

# HBOS plc

Report and Accounts

2009

Member of Lloyds Banking Group



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## Directors' report

**Results**

The consolidated income statement on page 12 shows a loss attributable to equity shareholders for the year ended 31 December 2009 of £9,979 million.

**Principal activities**

HBOS plc (the Company) together with its subsidiaries (the Group) provide a wide range of banking and financial services through branches and offices in the UK and overseas.

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

**Acquisition of the Group by Lloyds Banking Group plc**

On 16 January 2009, Lloyds Banking Group plc acquired 100 per cent of the ordinary share capital of HBOS plc. The Company's ordinary shares were de-listed from the Official List of the Listing Authority and admission to trading on the London Stock Exchange was cancelled on 19 January 2009.

**Business review**

The loss before tax increased by 14 per cent or £1,551 million to £12,376 million. The trading surplus increased by £5,437 million to £8,463 million but was more than offset by the increase in impairment charge, which increased by 67 per cent or £8,090 million to £20,140 million reflecting the weak credit environment and current economic conditions.

Total income, net of insurance claims, increased by 55 per cent or £5,427 million to £15,333 million. Net interest income decreased by 45 per cent or £4,551 million to £5,503 million as both interest income and interest expense fell in response to the historically low interest rate environment that has prevailed throughout the current year.

Other income increased by £25,933 million to £21,151 million. The largest driver of this increase was net trading income, which increased by £21,754 million as a result of gains arising on assets and liabilities held at fair value. These include the assets, held within the Group's life insurance operations, that support the insurance and investment contract liabilities. The increase in net trading income also reflected the inclusion of approximately £4,000 million of write-downs associated with the dislocation in financial markets in 2008. Excluding net trading income, other income increased by 52 per cent or £4,179 million to £12,292 million. The main driver of this increase was the receipt by Bank of Scotland plc, the Group's principal banking subsidiary, of subvention income of £3,000 million during the year from Lloyds TSB Bank plc. This payment was made by Lloyds TSB Bank plc to support the financial and reputational position of Bank of Scotland plc and to facilitate the ongoing integration of the Group's banking operations. Other income also includes gains of £2,514 million arising from a number of capital management transactions. Offsetting these increases, insurance premium income decreased by 8 per cent or £431 million due to the sale of St. Andrews, the Group's Australian insurance operation, in the last quarter of 2008 and lower new business in the current market environment. Net fee and commission income decreased by 45 per cent or £395 million reflecting lower volumes of new business.

Insurance claims increased by £15,955 million to £11,321 million reflecting the improvement in returns attributable to insurance and investment contracts.

Operating expenses were broadly unchanged at £6,870 million, reflecting integration savings and lower depreciation, mainly attributable to lower operating lease asset depreciation. These were offset by increased goodwill impairment which increased by £606 million to £764 million. The 2009 charge was principally in respect of Lex Vehicle Leasing and the operating assets and sales force of The Equitable Life Assurance business.

Impairment losses increased by 67 per cent or £8,090 million to £20,140 million. This largely represents falls in the value of commercial real estate and the impact of the economic deterioration during the year, including the effects of rising unemployment and reduced corporate cash flows. Significant provisions were required against the Group's Irish and Australian commercial real estate portfolios.

Loans and advances to customers decreased by 10 per cent or £46,346 million to £404,075 million reflecting activity undertaken in accordance with the strategy to reduce assets associated with non-relationship lending.

## Directors' report

Customer deposits decreased by 2 per cent or £5,426 million to £232,023 million resulting in a slight decrease in the customer loan to deposit ratio to 174 per cent from 190 per cent at 31 December 2008.

Loans and advances to fellow group undertakings principally comprise loans and advances to banks. Loans and advances to banks, including loans to fellow group undertakings, increased from £16,796 million to £98,524 million and deposits by banks, including deposits from fellow group undertakings increased from £97,150 million to £179,064 million reflecting transactions with other parts of the Lloyds Banking Group following the acquisition of the Group on 16 January 2009.

Debt securities in issue decreased by 37 per cent or £69,291 million to £119,157 million as some of the maturing debt securities were replaced by deposits by banks as the Group repositioned its funding through transactions with other Lloyds Banking Group subsidiaries. Improved conditions in the funding and liquidity markets along with the restructuring opportunities provided by the acquisition has enabled the purchase of its own debt reflected in the reduction of approximately £11,000 million in subordinated liabilities.

Shareholders' equity increased by £13,403 million to £24,885 million as capital injections and gains on available-for-sale assets during the year were significantly greater than the Group's loss for the year.

### Capital

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

	2009 £m	2008 £m
Tier 1 capital	<b>31,007</b>	19,790
Tier 2 capital	<b>12,849</b>	19,033
	<b>43,856</b>	38,823
Supervisory deductions	<b>(5,517)</b>	(5,044)
Total capital	<b>38,339</b>	33,779
<b>Risk weighted assets</b>	<b>324,645</b>	328,023
Core tier 1 ratio	<b>8.2%</b>	4.1%
Tier 1 capital ratio	<b>9.6%</b>	6.0%
Total capital ratio	<b>11.8%</b>	10.3%

### Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Company and its subsidiary undertakings, in relation to the use of financial instruments, is given in note 54 of the financial statements.

### Group structure

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

On 1 January 2010, the issued share capital of the Company was transferred from Lloyds Banking Group plc to Lloyds TSB Bank plc.

### Directors

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

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

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

## Directors' report

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

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

### **Directors' interests**

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

### **Directors' indemnities**

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

### **Statement of directors' responsibilities**

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

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the consolidated and parent company financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the parent company and the Group and of the profit or loss of the Group for that period. The directors consider that, in preparing the financial statements on pages 12 to 116, the Company and the Group have used appropriate accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, and that all accounting standards which they consider applicable have been followed.

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

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

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

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

### **Going concern**

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future the directors have considered a number of key dependencies as discussed in

## Directors' report

note 1 and additionally have considered projections for the Group's capital and funding position. Having considered these, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

### **Employees**

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

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

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

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

### **Policy and practice on payment of creditors**

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

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

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

### **Auditors and audit information**

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

On behalf of the board

### **Harry F Baines**

Company Secretary  
25 February 2010

Company Number 218813

HBOS plc

## Directors

Sir Winfried Bischoff *Chairman*

J E Daniels *Chief Executive*

T J W Tookey *Finance Director*

Dr W C G Berndt

Sir Julian Horn-Smith

A G Kane

Lord Leitch

G R Moreno  
(from 1 March 2010)

D L Roberts  
(from 1 March 2010)

T T Ryan, Jr

M A Scicluna

G T Tate

A Watson CBE

H A Weir CBE



## Principal risks and uncertainties

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

### **Credit**

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

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

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

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

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

### **Legal and regulatory**

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

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

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

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

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

## Principal risks and uncertainties

### Liquidity and funding

*Definition:* Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

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

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

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

### Customer treatment

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

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

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

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

### People

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

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

## Principal risks and uncertainties

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

### **Integration**

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

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

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

## Independent auditors' report to the members of HBOS plc

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

### **Respective responsibilities of directors and auditors**

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

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

### **Scope of the audit of the financial statements**

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

### **Opinion on financial statements**

In our opinion:

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

### **Opinion on other matter prescribed by the Companies Act 2006**

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

## Independent auditors' report to the members of HBOS plc

### **Matters on which we are required to report by exception**

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

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

**Ian Rankin** (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP

Chartered Accountants and Statutory Auditors

Edinburgh

25 February 2010

Consolidated income statement  
for the year ended 31 December 2009

	2009	2008 (restated) <sup>1</sup>
Note	£ million	£ million
Interest and similar income	<b>18,270</b>	35,779
Interest and similar expense	<b>(12,767)</b>	(25,725)
<b>Net interest income</b>	<b>5,503</b>	10,054
Fee and commission income	<b>1,492</b>	2,058
Fee and commission expense	<b>(1,007)</b>	(1,178)
Net fee and commission income	<b>485</b>	880
Net trading income	<b>8,859</b>	(12,895)
Insurance premium income	<b>4,913</b>	5,344
Subvention income	<b>3,000</b>	–
Other operating income	<b>3,894</b>	1,889
<b>Other income</b>	<b>21,151</b>	(4,782)
<b>Total income</b>	<b>26,654</b>	5,272
Insurance claims	<b>(11,321)</b>	4,634
<b>Total income, net of insurance claims</b>	<b>15,333</b>	9,906
Operating expenses	<b>(6,870)</b>	(6,880)
<b>Trading surplus</b>	<b>8,463</b>	3,026
Impairment	<b>(20,140)</b>	(12,050)
Share of results of joint ventures and associates	<b>(725)</b>	(956)
Profit (loss) on sale of businesses	<b>26</b>	(845)
<b>Loss before tax</b>	<b>(12,376)</b>	(10,825)
Taxation	<b>2,498</b>	3,409
<b>Loss for the year</b>	<b>(9,878)</b>	(7,416)
Profit attributable to minority interests	<b>101</b>	83
Loss attributable to equity shareholders	<b>(9,979)</b>	(7,499)
<b>Loss for the year</b>	<b>(9,878)</b>	(7,416)

<sup>1</sup>See note 57.

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

Consolidated statement of comprehensive income  
for the year ended 31 December 2009

	2009	2008 (restated) <sup>1</sup>
	<b>£ million</b>	£ million
<b>Loss for the year</b>	<b>(9,878)</b>	(7,416)
<b>Other comprehensive income:</b>		
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax:		
Change in fair value	1,877	(5,897)
Transferred to income statement in respect of disposals	2	(17)
Transferred to income statement in respect of impairment	446	915
	<b>2,325</b>	(4,999)
Movement in cash flow hedging reserve, net of tax:		
Effective portion of changes in fair value taken to other comprehensive income	(442)	(2,802)
Net gains transferred to the income statement	645	1,844
	<b>203</b>	(958)
Currency translation differences, net of tax	<b>39</b>	187
<b>Other comprehensive income for the year, net of tax</b>	<b>2,567</b>	(5,770)
<b>Total comprehensive income for the year</b>	<b>(7,311)</b>	(13,186)
Total comprehensive income attributable to minority interests	<b>101</b>	83
Total comprehensive income attributable to equity shareholders	<b>(7,412)</b>	(13,269)
<b>Total comprehensive income for the year</b>	<b>(7,311)</b>	(13,186)

<sup>1</sup>See note 57.

Consolidated balance sheet  
at 31 December 2009

	2009	2008 (restated) <sup>1</sup>	1 January 2008 (restated) <sup>1</sup>
Note	£ million	£ million	£ million
<b>Assets</b>			
Cash and balances at central banks	<b>2,905</b>	2,502	2,945
Items in the course of collection from banks	<b>534</b>	445	945
Trading and other financial assets at fair value through profit or loss	16 <b>101,908</b>	89,691	133,510
Derivative financial instruments	17 <b>30,919</b>	51,810	14,141
Loans and receivables:			
Loans and advances to fellow group undertakings	<b>88,620</b>	–	–
Loans and advances to other banks	<b>9,904</b>	16,796	5,825
Loans and advances to banks	18 <b>98,524</b>	16,796	5,825
Loans and advances to customers	19 <b>404,075</b>	450,421	454,941
Debt securities	22 <b>31,468</b>	39,053	702
	<b>534,067</b>	506,270	461,468
Available-for-sale financial assets	24 <b>21,591</b>	28,048	49,986
Investment properties	25 <b>2,417</b>	3,045	4,731
Investments in joint ventures and associates	13 <b>393</b>	1,161	1,724
Goodwill	27 <b>850</b>	1,556	1,940
Value of in-force business	28 <b>2,986</b>	3,284	3,505
Other intangible assets	29 <b>97</b>	117	122
Tangible fixed assets	30 <b>5,103</b>	5,810	6,544
Current tax recoverable	<b>495</b>	983	–
Deferred tax assets	42 <b>4,724</b>	2,832	70
Other assets	31 <b>10,194</b>	7,254	10,320
<b>Total assets</b>	<b>719,183</b>	704,808	691,951

<sup>1</sup>See note 57.

The accompanying notes are an integral part of the consolidated financial statements.  
The directors approved the consolidated financial statements on 25 February 2010.

**Sir Winfried Bischoff**  
Chairman

**J Eric Daniels**  
Chief Executive

**Tim J W Tookey**  
Finance Director



Consolidated balance sheet  
at 31 December 2009

	2009	2008 (restated) <sup>1</sup>	1 January 2008 (restated) <sup>1</sup>
Note	£ million	£ million	£ million
<b>Equity and liabilities</b>			
<b>Liabilities</b>			
Deposits from fellow group undertakings	<b>149,519</b>	–	–
Deposits from other banks	<b>29,545</b>	97,150	41,513
Deposits from banks	32 <b>179,064</b>	97,150	41,513
Customer deposits	33 <b>232,023</b>	237,449	268,155
Items in course of transmission to banks	<b>495</b>	521	542
Trading and other financial liabilities at fair value through profit or loss	34 <b>27,372</b>	18,851	22,705
Derivative financial instruments	17 <b>25,801</b>	38,905	12,311
Notes in circulation	<b>981</b>	957	881
Debt securities in issue	35 <b>119,157</b>	188,448	206,520
Liabilities arising from insurance contracts and participating investment contracts	36 <b>39,234</b>	36,873	34,056
Liabilities arising from non-participating investment contracts	38 <b>30,614</b>	29,057	40,387
Unallocated surplus within insurance businesses	39 <b>772</b>	551	1,493
Other liabilities	40 <b>17,474</b>	12,151	13,409
Retirement benefit obligations	41 <b>467</b>	562	570
Current tax liabilities	<b>29</b>	58	370
Deferred tax liabilities	42 <b>208</b>	227	2,526
Other provisions	43 <b>258</b>	147	175
Subordinated liabilities	44 <b>19,078</b>	30,119	24,253
<b>Total liabilities</b>	<b>693,027</b>	692,026	669,866
<b>Equity</b>			
Share capital	45 <b>3,763</b>	1,550	1,131
Share premium account	46 <b>16,056</b>	6,709	2,997
Other reserves	47 <b>6,560</b>	(5,616)	154
Retained profits	48 <b>(1,494)</b>	8,839	17,418
<b>Shareholders' equity</b>	<b>24,885</b>	11,482	21,700
Minority interests	<b>1,271</b>	1,300	385
<b>Total equity</b>	<b>26,156</b>	12,782	22,085
<b>Total equity and liabilities</b>	<b>719,183</b>	704,808	691,951

<sup>1</sup>See note 57.

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

Consolidated statement of changes in equity  
for the year ended 31 December 2009

	Attributable to equity shareholders				Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Minority interests £ million	
<b>Balance at 1 January 2008 as previously stated</b>	4,128	154	17,567	385	22,234
Prior year adjustment (note 57)	–	–	(149)	–	(149)
<b>Balance at 1 January 2008 as restated</b>	4,128	154	17,418	385	22,085
Total comprehensive income	–	(5,770)	(7,499)	83	(13,186)
Dividends	–	–	(1,286)	(55)	(1,341)
Issue of ordinary and preference shares	4,131	–	–	750	4,881
Purchase/sale of treasury shares	–	–	88	–	88
Employee share option schemes: value of employee services	–	–	118	–	118
Repayment of capital to minority shareholders	–	–	–	132	132
Other	–	–	–	5	5
<b>Balance at 31 December 2008</b>	8,259	(5,616)	8,839	1,300	12,782
Total comprehensive income	–	<b>2,567</b>	<b>(9,979)</b>	<b>101</b>	<b>(7,311)</b>
Dividends	–	–	<b>(355)</b>	<b>(95)</b>	<b>(450)</b>
Issue of ordinary shares	<b>15,827</b>	<b>9,468</b>	–	–	<b>25,295</b>
Redemption of preference shares	<b>(4,267)</b>	–	–	–	<b>(4,267)</b>
Purchase/sale of treasury shares	–	–	<b>36</b>	–	<b>36</b>
Capital redemption reserve	–	<b>141</b>	<b>(141)</b>	–	–
Employee share option schemes: value of employee services	–	–	<b>106</b>	–	<b>106</b>
Extinguishment of minority interest	–	–	–	<b>(35)</b>	<b>(35)</b>
<b>Balance at 31 December 2009</b>	<b>19,819</b>	<b>6,560</b>	<b>(1,494)</b>	<b>1,271</b>	<b>26,156</b>

Consolidated cash flow statement  
for the year ended 31 December 2009

	2009	2008 (restated) <sup>1</sup>
Note	£ million	£ million
<b>Loss before tax</b>	<b>(12,376)</b>	(10,825)
Adjustments for:		
Change in operating assets	56a <b>24,687</b>	23,347
Change in operating liabilities	56b <b>21,845</b>	10,186
Non-cash and other items	56c <b>19,796</b>	18,102
Tax received (paid)	<b>289</b>	(797)
<b>Net cash provided by operating activities</b>	<b>54,241</b>	40,013
<b>Cash flows from investing activities</b>		
Purchase of available-for-sale financial assets	<b>(10,944)</b>	(54,637)
Proceeds from sale and maturity of available-for-sale financial assets	<b>16,442</b>	17,832
Purchase of fixed assets	<b>(275)</b>	(845)
Proceeds from sale of fixed assets	<b>687</b>	992
Acquisition of businesses, net of cash acquired	56f <b>(314)</b>	(469)
Disposal of businesses, net of cash disposed	56g <b>259</b>	1,185
<b>Net cash provided by (used in) investing activities</b>	<b>5,855</b>	(35,942)
<b>Cash flows from financing activities</b>		
Dividends paid to equity shareholders	<b>(355)</b>	(1,286)
Dividends paid to minority interests	56e <b>(95)</b>	(55)
Interest paid on subordinated liabilities	<b>(1,302)</b>	(1,505)
Share cancellation	56e <b>(4,267)</b>	–
Proceeds from issue of subordinated liabilities	56e –	2,285
Proceeds from issue of ordinary shares	56e <b>25,295</b>	4,131
Proceeds from the issue of preference shares	56e –	750
Proceeds from disposal of own shares	<b>36</b>	101
Purchase of own shares	–	(189)
Repayment of subordinated liabilities	56e <b>(8,178)</b>	(3,021)
Minority interest acquired	–	242
Repayment of capital to minority shareholders	56e <b>(35)</b>	(110)
<b>Net cash provided by financing activities</b>	<b>11,099</b>	1,343
Effects of exchange rate changes on cash and cash equivalents	<b>46</b>	(363)
Change in cash and cash equivalents <sup>2</sup>	<b>71,241</b>	5,051
Cash and cash equivalents at beginning of year	<b>11,236</b>	6,185
<b>Cash and cash equivalents at end of year</b>	56d <b>82,477</b>	11,236

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

<sup>1</sup>Following the reclassification of the Group balance sheet to align the presentation with the presentation practices adopted by Lloyds Banking Group plc (as detailed in note 57) the cash flow statement has been represented on a basis consistent with the reclassified balance sheet.

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

Company statement of comprehensive income  
for the year ended 31 December 2009

	2009	2008 (restated) <sup>1</sup>
	£ million	£ million
<b>Loss for the year</b>	<b>(7,322)</b>	(1,902)
<b>Other comprehensive income:</b>		
Movement in cash flow hedging reserve, net of tax:		
Effective portion of changes in fair value taken to other comprehensive income	–	(2)
Currency translation differences, net of tax	<b>16</b>	–
<b>Other comprehensive income for the year, net of tax</b>	<b>16</b>	(2)
<b>Total comprehensive income for the year</b>	<b>(7,306)</b>	(1,904)

<sup>1</sup>See note 57.

Company balance sheet  
at 31 December 2009

	<i>Note</i>	<b>2009</b> £ million	2008 (restated) <sup>1</sup> £ million	1 January 2008 (restated) <sup>1</sup> £ million
<b>Assets</b>				
Amounts owed by Group entities	26	<b>46,186</b>	50,157	38,885
Derivative financial instruments	17	<b>1,711</b>	2,638	162
Loans and receivables: debt securities		<b>1</b>	–	1
Intangible assets	29	<b>2</b>	4	6
Current tax recoverable		–	170	380
Deferred tax assets	42	<b>113</b>	120	153
Other assets	31	<b>1,847</b>	232	15
Investments in subsidiary undertakings	26	<b>26,128</b>	15,783	14,475
<b>Total assets</b>		<b>75,988</b>	69,104	54,077
<b>Liabilities</b>				
Amounts owed to Group entities		<b>37,450</b>	36,450	29,267
Derivative financial instruments	17	<b>43</b>	55	56
Other liabilities	40	<b>432</b>	396	272
Current tax liabilities		<b>144</b>	–	–
Retirement benefit obligations	41	<b>479</b>	560	593
Subordinated liabilities	44	<b>14,554</b>	22,235	15,503
<b>Total liabilities</b>		<b>53,102</b>	59,696	45,691
<b>Equity</b>				
Issued share capital	45	<b>3,763</b>	1,550	1,131
Share premium account	46	<b>16,056</b>	6,709	2,997
Other reserves	47	<b>9,692</b>	67	69
Retained profits	48	<b>(6,625)</b>	1,082	4,189
<b>Shareholders' equity</b>		<b>22,886</b>	9,408	8,386
<b>Total equity and liabilities</b>		<b>75,988</b>	69,104	54,077

<sup>1</sup>See note 57.

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

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

**Sir Winfried Bischoff**  
Chairman

**J Eric Daniels**  
Chief Executive

**Tim J W Tookey**  
Finance Director

Company statement of changes in equity  
for the year ended 31 December 2009

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
<b>Balance at 1 January 2008 as previously stated</b>	4,128	69	4,354	8,551
Prior year adjustment (note 57)	–	–	(165)	(165)
<b>Balance at 1 January 2008 as restated</b>	4,128	69	4,189	8,386
Total comprehensive income	–	(2)	(1,902)	(1,904)
Dividends	–	–	(1,286)	(1,286)
Issue of ordinary and preference shares	4,131	–	–	4,131
Purchase/sale of treasury shares	–	–	(53)	(53)
Employee share option schemes: value of employee services	–	–	134	134
<b>Balance at 31 December 2008</b>	8,259	67	1,082	9,408
Total comprehensive income	–	16	(7,322)	(7,306)
Dividends	–	–	(355)	(355)
Issue of ordinary shares	15,827	9,468	–	25,295
Redemption of preference shares	(4,267)	–	–	(4,267)
Capital redemption reserve	–	141	(141)	–
Purchase/sale of treasury shares	–	–	12	12
Employee share option schemes: value of employee services	–	–	99	99
<b>Balance at 31 December 2009</b>	<b>19,819</b>	<b>9,692</b>	<b>(6,625)</b>	<b>22,886</b>

Company cash flow statement  
for the year ended 31 December 2009

	2009	2008 (restated) <sup>1</sup>
Note	£ million	£ million
<b>Loss before tax</b>	<b>(6,997)</b>	(1,949)
Adjustments for:		
Dividend income	–	(2,374)
Change in operating assets	56a <b>1,980</b>	30,170
Change in operating liabilities	56b <b>1,095</b>	8,814
Non-cash and other items	56c <b>9,050</b>	5,221
Tax received (paid)	<b>(3)</b>	245
<b>Net cash provided by operating activities</b>	<b>5,125</b>	40,127
<b>Cash flows from investing activities</b>		
Capital lending to subsidiaries	<b>(20,189)</b>	(7,955)
<b>Cash flows from financing activities</b>		
Dividends received from subsidiaries	–	2,374
Dividends paid to equity shareholders	<b>(355)</b>	(1,286)
Proceeds from issue of ordinary shares	56e <b>25,295</b>	4,131
Share cancellation	56e <b>(4,267)</b>	–
Proceeds from issue of subordinated liabilities	56e –	2,285
Repayment of subordinated liabilities	56e <b>(6,126)</b>	(267)
Interest paid on subordinated liabilities	<b>(973)</b>	(983)
Purchase of own shares	<b>12</b>	(12)
<b>Net cash provided by financing activities</b>	<b>13,586</b>	6,242
Change in cash and cash equivalents	<b>(1,478)</b>	38,414
Cash and cash equivalents at beginning of year	<b>39,591</b>	1,177
<b>Cash and cash equivalents at end of year</b>	56d <b>38,113</b>	39,591

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

<sup>1</sup>Following the reclassification of the Company balance sheet to align the presentation with the presentation practices adopted by Lloyds Banking Group plc (as detailed in note 57) the cash flow statement has been represented on a basis consistent with the reclassified balance sheet.

## Notes to the consolidated financial statements

### 1 Basis of preparation

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

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

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

### 2 Accounting policies

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

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

#### *Change in accounting policy – Defined benefit pension scheme*

Prior to the acquisition of the Group by Lloyds Banking Group, HBOS plc accounted for its defined benefit pension scheme using the full recognition method with any actuarial gains and losses arising being recognised immediately through other comprehensive income.

Lloyds Banking Group accounts for its defined benefit pension schemes using the 'corridor' approach under which actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10 per cent of the scheme assets or liabilities. In these circumstances the excess is charged or credited to the income statement over the employees' expected average remaining working lives.

Following the acquisition on 16 January 2009, the Group has aligned its accounting policy for defined benefit pension schemes to that of Lloyds Banking Group to provide consistency and more relevant information for the enlarged Lloyds Banking Group. This change in accounting policy has resulted in a restatement of previous years' net assets as previously recognised actuarial gains and losses are not recognised using the 'corridor' method. The prior year adjustment reduces the net assets of the Group as at 1 January 2008 by £149 million from £22,234 million to £22,085 million; the actuarial gains and losses in 2008 of £568 million are unrecognised (see note 57). No adjustment has been made to the 2008 income statement as the amount is not material.

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

- (i) *IAS 1 (revised), 'Presentation of financial statements'*. The revised standard prohibits the presentation of items of income and expense (that is 'non-owner changes in equity') in the statement of changes in equity, requiring 'non-owner changes in equity' to be presented separately from owner changes in equity. All non-owner changes in equity are required to be shown in a performance statement. Entities can choose whether to present one performance statement (the statement of comprehensive income) or two statements (the income statement and statement of comprehensive income). The Group has elected to present two statements: an income statement and a statement of comprehensive income. The financial statements have been prepared under the revised disclosure requirements; the application of this revised standard, which affects presentation only, has not had any impact for amounts recognised in these financial statements. A balance sheet as at 1 January 2008 is presented to deal with the change in accounting policy above and the reclassifications as detailed in note 57.
- (ii) *Amendments to IFRS 7 'Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments'*. The amendment requires enhanced disclosures about fair value measurement and liquidity risk. In particular, the amendment requires disclosure of a three level fair value measurement hierarchy for financial instruments carried on the Group's balance sheet at fair value. As the amendments only result in additional disclosures, the amendments have not had any impact for amounts recognised in these financial statements.
- (iii) *IFRS 8 'Operating Segments'*. The new standard replaces IAS 14 'Segment Reporting' and requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision maker has been identified as the Group Executive Committee (GEC). The Group is managed on the entity basis and not by segment, and the GEC does not assess performance and allocate resources across any segments; accordingly no segmental information is provided. A brief overview of its sources of income is provided in the Financial review.

The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Group.

