was consistent with the requirements of IFRS 15 and consequently the Group recognised no transitional adjustment as at 1 January 2018. There has been no impact of the adoption of IFRS 15 on the Group's results for the current period.

There has been no impact on the Company.

48 Future accounting developments

The following pronouncements are not applicable for the year ending 31 December 2018 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 certain minor amendments as at 14 March 2019 these pronouncements have been endorsed by the EU.

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

The Group's accounting as a lessor will remain aligned to the current approach under IAS 17; however for lessee accounting there will no longer be a distinction between finance and operating leases. The transition approach adopted by the Group will result in the recognition of right of use assets and lease liabilities of approximately £800 million in respect of leased properties previously accounted for as operating leases; there will be no impact on shareholders' equity. As permitted by the transition options under IFRS 16, comparative figures for the prior year will not be restated. Going forward, the Group will recognise a finance charge on the lease liability and a depreciation charge on the right-of-use asset, whereas previously the Group included lease rentals within operating expenses. The Group intends to take advantage of a number of exemptions within IFRS 16, including the election not to recognise a lease liability and a right-of-use asset for leases for which the underlying asset is of low value.

Minor amendments to other accounting standards
The IASB has issued a number of minor amendments to IFRSs effective 1 January 2019 and 1 January 2020 (including IAS 19 Employee Benefits, IAS 12 Income Taxes and IFRIC 23 Uncertainty over Income Tax Treatments). The Group will adopt the changes to IAS 12 Income Taxes with effect from 1 January 2019, resulting in the presentation of the tax benefit of distributions on other equity instruments issued by subsidiaries in the Group's income statement; these impacts are currently recognised directly in equity. Comparative information will be restated. For the comparative year ended 31 December 2018, this will result in the reclassification of a tax credit of £27 million. These changes will have no impact on the Group's reported balance sheets or profit before tax. The amendments to other accounting standards are not expected to have a significant impact on the Group.

49 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

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 2018. 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
Anglo Scottish Utilities Partnership 1	+ *
Automobile Association Personal Finance Ltd	3
Bank of Scotland (B G S) Nominees Ltd	4 *
Bank of Scotland (Stanlife) London Nominees Ltd	4 *
Bank of Scotland Branch Nominees Ltd	4
Bank of Scotland Central Nominees Ltd	4 *
Bank of Scotland Edinburgh Nominees Ltd	4 *
Bank of Scotland Equipment Finance Ltd	2
Bank of Scotland Leasing Ltd (In liquidation)	8
Bank of Scotland LNG Leasing (No 1) Ltd (In liquidation)	8
Bank of Scotland London Nominees Ltd	4 *
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)	8
Bank of Wales Ltd	2
Barents Leasing Ltd	1
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
BOSSAF Rail Ltd	1
BOS Personal Lending Ltd	3 i ii
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 (In liquidation)	8
Capital Bank Leasing 2 Ltd (In liquidation)	8
Capital Bank Leasing 3 Ltd	2
Capital Bank Leasing 4 Ltd (In liquidation)	8
Capital Bank Leasing 5 Ltd	2
Capital Bank Leasing 6 Ltd (In liquidation)	8
Capital Bank Leasing 7 Ltd (In liquidation)	8
Capital Bank Leasing 8 Ltd (In liquidation)	9
Capital Bank Leasing 9 Ltd (In liquidation)	8
Capital Bank Leasing 10 Ltd (In liquidation)	8
Capital Bank Leasing 11 Ltd (In liquidation)	8
Capital Bank Leasing 12 Ltd	4
Capital Bank Property Investments (3) Ltd	2
Capital Bank Vehicle Management Ltd (Inliquidation)	8
Capital Leasing (Edinburgh) Ltd (In liquidation)	9
Capital Personal Finance Ltd	3
Cartwright Finance Ltd	2 viii
	vii #
CBRail S.A.R.L.	7
CF Asset Finance Ltd	2
Chariot Finance Ltd I liquidation)	8
First Retail Finance (Chester) Ltd	3
Flexifly Ltd (in liquidation)	9
Forthright Finance Ltd	2
Freeway Ltd(In liquidation)	8
Glosstrips Ltd (In liquidation)	9
Godfrey Davis (Contract Hire) Ltd (In liquidation)	8
Halifax Credit Card Ltd	3 i
	ii
	vii
Halifax Group Ltd	3
Halifax Leasing (June) Ltd (In liquidation)	8
Halifax Leasing (March No.2) Ltd	1
Halifax Leasing (September) Ltd	1
Halifax Ltd	3
Halifax Loans Ltd	3
Halifax Mortgage Services (Holdings) Ltd (In liquidation)	8
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 Covered Bonds LLP	3 *
HBOS Directors Ltd (In liquidation)	8
HBOS Final Salary Trust Ltd	4
HBOS Social Housing Covered Bonds LLP	2 *
HBOS UK Ltd	4
Home Shopping Personal Finance Ltd	3
HSDL Nominees Ltd	3
IBOS Finance Ltd	2
ICC Enterprise Partners Ltd (In liquidation)	14
ICC Equity Partners Ltd (In liquidation)	14
ICC Holdings Unlimited Company	11
ICC Software Partners Ltd (In liquidation)	14
Intelligent Finance Financial Services Ltd	3
Intelligent Finance Software Ltd	3
Kanto Leasing Ltd (In liquidation)	8
Lex Vehicle Leasing (Holdings) Ltd	2 i
	ii
	x
Lex Vehicle Leasing Ltd	2
Lloyds Bank (Fountainbridge 1) Ltd	4
Lloyds Bank (Fountainbridge 2) Ltd	4
Lloyds Capital GP Ltd	5
Lloyds Hypotheken B.V.	13
Lloyds Secretaries Ltd	1
London Uberior (L.A.S. Group) Nominees Ltd	4 *
Membership Services Finance Ltd	3
NFU Mutual Finance Ltd	2 i
	ii #
	vii
Nordic Leasing Ltd	1
NWS Trust Ltd	4
Ocean Leasing (July) Ltd (In liquidation)	8
Ocean Leasing (No 2) Ltd (In liquidation)	8
Pacific Leasing Ltd	1
Saleslease Purchase Ltd (In liquidation)	9
Seabreeze Leasing Ltd	1
Seaforth Maritime (Highlander) Ltd (In liquidation)	9
Seaforth Maritime (Jarl) Ltd (In liquidation)	9
Seaspirit Leasing Ltd	1
Seaspray Leasing Ltd (In liquidation)	8
Share Dealing Nominees Ltd	3
Shogun Finance Ltd	16 ii #
Silentdale Ltd	8 iv
	vi
	vi
Standard Property Investment (1987) Ltd	4 i
	ii
Standard Property Investment Ltd	12 #
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 Nominees Ltd	4*
Uberior Trustees Ltd	4 *
Vehicle Leasing (4) Ltd (In liquidation)	8
Warwick Leasing Ltd (In liquidation)	8