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

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



## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

- IFRIC 13 *Customer Loyalty Programmes*. This interpretation addresses accounting by entities who grant customer loyalty award credits to customers as part of sales transactions and which can be redeemed in the future for free or discounted goods or services. The majority of customer loyalty award schemes are operated by third parties.
- IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*. This interpretation provides guidance on accounting for hedges of net investments in foreign operations in an entity's consolidated financial statements.
- IAS 23 *Borrowing Costs*. This revised standard requires interest and other costs incurred in connection with the borrowing of funds to be recognised as an expense excepting that those which are directly attributable to the acquisition, construction or production of assets that take a substantial period of time to get ready for their intended use or sale must be capitalised as part of the cost of those assets.
- Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation*. The amendments require some puttable financial instruments (being those which give the holder the right to put the instrument back to the issuer for cash or another financial asset) and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation to be classified as equity.
- *Improvements to IFRSs* (issued May 2008). Sets out minor amendments to IFRS standards as part of annual improvements process. Most amendments clarified existing practice.
- Amendment to IAS 27 *Consolidated and Separate Financial Statements – Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*. This amendment removes the definition of the cost method and requires the presentation of dividends as income in the separate financial statements of the investor.

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

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2009 and which have not been applied in preparing these financial statements are given in note 59.

The accounting policies are set out below.

#### a Consolidation

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

##### (1) Subsidiaries

Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 26.

Open Ended Investment Companies (OEICs) where the Group, through the Group's life funds, has a controlling interest are consolidated; the unitholders' interest is reported in other liabilities.

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

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

##### (2) Joint ventures and associates

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

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

#### b Goodwill

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

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

## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

#### c Other intangible assets

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

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

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

#### d Revenue recognition

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

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

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

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

Revenue recognition policies specific to life assurance and general insurance business are detailed below (see o).

#### e Financial assets and liabilities

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

##### (1) Financial instruments at fair value through profit or loss

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

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

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

- it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases. The main type of financial assets designated by the Group as at fair value through profit or loss are assets backing insurance contracts and investment contracts issued by the Group's life insurance businesses. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available-for-sale financial assets.
- the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis. As noted in accounting policy 2(a)(2), certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.
- where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

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

## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

estimates and judgements: Valuation of financial instruments) and note 54 (Financial risk management: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

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

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

#### (2) Available-for-sale financial assets

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

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

#### (3) Loans and receivables

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

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

#### (4) Borrowings

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

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense.

An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

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

#### (5) Sale and repurchase agreements

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

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

#### (6) Derecognition of financial assets and liabilities

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

- substantially all of the risks and rewards of ownership have been transferred; or
- the Group has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

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

#### f Derivative financial instruments and hedge accounting

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Valuation of financial instruments) and note 54 (Financial risk management: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

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

Derivatives embedded in financial instruments 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.

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

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

#### (1) Fair value hedges

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

#### (2) Cash flow hedges

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

#### (3) Net investment hedges

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

### g Offset

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

### h Impairment of financial assets

#### (1) Assets accounted for at amortised cost

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

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

- Delinquency in contractual payments of principal and/or interest;
- Indications that the borrower or group of borrowers is experiencing significant financial difficulty;
- Restructuring of debt to reduce the burden on the borrower;
- Breach of loan covenants or conditions; and
- Initiation of bankruptcy or individual voluntary arrangement proceedings.

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

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

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

## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

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

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

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

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

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

#### (2) Available-for-sale financial assets

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

#### i Investment property

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

#### j Tangible fixed assets

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

Premises (excluding land):

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

Equipment:

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

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

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

## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

#### k Leases

##### (1) As lessee

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

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

##### (2) As lessor

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

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

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

#### l Pensions and other post-retirement benefits

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.

Full actuarial valuations of the Group's principal defined benefit schemes are carried out every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. 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, the expected return on the schemes' assets, net of expected administration costs, and the interest cost on the schemes' liabilities. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10 per cent of the scheme assets or liabilities ('the corridor approach'). In these circumstances the excess is charged or credited to the income statement over the employees' expected average remaining working lives. Past service costs are charged immediately to the income statement, unless the charges are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

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 adjusted for any cumulative unrecognised actuarial gains or losses. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

The Group recognises the effect of material changes to the terms of its defined benefit pension plans which reduce future benefits as curtailments; gains and losses are recognised in the income statement when the curtailments occur.

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

#### m 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. 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 over the remaining vesting period, 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 over any remaining vesting period.

#### n Taxation

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

For the Group's long-term assurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on equity holders' returns. This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules.



## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

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

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

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

#### o Insurance

The Group undertakes both life insurance and general insurance business.

Products sold by the life insurance business are classified into three categories:

Insurance contracts – these contracts transfer significant insurance risk and may also transfer financial risk. The Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. These contracts may or may not include discretionary participation features.

Investment contracts containing a discretionary participation feature ('participating investment contracts') – these contracts do not transfer significant insurance risk, but contain a contractual right which entitle the holder to receive, in addition to the guaranteed benefits, further additional discretionary benefits or bonuses that are likely to be a significant proportion of the total contractual benefits and the amount and timing of which is at the discretion of the Group and based upon the performance of specified assets.

Non-participating investment contracts – these contracts do not transfer significant insurance risk or contain a discretionary participation feature.

The general insurance business issues only insurance contracts.

#### (1) Life insurance business

##### (i) Accounting for insurance and participating investment contracts

###### Premiums and claims

Premiums received in respect of insurance and participating investment contracts are recognised as revenue when due except for unit-linked contracts on which premiums are recognised as revenue when received. Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified.

###### Liabilities

###### – Insurance and participating investment contracts in the Group's with-profit funds

Liabilities of the Group's with-profit funds, including guarantees and options embedded within products written by these funds, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in unallocated surplus (see below). Further details on the realistic capital regime are given in note 36. Changes in the value of these liabilities are recognised through insurance claims.

###### – Insurance and participating investment contracts which are not unit-linked or in the Group's with-profit funds

A liability for contractual benefits that are expected to be incurred in the future is recorded when the premiums are recognised. The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date allowing for probabilities of occurrence. The liability will vary with movements in interest rates and with the cost of life insurance and annuity benefits where future mortality is uncertain.

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs.

Changes in the value of these liabilities are recognised in the income statement through insurance claims.

###### – Insurance and participating investment contracts which are unit-linked

Liabilities for unit-linked insurance contracts and participating investment contracts are stated at the bid value of units plus an additional allowance where appropriate (such as for any excess of future expenses over charges). The liability is increased or reduced by the change in the unit prices and is reduced by policy administration fees, mortality and surrender charges and any withdrawals. Changes in the value of the liability are recognised in the income statement through insurance claims. Excess benefit claims in excess of the account balances incurred in the period are charged as expenses in the income statement. Revenue consists of fees deducted for mortality, policy administration and surrender charges.

###### Unallocated surplus

Any amounts in the with-profit funds not yet determined as being due to policyholders or shareholders are recognised as an unallocated surplus which is shown separately from liabilities arising from insurance contracts and participating investment contracts.

##### (ii) Accounting for non-participating investment contracts

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment income allocated to non-participating investment contracts are included in insurance claims.

## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the non-participating investment contract liability.

The Group receives investment management fees in the form of an initial adjustment or charge to the amount invested. These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them over the estimated lives of the contracts, in line with the provision of investment management services.

Costs which are directly attributable and incremental to securing new non-participating investment contracts are deferred. This asset is subsequently amortised over the period of the provision of investment management services and is reviewed for impairment in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately through expenses in the income statement. All other costs are recognised as expenses when incurred.

#### (iii) *Value of in-force business*

The Group recognises as an asset the value of in-force business in respect of insurance contracts and participating investment contracts. The asset represents the present value of the shareholders' interest in the profits expected to emerge from those contracts written at the balance sheet date. This is determined after making appropriate assumptions about future economic and operating conditions such as future mortality and persistency rates and includes allowances for both non-market risk and for the realistic value of financial options and guarantees. Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. The asset in the consolidated balance sheet is presented gross of attributable tax and movements in the asset are reflected within other operating income in the income statement.

The Group's contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers is measured at fair value at the date of acquisition. The resulting asset is amortised over the estimated lives of the contracts. At each reporting date an assessment is made to determine if there is any indication of impairment. Where impairment exists, the carrying value of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement.

#### (2) *General insurance business*

The Group both underwrites and acts as intermediary in the sale of general insurance products. Underwriting premiums are included in insurance premium income, net of refunds, in the period in which insurance cover is provided to the customer; premiums received relating to future periods are deferred in the balance sheet within liabilities arising from insurance contracts and participating investment contracts and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

The underwriting business makes provision for the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The provision for the cost of claims notified but not settled is based upon a best estimate of the cost of settling the outstanding claims after taking into account all known facts. In those cases where there is insufficient information to determine the required provision, statistical techniques are used which take into account the cost of claims that have recently been settled and make assumptions about the future development of the outstanding cases. Similar statistical techniques are used to determine the provision for claims incurred but not reported at the balance sheet date. Claims liabilities are not discounted.

#### (3) *Liability adequacy test*

At each balance sheet date liability adequacy tests are performed to ensure the adequacy of insurance and participating investment contract liabilities net of related deferred cost assets and value of in-force business. In performing these tests current best estimates of discounted future contractual cash flows and claims handling and policy administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to the income statement, initially by writing off the relevant assets and subsequently by establishing a provision for losses arising from liability adequacy tests.

#### (4) *Reinsurance*

Contracts entered into by the Group with reinsurers under which the Group is compensated for losses on one or more contracts issued by the Group and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held.

The benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers as well as longer term receivables that are dependent on the expected claims and benefits arising under the related reinsured contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Premiums payable for reinsurance contracts are recognised as an expense when due within insurance premium income. Changes in the reinsurance assets are recognised in the income statement through insurance claims.

#### **p Foreign currency translation**

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

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



## Notes to the consolidated financial statements

### 2 Accounting policies (continued)

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

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

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

Foreign exchange differences arising on the 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 (see f). On disposal of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal.

#### q Provisions

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

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

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

#### r Dividends

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

#### s 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.

#### t Balance sheet presentation

To provide a more relevant presentation of the Group's financial instruments, an additional line has been added to the consolidated balance sheet to separately show debt securities classified as loans and receivables. In addition, certain amounts have been reclassified to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group (see note 57).

Comparatives have been reclassified to conform to the revised presentation.

#### u Investment in subsidiaries

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

### 3 Critical accounting judgements and estimates

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

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

#### Allowance for impairment losses on loans and receivables

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

At 31 December 2009 gross loans and receivables totalled £557,339 million (2008: £517,886 million) against which impairment allowances of £23,272 million (2008: £11,616 million) had been made (see note 23). Impairment allowances are made up of two components, those determined individually and those determined collectively. At 31 December 2009 the individual component was £20,440 million (2008: £6,736 million) and the collective component was £2,832 million (2008: £4,880 million).

#### Individual component

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

## Notes to the consolidated financial statements

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

significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

#### *Collective component*

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

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

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

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

#### **Impairment of available-for-sale financial assets**

In determining whether an impairment loss has been incurred in respect of an available-for-sale financial asset, the Group performs an objective review of the current financial circumstances and future prospects of the issuer and, in the case of equity shares, considers whether there has been a significant or prolonged decline in the fair value of that asset below its cost. This consideration requires management judgement. Among factors considered by the Group is whether the decline in fair value is a result of a change in the quality of the asset or a downward movement in the market as a whole. An assessment is performed of the future cash flows expected to be realised from the asset, taking into account, where appropriate, the quality of underlying security and credit protection available. The increase in the fair value of available-for-sale financial assets during the year was £2,550 million (2008: decrease of £8,173 million). Impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement totalled £620 million (2008: £1,270 million).

#### **Valuation of financial instruments**

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

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

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

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

The valuation techniques used are set out in note 53. This provides details of the inputs into valuation models that have the potential to significantly impact the value determined, sets out the assumptions used for those inputs and provides the effects of applying reasonably possible alternative assumptions.

#### **Taxation**

At 31 December 2009 the Group carried deferred tax assets on its balance sheet of £4,724 million (2008: £2,832 million) and deferred tax liabilities of £208 million (2008: £227 million) (note 42).

This statutory presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 42 also presents the Group's deferred tax assets and liabilities by tax category. The largest category of deferred tax asset which contains significant estimation uncertainty and which requires management judgement in assessing its recoverability relates to tax losses carried forward. At 31 December 2009, the Group recognised a deferred tax asset of £3,625 million (2008: £1,514 million) in respect of tax losses carried forward. The significant increase reflects the tax losses generated by certain Group companies, primarily Bank of Scotland plc, in the last two years.

Applicable accounting standards permit the recognition of deferred tax assets only to the extent that it is probable that future taxable profits will be available to utilise the tax losses carried forward. The assessment of future taxable profits involves significant estimation uncertainty, principally relating to an assessment of management's projections of future taxable income based on business plans and ongoing tax planning strategies. These projections include assumptions about the future strategy of the Group, the economic and regulatory environment in which the Group operates, future tax legislation, customer behaviour, and the ability of the

## Notes to the consolidated financial statements

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

Group to deliver expected integration benefits, amongst other variables. At 31 December 2009, management has concluded that future taxable profits generated by the Group companies with tax losses carried forward are expected to be sufficient to utilise the tax losses carried forward in full.

At 31 December 2009 the Group carried an asset for current tax recoverable of £495 million (2008: £983 million) and current tax liabilities of £29 million (2008: £58 million). In determining the carrying value of these balances, management have taken account of tax issues that are subject to ongoing discussion with HM Revenue & Customs and other tax authorities. Inherent in this is management's assessment of legal and professional advice, case law and other relevant guidance. The determination of the outcome of such matters requires significant management judgement in assessing the various risks and applying appropriate probability weightings in determining the carrying value of current and deferred tax balances.

#### Pensions

The net liability recognised in the balance sheet at 31 December 2009 in respect of the Group's retirement benefit obligations was £400 million (2008: £516 million) of which £346 million (2008: £461 million) related to defined benefit pension schemes. As explained in accounting policy 2(i), the Group adopts the corridor approach to accounting for pensions and consequently does not recognise actuarial losses of £488 million (2008: actuarial gains of £993 million). The defined benefit pension schemes' gross deficit totalled £834 million (2008: gross asset of £532 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The schemes' liabilities are calculated using the projected unit credit method, which takes into account projected earnings increases, using actuarial assumptions that give the best estimate of the future cash flows that will arise under the scheme liabilities. The resulting estimated cash flows are discounted at a rate equivalent to the market yield at the balance sheet date on high quality bonds with a similar duration and currency to the schemes' liabilities. In order to estimate the future cash flows, a number of financial and non-financial assumptions are made by management, changes to which could have a material impact upon the overall deficit or the net cost recognised in the income statement.

Two important assumptions are the rate of inflation and the expected lifetime of the schemes' members. The assumed rate of inflation affects the rate at which salaries are projected to grow and therefore the size of the pension that employees receive upon retirement and also the rate at which pensions in payment increase. Over the longer term rates of inflation can vary significantly. At 31 December 2009 it was assumed that the rate of inflation would be 3.4 per cent per annum (2008: 3.0 per cent), although if this was increased by 0.2 per cent the overall deficit would increase by approximately £284 million and the annual cost by approximately £22 million. A reduction of 0.2 per cent would reduce the overall deficit by approximately £274 million and the annual cost by approximately £22 million.

The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience. Assumptions used by management reflect recent longevity experience and extrapolate the improving trend. An increase of one year in the expected lifetime of scheme members would increase the overall deficit by approximately £197 million and the annual cost by approximately £15 million; a reduction of one year would reduce the overall deficit by approximately £204 million and the annual cost by approximately £15 million.

The size of the overall deficit is also sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variations. At 31 December 2009 the discount rate used was 5.7 per cent (2008: 6.3 per cent); a reduction of 0.2 per cent would increase the overall deficit by approximately £350 million and the annual cost by approximately £14 million, while an increase of 0.2 per cent would reduce the net deficit by approximately £333 million and the annual cost by approximately £14 million.

#### Goodwill

At 31 December 2009 the Group carried goodwill on its balance sheet totalling £850 million (2008: £1,556 million), substantially all of which relates to acquisitions made a number of years ago.

The Group reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place. The impairment review is performed by projecting future cash flows, excluding finance and tax, based upon budgets and plans and making appropriate assumptions about rates of growth and discounting these using a rate that takes into account prevailing market interest rates and the risks inherent in the business. If the present value of the projected cash flows is less than the carrying value of the underlying net assets and related goodwill an impairment charge is required in the income statement. This calculation requires the exercise of significant judgement by management; if the estimates made prove to be incorrect or performance does not meet expectations which affects the amount and timing of future cash flows, goodwill may become impaired in future periods. Further details are given in note 27.

#### Life insurance business

The Group carries in its balance sheet a value in-force asset, representing the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts, of £2,838 million at 31 December 2009 (2008: £3,083 million). The Group also recognises an acquired value in-force asset of £148 million at 31 December 2009 (2008: £201 million) representing contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers. The methodology used to value these assets is set out in accounting policy 2(o)(1). The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions. These assumptions are inherently uncertain and changes could significantly affect the value attributed to these assets.

At 31 December 2009 the Group carried substantial liabilities to holders of life, pensions and investment contracts in its balance sheet. Liabilities arising from insurance contracts and participating investment contracts were £32,735 million and £5,815 million respectively (2008: £30,004 million and £6,161 million) and those arising from non-participating investment contracts totalled £30,614 million (2008: £29,057 million). The methodology used to value the liabilities is described in accounting policy 2(o)(1). Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour.

The process for determining key assumptions that have been made for life insurance assets and liabilities at 31 December 2009 is detailed in notes 28 and 36. The impact on profit before tax of changes in key assumptions is detailed in note 37.

## Notes to the consolidated financial statements

**3 Critical accounting judgements and estimates** (continued)**General insurance business**

At 31 December 2009 the Group held a provision of £282 million (2008: £220 million) in respect of the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The methodology for valuing these liabilities, which includes the use of statistical techniques, is described in accounting policy 2(o)(2).

While management believes that the liability carried at year end is adequate, the application of statistical techniques requires significant judgement. An increase of 10 per cent in the cost of claims would result in the recognition of an additional loss of approximately £17 million. Similarly, an increase of 10 per cent in the ultimate number of such claims would lead to an additional loss of approximately £13 million; some relief would arise from reinsurance contracts held.

**Effective interest rate**

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

**4 Segmental analysis****Geographical areas**

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

	2009			2008		
	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
Total income	<b>24,351</b>	<b>2,303</b>	<b>26,654</b>	5,989	(717)	5,272
Total assets	<b>636,677</b>	<b>82,506</b>	<b>719,183</b>	605,254	99,554	704,808

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

**5 Net interest income**

	Weighted average effective interest rate		2009 £m	2008 £m
	2009 %	2008 %		
Interest and similar income:				
Loans and advances to customers	<b>3.66</b>	6.55	<b>16,229</b>	30,382
Loans and advances to banks	<b>0.86</b>	4.59	<b>468</b>	624
Debt securities held as loans and receivables	<b>1.83</b>	3.28	<b>690</b>	652
Lease and hire purchase receivables	<b>4.86</b>	6.76	<b>254</b>	299
Interest receivable on loans and receivables	<b>3.26</b>	6.37	<b>17,641</b>	31,957
Available-for-sale financial assets	<b>2.06</b>	4.53	<b>573</b>	2,059
Other	–	–	<b>56</b>	1,763
Total interest and similar income	<b>3.21</b>	6.54	<b>18,270</b>	35,779
Interest and similar expense:				
Deposits from banks	<b>0.76</b>	4.16	<b>(1,121)</b>	(2,884)
Customer deposits	<b>2.12</b>	3.71	<b>(4,245)</b>	(9,117)
Debt securities in issue	<b>2.31</b>	4.91	<b>(3,329)</b>	(10,149)
Subordinated liabilities	<b>4.50</b>	5.67	<b>(1,212)</b>	(1,450)
Liabilities under sale and repurchase agreements	<b>2.22</b>	4.89	<b>(1,261)</b>	(1,496)
Interest payable on liabilities held at amortised cost	<b>1.94</b>	4.35	<b>(11,168)</b>	(25,096)
Other	–	–	<b>(1,599)</b>	(629)
Total interest and similar expense	<b>2.20</b>	4.45	<b>(12,767)</b>	(25,725)
Net interest income			<b>5,503</b>	10,054

Included within interest and similar income is £969 million (2008: £351 million) in respect of impaired financial assets. Net interest income also includes a charge of £890 million (2008: £2,558 million) transferred from the cash flow hedging reserve.

## Notes to the consolidated financial statements

**6 Net fee and commission income**

	2009 £m	2008 £m
Fee and commission income:		
Current accounts	329	361
Insurance broking	239	254
Credit and debit card fees	212	253
Other	712	1,190
	<b>1,492</b>	<b>2,058</b>
Fee and commission expense	<b>(1,007)</b>	<b>(1,178)</b>
Net fee and commission income	<b>485</b>	<b>880</b>

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

**7 Net trading income**

	2009 £m	2008 £m
Foreign exchange translation gains (losses)	<b>(248)</b>	1,248
Gains on foreign exchange trading transactions	<b>105</b>	114
	<b>(143)</b>	1,362
Investment property losses (note 25)	<b>(112)</b>	(1,358)
Securities and other gains (losses)	<b>9,114</b>	(12,899)
Net trading income	<b>8,859</b>	(12,895)

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

	2009 £m	2008 £m
Net income (expense) arising on assets held at fair value through profit or loss:		
Debt securities, loans and advances to banks and customers	<b>773</b>	(373)
Equity shares	<b>9,510</b>	(11,538)
Total net income (expense) arising on assets designated at fair value through profit or loss	<b>10,283</b>	(11,911)
Net losses on financial instruments held for trading	<b>(1,169)</b>	(988)
Securities and other gains (losses)	<b>9,114</b>	(12,899)

**8 Insurance premium income**

	2009 £m	2008 £m
<b>Life insurance:</b>		
Gross premiums	<b>4,290</b>	4,549
Ceded reinsurance premiums	<b>(206)</b>	(186)
Net earned premiums	<b>4,084</b>	4,363
<b>Non-life insurance:</b>		
Gross premiums written	<b>794</b>	887
Ceded reinsurance premiums	<b>(66)</b>	–
Net premiums	<b>728</b>	887
Change in provision for gross unearned premiums	<b>86</b>	94
Change in provision for ceded unearned premiums	<b>15</b>	–
Net earned premiums	<b>829</b>	981
Total net earned premiums	<b>4,913</b>	5,344

## Notes to the consolidated financial statements

**8 Insurance premium income** (continued)

Life insurance gross written premiums can be further analysed as follows:

	2009 £m	2008 £m
Life and pensions	4,067	4,403
Annuities	223	129
Other	–	17
Gross premiums	<b>4,290</b>	<b>4,549</b>

Non-life insurance gross written premiums can be further analysed as follows:

	2009 £m	2008 £m
Credit protection	302	410
Home	492	469
Other	–	8
Gross written premiums	<b>794</b>	<b>887</b>

**9 Other operating income**

	2009 £m	2008 £m
Operating lease rental income	1,100	1,287
Rental income from investment properties (note 25)	177	241
Other rents receivable	19	26
Gains less losses on disposal of available-for-sale financial assets (note 47)	(3)	24
Gains on capital transactions	2,514	–
Movement in value of in-force business (note 28)	(178)	(300)
Other income	265	611
	<b>3,894</b>	<b>1,889</b>

During 2009, as part of the Group's management of capital, the Group exchanged certain existing subordinated debt securities for new securities as described below. These exchanges resulted in a gain on extinguishment of the existing liability of £2,514 million, being the difference between the carrying amount of the security extinguished and the fair value of the new security together with related fees and costs.

In January 2009, the Company redeemed preference shares in exchange for the issuance of new preference shares to its parent company, Lloyds Banking Group plc. This transaction gave rise to a gain of £705 million.

In February and March 2009, undated subordinated notes issued by a number of Group companies were exchanged for innovative tier 1 securities and unsecured notes, resulting in a gain of £1,380 million.

In July 2009, dated and undated subordinated liabilities issued by Clerical Medical Finance plc were exchanged for senior unsecured notes issued by Lloyds TSB Bank plc resulting in a gain of £260 million.

In October 2009, the Company redeemed its preference shares in exchange for the issue of ordinary shares, resulting in a loss of £24 million.

In November 2009, as part of the restructuring plan that was a requirement for EC approval of state aid received by the Lloyds Banking Group, the Group agreed to suspend the payment of coupons and dividends on certain preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. This suspension gave rise to a partial extinguishment of the original liability, equivalent to the present value of the suspended cash flows, and resulted in a gain of £193 million.

In addition to the other operating income above, during the year ended 31 December 2009 Bank of Scotland plc received a payment of £3,000 million (2008: £nil) from its fellow subsidiary Lloyds TSB Bank plc, to support its financial and reputational position and to facilitate the ongoing integration of the group's banking operations.

## Notes to the consolidated financial statements

**10 Insurance claims**

Insurance claims comprise:

	2009 £m	2008 £m
<b>Life insurance</b>		
Claims and surrenders:		
Gross	3,952	3,450
Reinsurers' share	(74)	(81)
	<b>3,878</b>	3,369
Change in insurance and participating investment contract liabilities:		
Gross	2,570	3,965
Reinsurers' share	(133)	21
	<b>2,437</b>	3,986
Change in gross non-participating investment contract liabilities	<b>4,399</b>	(11,304)
Change in unallocated surplus	<b>254</b>	(942)
Total life insurance	<b>10,968</b>	(4,891)
<b>Non-life insurance</b>		
Claims and claims paid:		
Gross	309	334
Reinsurers' share	(13)	-
	<b>296</b>	334
Change in liabilities:		
Gross	62	(73)
Reinsurers' share	(5)	(4)
	<b>57</b>	(77)
Total non-life insurance	<b>353</b>	257
Total insurance claims expense (credit)	<b>11,321</b>	(4,634)
Life insurance gross claims can also be analysed as follows:		
Deaths	367	295
Maturities	511	368
Surrenders	2,636	2,436
Annuities	170	122
Other	268	229
	<b>3,952</b>	3,450

A non-life insurance claims development table is included in note 36.

## Notes to the consolidated financial statements

**11 Operating expenses**

	2009 £m	2008 £m
Staff costs:		
Salaries	2,197	2,366
Social security costs	198	212
Pensions and other post-retirement benefit schemes (note 41)	279	272
Restructuring costs	225	80
Other staff costs	207	238
	<b>3,106</b>	3,168
Premises and equipment:		
Rent and rates	234	295
Hire of equipment	10	12
Repairs and maintenance	53	39
Other	144	161
	<b>441</b>	507
Other expenses:		
Communications and data processing	111	139
Advertising and promotion	158	293
Professional fees	198	157
Other	918	850
	<b>1,385</b>	1,439
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 30)	1,087	1,541
Amortisation of other intangible assets (note 29)	34	40
Amortisation of acquired value of in-force non-participating investment contracts (note 28)	53	27
	<b>1,174</b>	1,608
Goodwill impairment (note 27)	764	158
Total operating expenses	<b>6,870</b>	6,880

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

	2009	2008
UK	61,219	68,195
Overseas	4,767	6,481
	<b>65,986</b>	74,676

*Fees payable to the Company's auditors*

During the year the auditors earned the following fees:

	2009 £m	2008 £m
Fees payable for the audit of the Company's current year annual report	1.7	0.3
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	9.1	6.7
Other services supplied pursuant to legislation	1.1	7.1
Other services – audit related fees	0.1	–
Services relating to taxation	0.5	0.5
Services relating to corporate finance transactions	0.1	0.1
All other services	0.3	1.0
Total fees payable to the Company's auditors by the Group	<b>12.9</b>	15.7

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

	2009 £m	2008 £m
Audits of Group pension schemes	0.1	–
Reviews of the financial position of corporate and other borrowers	12.0	3.8

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



## Notes to the consolidated financial statements

**12 Impairment**

	2009 £m	2008 £m
Impairment losses on loans and receivables (note 23):		
Loans and advances to customers	<b>18,231</b>	9,857
Debt securities classified as loans and receivables	<b>1,284</b>	923
	<b>19,515</b>	10,780
Impairment of available-for-sale financial assets (note 47)	<b>620</b>	1,270
Other credit risk provisions (note 43)	<b>5</b>	–
Total impairment charged to the income statement	<b>20,140</b>	12,050

**13 Investments in joint ventures and associates**

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

	Joint ventures		Associates		Total	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Income	<b>698</b>	135	<b>5</b>	(233)	<b>703</b>	(98)
Expenses	<b>(544)</b>	(215)	<b>(96)</b>	(16)	<b>(640)</b>	(231)
Impairment	<b>(272)</b>	(267)	<b>(77)</b>	(53)	<b>(349)</b>	(320)
Insurance claims	<b>(465)</b>	(338)	–	–	<b>(465)</b>	(338)
Loss before tax	<b>(583)</b>	(685)	<b>(168)</b>	(302)	<b>(751)</b>	(987)
Tax	<b>24</b>	16	<b>2</b>	15	<b>26</b>	31
Share of post-tax results	<b>(559)</b>	(669)	<b>(166)</b>	(287)	<b>(725)</b>	(956)
Current assets	<b>2,744</b>	2,388	<b>606</b>	1,131	<b>3,350</b>	3,519
Non-current assets	<b>5,392</b>	5,470	<b>1,611</b>	1,557	<b>7,003</b>	7,027
Current liabilities	<b>(2,128)</b>	(1,562)	<b>(493)</b>	(615)	<b>(2,621)</b>	(2,177)
Non-current liabilities	<b>(5,726)</b>	(5,358)	<b>(1,613)</b>	(1,850)	<b>(7,339)</b>	(7,208)
Share of net assets	<b>282</b>	938	<b>111</b>	223	<b>393</b>	1,161
At 1 January	<b>938</b>	1,351	<b>223</b>	373	<b>1,161</b>	1,724
Additional investments	<b>140</b>	269	<b>12</b>	120	<b>152</b>	389
Acquisitions	<b>3</b>	60	<b>60</b>	40	<b>63</b>	100
Disposals	<b>(199)</b>	(62)	<b>(39)</b>	(14)	<b>(238)</b>	(76)
Share of post-tax results	<b>(559)</b>	(669)	<b>(166)</b>	(287)	<b>(725)</b>	(956)
Dividends paid	<b>(21)</b>	(12)	–	(8)	<b>(21)</b>	(20)
Exchange and other adjustments	<b>(20)</b>	1	<b>21</b>	(1)	<b>1</b>	–
At 31 December	<b>282</b>	938	<b>111</b>	223	<b>393</b>	1,161

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

The Group's main joint ventures at 31 December 2009 are as follows:

	Nature of business	Issued share capital	Group's interest	Statutory accounts made up to	Principal area of operations
esure Holdings Limited	Insurance	Ordinary Preference	70% 100%	31 December	UK
Sainsbury's Bank plc	Banking	Ordinary	50%	31 December	UK

All of the joint ventures listed above are incorporated in the UK. All interests in joint ventures are held by subsidiaries. Where entities have statutory accounts drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

On 11 February 2010, the Group announced the sale of its 70 per cent stake in esure Holdings Limited.

## Notes to the consolidated financial statements

**14 Profit (loss) on sale of businesses**

	2009 £m	2008 £m
Loss on the sale of Bank of Western Australia Limited and St. Andrews Australia Pty Limited	(100)	(845)
Profit on the sale of Insight Investment Management Limited	126	–
	<b>26</b>	<b>(845)</b>

On 12 August 2009 the Group announced the sale of Insight Investment Management Limited. The sale completed on 8 November 2009 and resulted in an estimated pre-tax profit on disposal of £126 million.

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

**15 Taxation****(a) Analysis of tax credit for the year**

	2009 £m	2008 £m
UK corporation tax:		
Current tax on loss for the year	(1)	286
Adjustments in respect of prior years	(203)	343
	(204)	629
Double taxation relief	10	49
	(194)	678
Foreign tax:		
Current tax on profit for the year	(110)	(219)
Adjustments in respect of prior years	33	(14)
	(77)	(233)
Current tax (charge) credit	(271)	445
Deferred tax (note 42):		
Origination and reversal of temporary differences	2,674	2,939
Adjustments in respect of prior years	95	25
	2,769	2,964
Tax credit	<b>2,498</b>	<b>3,409</b>

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

The above income tax credit is made up as follows:

Tax on policyholder returns	(196)	893
Tax on shareholder returns	2,694	2,516
	<b>2,498</b>	<b>3,409</b>

Notes to the consolidated financial statements

15 Taxation (continued)

(b) Factors affecting the tax credit for the year

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

	2009 £m	2008 £m
Loss before tax	<b>(12,376)</b>	(10,825)
Tax credit thereon at UK corporation tax rate of 28.0 per cent (2008: 28.5 per cent)	<b>3,465</b>	3,085
Factors affecting credit:		
Goodwill impairment	<b>(214)</b>	(30)
Disallowed and non-taxable items	<b>604</b>	(55)
Overseas tax rate differences	<b>(437)</b>	(20)
Gains exempted or covered by capital losses	<b>10</b>	135
Policyholder interests	<b>(141)</b>	639
Adjustments in respect of previous years	<b>(79)</b>	341
Impairment of financial instruments	<b>13</b>	(56)
Reduction in deferred tax from changes in tax rates	<b>-</b>	(11)
Effect of profit or loss in joint ventures and associates	<b>(200)</b>	(273)
Tax losses where no deferred tax provided	<b>(488)</b>	(310)
Other items	<b>(35)</b>	(36)
Tax credit on loss on ordinary activities	<b>2,498</b>	3,409

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

	Before tax amount £m	Tax (expense) benefit £m	After tax amount £m
<b>Year ended 31 December 2009</b>			
Movements in available-for-sale financial assets:			
Change in fair value	2,550	(673)	1,877
Transferred to income statement in respect of disposals	3	(1)	2
Transferred to income statement in respect of impairment	620	(174)	446
	<b>3,173</b>	<b>(848)</b>	<b>2,325</b>
Movement in cash flow hedges:			
Effective portion of changes in fair value taken to other comprehensive income	(613)	171	(442)
Net gains transferred to the income statement	895	(250)	645
	<b>282</b>	<b>(79)</b>	<b>203</b>
Currency translation differences and other movements	43	(4)	39
<b>Other comprehensive income for the year</b>	<b>3,498</b>	<b>(931)</b>	<b>2,567</b>
<b>Year ended 31 December 2008</b>			
Movements in available-for-sale financial assets:			
Change in fair value	(8,173)	2,276	(5,897)
Transferred to income statement in respect of disposals	(24)	7	(17)
Transferred to income statement in respect of impairment	1,270	(355)	915
	<b>(6,927)</b>	<b>1,928</b>	<b>(4,999)</b>
Movement in cash flow hedges:			
Effective portion of changes in fair value taken to other comprehensive income	(3,895)	1,093	(2,802)
Net gains transferred to the income statement	2,561	(717)	1,844
	<b>(1,334)</b>	<b>376</b>	<b>(958)</b>
Currency translation differences and other movements	189	(2)	187
<b>Other comprehensive income for the year</b>	<b>(8,072)</b>	<b>2,302</b>	<b>(5,770)</b>

## Notes to the consolidated financial statements

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

	2009 £m	2008 £m
Trading assets	<b>27,611</b>	22,571
Other financial assets at fair value through profit or loss	<b>74,297</b>	67,120
	<b>101,908</b>	89,691

These assets are comprised as follows:

	2009		2008	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to banks	5,577	635	3,344	849
Loans and advances to customers	13,307	–	5,689	–
Debt securities:				
Government securities	2,864	9,159	5,792	10,003
Other public sector securities	–	666	–	1,538
Bank and building society certificates of deposit	2,034	–	3,068	349
Asset-backed securities:				
Mortgage-backed securities	–	126	15	192
Other asset-backed securities	891	343	2,509	487
Corporate and other debt securities	2,938	7,034	2,154	8,596
	<b>8,727</b>	<b>17,328</b>	13,538	21,165
Equity shares:				
Listed	–	25,392	–	18,270
Unlisted	–	30,942	–	26,836
	–	<b>56,334</b>	–	45,106
	<b>27,611</b>	<b>74,297</b>	22,571	67,120

At 31 December 2009 £62,140 million (2008: £50,312 million) of trading and other financial assets at fair value through profit or loss had a contractual residual maturity of greater than one year.

Other financial assets at fair value through profit or loss include financial assets backing insurance contracts and investment contracts of £74,040 million (2008: £66,411 million) which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise.

The maximum exposure to credit risk at 31 December 2009 of the loans and advances to banks and customers designated at fair value through profit or loss was £635 million (2008: £849 million); the Group does not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk; this is determined by reference to the publicly available credit ratings of the instruments involved.

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

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

## Notes to the consolidated financial statements

**17 Derivative financial instruments**

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value, cash flow and net investment hedge approaches as described in note 54; and
- Derivatives held in policyholders funds as permitted by the investment strategies of those funds,

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 53.

The principal derivatives used by the Group are as follows:

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

Group	2009		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>Trading</b>			
Exchange rate contracts:			
Spot, forwards and futures	23,131	291	288
Currency swaps	92,342	4,302	545
	115,473	4,593	833
Interest rate contracts:			
Interest rate swaps	703,791	14,744	14,957
Forward rate agreements	796,099	401	381
Options purchased	19,999	763	–
Options written	25,832	–	706
Futures	12,303	2	7
	1,558,024	15,910	16,051
Credit derivatives	4,980	153	11
Equity and other contracts	14,489	1,329	878
Total derivative assets/liabilities held for trading	1,692,966	21,985	17,773
<b>Hedging</b>			
Derivatives designated as fair value hedges:			
Interest rate swaps	55,891	3,040	491
Cross currency swaps	26,162	635	108
	82,053	3,675	599
Derivatives designated as cash flow hedges:			
Interest rate swaps	229,390	5,246	7,277
Cross currency swaps	8,938	8	144
Options	2,754	4	5
Futures	5,137	1	3
	246,219	5,259	7,429
Total derivative assets/liabilities held for hedging	328,272	8,934	8,028
Total recognised derivative assets/liabilities	2,021,238	30,919	25,801

Notes to the consolidated financial statements

**17 Derivative financial instruments** (continued)

At 31 December 2009 £26,486 million of total recognised derivative assets of the Group and £22,106 million of total recognised derivative liabilities of the Group (2008: £42,627 million of assets and £29,945 million of liabilities) had a contractual residual maturity of greater than one year.

Group	2008		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>Trading</b>			
Exchange rate contracts:			
Spot, forwards and futures	79,211	2,209	3,690
Currency swaps	55,535	3,144	1,207
	134,746	5,353	4,897
Interest rate contracts:			
Interest rate swaps	831,891	19,417	21,267
Forward rate agreements	656,717	1,474	1,461
Options purchased	23,685	1,031	–
Options written	26,104	–	760
Futures	44,800	99	199
	1,583,197	22,021	23,687
Credit derivatives	7,150	748	33
Equity and other contracts	4,920	1,606	991
Total derivative assets/liabilities held for trading	1,730,013	29,728	29,608
<b>Hedging</b>			
Derivatives designated as fair value hedges:			
Interest rate swaps	68,474	4,738	574
Cross currency swaps	60,282	8,863	183
Options	103	–	55
	128,859	13,601	812
Derivatives designated as cash flow hedges:			
Interest rate swaps	323,971	7,218	8,337
Forward rate agreements	3,474	46	21
Cross currency swaps	10,484	1,037	123
Options	36,876	180	–
Futures	16	–	4
	374,821	8,481	8,485
Total derivative assets/liabilities held for hedging	503,680	22,082	9,297
Total recognised derivative assets/liabilities	2,233,693	51,810	38,905

Company	2009		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>Hedging</b>			
Derivatives designated as fair value hedges:			
Currency swaps	9,447	1,567	–
Interest rate swaps	1,416	144	43
Total recognised derivative assets/liabilities, held for hedging	10,863	1,711	43

At 31 December 2009 £1,711 million of total recognised derivative assets of the Company and £43 million of total recognised derivative liabilities of the Company (2008: £2,638 million of assets and £55 million of liabilities) had a contractual residual maturity of greater than one year.

Company	2008		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>Hedging</b>			
Derivatives designated as fair value hedges:			
Cross currency swaps	12,566	2,495	–
Interest rate swaps	1,430	143	55
Total recognised derivative assets/liabilities, held for hedging	13,996	2,638	55

## Notes to the consolidated financial statements

**18 Loans and advances to banks**

At 31 December 2009, the Group had loans and advances to banks of £98,524 million (2008: £16,796 million). No allowance for impaired loans was carried against these exposures at 31 December 2009 or 31 December 2008.

At 31 December 2009 £2,833 million (2008: £2,684 million) of loans and advances to banks had a contractual residual maturity of greater than one year.

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

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

**19 Loans and advances to customers**

	<b>2009</b>	2008
	<b>£m</b>	£m
Agriculture, forestry and fishing	<b>772</b>	854
Energy and water supply	<b>1,129</b>	890
Manufacturing	<b>6,836</b>	7,436
Construction	<b>11,169</b>	11,456
Transport, distribution and hotels	<b>21,496</b>	22,664
Postal and telecommunications	<b>1,449</b>	958
Property companies	<b>65,144</b>	63,807
Financial, business and other services	<b>36,613</b>	55,196
Personal:		
Mortgages	<b>252,745</b>	263,644
Other	<b>19,518</b>	23,854
Lease financing	<b>4,990</b>	5,655
Hire purchase	<b>3,486</b>	4,700
	<b>425,347</b>	461,114
Allowance for impairment losses (note 23)	<b>(21,272)</b>	(10,693)
	<b>404,075</b>	450,421

At 31 December 2009 £342,904 million (2008: £316,150 million) of loans and advances to customers of the Group had a contractual residual maturity of greater than one year.

The carrying value of loans and advances to customers of the Group that are subject to repurchase agreements was £9,559 million at 31 December 2009 (2008: £56,858 million) all of which the secured party is permitted by contract or custom to sell or repledge.

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

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

## Notes to the consolidated financial statements

**19 Loans and advances to customers**

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

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

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

	<b>2009</b> <b>£m</b>	2008 £m
Not later than 1 year	<b>644</b>	487
Later than 1 year and not later than 5 years	<b>1,511</b>	2,180
Later than 5 years	<b>2,835</b>	2,988
	<b>4,990</b>	5,655

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2009 and 2008 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables, included in the allowance for impairment losses for the Group is £103 million (2008: £105 million).



## Notes to the consolidated financial statements

**20 Securitisations and covered bonds**

The Group's principal securitisation and covered bonds programmes, together with the balances of the advances subject to notes in issue at 31 December, are listed below. The notes in issue are reported in note 35.

<i>Securitisation</i>	<i>Type of asset</i>	2009		2008 <sup>1</sup>	
		Gross assets securitised £m	Notes in issue £m	Gross assets securitised £m	Notes in issue £m
Permanent	UK residential mortgages	38,915	31,878	38,602	38,490
Balliol	UK residential mortgages	12,771	12,819	12,701	12,549
Pendeford	UK residential mortgages	12,240	9,174	12,894	9,870
Trinity	UK residential mortgages	11,033	11,466	12,975	12,638
Mound	UK residential mortgages	8,779	7,153	10,147	8,238
Picard	US residential mortgage-backed securities	7,897	7,897	–	–
Brae	UK residential mortgages	7,838	9,588	9,213	9,955
Deva	UK residential mortgages	6,691	6,906	6,747	6,703
Wolfhound	Irish residential mortgages	6,522	6,585	4,083	4,107
Penarth	Credit card receivables	5,155	2,699	4,189	2,633
Candide	Dutch residential mortgages	4,812	4,834	5,569	5,704
Dakota	UK residential mortgages	3,832	3,826	3,988	3,885
Handbridge	Personal loans	3,730	2,613	–	–
Tioba	UK residential mortgages	2,094	2,249	2,647	2,568
Prominent	Commercial loans	928	976	1,053	1,149
Bella	Motor vehicle loans	443	470	–	–
Other	UK residential mortgages	64	169	68	179
		<b>133,744</b>	<b>121,302</b>	124,876	118,668
Less held by the Group			<b>(87,359)</b>		(75,960)
Total securitisation (note 35)			<b>33,943</b>		42,708
<i>Covered bonds</i>	<i>Type of asset</i>				
Covered Bonds	UK residential mortgages	61,537	49,644	51,756	49,408
Covered Bonds	UK social housing loans	3,407	2,976	3,475	2,919
		<b>64,944</b>	<b>52,620</b>	55,231	52,327
Less held by the Group			<b>(23,060)</b>		(18,305)
Total covered bonds (note 35)			<b>29,560</b>		34,022
Total securitisations and covered bonds			<b>63,503</b>		76,730

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

*Securitisation*

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

*Covered bonds*

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

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

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

## Notes to the consolidated financial statements

**21 Special purpose entities**

In addition to the SPEs disclosed in note 20, which are used for securitisation and covered bond programmes, the Group sponsors two asset-backed conduits, Grampian and Landale, which invest in asset backed securities and other assets. All the external assets in these conduits are consolidated on the Groups' balance sheet. The total consolidated exposures in these conduits are set out in the table below:

	<b>Grampian £m</b>	<b>Landale £m</b>	<b>Total £m</b>
<b>At 31 December 2009</b>			
Debt securities classified as loans and receivables (note 22)	<b>9,924</b>	<b>698</b>	<b>10,622</b>
Total assets	<b>9,924</b>	<b>698</b>	<b>10,622</b>
	Grampian £m	Landale £m	Total £m
<b>At 31 December 2008</b>			
Debt securities classified as:			
Loans and receivables (note 22)	17,703	–	17,703
Available-for-sale financial assets (note 24)	–	681	681
Total assets	17,703	681	18,384

**22 Debt securities classified as loans and receivables**

Debt securities accounted for as loans and receivables comprise:

	<b>2009 £m</b>	2008 £m
Asset-backed securities:		
Mortgage-backed securities	<b>15,555</b>	18,273
Other asset-backed securities	<b>16,705</b>	20,783
Corporate and other debt securities	<b>1,208</b>	920
	<b>33,468</b>	39,976
Allowance for impairment losses (note 23)	<b>(2,000)</b>	(923)
	<b>31,468</b>	39,053

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

Included above are £10,622 million (2008: £17,703 million) held in Landale and Grampian, the Group's asset-backed commercial paper conduits (note 21).

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

## Notes to the consolidated financial statements

**23 Allowance for impairment losses on loans and receivables**

	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January 2008	3,373	–	3,373
Exchange and other adjustments	135	–	135
Advances written off	(2,515)	–	(2,515)
Recoveries of advances written off in previous years	107	–	107
Disposals of subsidiary undertakings	(115)	–	(115)
Unwinding of discount	(149)	–	(149)
Charge to the income statement (note 12)	9,857	923	10,780
At 31 December 2008	10,693	923	11,616
Exchange and other adjustments	162	(172)	(10)
Advances written off	(7,459)	(35)	(7,494)
Recoveries of advances written off in previous years	36	–	36
Unwinding of discount	(391)	–	(391)
Charge to the income statement (note 12)	18,231	1,284	19,515
<b>At 31 December 2009</b>	<b>21,272</b>	<b>2,000</b>	<b>23,272</b>

**24 Available-for-sale financial assets**

	2009 £m	2008 £m
Debt securities:		
Government securities	326	380
Bank and building society certificates of deposit	285	2,958
Asset-backed securities:		
Mortgage-backed securities	17	17
Other asset-backed securities	79	843
Corporate and other debt securities	18,935	21,589
	19,642	25,787
Equity shares:		
Listed	98	112
Unlisted	1,851	2,149
	1,949	2,261
	21,591	28,048

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

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

At 31 December 2009 £18,817 million (2008: £19,305 million) of available-for-sale financial assets had a contractual residual maturity of greater than one year.

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

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in accounting policy 2(h). Included in available-for-sale assets at 31 December 2009 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £329 million and in respect of which no collateral was held. In addition, included in available-for-sale assets at 31 December 2009 are equity securities individually determined to be impaired whose gross amount before impairment allowances was £nil. Comparatives have not been disclosed in relation to these amounts as it is impracticable to recreate this information.

## Notes to the consolidated financial statements

**25 Investment properties**

	2009 £m	2008 £m
At 1 January	<b>3,045</b>	4,731
Exchange and other adjustments	–	1
Additions:		
Acquisitions of new properties	–	148
Additional expenditure on existing properties	<b>69</b>	64
Total additions	<b>69</b>	212
Disposals	<b>(537)</b>	(541)
Changes in fair value (note 7)	<b>(112)</b>	(1,358)
Disposal of businesses	<b>(48)</b>	–
At 31 December	<b>2,417</b>	3,045

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

In addition, the following amounts have been recognised in the income statement:

	2009 £m	2008 £m
Rental income (note 9)	<b>177</b>	241
Direct operating expenses arising from investment properties that generate rental income	<b>25</b>	15
Capital expenditure in respect of investment properties:		
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	<b>48</b>	20

**26 Investment in subsidiary undertakings**

	2009 £m	2008 £m
At 1 January	<b>15,783</b>	14,475
Additional capital injections and transfers	<b>20,189</b>	5,500
Impairment	<b>(9,844)</b>	(4,192)
At 31 December	<b>26,128</b>	15,783

A reassessment of the carrying value of the Company's investment in Bank of Scotland plc resulted in the recognition of an impairment charge of £9,844 million which represents the write down of the Company's investment to its recoverable amount.

Recoverable amount is based on the fair value less cost to sell and was determined by using a discounted cash flow valuation technique. This calculation uses projections of future cash flows based on management's plans covering a five year period. These cash flows are based on past experience and have been adjusted to take into account expected future market conditions. Cash flows beyond the five year period have been extrapolated using a steady 4.5 per cent rate of increase. The expected cash flows have been discounted at a rate of 17.75 per cent which has been determined to be in line with available market information.

The impairment charge of £9,844 million (2008: £4,192 million) in respect of the Company's investment in Bank of Scotland plc was triggered by the continued deterioration in the financial performance of Bank of Scotland plc principally due to increased impairment losses in its lending portfolios.

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

	Company's interest in ordinary share capital and voting rights	Country of incorporation	Principal business
Bank of Scotland plc	100%	UK	Banking, financial and related services
HBOS Insurance & Investment Group Limited	100%	UK	Investment holding

The principal area of operation for each of the above group undertakings is the United Kingdom.

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

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

Amounts owed by Group undertakings of £46,186 million (2008: £50,157 million) include £12,027 million (2008: £12,499 million) of subordinated liabilities loaned to subsidiaries.

## Notes to the consolidated financial statements

**27 Goodwill**

	2009 £m	2008 £m
At 1 January	<b>1,556</b>	1,940
Exchange and other adjustments	<b>1</b>	30
Acquired through business combinations	<b>99</b>	–
Disposals	<b>(42)</b>	(256)
Impairment charged to the income statement	<b>(764)</b>	(158)
<b>At 31 December</b>	<b>850</b>	1,556
Cost*	<b>1,838</b>	1,780
Accumulated impairment losses	<b>(988)</b>	(224)
<b>At 31 December</b>	<b>850</b>	1,556

\*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 recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £850 million (2008: £1,556 million), £478 million (or 56 per cent of the total) has been allocated to insurance and investment businesses and £356 million (or 42 per cent of the total) to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2009 has been based upon value in use. This calculation uses cash flow projections based upon the 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 extrapolated using a growth rate of 2.5 per cent reflecting management's view of the expected future long-term trend in growth rate of the respective economies concerned, predominantly being in the UK, and the long-term performances of the businesses concerned. The discount rate used in discounting the projected cash flows is 12.5 per cent (pre-tax) reflecting, inter alia, the perceived risks within those businesses. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount to fall below the balance sheet carrying value.

The goodwill impairment charge of £764 million (2008: £158 million) includes the write-down, triggered primarily by deteriorating economic conditions, of the goodwill arising on the acquisition of Equitable Life Assurance Services (£368 million) and Lex Vehicle Leasing Services (£265 million).

**28 Value of in-force business**

The gross value of in-force business asset in the consolidated balance sheet is as follows:

	2009 £m	2008 £m
Acquired value of in-force non-participating investment contracts	<b>148</b>	201
Value of in-force insurance and participating investment contracts	<b>2,838</b>	3,083
	<b>2,986</b>	3,284

The movement in the acquired value of in-force non-participating investment contracts over the year is as follows:

	2009 £m	2008 £m
At 1 January	<b>201</b>	230
Amortisation taken to income statement (note 11)	<b>(53)</b>	(27)
Disposal of businesses	–	(2)
At 31 December	<b>148</b>	201

## Notes to the consolidated financial statements

**28 Value of in-force business** (continued)

The movement in the value of in-force insurance and participating investment contracts over the year is as follows:

	2009 £m	2008 £m
At 1 January	<b>3,083</b>	3,275
Movements in the year:		
New business	<b>376</b>	523
Existing business:		
Expected return	<b>(342)</b>	(272)
Operating experience variances	<b>53</b>	(185)
Operating assumption changes	<b>(419)</b>	(159)
Economic variance	<b>154</b>	(488)
Transfers from investment contracts to insurance contracts	–	281
Movement in value of in-force business taken to income statement (note 9)	<b>(178)</b>	(300)
Transfer to deferred costs (note 31)	–	(117)
Exchange and other adjustments	<b>(67)</b>	225
At 31 December	<b>2,838</b>	3,083

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown contributes to profit before tax, which would also contain changes in the other assets and liabilities of the relevant businesses. Economic variance is the element of earnings which is generated from changes to economic experience in the period and to assumptions over time. The presentation of economic variance includes the impact of financial market conditions being different at the end of the reporting period from those included in assumptions used to calculate new and existing business returns.

The principal features of the methodology and process used for determining key assumptions used in the calculation of the value of in-force business are set out below:

**Economic assumptions**

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn the risk-free rate and all cash flows are discounted at the risk-free rate.

A market consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date. The risk-free rate used for the value of financial options and guarantees is defined as the spot yield derived from the relevant government bond yield curve in line with FSA realistic balance sheet assumptions.

The liabilities in respect of the Group's UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds. In accordance with the approach adopted in December 2008, the value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for liquidity in respect of these corporate bond holdings. The liquidity premium is estimated to be 75 basis points as at 31 December 2009 (31 December 2008: 150 basis points). The reduction in the liquidity premium over 2009 has offset gains made on the assets backing the annuity liabilities, reducing the benefit within the results from the reduction in corporate bond spreads.

The risk-free rate assumed in valuing the non-annuity in-force business is the 15 year government bond yield for the appropriate territory. The risk-free rate assumed in valuing the in-force asset for the UK annuity business is presented as a single risk-free rate to allow a better comparison to the rate used for other business. That single risk-free rate has been derived to give the equivalent value to the UK annuity book, had that book been valued using the UK gilt yield curve increased to reflect the liquidity premium described above.