Group companies

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	10
Deva Financing Holdings Ltd	6
Deva Financing plc	6
Edgbaston RMBS 2010-1 plc	6
Edgbaston RMBS Holdings Ltd	6
Elland RMBS 2018 plc	6
Elland RMBS Holdings Ltd	6
Hart 2014-1 Ltd	15
Lingfield 2014 I Holdings Ltd	6
Lingfield 2014 I plc	6
Molineux RMBS 2016-1 plc	6
Molineux RMBS Holdings Ltd	6
Penarth Asset Securitisation Holdings Ltd	6
Penarth Funding 1 Ltd	10
Penarth Funding 2 Ltd	10
Penarth Master Issuer plc	6
Penarth Receivables Trustee Ltd	10
Permanent Funding (No. 1) Ltd	6
Permanent Funding (No. 2) Ltd	6
Permanent Holdings Ltd	6
Permanent Master Issuer plc	6
Permanent Mortgages Trustee Ltd	6
Permanent PECOH Holdings Ltd	6
Permanent PECOH Ltd	6
Swan Funding 2 Ltd	10
Trinity Financing Holdings Ltd	6
Trinity Financing plc	6

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	&
Connery Ltd	20%	44 Esplanade St Helier Jersey JE4 9WG	&

* 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

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) 2nd Floor, 21 Palmer Street,London, SW1H 0AD
(6) 35 Great St Helen's London, EC3A 6AP
(7) 6 Rue Jean Monnet, L-2180 Luxembourg,
(8) 1 More London Place, London, SE1 2AF
(9) EY Atria One, 144 Morrison Street, Edinburgh, EH3 8EB
(10) 44 Esplanade, St Helier, Jersey, JE4 9WG
(11) Rineanna House, Shannon Free Zone, Co. Clare, Ireland
(12) Caledonian Exchange, 19A Canning Street, Edinburgh, EH3 8HE
(13) Lichtenauerlann 170, 3062ME, Rotterdam, Netherlands
(14) McStay Luby, Dargan House, 21-23 Fenian Street, Dublin 2, Ireland
(15) 47 Esplanade, St. Helier, Jersey, JE1 0BD
(16) 116 Cockfosters Road, Barnet, Hertfordshire, EN4 0DY

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