The table below shows the range of resulting yields and other key assumptions at 31 December for UK business:

	2009 %	2008 %
Risk-free rate (value of in-force non-annuity business)	<b>4.45</b>	3.74
Risk-free rate (value of in-force annuity business)	<b>5.05</b>	5.18
Risk-free rate (financial options and guarantees)	<b>0.87-4.76</b>	3.74
Retail price inflation	<b>3.64</b>	2.49
Expense inflation	<b>4.42</b>	3.00

**Non-market risk**

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk and the With Profit Fund there are asymmetries in the range of potential outcomes for which an explicit allowance is made.

**Non-economic assumptions**

Future mortality, morbidity, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and represent management's best estimate of likely future experience.

Further information about the effect of changes in key assumptions is given in note 37.

## Notes to the consolidated financial statements

**29 Other intangible assets**

<b>Group</b>	Brands £m	Capitalised software enhance- ments £m	Total £m
Cost:			
At 1 January 2008	32	263	295
Exchange and other adjustments	(1)	–	(1)
Additions	2	57	59
Disposals	(9)	–	(9)
At 31 December 2008	24	320	344
Exchange and other adjustments	4	–	4
Additions	–	15	15
Disposals	(4)	(25)	(29)
<b>At 31 December 2009</b>	<b>24</b>	<b>310</b>	<b>334</b>
Accumulated amortisation:			
At 1 January 2008	12	161	173
Exchange and other adjustments	–	17	17
Charge for the year	5	35	40
Disposals	(3)	–	(3)
At 31 December 2008	14	213	227
Exchange and other adjustments	2	–	2
Charge for the year (note 11)	7	27	34
Disposals	(4)	(22)	(26)
<b>At 31 December 2009</b>	<b>19</b>	<b>218</b>	<b>237</b>
<b>Balance sheet amount at 31 December 2009</b>	<b>5</b>	<b>92</b>	<b>97</b>
Balance sheet amount at 31 December 2008	10	107	117
<b>Company</b>		Brands £m	Total £m
Cost:			
At 1 January 2008		10	10
At 31 December 2008		10	10
<b>At 31 December 2009</b>		<b>10</b>	<b>10</b>
Accumulated amortisation:			
At 1 January 2008		4	4
Charge for the year		2	2
At 31 December 2008		6	6
Charge for the year		2	2
<b>At 31 December 2009</b>		<b>8</b>	<b>8</b>
<b>Balance sheet amount at 31 December 2009</b>		<b>2</b>	<b>2</b>
Balance sheet amount at 31 December 2008		4	4

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

## Notes to the consolidated financial statements

**30 Tangible fixed assets**

	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:				
At 1 January 2008	1,733	2,682	6,483	10,898
Exchange and other adjustments	17	94	96	207
Additions	180	479	1,488	2,147
Disposals	(255)	(480)	(1,733)	(2,468)
At 31 December 2008	1,675	2,775	6,334	10,784
Exchange and other adjustments	(2)	(10)	(78)	(90)
Additions	59	132	1,478	1,669
Disposals	(123)	(139)	(2,511)	(2,773)
<b>At 31 December 2009</b>	<b>1,609</b>	<b>2,758</b>	<b>5,223</b>	<b>9,590</b>
Accumulated depreciation and impairment:				
At 1 January 2008	628	1,886	1,840	4,354
Exchange and other adjustments	8	31	34	73
Charge for the year	63	300	1,178	1,541
Impairment losses on property under construction	10	–	–	10
Disposals	(45)	(274)	(685)	(1,004)
At 31 December 2008	664	1,943	2,367	4,974
Exchange and other adjustments	2	(7)	5	–
Charge for the year (note 11)	57	195	835	1,087
Disposals	(17)	(103)	(1,454)	(1,574)
<b>At 31 December 2009</b>	<b>706</b>	<b>2,028</b>	<b>1,753</b>	<b>4,487</b>
<b>Balance sheet amount at 31 December 2009</b>	<b>903</b>	<b>730</b>	<b>3,470</b>	<b>5,103</b>
Balance sheet amount at 31 December 2008	1,011	832	3,967	5,810

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

	2009 £m	2008 £m
Receivable within 1 year	428	849
1 to 5 years	1,376	2,245
Over 5 years	51	52
	<b>1,855</b>	<b>3,146</b>

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

In addition, total future minimum sub-lease income of £7 million at 31 December 2009 (2008: £18 million) is expected to be received under non-cancellable sub-leases of the Group's premises.

**31 Other assets**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Assets arising from reinsurance contracts held (note 36)	1,456	1,396	–	–
Deferred acquisition costs	1,023	1,181	–	–
Settlement balances	1,435	1,063	–	–
Other assets and prepayments	6,280	3,614	1,847	232
	<b>10,194</b>	<b>7,254</b>	<b>1,847</b>	<b>232</b>



## Notes to the consolidated financial statements

**31 Other assets** (continued)

Deferred acquisition costs of the Group:	2009 £m	2008 £m
At 1 January	1,181	1,101
Acquisition costs deferred during the year	349	418
Amortisation	(506)	(312)
Transfers from investment contracts to insurance contracts	–	(144)
Movement in deferred acquisition costs charged to the income statement	(157)	(38)
Transfers from value of in-force business asset (note 28)	–	117
Disposal of businesses	–	(3)
Exchange and other adjustments	(1)	4
At 31 December	<u>1,023</u>	<u>1,181</u>

**32 Deposits from banks**

Deposits from banks	2009 £m	2008 £m
	<u>179,064</u>	<u>97,150</u>

At 31 December 2009 £11,099 million (2008: £2,287 million) of deposits from banks had a contractual residual maturity of greater than one year.

Included in deposits from banks of the Group were amounts received from counterparties under repurchase agreements which are treated as secured borrowings and amounted to £70,935 million at 31 December 2009 (2008: £77,273 million).

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

**33 Customer deposits**

Customer deposits	2009 £m	2008 £m
Non-interest bearing current accounts	2,471	1,935
Interest bearing current accounts	46,149	45,210
Savings and investment accounts	137,902	142,218
Other customer deposits	45,501	48,086
Customer deposits	<u>232,023</u>	<u>237,449</u>

At 31 December 2009 £19,011 million (2008: £11,802 million) of customer deposits had a contractual residual maturity of greater than one year.

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

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

**34 Trading and other liabilities at fair value through profit or loss**

Trading and other liabilities at fair value through profit or loss	2009 £m	2008 £m
Liabilities held at fair value through profit or loss	–	–
Trading liabilities	27,372	18,851
Trading and other liabilities at fair value through profit or loss	<u>27,372</u>	<u>18,851</u>

At 31 December 2009 £131 million (2008: £nil) of trading and other liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

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

Notes to the consolidated financial statements

**35 Debt securities in issue**

	2009 £m	2008 £m
Medium-term notes	36,455	48,630
Covered bonds (note 20)	29,560	34,022
Certificates of deposit	6,413	50,956
Securitisation notes (note 20)	33,943	42,708
Commercial paper	12,786	12,132
<b>Total debt securities in issue</b>	<b>119,157</b>	<b>188,448</b>

All debt securities in issue are held at amortised cost.

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

At 31 December 2009 £76,483 million (2008: £97,341 million) of debt securities in issue had a contractual residual maturity of greater than one year.

**36 Liabilities arising from insurance contracts and participating investment contracts**

	2009			2008		
	Gross £m	Reinsurance* £m	Net £m	Gross £m	Reinsurance* £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	32,735	(1,425)	31,310	30,004	(1,387)	28,617
Participating investment contracts	5,815	(2)	5,813	6,161	–	6,161
	<b>38,550</b>	<b>(1,427)</b>	<b>37,123</b>	36,165	(1,387)	34,778
Non-life insurance contracts (see (2) below):						
Unearned premiums	402	(20)	382	488	(5)	483
Claims outstanding	282	(9)	273	220	(4)	216
	<b>684</b>	<b>(29)</b>	<b>655</b>	708	(9)	699
	<b>39,234</b>	<b>(1,456)</b>	<b>37,778</b>	36,873	(1,396)	35,477

\*Reinsurance assets are reported within other assets (note 31).

At 31 December 2009 £33,319 million (31 December 2008: £32,708 million) of liabilities arising from insurance contracts and participating investment contracts had an expected residual maturity of greater than one year.

**(1) Life insurance**

The movement in life insurance contract and participating investment contract liabilities over the year can be analysed as follows:

	Insurance contracts	Participating investment contracts	Gross £m	Reinsurance £m	Net £m
At 1 January 2008	26,043	7,192	33,235	(959)	32,276
New business	3,219	9	3,228	–	3,228
Changes in existing business	(6,184)	(1,362)	(7,546)	(143)	(7,689)
Transfer from investment contracts to insurance contracts	6,203	–	6,203	–	6,203
Exchange and other adjustments	743	322	1,065	(286)	779
Disposal of businesses	(20)	–	(20)	1	(19)
At 31 December 2008	30,004	6,161	36,165	(1,387)	34,778
New business	2,255	10	2,265	(1)	2,264
Changes in existing business	638	(333)	305	(132)	173
Exchange and other adjustments	(162)	(23)	(185)	93	(92)
<b>At 31 December 2009</b>	<b>32,735</b>	<b>5,815</b>	<b>38,550</b>	<b>(1,427)</b>	<b>37,123</b>

Liabilities for life insurance contracts and participating investment contracts can be split into with-profit fund liabilities, accounted for using the FSA's realistic capital regime (realistic liabilities) and non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

## Notes to the consolidated financial statements

**36 Liabilities arising from insurance contracts and participating investment contracts** (continued)

	2009			2008		
	With-profit Fund £m	Non-profit Fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	4,283	28,452	32,735	5,394	24,610	30,004
Participating investment contracts	5,785	30	5,815	6,161	–	6,161
	<b>10,068</b>	<b>28,482</b>	<b>38,550</b>	<b>11,555</b>	<b>24,610</b>	<b>36,165</b>

**With-profit fund realistic liabilities***(I) Business description*

The Group has a with-profit fund within Clerical Medical Investment Group Limited containing both insurance contracts and participating investment contracts.

The primary purpose of the conventional and unitised business written in the with-profit fund is to provide a long-term smoothed investment vehicle to the policyholder, protecting them against short-term market fluctuations. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, the shareholders receiving the balance. The policyholder is also usually insured against death and the policy may carry a guaranteed annuity option at maturity.

*(II) Method of calculation of liabilities*

With-profit liabilities are stated at their realistic value, the main components of which are:

- With-profit benefit reserve;
- Cost of options and guarantees;
- Deductions levied against asset shares; and
- Impact of the smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market consistent basis. The calculation of realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 28.

*(III) Assumptions*

Key assumptions used in the calculation of with-profit liabilities, and the processes for determining these, are:

**Investment returns and discount rates**

The realistic capital regime dictates that with-profit fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant government bond yield curve.

**Guaranteed annuity options**

Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract. For contracts that contain such options the key assumptions in determining the cost of the options are economic conditions in which the option has value, mortality rates and take-up rates of the options. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

**Investment volatility**

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical volatility where it is not possible to observe meaningful prices.

**Mortality**

The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.

**Lapse rates (persistency)**

Lapse rates refer to the rate of policy termination or the rate at which policyholders stop paying regular premiums due under the contract.

Historical persistency experience is analysed using statistical techniques. As experience can vary considerably between different product types and for contracts that have been in force for different periods, the data is broken down into broadly homogenous groups for the purposes of this analysis.

The most recent experience is considered along with the results of previous analyses and management's views on future experience, taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions, in order to determine a 'best estimate' view of what persistency will be. In determining this best estimate view a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration, any known or expected trends in underlying data and relevant published market data.

**Non-profit fund liabilities***(I) Business description*

The Group principally writes the following types of life insurance contracts within its UK non-profit funds. Shareholder profits on this type of business arise from management fees and other policy charges.

*Unit-linked business* – This includes unit-linked pensions and unit-linked bonds, the primary purpose of which is to provide an investment vehicle where the policyholder is also insured against death.

## Notes to the consolidated financial statements

**36 Liabilities arising from insurance contracts and participating investment contracts (continued)**

*Life insurance* – The policyholder is insured against death or permanent disability, usually for predetermined amounts. Such business includes whole of life and term assurance and long-term creditor policies.

*Annuities* – The policyholder is entitled to payments for the duration of their life and is therefore insured against surviving longer than expected.

German insurance and pensions business, written through the Group's subsidiary Heidelberger Leben, comprises policies similar to the UK definitions above, except that there is participation by the policyholder in the investment, insurance and expense profits of Heidelberger Leben. A minimum level of policyholder participation is prescribed by German law. The following types of life insurance contracts are written:

Traditional and unit linked endowment and pensions business  
Life insurance business

*(II) Method of calculation of liabilities*

The non-profit fund liabilities are determined on the basis of recognised actuarial methods and consistent with the approach required by regulatory rules. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting the cash flows back to the valuation date allowing for probabilities of occurrence.

*(III) Assumptions*

Generally, assumptions used to value non-profit fund liabilities are prudent in nature and therefore contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgement and reflects management's views on the inherent level of uncertainty. The key assumptions used in the measurement of non-profit fund liabilities are:

**Interest rates**

The rates used are derived in accordance with the guidelines set by local regulatory bodies. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the local regulatory guidelines, including reductions made to the available yields to allow for default risk based upon the credit rating of the securities allocated to the insurance liability.

**Mortality and morbidity**

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and include a margin for adverse deviation.

**Lapse rates (persistence)**

Lapse rates are allowed for on some non-profit fund contracts. The process for setting these rates is as described for with-profit liabilities, however a prudent scenario is assumed by the inclusion of a margin for adverse deviation within the non-profit fund liabilities.

**Maintenance expenses**

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation.

**Key changes in assumptions**

A detailed review of the Group's assumptions in 2009 resulted in the following key impacts on profit before tax:

Change in persistence assumptions (£156 million decrease)  
Alignment of expense assumptions on integration into Lloyds Banking Group (£203 million decrease)

These amounts include the impacts of movements in liabilities and value of in-force business in respect of insurance contracts and participating investment contracts.

**(2) Non-life insurance**

Gross non-life insurance contract liabilities are analysed by line of business as follows:

	2009 £m	2008 £m
Credit protection	307	348
Home	377	356
Other	–	4
	<b>684</b>	<b>708</b>

For non-life insurance contracts, the methodology and assumptions used in relation to determining the bases of the earned premium and claims provisioning levels are derived for each individual underwritten product. Assumptions are intended to be neutral estimates of the most likely or expected outcome. There has been no significant change in the assumptions and methodologies used for setting reserves.

The reserving methodology and associated assumptions are set out below:

The unearned premium reserve is determined on a basis that reflects the length of time for which contracts have been in force and the projected incidence of risk over the term of each contract.

Claims outstanding comprise those claims that have been notified and those that have been incurred but not reported. Claims incurred but not reported are determined based on the historical emergence of claims and their average cost. The notified claims element represents the best estimate of the cost of claims reported using projections and estimates based on historical experience.

## Notes to the consolidated financial statements

**36 Liabilities arising from insurance contracts and participating investment contracts** (continued)

The movements in non-life insurance contract liabilities and reinsurance assets over the year have been as follows:

	Gross £m	Reinsurance £m	Net £m
<b>Provisions for unearned premiums</b>			
At 1 January 2008	528	(3)	525
Increase in the year	663	(33)	630
Release in the year	(696)	31	(665)
Disposal of businesses	(8)	–	(8)
Exchange and other adjustments	1	–	1
At 31 December 2008	488	(5)	483
Increase in the year	<b>670</b>	<b>(66)</b>	<b>604</b>
Release in the year	<b>(756)</b>	<b>51</b>	<b>(705)</b>
<b>At 31 December 2009</b>	<b>402</b>	<b>(20)</b>	<b>382</b>

These provisions represent the liability for short-term insurance contracts for which the Group's obligations are not expired at the year end.

	Gross £m	Reinsurance £m	Net £m
<b>Claims outstanding</b>			
At 1 January 2008	293	–	293
Cash paid for claims settled in the year	(304)	8	(296)
Increase (decrease) in liabilities:			
Arising from current year claims	194	(9)	185
Arising from prior year claims	37	(3)	34
At 31 December 2008	220	(4)	216
Cash paid for claims settled in the year	<b>(275)</b>	<b>13</b>	<b>(262)</b>
Increase (decrease) in liabilities:			
Arising from current year claims	<b>329</b>	<b>(16)</b>	<b>313</b>
Arising from prior year claims	<b>8</b>	<b>(2)</b>	<b>6</b>
<b>At 31 December 2009</b>	<b>282</b>	<b>(9)</b>	<b>273</b>
Notified claims	<b>127</b>	<b>(5)</b>	<b>122</b>
Incurred but not reported	<b>155</b>	<b>(4)</b>	<b>151</b>
<b>At 31 December 2009</b>	<b>282</b>	<b>(9)</b>	<b>273</b>
Notified claims	105	(2)	103
Incurred but not reported	115	(2)	113
At 31 December 2008	220	(4)	216

## Notes to the consolidated financial statements

**36 Liabilities arising from insurance contracts and participating investment contracts (continued)****Non-life insurance claims development table**

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

**Non-life insurance all risks – net**

	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	Total £m
<b>Accident year</b>						
Estimate of ultimate claims costs:						
At end of accident year	328	363	482	312	<b>366</b>	<b>1,851</b>
One year later	278	316	391	266		
Two years later	277	313	383			
Three years later	274	311				
Four years later	275					
Current estimate of cumulative claims	275	311	383	266	<b>366</b>	<b>1,601</b>
Cumulative payments to date	(272)	(309)	(378)	(237)	<b>(151)</b>	<b>(1,347)</b>
Liability recognised in the balance sheet	3	2	5	29	<b>215</b>	<b>254</b>
Liability in respect of earlier years						<b>19</b>
Total liability included in the balance sheet						<b>273</b>

The liability of £273 million shown in the above table excludes £9 million of unallocated claims handling expenses.

**37 Life insurance sensitivity analysis**

The following table demonstrates the effect of changes in key assumptions on profit before tax and equity disclosed in these financial statements assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated. These amounts include movements in assets, liabilities and the value of the in-force business in respect of insurance contracts and participating investment contracts. The impact is shown in one direction but can be assumed to be reasonably symmetrical.

	Change in variable	Increase (reduction) in profit before tax	Increase (reduction) in equity £m
Non-annuitant mortality <sup>1</sup>	5% reduction	55	39
Annuitant mortality <sup>2</sup>	5% reduction	(38)	(27)
Lapse rates <sup>3</sup>	10% reduction	129	93
Future maintenance and investment expenses <sup>4</sup>	10% reduction	110	79
Risk-free rate <sup>5</sup>	0.25% reduction	8	5
Guaranteed annuity option take-up <sup>6</sup>	5% addition	(2)	(1)
Equity investment volatility <sup>7</sup>	1% addition	(4)	(3)
Widening of credit default spreads on corporate bonds <sup>8</sup>	0.25% addition	(39)	(28)
Increase in liquidity premium <sup>9</sup>	0.10% addition	21	15

Assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and statutory reserving bases.

<sup>1</sup>This sensitivity shows the impact of reducing mortality and morbidity rates on non-annuity business to 95 per cent of the expected rate.

<sup>2</sup>This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

<sup>3</sup>This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

<sup>4</sup>This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

<sup>5</sup>This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

<sup>6</sup>This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

<sup>7</sup>This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

<sup>8</sup>This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Government bond yields, the risk-free rate and liquidity premium are all assumed to be unchanged.

<sup>9</sup>This sensitivity shows the impact of a 10 basis point increase in the allowance for liquidity premium. It assumes the overall corporate bond spreads are unchanged and hence market values are unchanged. Government bond yields and the non-annuity risk-free rate are both assumed to be unchanged. The liquidity premium increases the annuity risk-free rate.

## Notes to the consolidated financial statements

**38 Liabilities arising from non-participating investment contracts**

The movement in liabilities arising from non-participating investment contracts may be analysed as follows:

	£m
At 1 January 2008	40,387
Exchange and other adjustments	4
New business	4,149
Changes in existing business	(9,145)
Transfer from investment contracts to insurance contracts	(6,263)
Disposal of businesses	(75)
At 31 December 2008	29,057
Exchange and other adjustments	(4)
New business	3,227
Changes in existing business	(1,666)
<b>At 31 December 2009</b>	<b>30,614</b>

**39 Unallocated surplus within insurance businesses**

The movement in the unallocated surplus within long-term insurance business over the year can be analysed as follows:

	2009 £m	2008 £m
At 1 January	551	1,493
Exchange and other adjustments	(33)	–
Change in unallocated surplus recognised in the income statement	254	(942)
At 31 December	772	551

**40 Other liabilities**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Settlement balances	1,709	411	–	–
Unitholders' interest in Open Ended Investment Companies	6,508	4,264	–	–
Other creditors and accruals	9,257	7,476	432	396
	<b>17,474</b>	12,151	<b>432</b>	396

At 31 December 2009 £1,357 million (2008: £1,326 million) of other liabilities of the Group and £nil (2008: £nil) of the Company had a contractual residual maturity of greater than one year.

**41 Retirement benefit obligations**

	Group			Company		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
<b>Charge to the income statement</b>						
Defined benefit pension schemes	190	167	141	185	163	132
Other post-retirement benefit schemes	1	4	5	1	4	5
Total defined benefit schemes	191	171	146	186	167	137
Defined contribution pension schemes	88	101	60	–	–	–
	<b>279</b>	272	206	<b>186</b>	167	137
	Group			Company		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
<b>Amounts recognised in the balance sheet<sup>1</sup></b>						
Defined benefit pension schemes	346	461	517	358	459	540
Other post-retirement benefit schemes	54	55	53	54	55	53
	<b>400</b>	516	570	<b>412</b>	514	593

## Notes to the consolidated financial statements

**41 Retirement benefit obligations** (continued)

Analysed as:

	Group			Company		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Retirement benefit (asset) included within other assets	(67)	(46)	(26)	(67)	(46)	–
Retirement benefit obligation	467	562	596	479	560	593
	<b>400</b>	<b>516</b>	<b>570</b>	<b>412</b>	<b>514</b>	<b>593</b>

<sup>1</sup>As restated (note 2 and 57)**Pension schemes**

Defined Benefit schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas, the most significant being the HBOS Final Salary Pension Scheme (HFSPS). This scheme provides retirement benefits calculated as a percentage of final salary depending upon the length of service; the minimum retirement age under the rules of the schemes is 50.

The provisional results have been updated to 31 December 2009 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates by qualified independent actuaries.

The Group's obligations in respect of its defined benefit schemes are funded. The Group currently has paid contributions of £50 million during 2009 as part of its agreement to make annual deficit contributions of £50 million per annum for each of the years 2007 to 2010 inclusive. The Group currently expects to pay contributions of at least £240 million to its defined benefit schemes in 2010.

	Group			Company		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
<b>Amount included in the balance sheet</b>						
Present value of funded obligations	(8,276)	(6,709)	(7,623)	(8,164)	(6,559)	(7,498)
Fair value of scheme assets	7,442	7,241	7,329	7,351	7,139	7,191
	(834)	532	(294)	(813)	580	(307)
Unrecognised actuarial losses (gains)	488	(993)	(223)	455	(1,039)	(233)
Asset (liability) in the balance sheet	(346)	(461)	(517)	(358)	(459)	(540)

	Group			Company		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
<b>Movements in the defined benefit obligation</b>						
At 1 January	6,709	7,623	7,501	6,559	7,498	7,065
Current service cost	175	211	222	170	219	210
Employee contributions	2	12	24	2	11	23
Interest cost	418	435	386	413	428	360
Actuarial losses (gains)	1,272	(1,387)	(335)	1,278	(1,381)	2
Benefits paid	(285)	(223)	(184)	(283)	(221)	(165)
Benefits paid directly by the Group	(2)	(2)	(1)	–	–	–
Past service cost	36	14	6	36	14	4
Curtailments	(8)	(9)	(4)	(8)	(9)	–
Exchange and other adjustments	(41)	35	8	(3)	–	(1)
At 31 December	<b>8,276</b>	<b>6,709</b>	<b>7,623</b>	<b>8,164</b>	<b>6,559</b>	<b>7,498</b>

	Group			Company		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
<b>Changes in the fair value of scheme assets</b>						
At 1 January	7,241	7,329	6,644	7,139	7,191	6,233
Expected return	405	497	475	399	489	442
Curtailment	(12)	(13)	(6)	(11)	–	–
Employer contributions	293	221	292	286	216	252
Actuarial (losses) gains	(176)	(615)	76	(182)	(573)	408
Benefits paid	(285)	(223)	(184)	(282)	(219)	(166)
Employee contributions	2	12	24	2	11	23
Exchange and other adjustments	(26)	33	8	–	24	(1)
At 31 December	<b>7,442</b>	<b>7,241</b>	<b>7,329</b>	<b>7,351</b>	<b>7,139</b>	<b>7,191</b>
Actual return on scheme assets	229	(118)	551	217	(84)	850



Notes to the consolidated financial statements

**41 Retirement benefit obligations** (continued)

**Assumptions**

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

	Group and Company		
	2009 %	2008 %	2007 %
Discount rate	<b>5.7</b>	6.25	5.7
Rate of inflation	<b>3.4</b>	3.0	3.4
Rate of salary increases	<b>3.75</b>	3.5	3.9
Rate of increase for pensions in payment	<b>3.2</b>	3.0	3.3
	Years	Years	Years
Life expectancy for member aged 60, on the valuation date:			
Men	<b>27</b>	26	26
Women	<b>28</b>	27	27
Life expectancy for member aged 60, 15 years after the valuation date:			
Men	<b>28</b>	27	27
Women	<b>30</b>	29	28

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 as at 31 December 2009 is assumed to live for, on average, 27 years for a male and 28 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.

An analysis of the impact of a reasonable change in these assumptions is provided in note 3.

The expected return on scheme assets has been calculated using the following assumptions:

	Group and Company		
	2009 %	2008 %	2007 %
Equities	<b>8.4</b>	8.20	8.20
Fixed interest gilts	<b>3.7</b>	4.50	4.50
Index linked gilts	<b>4.0</b>	4.50	4.50
Non-Government bonds	<b>6.7</b>	5.60	5.60
Property	<b>6.4</b>	6.80	6.80
Money market instruments and cash	<b>3.8</b>	5.50	5.50

The expected return on scheme assets in 2010 will be calculated using the following assumptions:

	2010 %
Equities and alternative assets	<b>8.3</b>
Fixed interest gilts	<b>4.5</b>
Index linked gilts	<b>4.1</b>
Non-Government bonds	<b>6.0</b>
Property	<b>7.5</b>
Money market instruments and cash	<b>4.3</b>

Composition of scheme assets:

	Group			Company		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Equities	<b>3,246</b>	2,036	4,134	<b>3,189</b>	1,981	4,121
Fixed interest gilts	<b>709</b>	349	2,347	<b>691</b>	321	2,322
Index linked gilts	<b>1,407</b>	1,885	52	<b>1,400</b>	1,876	–
Non-Government bonds	<b>231</b>	406	181	<b>231</b>	398	156
Property	<b>185</b>	178	298	<b>182</b>	178	298
Money market instruments, cash and other assets and liabilities	<b>1,664</b>	2,387	317	<b>1,658</b>	2,385	294
At 31 December	<b>7,442</b>	7,241	7,329	<b>7,351</b>	7,139	7,191

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

## Notes to the consolidated financial statements

**41 Retirement benefit obligations** (continued)

The expected return on plan assets was determined by considering the expected returns available on the assets underlying the current investment policy. Expected yields on fixed interest investments are based on gross redemption yields at the balance sheet date at a term and credit rating broadly appropriate for the bonds held. Expected returns on equity and property investment are long-term rates based on the views of the plan's independent investment consultants. The expected return on equities allows for the different expected returns from the private equity, infrastructure and hedge fund investments held by some of the funded plans. Some of the funded plans also invest in certain money market instruments and the expected return on these investments has been assumed to be the same as cash.

Experience adjustments history for the HBOS FSPS and other schemes (since the date of adoption of IAS 19):

	<b>2009</b> £m	2008 £m	2007 £m	2006 £m	2005 £m
Present value of defined benefit obligation	<b>(8,276)</b>	(6,709)	(7,623)	(7,501)	(7,135)
Fair value of scheme assets	<b>7,442</b>	7,241	7,329	6,644	5,343
	<b>(834)</b>	532	(294)	(857)	(1,792)
Experience gains (losses) on scheme liabilities	<b>38</b>	(22)	(95)	143	(90)
Experience (losses) gains on scheme assets	<b>(176)</b>	(615)	76	174	591

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

	Group			Company		
	<b>2009</b> £m	2008 £m	2007 £m	<b>2009</b> £m	2008 £m	2007 £m
Current service cost	<b>175</b>	211	222	<b>170</b>	219	210
Interest cost	<b>418</b>	435	386	<b>413</b>	428	360
Expected return on scheme assets	<b>(405)</b>	(497)	(475)	<b>(399)</b>	(489)	(442)
Amortisation – outside corridor	<b>(38)</b>	–	–	<b>(38)</b>	–	–
Curtailments	<b>4</b>	4	2	<b>3</b>	(9)	–
Past service cost	<b>36</b>	14	6	<b>36</b>	14	4
Total defined benefit pension expense	<b>190</b>	167	141	<b>185</b>	163	132

**Defined contribution schemes**

During the year ended 31 December 2009 the charge to the income statement in respect of these schemes was £88 million (2008: £101 million), representing the contributions payable by the employer in accordance with each scheme's rules.

**Other post-retirement benefit schemes**

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 4 November 2009; this valuation has been updated to 31 December 2009 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 6.25 per cent (2008: 5.70 per cent).

Movements in the other post-retirement benefits obligation:

	Group and Company		
	<b>2009</b> £m	2008 £m	2007 £m
At 1 January	<b>55</b>	53	49
Exchange and other adjustments	<b>(2)</b>	(2)	2
Charge for the year	<b>1</b>	4	5
Benefits paid	–	–	(3)
At 31 December	<b>54</b>	55	53

## Notes to the consolidated financial statements

**42 Deferred tax**

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

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Statutory position</b>				
Deferred tax asset	4,724	2,832	113	120
Deferred tax liability	(208)	(227)	–	–
<b>Net deferred tax asset</b>	<b>4,516</b>	<b>2,605</b>	<b>113</b>	<b>120</b>
<b>Tax disclosure</b>				
Deferred tax asset	5,443	4,069	113	120
Deferred tax liability	(927)	(1,464)	–	–
<b>Net deferred tax asset</b>	<b>4,516</b>	<b>2,605</b>	<b>113</b>	<b>120</b>

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

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Asset (liability) at 1 January as previously stated		(2,530)		85
Prior year adjustment (note 57)		74		68
Asset (liability) at 1 January as restated	2,605	(2,456)	120	153
Exchange and other adjustments	69	(153)	–	(47)
Adjustment on acquisition	3	–	–	–
Disposals	1	(41)	–	–
Income statement credit (note 15)	2,769	2,964	(7)	13
Amount (charged) credited to equity:				
Available-for-sale financial assets (note 47)	(848)	1,917	–	–
Cash flow hedges (note 47)	(79)	376	–	1
Share based compensation	–	(2)	–	–
Other	(4)	–	–	–
	(931)	2,291	–	1
Asset at 31 December	4,516	2,605	113	120

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

	Group	
	2009 £m	2008 £m
Accelerated capital allowances	546	518
Pensions and other post-retirement benefits	14	(20)
Unrealised gains	1	(975)
Tax on long-term assurance business	(121)	1,012
Effective interest rate	–	12
Tax losses carried forward	2,207	1,513
Provisions	(121)	348
Other temporary differences	243	556
	2,769	2,964

Deferred tax assets and liabilities are comprised as follows:

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Deferred tax assets:				
Employee benefits	147	132	112	119
Other provisions	386	478	–	–
Derivatives	329	410	1	1
Available-for-sale asset revaluation	612	924	–	–
Tax losses carried forward	3,625	1,514	–	–
Other temporary differences	344	611	–	–
	5,443	4,069	113	120

## Notes to the consolidated financial statements

**42 Deferred tax** (continued)

	Group	
	2009 £m	2008 £m
Deferred tax liabilities:		
Accelerated capital allowances	(35)	(611)
Tax on long term assurance business	(768)	(668)
Effective interest rate	(86)	(86)
Other temporary differences	(38)	(99)
	<b>(927)</b>	<b>(1,464)</b>

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised a deferred tax asset of £3,625 million for the Group and £nil for the Company (2008: £1,514 million for the Group £nil for the Company) in relation to tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset.

Deferred tax assets of £396 million for the Group and £nil for the Company (2008: £92 million for the Group and £nil for the Company) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits to offset them. Capital losses can be carried forward indefinitely.

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

In addition, deferred tax assets have not been recognised in respect of Unrelieved Foreign Tax carried forward as at 31 December 2009 of £40 million for the Group and £nil for the Company (2008: £69 million for the Group and £31 million for the Company), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

**43 Other provisions**

	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2009	–	96	51	147
Provisions applied	–	(5)	(3)	(8)
Charge for the year	<b>5</b>	<b>105</b>	<b>9</b>	<b>119</b>
<b>At 31 December 2009</b>	<b>5</b>	<b>196</b>	<b>57</b>	<b>258</b>

**Provisions for contingent liabilities and commitments**

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

**Customer remediation provisions**

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

**Vacant leasehold property and other**

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

**44 Subordinated liabilities**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Preference shares	–	2,750	–	2,325
Preferred securities	<b>3,527</b>	4,072	–	–
Undated subordinated liabilities	<b>3,245</b>	8,280	<b>4,787</b>	8,983
Dated subordinated liabilities	<b>12,306</b>	15,017	<b>9,767</b>	10,927
	<b>19,078</b>	30,119	<b>14,554</b>	22,235

## Notes to the consolidated financial statements

**44 Subordinated liabilities** (continued)

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Preference shares</b>				
£300 million 9 1/4% Non-cumulative Irredeemable £1 preference shares	–	309	–	309
£100 million 9 3/4% Non-cumulative Irredeemable £1 preference shares	–	103	–	103
US\$750 million 6.413% Fixed-to-Floating Rate US\$1 series A preference shares	–	601	–	527
US\$750 million 5.92% Fixed-to-Floating Rate US\$1 series B preference shares	–	777	–	562
US\$750 million 6.657% Fixed-to-Floating rate US\$1 preference shares	–	960	–	824
£100 million 6% Non-cumulative irredeemable £1 preference shares	–	–	–	–
	–	2,750	–	2,325

	Group			
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Preferred securities</b>				
US\$750 million 6.071% Non-cumulative Perpetual Preferred Securities of US\$1,000 each			507	587
US\$1,000 million 6.85% Non-cumulative Perpetual Preferred Securities of US\$1,000 each			657	1,004
£600 million 6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities Series A of £1,000 each			603	602
£250 million 8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1,000 each (Class A)			252	252
£150 million 7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B)			151	151
£245 million 7.881% Guaranteed Non-voting Non-cumulative Preferred Securities			255	288
€415 million Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities			389	414
€750 million 4.939% Non-voting Non-cumulative Perpetual Preferred Securities			713	774
			<b>3,527</b>	<b>4,072</b>

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Undated subordinated liabilities</b>				
£500 million Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes	4	498	3	498
US\$750 million 6.071% Undated Subordinated Fixed to Floating Rate Instruments	–	–	462	511
€750 million 4.875% Undated Fixed to Floating Rate Subordinated Notes	183	780	183	742
€500 million Floating Rate Undated Subordinated Notes	103	481	101	477
US\$1,000 million 5.375% Undated Fixed to Floating Rate Subordinated Notes	684	774	621	688
£750 million Undated Subordinated Fixed to Floating Notes	285	767	285	721
£600 million 5.75% Undated Subordinated Step-up Notes	3	621	3	620
US\$1,000 million 6.85% Undated Subordinated Notes	–	–	608	674
£600 million Fixed to Floating Rate Undated Subordinated Notes	–	–	603	602
€500 million Fixed to Floating Rate Undated Subordinated Notes	71	505	71	484
£300 million Perpetual Regulatory Tier One Securities	300	300	–	–
£300 million 7.5% Undated Subordinated Step-up Notes	5	312	6	313
JPY 42.5 billion 3.50% Undated Subordinated Yen Step-up Notes	309	373	287	325
£200 million Perpetual Notes	62	202	–	–
£200 million 7.375% Undated Subordinated Guaranteed Bonds	51	201	–	–
€300 million Floating Rate Undated Subordinated Step-up Notes	65	290	65	288
US\$250 million Floating Rate Primary Capital Notes	146	171	–	–
£150 million Instruments	77	206	–	–
JPY 17 billion Instruments	135	150	–	–
£100 million Instruments	60	104	–	–
£100 million 12% Perpetual Subordinated Bonds	104	104	–	–
£100 million 8.75% Perpetual Subordinated Bonds	103	103	–	–
£75 million 13.625% Perpetual Subordinated Bonds	77	75	–	–
£50 million 9.375% Perpetual Subordinated Bonds	54	51	–	–
£500 million 5.75% Undated Subordinated Step-up Notes	6	498	6	498
€750 million 4.25% Perpetual Fixed/Floating Rate Reset Subordinated Guaranteed Notes	358	714	–	–
€750 million 4.939% Undated Fixed to Floating Rate Subordinated Notes	–	–	713	773
£750 million Undated Perpetual Preferred Securities	–	–	770	769
	<b>3,245</b>	<b>8,280</b>	<b>4,787</b>	<b>8,983</b>

On 19 March 2008 HBOS plc issued £750 million Undated Fixed to Floating Rate Subordinated Notes at an issue price of 99.25 per cent of the principal amount to HBOS Capital Funding No. 4 L.P., a subsidiary undertaking. The notes pay interest at a rate of 9.54 per cent per annum, payable semi-annually in arrears until 19 March 2018 at which time the interest rate will become 3 month LIBOR plus 6.75 per cent per annum payable quarterly in arrears. The Company has the option to redeem these notes on 19 March 2018 and quarterly thereafter. Upon consolidation this is eliminated and minority interest arises.

## Notes to the consolidated financial statements

**44 Subordinated liabilities** (continued)

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

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Dated subordinated liabilities</b>				
€650 million 4.75% Subordinated Bonds 2009	–	644	–	–
€500 million 5.50% Instruments 2009	–	489	–	–
US\$500 million Notes 2010	<b>326</b>	370	–	–
US\$150 million Notes 2011	<b>101</b>	116	–	–
€750 million Subordinated Fixed Rate Notes 2012	<b>724</b>	763	–	–
€12.8 million 6.25% Instruments 2012	<b>10</b>	9	–	–
€325 million 6.125% Notes 2013	<b>306</b>	327	–	–
US\$1,000 million 4.25% Subordinated Guaranteed Notes 2013	<b>650</b>	738	<b>619</b>	689
US\$500 million Subordinated Callable Notes 2014	–	343	–	343
£250 million 11% Subordinated Bonds 2014	<b>276</b>	276	–	–
€1,000 million 4.875% Subordinated Notes 2015	<b>989</b>	1,045	<b>927</b>	999
€500 million Callable Floating Rate Subordinated Notes 2016	<b>444</b>	479	<b>447</b>	479
€500 million Subordinated Notes 2016	<b>444</b>	478	<b>444</b>	478
US\$750 million Notes 2016	<b>459</b>	506	<b>459</b>	506
€1,000 million Subordinated Lower Tier II Notes 2017	<b>887</b>	954	<b>887</b>	954
US\$1,000 million Subordinated Callable Notes 2017	<b>611</b>	675	<b>610</b>	675
Aus\$400 million Subordinated Callable Floating Rate Instruments 2017	<b>222</b>	187	<b>222</b>	187
Aus\$200 million Subordinated Callable Fixed/Floating Rate Instruments 2017	<b>114</b>	101	<b>114</b>	101
Can\$500 million Callable Fixed to Floating Rate Notes 2017	<b>317</b>	309	<b>317</b>	309
£500 million Lower Tier II Subordinated Notes 2017	<b>548</b>	552	<b>548</b>	552
£150 million 10.5% Subordinated Bonds 2018	<b>164</b>	164	–	–
US\$2,000 million 6.75% Subordinated Fixed Rate Notes 2018	<b>1,384</b>	1,642	<b>1,397</b>	1,642
£250 million 6.375% Instruments 2019	<b>287</b>	304	–	–
€750 million Callable Fixed to Floating Rate Subordinated Notes 2019	<b>712</b>	749	<b>671</b>	721
£500 million 9.375% Subordinated Bonds 2021	<b>580</b>	534	–	–
€160 million Subordinated Fixed Rate Notes 2021	<b>159</b>	171	<b>159</b>	171
€400 million 6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023	<b>201</b>	388	–	–
€175 million 6.5% Subordinated Fixed Rate Notes 2023	<b>156</b>	167	<b>155</b>	167
€750 million Fixed Rate Step-up Subordinated Notes due 2030	<b>706</b>	757	<b>706</b>	757
US\$750 million 6.00% Subordinated Notes 2033	<b>529</b>	780	<b>461</b>	512
£245 million 7.881% Subordinated Extendable Maturity Notes 2048	–	–	<b>254</b>	288
€415 million Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048	–	–	<b>370</b>	397
	<b>12,306</b>	15,017	<b>9,767</b>	10,927

During 2008 the following dated subordinated liabilities were issued:

On 8 April 2008 HBOS plc issued €175 million Subordinated Lower Tier 2 Notes at par. The notes pay interest at a rate of 6.5 per cent plus Indexation (HICP excluding tobacco for Eurozone) annually in arrears until maturity on 8 April 2023.

On 21 May 2008 HBOS plc issued US\$2 billion Subordinated Lower Tier 2 Notes at an issue price of 99.334 per cent of the principal amount. The notes pay interest at a rate of 6.75 per cent per annum, payable semi-annually in arrears until maturity on 21 May 2018.

At 31 December 2009 £11,980 million (2008: £13,884 million) of subordinated liabilities of the Group and £9,767 million (2008: £10,927 million) of the Company has a contractual residual maturity of greater than one year.

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

**Repayment of subordinated liabilities**

During 2009, the Group was involved in a number of transactions which were designed to improve the overall capital structure of the Lloyds Banking Group. These resulted in the exchange of certain subordinated liabilities for new subordinated liabilities or debt securities in issue. Further detail of the gains arising on these liability management transactions is set out in note 9.

In order to improve the capital structure of the Group, in October 2009, the Company redeemed all nine issues of preference shares in exchange for the issue of ordinary shares to its parent, Lloyds Banking Group plc. This transaction gave rise to the transfer of £141 million from the Company's distributable reserves to the capital redemption reserve (see note 47).

Since 2009, the Company has had in issue, 100 6% non-cumulative preference shares of £1 each. The shares are redeemable at the option of the Company at any time, carry the rights to a fixed rate non-cumulative preferential dividend of 6% per annum; no dividend shall be paid in the event that the directors determine that prudential capital ratios would not be maintained if the dividend were paid. Upon winding up the shares rank equally with any other preference shares issued by the Company. The holder of the 100 £1 6% preference shares has waived its right to payment for the period from 1st March 2010 to 1st March 2012.

## Notes to the consolidated financial statements

**45 Share capital****(1) Authorised share capital**

There were no movements in authorised share capital during 2009.

The balance of authorised share capital at 31 December 2009 was £3,785 million comprising 15,140 million authorised ordinary shares of £0.25 each.

On 4 August 2009 the redemption of all HBOS preference shares was approved.

**(2) Issued share capital**

	Group and Company			
	2009 Number of shares	2008 Number of shares	2009 £m	2008 £m
<b>Ordinary shares of 25p each</b>				
At 1 January	5,406,574,275	3,730,415,166	1,352	933
Rights issue July 2008	–	1,499,662,328	–	375
Share issue October 2008	–	137,482,576	–	34
HM Treasury placing and open offer January 2009	7,482,394,360	–	1,870	–
Rights issue June 2009	2,000,000,000	–	500	–
Share issue October 2009	158,116,500	–	40	–
Rights issue December 2009	3,500,000	–	1	–
Issued under employee share schemes	78,201	39,014,205	–	10
At 31 December	15,050,663,336	5,406,574,275	3,763	1,352
<b>Issued and fully paid preference shares</b>				
<i>6.475% fixed-rate non-cumulative preference shares of £1 each</i>				
At 1 January	198,065,600	198,065,600	197	197
Redeemed during the year	(198,065,600)	–	(197)	–
At 31 December	–	198,065,600	–	197
<i>6.0884% fixed-rate non-cumulative preference shares of £1 each</i>				
At 1 January	750,002	750,000	1	1
Issued during year	–	2	–	–
Redeemed during the year	(750,002)	–	(1)	–
At 31 December	–	750,002	–	1
<i>6.3673% fixed-to-floating rate non-cumulative preference shares of £1 each</i>				
At 1 January	350,000	350,000	–	–
Redeemed during the year	(350,000)	–	–	–
At 31 December	–	350,000	–	–
<i>12.0% fixed-to-floating rate non-cumulative preference shares of £0.25 each</i>				
At 1 January	–	–	–	–
Issued during year	3,000,000	–	1	–
Redeemed during the year	(3,000,000)	–	(1)	–
At 31 December	–	–	–	–
<b>Total share capital at 31 December</b>	<b>15,050,663,336</b>	<b>5,605,739,877</b>	<b>3,763</b>	<b>1,550</b>

**Share issuances during 2009***Ordinary shares*

On 15 January 2009 there was a placing and open offer with the UK Government through HM Treasury which raised £8,499 million, comprising £1,870 million of ordinary shares and £6,629 million being taken to a merger reserve.

On 26 June 2009 £5,000 million was raised through a capital injection by Lloyds Banking Group, comprising £500 million of ordinary shares and £4,500 million of share premium.

On 14 October 2009 £5,456 million was raised through the issue of ordinary shares, comprising £40 million of ordinary shares and £5,416 million of share premium. This transaction arose following the redemption of all preference shares noted in note 45(1).

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

## Notes to the consolidated financial statements

**45 Share capital** (continued)*Preference shares*

On 16 January 2009 there was an issue to the UK Government through HM Treasury of three million 25 pence equity preference shares which raised £3,000 million, comprising £750,000 of equity preference shares and £2,839 million (net of £160 million of placing costs) being taken to the merger reserve.

Following the acquisition, these shares were transferred to the Lloyds Banking Group plc.

On 14 October 2009 all preference shares were redeemed and reissued as ordinary share capital at fair value.

**46 Share premium account**

	Group and Company	
	2009 £m	2008 £m
At 1 January	<b>6,709</b>	2,997
Issue of ordinary and preference shares	<b>13,415</b>	3,578
Issued under employee share schemes	-	134
Redemption of preference shares	<b>(4,068)</b>	-
At 31 December	<b>16,056</b>	6,709

**47 Other reserves**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Other reserves comprise:				
Merger and other reserves	<b>10,051</b>	583	<b>9,537</b>	69
Capital redemption reserve	<b>141</b>	-	<b>141</b>	-
Revaluation reserve in respect of available-for-sale financial assets	<b>(2,972)</b>	(5,335)	-	-
Cash flow hedging reserve	<b>(840)</b>	(1,043)	<b>(2)</b>	(2)
Foreign currency translation reserve	<b>180</b>	179	<b>16</b>	-
	<b>6,560</b>	(5,616)	<b>9,692</b>	67

Movements in other reserves were as follows:

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Merger and other reserves</b>				
At 1 January	<b>583</b>	583	<b>69</b>	69
Issue of ordinary shares	<b>6,629</b>	-	<b>6,629</b>	-
Issue of equity preference shares	<b>2,839</b>	-	<b>2,839</b>	-
At 31 December	<b>10,051</b>	583	<b>9,537</b>	69

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Capital redemption reserve</b>				
At 1 January	-	-	-	-
Redemption of preference shares	<b>141</b>	-	<b>141</b>	-
At 31 December	<b>141</b>	-	<b>141</b>	-





Notes to the consolidated financial statements

**49 Dividends**

	2009 £m	2008 £m
<b>Ordinary share dividends</b>		
Final dividend for previous year paid during the current year	–	1,205
<b>Preference share dividends</b>		
Equity dividends paid	<b>355</b>	81
	<b>355</b>	1,286

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

**50 Share based payments**

**Charge to the income statement**

The charge to the income statement is set out below:

	2009 £m	2008 £m
Sharesave schemes:		
Options granted in the year	–	4
Options granted in prior years	<b>60</b>	23
	<b>60</b>	27
Share incentive plans:		
Shares granted in the year	<b>23</b>	39
Shares granted in prior years	<b>115</b>	90
	<b>138</b>	129
	<b>198</b>	156

Included within the charge for the year is £8 million (2008: £16 million) in respect of share-based arrangements within St. James's Place and £27 million in respect of the Insight Investment plan (2008: £15 million).

**Share based payment scheme details**

During the year ended 31 December 2009 the Group operated the following share based payment schemes, which are predominantly equity settled.

The rebasement adjustment arose due to pre-2009 schemes lapsing and the 2009 schemes rolling into Lloyds Banking Group plc schemes.

**HBOS Executive Stock Option Plan**

The executive stock option scheme was available to certain senior executives of the Group. The last grant of executive options was made in 2000. The options vested upon satisfaction of a performance measure over a three year period. Options are exercisable from the date the measure is satisfied until the tenth anniversary of the date of grant.

Movements in the number of share options outstanding under the Executive stock option plan during 2008 and 2009 are set out below:

	2009		2008	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	614,463	634	813,927	628
Rights Issue	–	–	5,267	–
Rebasement adjustment	(233,032)	–	–	–
Exercised	–	–	(2,000)	591
Forfeited	(190,761)	671	(202,731)	594
Outstanding at 31 December	<b>190,670</b>	<b>597</b>	614,463	634
Exercisable at 31 December	<b>190,670</b>	<b>597</b>	614,463	634

No options were exercised during 2009. The weighted average share price at the time that the options were exercised during 2008 was 642 pence. The options outstanding at 31 December 2009 had exercise prices in the range of £5.34 to £6.06 and a weighted average remaining contractual life of 0.8 years (2008: 1.5 years).

## Notes to the consolidated financial statements

**50 Share based payments** (continued)**HBOS Sharesave Plan**

Eligible employees could enter into contracts through the sharesave schemes to save up to £250 per month for a fixed term of three, five or seven years. At the end of the savings period a tax-free bonus is added to the savings and colleagues have the option to acquire shares in the Group at a price equal to 80 per cent of the share price at the date the options were granted.

All sharesave plans, except the interim 2008 award vested on 12 January 2009. Options were awarded to colleagues at this time.

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

	2009		2008	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	75,422,836	280	40,293,627	665
Rights Issue	–	–	264,059	–
Rebasement adjustment	(15,932,964)	–	–	–
Granted	–	–	106,388,319	295
Exercised	–	–	(5,903,580)	552
Forfeited	(7,297,246)	548	(2,763,722)	538
Cancelled	(30,182,333)	274	(60,319,267)	512
Expired	(4,067,669)	578	(2,536,600)	588
Outstanding at 31 December	17,942,624	365	75,422,836	280
Exercisable at 31 December	–	–	25,638	554

No options were exercised during 2009. The weighted average share price at the time that the options were exercised during 2008 was 677 pence. The options outstanding at 31 December 2009 had exercise prices in the range of £2.20 to £3.64 and a weighted average remaining contractual life of 4.0 years (2008: 4.6 years).

**Lloyds Banking Group Save-As-You-Earn schemes**

Eligible employees may enter into contracts through the Save-As-You-Earn (SAYE) schemes to save up to £250 per month and, at the expiry of a fixed term of three, five or seven years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in Lloyds Banking Group plc at a discounted price equal to 80 per cent of the market price at the date the options were granted.

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

	2009	2009
	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	190,478,449	152.54
Forfeited	(4,436,478)	180.34
Cancelled	(68,822,665)	144.31
Expired	(5,063,534)	347.51
Outstanding at 31 December	112,155,772	147.69
Exercisable at 31 December	754,554	317.32

The weighted average share price at the time that the options were exercised during 2008 was 370.29 pence. The weighted average remaining contractual life of options outstanding at the end of the year was 2.5 years (2008: 3.4 years).

The weighted average fair value of SAYE options granted during the year was £nil (2008: £0.61). The values for the SAYE options have been determined using a standard Black-Scholes model.

**Other share option plans****HBOS Plan**

The final award under the HBOS plan was made in 2004. Under this plan options over shares at market value, with a face value equal to 20 per cent of salary, were awarded to all colleagues with the exception of those of level 8 and above. A separate option plan exists for some of the colleagues of St. James's Place, which awards options, and which continues to operate.

## Notes to the consolidated financial statements

**50 Share based payments** (continued)

Movements in the number of share options outstanding under the Share Option plans are set out below:

	2009		2008	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	19,387,383	716	20,782,033	726
Granted during the year	4,040,555	105	1,220,709	657
Rights issue	–	–	128,630	–
Rebasement adjustment	(6,690,164)	–	–	–
Exercised during the year	–	–	(55,211)	668
Forfeited during the year	(2,628,668)	698	(2,688,778)	728
Outstanding at 31 December	14,109,106	607	19,387,383	716
Exercisable at 31 December	9,005,915	747	17,079,383	701

No options were exercised during 2009. The weighted average share price at the time that the options were exercised during 2008 was 666 pence. The options outstanding at 31 December 2009 had exercise prices in the range of £1.05 to £7.07 and a weighted average remaining contractual life of 1.4 years (2008: 1.5 years).

**Lloyds TSB 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 granted to date under this scheme were granted specifically to facilitate recruitment. Options granted under this plan are not subject to any performance conditions.

	2009	2009
	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	857,611	Nil
Granted	24,704,070	Nil
Rebasement adjustment	1,876,005	Nil
Exercised	(157,105)	Nil
Forfeited	(1,181,396)	Nil
Outstanding at 31 December	26,099,185	Nil
Exercisable at 31 December	33,794	Nil

The weighted average fair value of options granted in the year was £0.68 (2008: £2.92). The weighted average share price at the time that the options were exercised during 2009 was 71.14 pence (2008: 291.04 pence). The weighted average remaining contractual life of options outstanding at the end of the year was 3.0 years (2008: 2.5 years).

**Other Share Plans****HBOS Free Shares Scheme**

This was introduced in 2005 under the share incentive plan legislation as a replacement for the share option plan (not including the St. James's Place plan). In broad terms, it covers all colleagues and free shares up to a limit of £3,000 annually are awarded to each colleague.

**HBOS Sharekicker Plan**

This provides colleagues with the opportunity to purchase shares with a proportion of their annual net bonus. For every two shares purchased a matching share is awarded after three years.

**HBOS Performance Sharekicker Plan**

With effect from September 2008, the EPS Sharekicker Plan was renamed the Performance Sharekicker Plan. The plan is open to colleagues of level 7 and above (in relation to annual net bonuses) and colleagues of level 8 and above (in relation to net bonuses payable under the two-year incentive scheme). This provides colleagues with the opportunity to purchase shares with a proportion of their annual net bonus. For every two shares purchased a matching share is awarded after three years. For the 2006 and 2007 awards, matching shares awarded under this plan depends on EPS performance over the three year vesting period. For the 2008 award, matching shares awarded under this plan depends on EPS performance in excess of the RPI and on operating cost performance over the three year vesting period.

**HBOS Long Term Incentive Plan (LTIP)**

For most senior colleagues, share grants of varying percentages of salaries are made and colleagues may receive up to 200 per cent of the grant depending on the Group's annualised TSR compared to the annualised weighted average TSR of a basket of comparator companies, over a three year period.

## Notes to the consolidated financial statements

**50 Share based payments** (continued)**Allowance for Performance Conditions**

The long term incentive plan includes a market based performance condition based on the Group's total shareholder return relative to an index of comparator companies. The impact of this performance condition has been modelled using Monte Carlo Simulation techniques, which involves running several thousands of simulations of future share price movements for both the Group and the comparator index. For the purpose of these simulations it is assumed that the share price of the Group and the comparator index are 80 per cent correlated and that the comparator index has volatility of 30 per cent p.a. for the 2008 award.

The performance condition is based on the Group's performance relative to the comparator index over a three year period commencing on 1 January each year. The fair value calculations for the awards that were made in 2008 therefore include an allowance for the actual performance of the Group's share price relative to the index over the period between 1 January and the award date.

In 2008 the weightings attached to certain comparators were amended with effect from 1 January 2008 and apply, from that date to 2005, 2006 and 2007 awards. To better match the business profile of the Group, the committee decided to amend the comparator companies and Northern Rock has dropped out of the comparator group due to government involvement. Alliance and Leicester and Bradford & Bingley remain within the comparator group at their delisted prices. This amendment also applies to all future awards. The modifications did not alter the fair values of any of the awards, nor make additional changes necessary.

**Insight Long Term Incentive Plan**

In 2007 Insight Investment Management Ltd converted an existing incentive scheme into a share-based payment arrangement, offering options and/or shares to some of its colleagues. The award has a contractual life of 5 years and a vesting period of 3 years service.

The number of shares awarded in 2009 was 17,318,644 (2008: 18,438,902 post rights issue, which assumed a cashless take-up of the rights at a nil-paid rights price of 11.27 pence). Award of options include nil-priced options and options with an exercise price equal to the price of the Company's B ordinary shares based on the most recently approved annual valuation of the Insight business at the date of the grant.

**Invista Real Estate Plans**

Various share-based plans are offered to certain colleagues in Invista Real Estate Investment Management Holdings plc.

**Modifications and Vesting**

The Sharekicker, Performance shareholder and LTIP schemes vested on 12 January 2009. Immediately prior to vesting the plan was modified to be settled in cash at the share price of 84.1p per share. No incremental charges were due in respect of the modification.

Insight Investment Management Ltd's long term incentive plan vested on its sale on 31 October 2009. Immediately prior to vesting the plan was modified to be settled in cash at the share price of £2.133. No incremental charges were due in respect of modification.

All long term incentive awards vested on 12 January 2009 for the long term incentive award made in 2006 no payment was made. Where no final performance of the award could be assessed for the 2007 and 2008 award two thirds of the on target amount was paid, reflecting the default position under the scheme rules, reduced by one third to reflect waiver of any 2008 equivalent.

The fair value calculations for grants made in 2009 were based on the following assumptions:

	<b>Insight</b>
Risk-free interest rate	<b>2.07</b>
Expected life (years)	<b>3</b>
Expected volatility (% p.a)	<b>60</b>
Expected dividend yield (% p.a.)	<b>4</b>
Share price (pence)	<b>196.5</b>
Exercise price (pence)	<b>196.5</b>
Fair value (pence)	<b>66.1</b>
Expected forfeitures (% p.a.)	<b>3</b>

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.

Notes to the consolidated financial statements

**51 Related party transactions**

**Key management personnel**

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity. At 31 December 2008, key management personnel comprised the members of the board, the Company Secretary and the HBOS Executive Committee. At 31 December 2009, the Group's key management personnel are the members of its executive committee together with its non-executive directors.

The table below details, on an aggregated basis, key management personnel compensation. In 2009 the compensation of key management personnel has been allocated to the Company on an estimated basis.

	2009 £m	2008 £m
Compensation		
Salaries and other short-term benefits	8	11
Post-employment benefits	1	–
Share based payments	–	2
	<b>9</b>	<b>13</b>

The aggregate of the emoluments of the directors was £4,950,000. The total for the highest paid director (G T Tate) was £903,000.

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

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

	2009 million
Share options	
At 16 January 2009 and 31 December 2009	2
	<b>2009 million</b>
Share incentive plans	
At 16 January 2009	7
Granted (including entitlements of appointed directors)	17
Exercised/lapsed (including entitlements of former directors)	(5)
At 31 December 2009	<b>19</b>

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

	2009 £m
<b>Loans</b>	
At 16 January 2009	3
Advanced (including loans of appointed directors)	–
Repayments (including loans of former directors)	(1)
At 31 December 2009	<b>2</b>

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 1.28 per cent and 24.9 per cent in 2009.

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

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

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

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

## Notes to the consolidated financial statements

**51 Related party transactions** (continued)

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

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

**Share Schemes***Potential pre-tax gains on share options exercised*

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

*Shares vested under long-term incentive schemes*

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

*Shares vested under short-term incentive schemes*

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

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

*Value of shares vested under free shares plan*

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

*Change of control*

All of the HBOS share plans contained a provision relating to change of control. The acquisition of HBOS by Lloyds Banking Group resulted in awards and options vesting and becoming exercisable, in accordance with contractual entitlements under plan rules. Certain awards were exchanged for awards over Lloyds Banking Group ordinary shares, but otherwise subject to the same terms as the original award. Certain options will also be exchanged to the extent they have not been exercised within the 6 month exercise period following the change of control.

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

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

**Loans**

	£m
At 1 January 2008	2
Advanced	–
Repayments	–
At 31 December 2008	<u>2</u>

**Deposits**

At 1 January 2008	12
Net movements	(5)
At 31 December 2008	<u>7</u>

**Subsidiaries**

Details of the principal subsidiaries are given in note 26. In accordance with IAS 27, transactions and balances with subsidiaries have been eliminated on consolidation.

## Notes to the consolidated financial statements

**51 Related party transactions** (continued)**Transactions with Lloyds Banking Group**

On 16 January 2009 Lloyds Banking Group plc acquired HBOS plc and as a result Lloyds Banking Group and its subsidiaries became related parties. The Group transacts with the Lloyds Banking Group of companies during the ordinary course of business. Details of transactions and outstanding balances as at and for the year ended 31 December 2009 are set out below:

	2009 £m
<b>Transactions</b>	
Interest income	277
Interest expense	(839)
Other income	2,530
	As at 31 Dec 2009 £m
<b>Balances</b>	
Loans and advances to banks	88,620
Loans and advances to customers	261
Debt securities designated as loans and receivables	554
Trading and other financial assets designated at fair value through profit or loss	1,147
Derivative assets	664
Available-for-sale financial assets	132
Other assets	2,264
Deposits from banks	(149,519)
Trading liabilities	(5,463)
Debt securities in issue	(1,646)
Derivative liabilities	(853)
Other liabilities	(28)
Subordinated liabilities	(2,444)

**HM Treasury**

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

*Emergency Liquidity Assistance*

On 16 January 2009, immediately prior to the acquisition by Lloyds Banking Group, HBOS plc repaid £5,000 million of funding provided by the Bank of England under the terms of the emergency liquidity assistance programme and was guaranteed by HM Treasury. This liquidity assistance was provided to HBOS on 1 October 2008, at a time when turbulence in financial markets made it increasingly difficult for HBOS to raise funds in the wholesale markets. In order to maintain financial stability, the Bank of England agreed to provide emergency liquidity assistance to HBOS plc on 1 October 2008; use of this funding peaked at £25,650 million. However, as confidence returned, facilitated by the UK Government's announced range of measures intended to ease the turbulence in the UK banking system, the emergency liquidity assistance was repaid on 16 January 2009, immediately prior to the Group's acquisition by Lloyds Banking Group.

*Credit Guarantee Scheme*

HM Treasury launched the Credit Guarantee Scheme (CGS) in October 2008 as part of a range of measures announced by the UK Government intended to ease the turbulence in the UK banking system. It charges a commercial fee for the guarantee of new short and medium-term debt issuance. The fee payable to HM Treasury on guaranteed issues is based on a per annum rate of 50 basis points plus the media five-year Credit Default Swap spread. At 31 December 2009, the Group had £8,725 million of debt securities issued under the CGS. During the period from 15 January 2009 to 31 December 2009 fees of £236 million payable to HM Treasury in respect of guaranteed funding were included in the Group's income statement.

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

**Other related party disclosures**

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

At 31 December 2009 there were loans and advances to customers of £12,235 million (2008: £14,196 million) outstanding and balances within customer deposits of £254 million (2008: £342 million) relating to joint ventures and associates. In addition, £175 million (2008: £175 million) of preference shares in esure were held by the Group.

At 31 December 2009, there were customer deposits of £39 million (2008: £30 million) and investment and insurance contract liabilities of £320 million (2008: £872 million) related to the Group's pension arrangements.



## Notes to the consolidated financial statements

### 51 Related party transactions (continued)

The Group manages 273 (2008: 251) Open Ended Investment Companies (OEICs), and of these 61 (2008: 59) are consolidated. The Group's net investment in the unconsolidated OEICs was £145 million (2008: £439 million) and the Group had investments, at fair value, of £3,589 million (2008: £2,768 million) at 31 December. The Group earned fees of £30 million from the unconsolidated OEICs (2008: £32 million). The Company held no investments in OEICs at any time during 2008 or 2009.

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

Banking transactions are entered into by the Company with its subsidiaries in the normal course of business and are at normal commercial terms. These include loans, deposits and foreign currency transactions. Balances between HBOS plc and its subsidiaries are shown on the Company balance sheet. Interest income and expense are £1,952 million (2008: £2,880 million) and £888 million (2008: £2,344 million) respectively. HBOS plc is the principal employer of the Group and staff and other costs in the year of £2,476 million (2008: £2,582 million) were recharged to subsidiaries.

### 52 Contingent liabilities and commitments

#### Legal proceedings

##### Payment Protection Insurance

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

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

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

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

##### Interchange fees

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

##### Unarranged overdraft charges

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

##### Other legal proceedings

In addition, during the ordinary course of business the Group is subject to threatened or actual legal proceedings both in the UK and overseas. All such material cases are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Lloyds Banking Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts

## Notes to the consolidated financial statements

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

are unclear or because further time is needed to properly assess the merits of the case and no provisions are held against such case(s). However the Lloyds Banking Group does not currently expect the final outcome of any such cases to have a material adverse effect on its financial position.

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

Acceptances and endorsements arise where the Group agrees to guarantee payment on a negotiable instrument drawn up by a customer.

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

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

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

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Contingent liabilities</b>				
Acceptances and endorsements	5	–	–	–
Other:				
Other items serving as direct credit substitutes	99	73	–	–
Performance bonds and other transaction-related contingencies	1,263	1,279	–	–
	<b>1,362</b>	1,352	–	–
	<b>1,367</b>	1,352	–	–

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.

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
<b>Commitments</b>				
Documentary credits and other short-term trade-related transactions	69	137	–	–
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	6,188	11,847	–	–
Other commitments	30,148	38,364	–	–
	<b>36,336</b>	50,211	–	–
1 year or over original maturity	17,673	26,341	–	–
	<b>54,078</b>	76,689	–	–

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £30,150 million (2008: 49,551 million) was irrevocable.

**Operating lease commitments**

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

	2009 £m	2008 £m
Not later than 1 year	188	177
Later than 1 year and not later than 5 years	659	645
Later than 5 years	1,195	1,230
	<b>2,042</b>	2,052

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

## Notes to the consolidated financial statements

## 53 Financial instruments

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

The accounting policies in accounting policy 2(e) 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.

Group	At fair value through profit or loss						Insurance contracts £m	Total £m
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m		
<b>As at 31 December 2009</b>								
<b>Financial assets</b>								
Cash and balances at central banks	-	-	-	-	-	2,905	-	2,905
Items in the course of collection from banks	-	-	-	-	-	534	-	534
Trading and other financial assets at fair value through profit or loss	-	27,611	74,297	-	-	-	-	101,908
Derivative financial instruments	8,934	21,985	-	-	-	-	-	30,919
Loans and receivables:								
Loans and advances to customers	-	-	-	-	404,075	-	-	404,075
Loans and advances to banks	-	-	-	-	98,524	-	-	98,524
Debt securities	-	-	-	-	31,468	-	-	31,468
	-	-	-	-	534,067	-	-	534,067
Available-for-sale financial assets	-	-	-	21,591	-	-	-	21,591
<b>Total financial assets</b>	<b>8,934</b>	<b>49,596</b>	<b>74,297</b>	<b>21,591</b>	<b>534,067</b>	<b>3,439</b>	<b>-</b>	<b>691,924</b>
<b>Financial liabilities</b>								
Deposits from banks	-	-	-	-	-	179,064	-	179,064
Customer deposits	-	-	-	-	-	232,023	-	232,023
Items in course of transmission to banks	-	-	-	-	-	495	-	495
Trading and other financial liabilities at fair value through profit or loss	-	27,372	-	-	-	-	-	27,372
Derivative financial instruments	8,028	17,773	-	-	-	-	-	25,801
Notes in circulation	-	-	-	-	-	981	-	981
Debt securities in issue	-	-	-	-	-	119,157	-	119,157
Liabilities arising from insurance contracts and participating investment contracts	-	-	-	-	-	-	39,234	39,234
Liabilities arising from non-participating investment contracts	-	-	-	-	-	-	30,614	30,614
Unallocated surplus within insurance businesses	-	-	-	-	-	-	772	772
Subordinated liabilities	-	-	-	-	-	19,078	-	19,078
<b>Total financial liabilities</b>	<b>8,028</b>	<b>45,145</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>550,798</b>	<b>70,620</b>	<b>674,591</b>

## Notes to the consolidated financial statements

**53 Financial instruments** (continued)**Group**

	At fair value through profit or loss			Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m					
As at 31 December 2008								
Financial assets								
Cash and balances at central banks	-	-	-	-	-	2,502	-	2,502
Items in the course of collection from banks	-	-	-	-	-	445	-	445
Trading and other financial assets at fair value through profit or loss	-	22,571	67,120	-	-	-	-	89,691
Derivative financial instruments	22,082	29,728	-	-	-	-	-	51,810
Loans and receivables:								
Loans and advances to banks	-	-	-	-	16,796	-	-	16,796
Loans and advances to customers	-	-	-	-	450,421	-	-	450,421
Debt securities	-	-	-	-	39,053	-	-	39,053
Available-for-sale financial assets	-	-	-	28,048	-	-	-	28,048
<b>Total financial assets</b>	<b>22,082</b>	<b>52,299</b>	<b>67,120</b>	<b>28,048</b>	<b>506,270</b>	<b>2,947</b>	<b>-</b>	<b>678,766</b>
Financial liabilities								
Deposits from banks	-	-	-	-	-	97,150	-	97,150
Customer deposits	-	-	-	-	-	237,449	-	237,449
Items in course of transmission to banks	-	-	-	-	-	521	-	521
Trading and other financial liabilities at fair value through profit or loss	-	18,851	-	-	-	-	-	18,851
Derivative financial instruments	9,297	29,608	-	-	-	-	-	38,905
Notes in circulation	-	-	-	-	-	957	-	957
Debt securities in issue	-	-	-	-	-	188,448	-	188,448
Liabilities arising from insurance contracts and participating investment contracts	-	-	-	-	-	-	36,873	36,873
Liabilities arising from non-participating investment contracts	-	-	-	-	-	-	29,057	29,057
Unallocated surplus within insurance businesses	-	-	-	-	-	-	551	551
Subordinated liabilities	-	-	-	-	-	30,119	-	30,119
<b>Total financial liabilities</b>	<b>9,297</b>	<b>48,459</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>554,644</b>	<b>66,481</b>	<b>678,881</b>

## Notes to the consolidated financial statements

**53 Financial instruments** (continued)

<b>Company</b>	<b>Derivatives designated as hedging instruments £m</b>	<b>Held for trading at fair value through profit or loss £m</b>	<b>Loans and receivables £m</b>	<b>Held at amortised cost £m</b>	<b>Total £m</b>
<b>As at 31 December 2009</b>					
Financial assets:					
Derivative financial instruments	1,711	–	–	–	1,711
Loans and receivables:					
Amounts due from subsidiaries	–	–	46,186	–	46,186
Debt securities	–	–	1	–	1
<b>Total financial assets</b>	<b>1,711</b>	<b>–</b>	<b>46,187</b>	<b>–</b>	<b>47,898</b>
Financial liabilities:					
Derivative financial instruments	43	–	–	–	43
Subordinated liabilities	–	–	–	14,554	14,554
<b>Total financial liabilities</b>	<b>43</b>	<b>–</b>	<b>–</b>	<b>14,554</b>	<b>14,597</b>
<b>As at 31 December 2008</b>					
Financial assets:					
Derivative financial instruments	2,638	–	–	–	2,638
Loans and receivables:					
Amounts due from subsidiaries	–	–	50,157	–	50,157
<b>Total financial assets</b>	<b>2,638</b>	<b>–</b>	<b>50,157</b>	<b>–</b>	<b>52,795</b>
Financial liabilities:					
Derivative financial instruments	55	–	–	–	55
Subordinated liabilities	–	–	–	22,235	22,235
<b>Total financial liabilities</b>	<b>55</b>	<b>–</b>	<b>–</b>	<b>22,235</b>	<b>22,290</b>

**Interest rate risk and currency risk**

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

As discussed in note 54 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) Reclassification of financial assets**

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

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

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

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

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

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

## Notes to the consolidated financial statements

**53 Financial instruments** (continued)**Carrying amount and fair values of reclassified assets**

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

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

**Additional fair value gains (losses) that would have been recognised had the reclassifications not occurred**

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

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

\*amounts recognised through available-for-sale revaluation reserve (post tax).

**Actual amounts recognised in respect of reclassified assets**

After reclassification the reclassified financial assets contributed the following amounts to the Group income statement:

	2009			2008	
	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables:					
Net interest income	45	–	45	–	–
Impairment losses	(110)	–	(110)	–	–
Gains on disposal	17	–	17	–	–
Total	<b>(48)</b>	<b>–</b>	<b>(48)</b>	<b>–</b>	<b>–</b>

	2009			2008	
	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to available-for-sale:					
Net interest income	–	281	281	442	442
Impairment losses	–	(305)	(305)	(215)	(215)
Gains on disposal	–	70	70	–	–
Total	<b>–</b>	<b>46</b>	<b>46</b>	<b>227</b>	<b>227</b>

	2009			2008	
	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From available-for-sale to loans and receivables:					
Net interest income	25	377	402	82	82
Impairment losses	–	(371)	(371)	(558)	(558)
Gains (losses) on disposal	–	(152)	(152)	16	16
Total	<b>25</b>	<b>(146)</b>	<b>(121)</b>	<b>(460)</b>	<b>(460)</b>

## Notes to the consolidated financial statements

**53 Financial instruments** (continued)**(3) Fair values of financial assets and liabilities**

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

**Group**

	Carrying value 2009 £m	Carrying value 2008 £m	Fair value 2009 £m	Fair value 2008 £m
<b>Financial assets</b>				
Trading and other financial assets at fair value through profit or loss	<b>101,908</b>	89,691	<b>101,908</b>	89,691
Derivative financial instruments	<b>30,919</b>	51,810	<b>30,919</b>	51,810
Loans and receivables:				
Loans and advances to banks	<b>98,524</b>	16,796	<b>98,588</b>	16,829
Loans and advances to customers	<b>404,075</b>	450,421	<b>382,542</b>	436,756
Debt securities	<b>31,468</b>	39,053	<b>29,848</b>	38,227
Available-for-sale financial assets	<b>21,591</b>	28,048	<b>21,591</b>	28,048
<b>Financial liabilities</b>				
Deposits from banks	<b>179,064</b>	97,150	<b>179,137</b>	97,184
Customer deposits	<b>232,023</b>	237,449	<b>232,057</b>	238,241
Trading and other financial liabilities at fair value through profit or loss	<b>27,372</b>	18,851	<b>27,372</b>	18,851
Derivative financial instruments	<b>25,801</b>	38,905	<b>25,801</b>	38,905
Debt securities in issue	<b>119,157</b>	188,448	<b>116,133</b>	182,470
Liabilities arising from non-participating investment contracts	<b>30,614</b>	29,057	<b>30,614</b>	29,057
Subordinated liabilities	<b>19,078</b>	30,119	<b>14,213</b>	20,895

**Company**

	Carrying value 2009 £m	Carrying value 2008 £m	Fair value 2009 £m	Fair value 2008 £m
<b>Financial assets:</b>				
Derivative financial instruments	<b>1,711</b>	2,638	<b>1,711</b>	2,638
Amounts due from subsidiaries	<b>46,186</b>	50,157	<b>43,567</b>	44,793
<b>Financial liabilities:</b>				
Derivative financial instruments	<b>43</b>	55	<b>43</b>	55
Subordinated liabilities	<b>14,554</b>	22,235	<b>10,764</b>	15,229

**(4) Valuation methodology**

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

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

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

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

## Notes to the consolidated financial statements

**53 Financial instruments** (continued)

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

<b>Valuation hierarchy</b>		<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>2009</b>
<b>At 31 December 2009</b>		<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>Total</b>
Trading and other financial assets at fair value through profit or loss	(i)	<b>69,167</b>	<b>31,421</b>	<b>1,320</b>	<b>101,908</b>
Available-for-sale financial assets	(ii)	<b>1,842</b>	<b>17,882</b>	<b>1,867</b>	<b>21,591</b>
Derivative financial instruments	(iii)	<b>43</b>	<b>30,802</b>	<b>74</b>	<b>30,919</b>
<b>Financial assets</b>		<b>71,052</b>	<b>80,105</b>	<b>3,261</b>	<b>154,418</b>
Trading and other financial liabilities at fair value through profit or loss	(iv)	<b>511</b>	<b>26,861</b>	<b>–</b>	<b>27,372</b>
Derivative financial instruments	(iii)	<b>60</b>	<b>25,545</b>	<b>196</b>	<b>25,801</b>
<b>Financial liabilities</b>		<b>571</b>	<b>52,406</b>	<b>196</b>	<b>53,173</b>

  

At 31 December 2008		Level 1	Level 2	Level 3	2008
		£m	£m	£m	Total
Trading and other financial assets at fair value through profit or loss		71,320	14,985	3,386	89,691
Available-for-sale financial assets		797	24,959	2,292	28,048
Derivative financial instruments		178	51,063	569	51,810
<b>Financial assets</b>		<b>72,295</b>	<b>91,007</b>	<b>6,247</b>	<b>169,549</b>
Trading and other financial liabilities at fair value through profit or loss		–	18,851	–	18,851
Derivative financial instruments		309	37,494	1,102	38,905
<b>Financial liabilities</b>		<b>309</b>	<b>56,345</b>	<b>1,102</b>	<b>57,756</b>

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

**Level 1 portfolios**

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise government securities.

**Level 2 portfolios**

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

**Level 3 portfolios**

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



## Notes to the consolidated financial statements

**53 Financial instruments** (continued)**Level 3 portfolio**

At 31 December 2009

	Valuation basis/technique	Main assumptions	Carrying value £m	Effect of reasonably possible alternative assumptions £m
<b>Trading and other financial assets at fair value through profit or loss:</b>				
Asset-backed securities	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	<b>891</b>	74
Equity investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	<b>234</b>	
Unlisted equities and property partnerships in the life funds	Third party valuations	n/a	<b>195</b>	
			<b>1,320</b>	
<b>Available-for-sale financial assets:</b>				
Equity investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	<b>1,867</b>	
<b>Derivative financial assets:</b>				
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	<b>74</b>	31
<b>Financial assets</b>				
			<b>3,261</b>	
<b>Derivative financial liabilities:</b>				
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	<b>196</b>	8
<b>Financial liabilities</b>				
			<b>196</b>	

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

The valuation techniques used for unlisted equities vary depending on the nature of the investment. Further details of these are given below. As these factors differ for each investment depending on the nature of the valuation technique used and the inputs there is no single common factor that could be adjusted to provide a reasonable alternative valuation for these investment portfolios. Third party valuers have been used to determine the value of unlisted equities and property partnerships included in the Group's life insurance funds.

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

**Asset-backed securities**

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

## Notes to the consolidated financial statements

### 53 Financial instruments (continued)

#### Equity investments

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

- The earnings multiple methodology involves applying the relevant earnings multiple to the maintainable earnings of the business being valued. A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- Valuations using net asset values are often used for property based businesses and use the latest valuations included in management or statutory accounts adjusted for subsequent movements in property valuations and other factors including recoverability.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return.

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

#### Unquoted equities and property partnerships in the life funds

Third party valuations are used to obtain the fair value of unquoted investments. 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.

#### Derivatives

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

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

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

#### Credit valuation adjustment

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

## Notes to the consolidated financial statements

**53 Financial instruments** (continued)**Movement in level 3 portfolio**

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

	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Derivative assets £m	Total financial assets £m
At 31 December 2008	3,386	2,292	569	6,247
Losses recognised in the income statement	(293)	(600)	(555)	(1,448)
Gains recognised in other comprehensive income	–	141	–	141
Purchases	34	403	60	497
Sales	(65)	(259)	–	(324)
Transfers into the level 3 portfolio	–	11	–	11
Transfers out of the level 3 portfolio	(1,742)	(121)	–	(1,863)
<b>At 31 December 2009</b>	<b>1,320</b>	<b>1,867</b>	<b>74</b>	<b>3,261</b>

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

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

Included with the gains (losses) recognised in the income statement are losses of £1,010 million related to financial instruments that are held at the relevant year end.

**Fair value of financial instruments carried at amortised cost****Loans and advances to banks and customers**

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair values of ABS and secondary loans, 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.

**Deposits from banks and customer accounts**

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits and customer accounts is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

**Debt securities in issue and subordinated liabilities**

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices.

## Notes to the consolidated financial statements

### 54 Financial risk management

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

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

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

#### (i) Qualitative information

##### (1) Credit risk

###### Definition

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

###### Risk appetite

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

###### Exposures

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

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

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 17 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2009. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in the credit risk table on page 96.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers. A significant proportion of the investments are held in unit linked and with profit funds where the shareholder risk is limited, subject to any guarantees given.

###### Measurement

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

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

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

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

###### Mitigation

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

###### Internal control

- Credit principles and policy: Lloyds Banking Group Risk sets out the Group's credit principles and policy according to which credit risk is managed, which in turn is the basis for business unit credit policy. Principles and policy are reviewed regularly and any changes are subject to a review and approval process. Business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions.

## Notes to the consolidated financial statements

### 54 Financial risk management (continued)

- Counterparty limits: Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.
- Individual credit assessment and sanction: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting are the same as that for assets intended to be held over the period to maturity.
- Credit scoring: In its principal retail portfolios, the Group uses statistically-based decisioning techniques (primarily credit scoring). Business unit risk departments review scorecard effectiveness and approve changes, with material changes being subject to Lloyds Banking Group risk approval.
- Controls over rating systems: The Group has established an independent process built on a set of common minimum standards designed to challenge the discriminatory power of the systems, accuracy of calibration and ability to rate consistently over time and across obligors. The internal rating systems are developed and implemented by independent risk functions in the business units with the business unit managing directors having ownership of the systems. They also take responsibility for ensuring the validation of the respective internal rating systems, supported and challenged by specialist functions in their respective business units.
- Cross-border and cross-currency exposures: Country limits are authorised by the Lloyds Banking Group Country Limits Panel taking into account economic and political factors.
- Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to the Group's risk appetite and restricts exposure to certain high risk and more vulnerable sectors and segments. Note 19 provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.
- Stress testing and scenario analysis: The credit portfolio is also subjected to stress-testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group wide level, at business unit level and by rating model and portfolio, for example, for a specific industry sector.
- Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector-specific expertise; and legal services applicable to the particular market place and product range offered by the business.
- Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.
- Risk assurance and oversight: Oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Risk assurance teams are engaged where appropriate to conduct further credit reviews if a need for closer scrutiny is identified.

#### Collateral

The principal collateral types for loans and advances are:

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

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

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

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

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

#### Master netting agreements

Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), the Group enters into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are terminated and settled on a net

## Notes to the consolidated financial statements

### 54 Financial risk management (continued)

basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period since it is affected by each transaction subject to the agreement.

#### Other credit risk transfers

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

#### Monitoring

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

### (2) Market risk

#### Definition

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

#### Risk appetite

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

#### Exposures

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

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

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

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

The Group's insurance activities also expose it to market risk, encompassing interest rate, exchange rate, property, credit spreads and equity risk:

- The management of the With Profit Funds within the Group's insurance companies involves mismatching of assets and liabilities with the aim of generating a higher rate of return on assets to meet policyholders' expectations.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in Force (VIF) see note 28.)
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.
- Surplus assets are held primarily in four portfolios: (a) surpluses in the long term funds of Clerical Medical Investment Group Limited and its subsidiaries; (b) assets in shareholder funds of life assurance companies; (c) an investment portfolio within the general insurance business and (d) surplus within the main fund of Heidelberger Lebensversicherung AG.

The Group's defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 41.

#### Measurement

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

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the

## Notes to the consolidated financial statements

### 54 Financial risk management (continued)

business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures.

#### Banking – trading assets and other treasury positions

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

#### Banking – non-trading

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

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

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

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

#### Pension schemes

Management of the assets of the Group's defined benefit pension schemes is the responsibility of the Scheme Trustees, who also appoint the Scheme Actuaries to perform the triennial valuations. The Group monitors its pensions exposure holistically using a variety of metrics including accounting and economic deficits and contribution rates. These and other measures are regularly reviewed by the Lloyds Banking Group's Pensions Strategy Committee and used in discussions with the Trustees, through whom any risk management and mitigation activity must be conducted.

#### Insurance portfolios

The Group's market risk exposure in respect of insurance activities described above is measured using European Embedded Value (EEV) as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2009 and 2008. During 2009, the credit spread sensitivity was changed from a 25 basis point increase to a 30 per cent widening of the spread between corporate bonds and the swap curve including an allowance for the assumed change in the illiquidity premium. Foreign exchange risk arises predominantly from overseas equity holdings. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently is not tracked on a daily basis.

	<b>31 December 2009</b>	31 December 2008 unaudited
	<b>£m</b>	£m
Equity risk (impact of 10 per cent fall pre-tax)	<b>(188)</b>	(193)
Interest rate risk (impact of 25 basis point reduction pre-tax)	<b>(1)</b>	1
Credit spread risk (impact of 30 per cent increase pre-tax)	<b>14</b>	n/a

#### Mitigation

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

#### Banking – non-trading activities

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

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

#### Insurance activities

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

#### Monitoring

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

## Notes to the consolidated financial statements

### 54 Financial risk management (continued)

#### Banking activities

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

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

#### Insurance activities

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the Group's overall risk appetite and regularly reviewed by the Lloyds Banking Group Asset and Liability Committee:

- The With Profit Funds are managed in accordance with the relevant fund's principles and practices of financial management and legal requirements.
- The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.
- Investment strategy for surplus assets held in excess of liabilities takes account of the legal, regulatory and internal business requirements for capital to be held to support the business now and in the future.

The Group also agrees strategies for the overall mix of pension assets with the pension scheme trustees.

### (3) Liquidity risk

#### Definition

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

Consistent with regulatory requirements, the Banking and Insurance parts of the Group manage their liquidity independently on a stand-alone basis. Liquidity for all banking business is managed centrally. Liquidity risk taken in insurance business is managed at business unit level and is not considered further in this section.

#### Risk appetite

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

#### Exposure

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

#### Measurement

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

#### Mitigation

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

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

#### Monitoring

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



## Notes to the consolidated financial statements

### 54 Financial risk management (continued)

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

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

#### (4) Insurance risk

##### *Definition*

The risk of reductions in earnings and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/underwritten events and to fluctuations in the timing and amount of claim settlements. This includes fluctuations in profits due to customer behaviour.

##### *Risk appetite*

Insurance risk appetite is defined with regard to the quantum and composition of insurance risk that exists currently in the Group and the direction in which the Lloyds Banking Group wishes to manage this. It takes account of the need for each entity in the Lloyds Banking Group to maintain solvency in excess of the minimum level required by the entity's jurisdictional legal or regulatory requirements.

The Group's overall appetite for insurance risk is reviewed and approved annually by the Lloyds Banking Group board.

##### *Exposures*

The major sources of insurance risk within the Group are the insurance businesses and the Group's defined benefit staff pension schemes. The nature of insurance business involves the accepting of insurance risks which relate primarily to mortality, longevity, morbidity, persistency, expenses, property damage and unemployment. The prime insurance risk carried by the Group's staff pension schemes is related to longevity.

##### *Measurement*

Insurance risks are measured using a variety of techniques including stress and scenario testing; and, where appropriate, stochastic modelling.

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate.

##### *Mitigation*

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level committees/boards. For the life assurance businesses the key control body is the board of HBOS Financial Services Limited with the more significant risks also being subject to approval by the Lloyds Banking Group Executive Committee and/or Lloyds Banking Group board. For the general insurance businesses the key control bodies are the boards of St Andrew's Insurance and the Irish subsidiaries, with the more significant risks again being subject to Lloyds Banking Group Executive Committee and/or Lloyds Banking Group board approval. All Group staff pension schemes issues are covered by the Lloyds Banking Group Asset and Liability and Business Risk Committees.

The overall insurance risk is mitigated through pooling and through diversification across large numbers of uncorrelated individuals, geographical areas, and different types of risk exposure. Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)
- Pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products)
- Claims management
- Product design
- Policy wording
- Product management
- The use of reinsurance or other risk mitigation techniques.

In addition, limits are used as a control mechanism for insurance risk at policy level.

At all times, close attention is paid to the adequacy of reserves, solvency management and regulatory requirements.

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present.

In respect of insurance risks in the staff pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees to assist with the management of risk in line with the Group's risk appetite.

## Notes to the consolidated financial statements

**54 Financial risk management** (continued)*Monitoring*

Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk. Reasons for any significant divergence from experience are investigated and remedial action is taken.

Insurance risk exposures are reported and monitored regularly by the Lloyds Banking Group Executive Committee.

**(ii) Quantitative information****(1) Credit risk**

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

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

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Loans and receivables:				
Loans and advances to customers	425,347	461,114	–	–
Loans and advances to banks	98,524	16,796	–	–
Debt securities	33,468	39,976	1	–
Deposit amounts available for offset <sup>1</sup>	(9,257)	(15,198)	–	–
Impairment losses	(23,272)	(11,616)	–	–
	524,810	491,072	1	–
Available-for-sale financial assets (excluding equity shares)	19,642	25,787	–	–
Trading and other financial assets at fair value through profit or loss (excluding equity shares)	45,574	44,585	–	–
Derivative assets, before netting	30,919	51,810	1,711	2,638
Amounts available for offset under master netting arrangements <sup>1</sup>	(19,941)	(37,369)	(1,711)	(2,638)
	10,978	14,441	–	–
Assets arising from reinsurance contracts held	1,456	1,396	–	–
Financial guarantees	8,025	10,314	4,369	4,633
Irrevocable loan commitments and other credit-related contingencies <sup>2</sup>	31,517	50,903	–	–
	642,002	638,498	4,370	4,633
Maximum credit risk exposure	642,002	638,498	4,370	4,633
Maximum credit risk exposure before offset items	671,200	691,065	6,081	7,271

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

<sup>2</sup>See note 52 – Contingent liabilities and commitments for further information.

A general description of collateral held in respect of financial instruments is disclosed on page 91.

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

**Available-for-sale debt securities, treasury and other bills, and trading and other financial assets at fair value through profit or loss** – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 16 and a similar analysis for available-for-sale financial assets is included in note 24. The Group's non-participating investment contracts are all unit-linked. Trading and other financial assets at fair value through profit or loss which back those investment contracts were £13,705 million (2008: £15,943 million). Movements in the fair value of such assets, including movements arising from credit risk, are borne by the contract holders.

**Derivative assets** – the Group reduces exposure to credit risk by using master netting agreements and by obtaining cash collateral. An analysis of derivative assets is given in note 17. Of the net derivative assets of £10,978 million (2008 £14,441 million), cash collateral of £568 million (2008: £nil) was held and a further £4,048 million was due from OECD banks (2008: £5,802 million).

**Assets arising from reinsurance contracts held** – of the assets arising from reinsurance contracts held at 31 December 2009 of £1,456 million (2008: £1,396 million), £278 million (2008: £272 million) were due from insurers with a credit rating of AA or above.

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

## Notes to the consolidated financial statements

**54 Financial risk management** (continued)

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

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

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

**Loans and advances**

	Loans and advances to customers					Loans and advances designated at fair value through profit or loss £m
	Loans and advances to banks £m	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
<b>31 December 2009</b>						
Neither past due nor impaired	98,524	236,050	17,672	109,300	363,022	19,519
Past due but not impaired	–	9,793	805	4,708	15,306	–
Impaired – no provision required	–	1,515	26	5,015	6,556	–
– provision held	–	4,405	1,438	34,620	40,463	–
Gross	98,524	251,763	19,941	153,643	425,347	19,519
Allowance for impairment losses (note 23)	–	(1,412)	(749)	(19,111)	(21,272)	–
Net	98,524	250,351	19,192	134,532	404,075	19,519
<b>31 December 2008</b>						
Neither past due nor impaired	16,796	243,011	21,448	153,606	418,065	9,882
Past due but not impaired	–	11,974	660	6,745	19,379	–
Impaired – no provision required	–	1,057	1	3,327	4,385	–
– provision held	–	2,928	2,556	13,801	19,285	–
Gross	16,796	258,970	24,665	177,479	461,114	9,882
Allowance for impairment losses (note 23)	–	(1,280)	(1,907)	(7,506)	(10,693)	–
Net	16,796	257,690	22,758	169,973	450,421	9,882

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

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

## Notes to the consolidated financial statements

## 54 Financial risk management (continued)

## Loans and advances which are neither past due nor impaired

	Loans and advances to customers					Loans and advances designated at fair value through profit or loss £m
	Loans and advances to banks £m	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	
<b>31 December 2009</b>						
Good quality	97,787	227,558	11,237	20,685		19,519
Satisfactory quality	–	6,296	4,212	32,262		–
Lower quality	–	746	632	38,712		–
Below standard, but not impaired	737	1,450	1,591	17,641		–
<b>Total</b>	<b>98,524</b>	<b>236,050</b>	<b>17,672</b>	<b>109,300</b>	<b>363,022</b>	<b>19,519</b>
<b>31 December 2008</b>						
Good quality	16,369	238,891	14,660	32,030		9,882
Satisfactory quality	–	3,193	4,796	66,956		–
Lower quality	–	371	552	41,295		–
Below standard, but not impaired	427	556	1,440	13,325		–
<b>Total</b>	<b>16,796</b>	<b>243,011</b>	<b>21,448</b>	<b>153,606</b>	<b>418,065</b>	<b>9,882</b>

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

## Loans and advances which are past due but not impaired

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

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

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

## Notes to the consolidated financial statements

**54 Financial risk management** (continued)

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

**Renegotiated loans and advances**

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

**Reposessed collateral**

	2009 £m	2008 £m
Residential property	1,143	617
Other	17	–
<b>Total</b>	<b>1,160</b>	<b>617</b>

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.

**Loan-to-value ratio of mortgage lending**

	2009 £m	2008 £m
Analysis by loan-to-value ratio of the Group's residential mortgage lending which is neither past due nor impaired:		
Less than 70 per cent	88,795	92,098
70 per cent to 80 per cent	37,214	33,052
80 per cent to 90 per cent	37,177	38,877
Greater than 90 per cent	72,864	78,984
<b>Total</b>	<b>236,050</b>	<b>243,011</b>

## Notes to the consolidated financial statements

**54 Financial risk management** (continued)

Debt securities – analysis by credit rating:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>As at 31 December 2009</b>							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	2,059	805	–	–	–	–	2,864
Corporate and other debt securities	1,331	1,613	2,608	283	28	–	5,863
Total held as trading assets	3,390	2,418	2,608	283	28	–	8,727
<i>Other assets held at fair value through profit or loss:</i>							
Government securities	8,528	442	155	24	1	9	9,159
Other public sector securities	650	16	–	–	–	–	666
<i>Asset-backed securities:</i>							
Mortgage-backed securities	117	6	3	–	–	–	126
Other asset-backed securities	149	31	118	31	14	–	343
	266	37	121	31	14	–	469
Corporate and other debt securities	1,521	777	1,876	991	458	1,411	7,034
Total held at fair value through profit or loss*	14,355	3,690	4,760	1,329	501	1,420	26,055
<b>Available-for-sale financial assets</b>							
<i>Debt securities:</i>							
Government securities	12	314	–	–	–	–	326
Bank and building society certificates of deposit	22	142	99	22	–	–	285
<i>Asset-backed securities:</i>							
Mortgage-backed securities	17	–	–	–	–	–	17
Other asset-backed securities	69	10	–	–	–	–	79
	86	10	–	–	–	–	96
Corporate and other debt securities	2,011	6,653	8,667	1,350	228	26	18,935
Total held as available-for-sale assets	2,131	7,119	8,766	1,372	228	26	19,642
<b>Debt securities classified as loans and receivables</b>							
<i>Asset-backed securities:</i>							
Mortgage-backed securities	9,192	2,917	1,524	890	1,032	–	15,555
Other asset-backed securities	11,767	2,308	1,383	412	835	–	16,705
	20,959	5,225	2,907	1,302	1,867	–	32,260
Corporate and other debt securities	–	–	–	–	–	1,208	1,208
Total debt securities classified as loans and receivables	20,959	5,225	2,907	1,302	1,867	1,208	33,468

\*This total excludes equity shares of £56,334 million and loans and advances of £19,519 million.

## Notes to the consolidated financial statements

**54 Financial risk management** (continued)

Debt securities – analysis by credit rating:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>As at 31 December 2008</b>							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	5,556	236	–	–	–	–	5,792
Corporate and other debt securities	2,543	2,626	2,307	106	164	–	7,746
Total held as trading assets	8,099	2,862	2,307	106	164	–	13,538
<i>Other assets held at fair value through profit or loss:</i>							
Government securities	9,391	387	206	5	–	14	10,003
Other public sector securities	1,283	130	79	1	45	–	1,538
Bank and building society certificates of deposit	–	–	349	–	–	–	349
<i>Asset-backed securities:</i>							
Mortgage-backed securities	176	9	5	2	–	–	192
Other asset-backed securities	360	23	63	31	10	–	487
	536	32	68	33	10	–	679
Corporate and other debt securities	3,996	1,669	1,789	617	85	440	8,596
Total held at fair value through profit or loss*	23,305	5,080	4,798	762	304	454	34,703
<b>Available-for-sale financial assets</b>							
<i>Debt securities:</i>							
Government securities	23	343	–	14	–	–	380
Bank and building society certificates of deposit	1,032	977	904	45	–	–	2,958
<i>Asset-backed securities:</i>							
Mortgage-backed securities	5	12	–	–	–	–	17
Other asset-backed securities	240	591	–	–	–	12	843
	245	603	–	–	–	12	860
Corporate and other debt securities	3,739	9,302	7,926	298	204	120	21,589
Total held as available-for-sale assets	5,039	11,225	8,830	357	204	132	25,787
<b>Debt securities classified as loans and receivables</b>							
<i>Asset-backed securities:</i>							
Mortgage-backed securities	13,090	1,930	824	1,054	1,375	–	18,273
Other asset-backed securities	15,649	1,735	1,422	785	1,192	–	20,783
	28,739	3,665	2,246	1,839	2,567	–	39,056
Corporate and other debt securities	–	–	–	–	–	920	920
Total debt securities classified as loans and receivables	28,739	3,665	2,246	1,839	2,567	920	39,976

\*This total excludes equity shares of £45,106 million and loans and advances of £9,882 million.

## Notes to the consolidated financial statements

**54 Financial risk management** (continued)**(2) Market risk**

## Interest rate risk

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

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

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

At 31 December 2009 the aggregate notional principal of interest rate swaps designated as fair value hedges was £55,891 million (2008: £68,474 million) with a net fair value asset of £2,549 million (2008: £4,164 million) (see note 17). The losses on the hedging instruments were £991 million (2008: gains of £3,467 million). The gains on the hedged items attributable to the hedged risk were £1,091 million (2008: losses of £3,110 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next six years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2009 was £229,390 million (2008: £323,971 million) with a net fair value liability of £2,031 million (2008: £1,119 million) (see note 17). In 2009, ineffectiveness recognised in the income statement that arises from cash flow hedges was £5 million (2008: £3 million). There were no transactions for which cash flow hedge accounting had to be ceased in 2009 or 2008 as a result of the highly probable cash flows no longer being expected to occur.

**(3) Currency risk**

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

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

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

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

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

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Functional currency of Group operations				
Euro:				
Gross exposure	2,651	3,011	-	-
Net investment hedge	(2,651)	(3,011)	-	-
	-	-	-	-
Australian Dollar:				
Gross exposure	1,869	2,015	-	-
Net investment hedge	(1,832)	(2,015)	-	-
	37	-	-	-
US Dollar:				
Gross exposure	(62)	191	-	-
Net investment hedge	62	(181)	-	-
	-	10	-	-
Other non-sterling	(2)	(23)	-	-
	35	(13)	-	-



## Notes to the consolidated financial statements

**54 Financial risk management** (continued)**(4) Liquidity risk**

The table below analyses financial instrument liabilities of the Group, excluding those arising from insurance and participating investment contracts, 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.

<b>Group</b>	<b>Up to 1 month £m</b>	<b>1-3 months £m</b>	<b>3-12 months £m</b>	<b>1-5 years £m</b>	<b>Over 5 years £m</b>	<b>Total £m</b>
<b>As at 31 December 2009</b>						
Deposits from banks	83,049	71,519	16,167	2,281	7,314	180,330
Customer deposits	158,313	29,194	23,271	20,267	2,049	233,094
Trading and other financial liabilities at fair value through profit or loss	15,471	5,120	6,684	134	–	27,409
Debt securities in issue	14,169	11,938	18,722	69,671	20,270	134,770
Liabilities arising from non-participating investment contracts	30,306	4	58	185	186	30,739
Subordinated liabilities	42	28	1,034	10,137	13,720	24,961
<b>Total non-derivative financial liabilities</b>	<b>301,350</b>	<b>117,803</b>	<b>65,936</b>	<b>102,675</b>	<b>43,539</b>	<b>631,303</b>
Derivative financial liabilities:						
Gross settled derivative – outflow	14,583	6,048	8,285	37,620	37,790	104,326
Gross settled derivative – inflow	(14,399)	(6,134)	(8,364)	(37,097)	(36,202)	(102,196)
Gross settled derivative – netflow	184	(86)	(79)	523	1,588	2,130
Net settled derivative liabilities	1,293	2,240	9,613	8,970	15	22,131
<b>Total derivative financial liabilities</b>	<b>1,477</b>	<b>2,154</b>	<b>9,534</b>	<b>9,493</b>	<b>1,603</b>	<b>24,261</b>
<b>As at 31 December 2008</b>						
Deposits from banks	49,712	41,710	3,881	1,456	546	97,305
Customer deposits	175,814	15,648	41,634	6,474	1,670	241,240
Trading and other financial liabilities at fair value through profit or loss	10,994	4,640	3,518	–	–	19,152
Debt securities in issue	21,684	25,443	40,453	83,513	26,732	197,825
Liabilities arising from non-participating investment contracts	29,057	–	1	–	26	29,084
Subordinated liabilities	28	1,238	1,668	13,604	24,750	41,288
<b>Total non-derivative financial liabilities</b>	<b>287,289</b>	<b>88,679</b>	<b>91,155</b>	<b>105,047</b>	<b>53,724</b>	<b>625,894</b>
Derivative financial liabilities:						
Gross settled derivative – outflow	35,701	31,615	19,016	42,827	35,077	164,236
Gross settled derivative – inflow	(36,761)	(32,588)	(19,028)	(42,323)	(33,121)	(163,821)
Gross settled derivative – netflow	(1,060)	(973)	(12)	504	1,956	415
Net settled derivative liabilities	1,041	1,085	8,557	15,201	7,708	33,592
<b>Total derivative financial liabilities</b>	<b>(19)</b>	<b>112</b>	<b>8,545</b>	<b>15,705</b>	<b>9,664</b>	<b>34,007</b>
<b>Company</b>						
	<b>Up to 1 month £m</b>	<b>1-3 months £m</b>	<b>3-12 months £m</b>	<b>1-5 years £m</b>	<b>Over 5 years £m</b>	<b>Total £m</b>
<b>As at 31 December 2009</b>						
Subordinated liabilities	–	89	940	8,683	9,312	19,024
<b>Total non-derivative financial liabilities</b>	<b>–</b>	<b>89</b>	<b>940</b>	<b>8,683</b>	<b>9,312</b>	<b>19,024</b>
Derivative financial liabilities:						
Gross settled derivative – outflow	1	–	4	35	238	278
Gross settled derivative – inflow	(1)	–	(3)	(35)	(216)	(255)
Gross settled derivative – netflow	–	–	1	–	22	23
Net settled derivative liabilities	(1)	–	7	10	9	25
<b>Total derivative financial liabilities</b>	<b>(1)</b>	<b>–</b>	<b>8</b>	<b>10</b>	<b>31</b>	<b>48</b>
<b>As at 31 December 2008</b>						
Subordinated liabilities	–	530	812	8,369	18,361	28,072
<b>Total non-derivative financial liabilities</b>	<b>–</b>	<b>530</b>	<b>812</b>	<b>8,369</b>	<b>18,361</b>	<b>28,072</b>
Derivative financial liabilities:						
Gross settled derivative – outflow	3	–	6	38	262	309
Gross settled derivative – inflow	(3)	–	(5)	(32)	(214)	(254)
Gross settled derivative – netflow	–	–	1	6	48	55
Net settled derivative liabilities	(3)	–	6	9	12	24
<b>Total derivative financial liabilities</b>	<b>(3)</b>	<b>–</b>	<b>7</b>	<b>15</b>	<b>60</b>	<b>79</b>

## Notes to the consolidated financial statements

**54 Financial risk management** (continued)

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

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

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £54 million (2008: £62 million) for the Group and £42 million (2008: £47 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.

Liabilities arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>As at 31 December 2009</b>	<b>5,759</b>	<b>1,100</b>	<b>2,901</b>	<b>9,907</b>	<b>19,567</b>	<b>39,234</b>
As at 31 December 2008	366	644	2,953	10,836	22,074	36,873

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

<b>Group</b>	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
<b>31 December 2009</b>					
Acceptances and endorsements	5	–	–	–	5
Other contingent liabilities	489	54	765	54	1,362
Total contingent liabilities	494	54	765	54	1,367
Lending commitments	36,336	3,292	10,786	3,595	54,009
Other commitments	55	–	14	–	69
Total commitments	36,391	3,292	10,800	3,595	54,078
Total contingents and commitments	36,885	3,346	11,565	3,649	55,445
	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
<b>31 December 2008</b>					
Acceptances and endorsements	–	–	–	–	–
Other contingent liabilities	495	74	644	139	1,352
Total contingent liabilities	495	74	644	139	1,352
Lending commitments	50,211	1,492	15,272	9,577	76,552
Other commitments	83	–	54	–	137
Total commitments	50,294	1,492	15,326	9,577	76,689
Total contingents and commitments	50,789	1,566	15,970	9,716	78,041

## Notes to the consolidated financial statements

**55 Capital**

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

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

In the case of the Group, this means that the net assets of its life assurance and general insurance businesses are excluded from its total regulatory capital. The Group's capital resources are summarised as follows:

	2009 £m	2008 £m
Tier 1 capital	<b>31,007</b>	19,790
Tier 2 capital	<b>12,849</b>	19,033
	<b>43,856</b>	38,823
Supervisory deductions	<b>(5,517)</b>	(5,044)
Total capital	<b>38,339</b>	33,779

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities. The unpredictable nature of movements in the value of the investments supporting the long-term assurance funds could cause the amount of qualifying tier 2 capital to be restricted because of falling tier 1 resources. The Group seeks to ensure that even in the event of such restrictions the total capital ratio will remain adequate.

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

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

**56 Consolidated cash flow statement****(a) Change in operating assets**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Change in loans and advances to banks	<b>(10,868)</b>	(10,971)	<b>2,496</b>	(11,272)
Change in loans and advances to customers	<b>35,573</b>	2,822	–	–
Change in debt securities held as loans and receivables	<b>6,301</b>	(37,428)	–	–
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	<b>(2,879)</b>	28,869	<b>935</b>	(2,476)
Change in other operating assets	<b>(3,440)</b>	40,055	<b>(1,451)</b>	43,918
Change in operating assets	<b>24,687</b>	23,347	<b>1,980</b>	30,170

**(b) Change in operating liabilities**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Change in deposits from banks	<b>81,914</b>	55,637	<b>1,000</b>	–
Change in customer deposits	<b>(5,426)</b>	(20,920)	–	–
Change in debt securities in issue	<b>(69,291)</b>	(18,072)	–	–
Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss	<b>7,251</b>	1,200	<b>(12)</b>	(1)
Change in investment contract liabilities	<b>1,557</b>	(13,346)	–	–
Change in other operating liabilities	<b>5,840</b>	5,687	<b>107</b>	8,815
Change in operating liabilities	<b>21,845</b>	10,186	<b>1,095</b>	8,814

## Notes to the consolidated financial statements

**56 Consolidated cash flow statement** (continued)**(c) Non-cash and other items**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Depreciation and amortisation	1,174	1,608	2	–
Revaluation of investment properties	112	1,358	–	–
Allowance for loan losses	19,515	10,780	–	–
Write-off of allowance for loan losses	(7,458)	(2,408)	–	–
Impairment of available-for-sale securities	620	1,270	–	–
Impairment of goodwill	764	158	–	–
Impairment losses on investments in subsidiaries	–	–	9,844	4,192
Change in insurance contract liabilities	2,361	2,817	–	–
Other provision movements	111	172	73	–
Net charge in respect of defined benefit schemes	177	171	279	(20)
Contributions to defined benefit schemes	(293)	(225)	(360)	–
Other non-cash items	1,621	(23)	(1,637)	(19)
Total non-cash items	18,704	15,678	8,201	4,153
Interest expense on subordinated liabilities	1,118	1,579	849	1,068
Loss/(profit) on disposal of businesses	(26)	845	–	–
Total other items	1,092	2,424	849	1,068
Non-cash and other items	19,796	18,102	9,050	5,221

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

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Cash and balances with central banks	2,905	2,502	–	–
Less: mandatory reserve deposits <sup>1</sup>	(335)	(314)	–	–
	2,570	2,188	–	–
Loans and advances to banks	98,524	16,796	46,186	50,157
Less: amounts with a maturity of three months or more	(18,617)	(7,748)	(8,073)	(10,566)
	79,907	9,048	38,113	39,591
Total cash and cash equivalents	82,477	11,236	38,113	39,591

<sup>1</sup>Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

**(e) Analysis of changes in financing during the year**

	Group		Company	
	2009 £m	2008 £m	2009 £m	2008 £m
Share capital (including share premium account and merger reserve):				
At 1 January	9,009	4,128	8,259	4,128
Issue of ordinary and preference shares	25,295	4,881	25,295	4,131
Redemption of preference shares	(4,267)	–	(4,267)	–
At 31 December	30,037	9,009	29,287	8,259
Minority interests:				
At 1 January	1,300	385	–	–
Issue of equity preference shares to minority shareholders	–	750	–	–
Exchange and other adjustments	–	5	–	–
Minority interest acquired	–	242	–	–
Repayment of capital to minority shareholders	(35)	(110)	–	–
Minority share of profit after tax	101	83	–	–
Dividends to minority shareholders	(95)	(55)	–	–
At 31 December	1,271	1,300	–	–

## Notes to the consolidated financial statements

**56 Consolidated cash flow statement** (continued)

	<b>2009</b>	2008	<b>2009</b>	2008
	<b>£m</b>	£m	<b>£m</b>	£m
Subordinated liabilities:				
At 1 January	<b>30,119</b>	24,253	<b>22,235</b>	15,503
Exchange and other adjustments	<b>(2,863)</b>	6,602	<b>(1,555)</b>	4,714
Issue of subordinated liabilities	–	2,285	–	2,285
Repayments of subordinated liabilities	<b>(8,178)</b>	(3,021)	<b>(6,126)</b>	(267)
At 31 December	<b>19,078</b>	30,119	<b>14,554</b>	22,235
<b>(f) Acquisition of group undertakings, joint ventures and associates</b>				
	<b>2009</b>	2008	<b>2009</b>	2008
	<b>£m</b>	£m	<b>£m</b>	£m
Capital subscriptions in joint ventures and associates	<b>(215)</b>	(469)	–	–
Additional capital injections and investment in subsidiaries	<b>(99)</b>	–	<b>(20,189)</b>	(7,955)
At 31 December	<b>(314)</b>	(469)	<b>(20,189)</b>	(7,955)
<b>(g) Disposal and closure of group undertakings, joint ventures and associates</b>				
	<b>2009</b>	2008	<b>2009</b>	2008
	<b>£m</b>	£m	<b>£m</b>	£m
Cash and balances at central banks	–	577	–	–
Trading and other financial assets at fair value through profit or loss	<b>(28)</b>	490	–	–
Liabilities arising from insurance contracts and participating investment contracts	–	(27)	–	–
Liabilities arising from non-participating investment contracts	–	(77)	–	–
Other net assets and liabilities	<b>23</b>	1,569	–	–
	<b>(5)</b>	2,532		
Profit/(loss) on sale of businesses	<b>26</b>	(845)	–	–
Cash and cash equivalents disposed of	–	(577)	–	–
Net cash inflow from disposals	<b>21</b>	1,110	–	–
Capital redemptions in joint ventures and associates	<b>238</b>	75	–	–
At 31 December	<b>259</b>	1,185	–	–

## Notes to the consolidated financial statements

**57 Prior year reclassifications**

The following tables set out the balance sheet as at 31 December 2008 as presented in the 2008 financial statements of the Group and the income statement for the year ended 31 December 2008 as presented in the 2008 interim results for the Group with reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group.

Consolidated balance sheet as at 31 December 2008

	Adjustments			As restated £m
	As previously presented £m	Prior year adjustments £m	Balance sheet reclassifi- cations £m	
<b>Assets</b>				
Cash and balances at central banks	2,502	–	–	2,502
Items in course of collection from banks	445	–	–	445
Trading and other assets designated at fair value through profit or loss	(i) 22,571	–	67,120	89,691
Derivative financial instruments	51,810	–	–	51,810
Loans and receivables:				
Loans and advances to banks	(i) 17,645	–	(849)	16,796
Loans and advances to customers	(v) 435,223	–	15,198	450,421
Debt securities	(i) –	–	39,053	39,053
	452,868	–	53,402	506,270
Investment securities	(i) 133,372	–	(133,372)	–
Available-for-sale financial assets	(i) –	–	28,048	28,048
Investment properties	3,045	–	–	3,045
Interests in joint ventures and associates	1,161	–	–	1,161
Goodwill and other intangible assets	(iv) 2,375	–	(2,375)	–
Goodwill	(iv) –	–	1,556	1,556
Value of in-force business	(iv) 2,992	–	292	3,284
Other intangible assets	(iv) –	–	117	117
Property and equipment/tangible fixed assets	(ii) (iv) 1,433	–	4,377	5,810
Operating lease assets	(ii) 3,967	–	(3,967)	–
Deferred costs	(iii) 1,181	–	(1,181)	–
Current tax assets	983	–	–	983
Deferred tax assets	2,556	276	–	2,832
Retirement benefit asset	(iii) 629	(583)	(46)	–
Other assets	(iii) 4,851	–	2,403	7,254
Prepayments and accrued income	(iii) 1,176	–	(1,176)	–
<b>Total assets</b>	<b>689,917</b>	<b>(307)</b>	<b>15,198</b>	<b>704,808</b>

## Notes to the consolidated financial statements

## 57 Prior year reclassifications (continued)

	Adjustments			
	As previously presented £m	Prior year adjustments £m	Balance sheet reclassifications £m	As restated £m
<b>Liabilities</b>				
Deposits from banks	97,150	–	–	97,150
Customer deposits	(v) 222,251	–	15,198	237,449
Items in course of transmission to banks	(vi) –	–	521	521
Trading and other financial liabilities at fair value through profit or loss	18,851	–	–	18,851
Derivative financial instruments	38,905	–	–	38,905
Notes in circulation	957	–	–	957
Debt securities in issue	188,448	–	–	188,448
Insurance contract liabilities	(vii) 30,712	–	(30,712)	–
Investment contract liabilities	(vi)(vii) 39,482	–	(39,482)	–
Liabilities arising from insurance contracts and participating investment contracts	(vii) –	–	36,873	36,873
Liabilities arising from non-participating investment contracts	(vii) –	–	29,057	29,057
Unallocated surplus within insurance businesses	551	–	–	551
Other liabilities	(vi)(vii) 5,109	–	7,042	12,151
Retirement benefit obligations	152	410	–	562
Current tax liabilities	58	–	–	58
Deferred tax liabilities	227	–	–	227
Accruals and deferred income	(vi) 3,099	–	(3,099)	–
Other provisions	(vi) 347	–	(200)	147
Subordinated liabilities/other borrowed funds	30,119	–	–	30,119
<b>Total liabilities</b>	<b>676,418</b>	<b>410</b>	<b>15,198</b>	<b>692,026</b>
<b>Net assets</b>	<b>13,499</b>	<b>(717)</b>	<b>–</b>	<b>12,782</b>

*Prior year adjustments*

As detailed in accounting policy 2(l), the Group changed its accounting policy for its defined benefits pension schemes during the period. This change in accounting policy has resulted in a restatement of previous years' recognised actuarial gains and losses which amount to £993 million (gross of tax) and £717 million (net of tax). This has resulted in the net assets of the Group as at 1 January 2008 decreasing by £149 million from £22,234 million to £22,085 million. The actuarial gains and losses of £568 million for the year ended 31 December 2008 are unrecognised. No adjustment has been made to the 2008 income statement as the amount is not material.

*Balance sheet reclassifications*

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

- (i) the reclassification of investment securities (£133,372 million) and certain loans and advances to banks (£849 million) to trading and other financial assets at fair value through the profit and loss (£67,120 million); available-for-sale financial assets (£28,048 million) and debt securities classified as loans and receivables (£39,053 million);
- (ii) the reclassification of operating lease assets (£3,967 million) to tangible fixed assets;
- (iii) the reclassification of deferred costs (£1,181 million), prepayments and accrued income (£1,176 million) and the retirement benefit asset (£46 million) to other assets;
- (iv) the reclassification of goodwill and intangible assets into their separate components, goodwill (£1,556 million), other intangibles (£117 million) and the reclassification of software items deemed integral to the equipment balance from within intangibles to tangible fixed assets (£410 million). The reclassification of purchased value of in-force investment contracts to value of in-force long-term insurance business (£292 million);
- (v) the representation of certain customer deposit amounts (£15,198 million) available for offset onto a gross basis;
- (vi) the reclassification of accruals and deferred income (£3,099 million) to other liabilities, the reclassification of other liabilities (£521 million) to items in the course of transmission to banks. The reclassification of other provisions (£200 million) to other liabilities, and the reclassification of investment contracts related to collective investment schemes (£4,264 million) within investment contract liabilities, to other liabilities; and
- (vii) the reclassification of insurance contract liabilities (£30,712 million) to liabilities arising from insurance contracts and participating investment contracts, the reclassification of participating investment contracts (£6,161 million) from investment contract liabilities to liabilities arising from insurance contracts and participating investment contracts, the reclassification of non-participating investment contracts (£29,057 million) to liabilities arising from non-participating investment contracts and the remainder of investment contract liabilities (£4,264 million) to other liabilities.

## Notes to the consolidated financial statements

**57 Prior year reclassifications** (continued)

Consolidated income statement for the year ended 31 December 2008

		As previously presented £m	Reclassifi- cations £m	As restated £m
Interest and similar income	(i)(ii)	37,411	(1,632)	35,779
Interest and similar expense	(i)	(29,240)	3,515	(25,725)
Fees and commission income	(i)	2,305	(247)	2,058
Fees and commission expense		(1,178)	–	(1,178)
Net trading income	(ii)	(2,878)	(10,017)	(12,895)
Net earned premiums on insurance contracts/insurance premium income		5,344	–	5,344
Change in value of in force long-term assurance business		(300)	300	–
Net investment income related to insurance and investment business	(ii)	(9,524)	9,524	–
Other operating income	(ii)	1,672	217	1,889
Change in investment contract liabilities	(iii)	12,816	(12,816)	–
Net claims incurred on insurance contracts	(iii)	(3,703)	3,703	–
Net change in insurance contract liabilities	(iii)	(3,863)	3,863	–
Insurance claims	(iii)	–	4,634	4,634
Operating expenses	(iv)	–	(6,880)	(6,880)
Change in unallocated surplus	(iii)	942	(942)	–
Administrative expenses	(iv)	(5,114)	5,114	–
Depreciation and amortisation:				
Intangible assets other than goodwill	(iv)	(209)	209	–
Property and equipment	(iv)	(221)	221	–
Operating lease assets	(iv)	(1,178)	1,178	–
		(1,608)	1,608	–
Goodwill impairment	(iv)	(158)	158	–
Impairment losses on loans and advances	(v)	(9,857)	9,857	–
Impairment of investment securities	(v)	(2,193)	2,193	–
Impairment	(v)	–	(12,050)	(12,050)
Share of losses of jointly controlled entities	(vi)	(669)	669	–
Share of losses of associated undertakings	(vi)	(287)	287	–
Share of results of joint ventures and associates	(vi)	–	(956)	(956)
Non-operating income/profit on sale of businesses		(743)	(102)	(845)
<b>Loss before taxation</b>		(10,825)	–	(10,825)
Tax on loss		3,409	–	3,409
<b>Loss for the year</b>		(7,416)	–	(7,416)

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

- (i) the representation of certain derivative income amounts (£3,515 million) that are available for offset onto a net basis from within interest and similar income to interest and similar expense, the reclassification of £1,558 million of OEIC's income from change in investment contract liabilities to interest income, and the reclassification of certain loan fees from fee and commission income to interest and similar income (£247 million) as they form part of the effective yield.
- (ii) the reclassification of net investment income (expense of £9,524 million) to net trading income (expense of £9,651 million), interest and similar income (income of £127 million) and other operating income (expense of £415 million) to net trading income offset by a £49 million reclassification from interest and similar income to net trading income;
- (iii) the reclassification of change in investment contract liabilities (£12,816 million), offset by net claims incurred on insurance contracts (£3,703 million), net change in insurance contract liabilities (£3,863 million) and the change in unallocated surplus (£942 million) to insurance claims;
- (iv) the reclassification of administrative expenses (£5,114 million), depreciation and amortisation (£1,608 million) and goodwill impairment (£158 million) to operating expenses;
- (v) the reclassification of impairment losses on loans and advances (£9,857 million) and investment securities (£2,193 million) to impairment losses; and
- (vi) the reclassification of share of profits of jointly controlled entities (£669 million) and share of losses of associated undertakings (£287 million) to shares of results of joint ventures and associates.



## Notes to the consolidated financial statements

**57 Prior year reclassifications** (continued)**Prior year reclassifications 2008 – Company only**

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

Balance sheet as at 31 December 2008

	As previously presented £m	Adjustments		As restated £m
		Prior year adjustments £m	Balance sheet reclassifications £m	
<b>Assets</b>				
Amounts owed by group entities	50,157	–	–	50,157
Derivative financial instruments	2,638	–	–	2,638
Intangible assets	4	–	–	4
Deferred tax assets	–	120	–	120
Retirement benefit asset	(i) 629	(583)	(46)	–
Other assets	(i)(ii) 185	–	47	232
Current tax recoverable	(ii) –	–	170	170
Prepayments and accrued income	(i) 171	–	(171)	–
Investments in subsidiaries	15,783	–	–	15,783
<b>Total assets</b>	<b>69,567</b>	<b>(463)</b>	<b>–</b>	<b>69,104</b>
<b>Liabilities</b>				
Amounts owed to group entities	36,450	–	–	36,450
Derivative financial instruments	55	–	–	55
Other liabilities	(iii) 296	–	100	396
Retirement benefit obligations	104	456	–	560
Deferred tax liabilities	161	(161)	–	–
Accruals and deferred income	(iii) 100	–	(100)	–
Subordinated liabilities/other borrowed funds	22,235	–	–	22,235
<b>Total liabilities</b>	<b>59,401</b>	<b>295</b>	<b>–</b>	<b>59,696</b>
<b>Net assets</b>	<b>10,166</b>	<b>(758)</b>	<b>–</b>	<b>9,408</b>

*Prior year adjustments*

For further details of the prior year adjustment at 31 December 2008, refer to note 2.

*Balance sheet reclassifications*

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

- (i) the reclassification of prepayments and accrued income (£171 million) and retirement benefit asset (£46 million) to other assets;
- (ii) the reclassification of current tax recoverable (£170 million) from other assets to current tax recoverable;
- (iii) the reclassification of accruals and deferred income (£100 million) to other liabilities.

## Notes to the consolidated financial statements

**57 Prior year reclassifications** (continued)**Prior year reclassifications 2007**

The following tables set out the balance sheet as at 31 December 2007 as presented in the 2007 financial statements of the Group with reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group.

Consolidated balance sheet as at 1 January 2008

	As previously presented £m	Adjustments		Restated £m
		Balance sheet reclassifications £m		
<b>Assets</b>				
Cash and balances at central banks	2,945	–		2,945
Items in course of collection from banks	945	–		945
Trading and other assets designated at fair value through profit or loss	(i) 54,681	78,829		133,510
Derivative financial instruments	14,141	–		14,141
Loans and receivables:				
Loans and advances to banks	(i) 7,683	(1,858)		5,825
Loans and advances to customers	(v) 430,007	24,934		454,941
Debt securities	(i) –	702		702
	437,690	23,778		461,468
Investment securities	(i) 127,659	(127,659)		–
Available-for-sale financial assets	(i) –	49,986		49,986
Investment properties	4,731	–		4,731
Interests in joint ventures and associates	1,724	–		1,724
Goodwill and other intangible assets	(iv) 2,790	(2,790)		–
Goodwill	(iv) –	1,940		1,940
Value of in-force business	(iv) 3,184	321		3,505
Other intangible assets	(iv) –	122		122
Property and equipment/tangible fixed assets	(ii)(iv) 1,494	5,050		6,544
Operating lease assets	(ii) 4,643	(4,643)		–
Deferred costs	(iii) 1,101	(1,101)		–
Current tax assets	–	–		–
Deferred tax assets	70	–		70
Other assets	(iii) 7,468	2,852		10,320
Prepayments and accrued income	(iii) 1,751	(1,751)		–
<b>Total assets</b>	<b>667,017</b>	<b>24,934</b>		<b>691,951</b>

## Notes to the consolidated financial statements

**57 Prior year reclassifications** (continued)

	As previously presented £m	Adjustments		As restated £m
		2007 adjustments £m	Balance sheet reclassifications £m	
<b>Liabilities</b>				
Deposits from banks	41,513	–	–	41,513
Customer deposits	(v) 243,221	–	24,934	268,155
Items in course of transmission to banks	(vi) –	–	542	542
Trading and other financial liabilities at fair value through profit or loss	22,705	–	–	22,705
Derivative financial instruments	12,311	–	–	12,311
Notes in circulation	881	–	–	881
Debt securities in issue	206,520	–	–	206,520
Insurance contract liabilities	(vii) 26,864	–	(26,864)	–
Investment contract liabilities	(vi)(vii) 52,828	–	(52,828)	–
Liabilities arising from insurance contracts and participating investment contracts	(vii) –	–	34,056	34,056
Liabilities arising from non-participating investment contracts	(vii) –	–	40,387	40,387
Unallocated surplus within insurance businesses	1,493	–	–	1,493
Other liabilities	(vi)(vii) 5,072	–	8,337	13,409
Retirement benefit obligations	347	223	–	570
Current tax liabilities	370	–	–	370
Deferred tax liabilities	2,600	(74)	–	2,526
Accruals and deferred income	(vi) 3,630	–	(3,630)	–
Other provisions	175	–	–	175
Subordinated liabilities/other borrowed funds	24,253	–	–	24,253
<b>Total liabilities</b>	<b>644,783</b>	<b>149</b>	<b>24,934</b>	<b>669,866</b>
<b>Net assets</b>	<b>22,234</b>	<b>(149)</b>	<b>–</b>	<b>22,085</b>

*Prior year adjustments*

For further details of the prior year adjustment at 31 December 2008, refer to note 2.

*Balance sheet reclassifications*

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

- (i) the reclassification of investment securities (£127,659 million) and certain loans and advances to banks (£1,858 million) to trading and other financial assets at fair value through the profit or loss (£78,829 million); available for sale financial assets (£49,986 million), and debt securities classified as loans and receivables (£702 million);
- (ii) the reclassification of operating lease assets (£4,643 million) to tangible fixed assets;
- (iii) the reclassification of deferred costs (£1,101 million) and prepayments and accrued income (£1,751 million) to other assets;
- (iv) the reclassification of goodwill and intangible assets into their separate components: goodwill (£1,940 million), other intangibles (£122 million) and the reclassification of software items deemed integral to the equipment balance within intangibles to tangible fixed assets (£407 million). The reclassification of purchased value of in-force investment contracts to value of in-force long-term insurance business (£321 million);
- (v) the representation of certain customer deposit amounts (£24,934 million) available for offset onto a gross basis;
- (vi) the reclassification of accruals and deferred income (£3,630 million) to other liabilities, the reclassification of other liabilities (£542 million) to items in the course of transmission to banks. The reclassification of investment contracts related to collective investment schemes (£5,249 million) within investment contract liabilities, to other liabilities; and
- (vii) the reclassification of insurance contract liabilities (£26,864 million) to liabilities arising from insurance contracts and participating investment contracts, the reclassification of participating investment contracts (£7,192 million) from investment contract liabilities to liabilities arising from insurance contracts and participating investment contracts, the reclassification of non-participating investment contracts (£40,387 million) to liabilities arising from non-participating investment contracts and the remainder of investment contract liabilities (£5,249 million) to other liabilities.

## Notes to the consolidated financial statements

**57 Prior year reclassifications** (continued)**Prior year reclassifications 2007 – Company only**

The following table sets out the balance sheet as at 31 December 2007 as presented in the 2007 financial statements of the Group with reclassifications made to present these statements on a basis consistent with the presentation practices adopted by Lloyds Banking Group.

Balance sheet as at 1 January 2008

	As previously presented £m	Adjustments		Restated £m
		2007 adjustments £m	Balance sheet reclassifi- cations £m	
<b>Assets</b>				
Assets owed by Group entities	38,885	–	–	38,885
Derivative financial instruments	162	–	–	162
Loans and receivables:				
Loans and advances to customers	1	–	(1)	–
Debt securities	–	–	1	1
	1	–	–	1
Intangible assets	6	–	–	6
Current tax recoverable	–	–	380	380
Deferred tax assets	85	68	–	153
Other assets	395	–	(380)	15
Investments in subsidiaries	14,475	–	–	14,475
<b>Total assets</b>	<b>54,009</b>	<b>68</b>	<b>–</b>	<b>54,077</b>
<b>Liabilities</b>				
Amounts owed to Group entities	29,267	–	–	29,267
Derivative financial instruments	56	–	–	56
Other liabilities	204	–	68	272
Retirement benefit obligations	360	233	–	593
Accruals and deferred income	68	–	(68)	–
Subordinated liabilities/other borrowed funds	15,503	–	–	15,503
<b>Total liabilities</b>	<b>45,458</b>	<b>233</b>	<b>–</b>	<b>45,691</b>
<b>Net assets</b>	<b>8,551</b>	<b>(165)</b>	<b>–</b>	<b>8,386</b>

*Prior year adjustments*

For further details of the prior year adjustment at 31 December 2007, refer to note 2.

*Balance sheet reclassifications*

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

- (i) the reclassification of accruals and deferred income (£68 million) to other liabilities.
- (ii) the reclassification of current tax recoverable (£380 million) from other assets to current tax recoverable.

## Notes to the consolidated financial statements

**58 Ultimate parent undertaking**

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

Copies of the annual report and accounts of HBOS plc for the year ended 31 December 2009 may be obtained from HBOS plc's registered office at The Mound, Edinburgh, EH1 1YZ or downloaded via [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

**59 Future accounting developments**

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

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

Pronouncement	Nature of change	Effective date
IFRS 3 <i>Business Combinations</i>	The revised standard continues to apply the acquisition method to business combinations, however, all payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the minority interest, and all transaction costs are expensed.	Annual periods beginning on or after 1 July 2009.
IAS 27 <i>Consolidated and Separate Financial Statements</i>	Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is re-measured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.	Annual periods beginning on or after 1 July 2009.
IFRIC 17 <i>Distributions of Non-cash Assets to Owners</i>	Provides accounting guidance for non-reciprocal distributions of non-cash assets to owners (and those in which owners may elect to receive a cash alternative).	Annual periods beginning on or after 1 July 2009.
Amendment to IAS 39 <i>Financial Instruments: Recognition and Measurement – Eligible Hedged Items</i>	Clarifies how the principles underlying hedge accounting should be applied in particular situations.	Annual periods beginning on or after 1 July 2009.
Improvements to IFRSs <sup>1</sup> (issued April 2009)	Sets out minor amendments to IFRS standards as part of annual improvements process.	Dealt with on a standard by standard basis but not earlier than annual periods beginning on or after 1 January 2010.
Amendments to IFRS 2 <i>Group Cash-settled Share-based Payment Transactions</i> <sup>1</sup>	Clarifies that an entity that receives goods or services in a share-based payment arrangement must account for those goods or services no matter which entity in the group settles the transaction, whether or not settled in shares or cash.	Annual periods beginning on or after 1 January 2010.
Amendment to IAS 32 <i>Financial Instruments: Presentation – Classification of Rights Issues</i>	Requires rights issues denominated in a currency other than the functional currency of the issuer to be classified as equity regardless of the currency in which the exercise price is denominated.	Annual periods beginning on or after 1 February 2010.
IFRIC 19 <i>Extinguishing Financial Liabilities with Equity Instruments</i> <sup>1</sup>	Clarifies that when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor, a gain or loss is recognised in profit or loss representing the difference between the carrying value of the financial liability and the fair value of the equity instruments issued; the fair value of the financial liability is used to measure the gain or loss where the fair value of the equity instruments cannot be reliably measured.	Annual periods beginning on or after 1 July 2010.
IAS 24 <i>Related Party Disclosures</i> <sup>1</sup>	Simplifies the definition of a related party and provides a partial exemption from the disclosure requirements for government related entities	Annual periods beginning on or after 1 January 2011.

## Notes to the consolidated financial statements

**59 Future accounting developments** (continued)

Amendment to IFRIC 14 <i>Prepayments of a Minimum Funding Requirement</i> <sup>1</sup>	Applies when an entity is subject to minimum funding requirements and makes an early payment of contributions to cover those requirements and permits such an entity to treat the benefit of such an early payment as an asset	Annual periods beginning on or after 1 January 2011.
IFRS 9 <i>Financial Instruments: Classification and Measurement</i> <sup>1</sup>	Replaces those parts of IAS 39 <i>Financial Instruments: Recognition and Measurement</i> relating to the classification and measurement of financial assets. Requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of entity's business model for managing its financial assets and the contractual cash flow characteristics of the instrument. The available-for-sale financial asset and held-to-maturity categories in existing IAS 39 will be eliminated.	Annual periods beginning on or after 1 January 2013.

<sup>1</sup> At the date of this report, these pronouncements are awaiting EU endorsement.

**60 Post balance sheet events****Corporate structure**

On 23 December 2009 Lloyds Banking Group plc announced its intention to adjust the Group's corporate structure and transfer its current holding in the Group to Lloyds TSB Bank plc.

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

Following this move Lloyds TSB Bank plc has become the immediate parent of the Group. Lloyds Banking Group plc continues to directly own Lloyds TSB Bank plc but, as a result of this transaction owns the Group indirectly, as Lloyds TSB Bank plc is now the immediate parent of the Group.

**Disposal of esure**

On 11 February 2010 Lloyds Banking Group plc announced the sale of the Group's 70 per cent stake in esure, the online insurer, to a management buyout vehicle to be called esure Group Holdings Limited, for a cash consideration approximately equating to the book value in the Group accounts at 31 December 2009. The impact on the Group's financial statements is not expected to be material.

**61 Approval of financial statements**

The consolidated financial statements were approved by the directors of HBOS plc on 25 February 2010.

